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A Month in the Markets

OCTOBER 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in September. Share and bond prices declined across a wide range of markets in September as investors came to terms with the fact that interest rates are likely to stay higher for longer as rising oil prices make it more difficult to reduce inflation.[1]

Market Overview

Yields (the income an investor expects to receive each year for a bond) on US government bonds surged to 16-year highs after the Federal Reserve (Fed) indicated that another interest rate hike may be likely before the end of 2023.[2] As bond prices and yields move in opposite directions, bond prices tumbled. Yields on Eurozone[3], Japanese[4] and Chinese[5] bonds also climbed this month, while UK bond yields fell slightly.[6]

High interest rates and bond yields are influencing the broader economy. In currency markets, the pound and euro fell to six-month lows against the dollar as investors sought the higher yields offered by US bonds, compared to their UK and European counterparts.[7]

The fact that European banks are setting stricter lending conditions because of high interest rates means it's harder for businesses and consumers to obtain loans, which economists predict will contribute to Eurozone growth slowing in 2023 and 2024.[8] Persistent inflation and high interest rates are also contributing to US consumer spending – the main driver of Eurozone economic growth – weakening.[9]

Soaring bond yields affected stock markets, with bonds becoming more compelling as an alternative to shares. High bond yields meant that bonds and shares offered investors comparable returns, while bonds are generally considered less risky than shares because they only fail to provide a return if the company or government issuing them is unable to pay its debts. Even in the event of bankruptcy, bondholders are repaid before shareholders.

The reduced appeal of shares contributed to global stock markets experiencing their biggest monthly decline – and first quarterly decline – in a year.[10] The FTSE 100 Index, which tracks the largest companies listed on the London Stock Exchange, bucked this trend by ending the month and quarter higher[11] as new economic data suggested the UK economy was performing better than had been predicted.[12]

UK and Europe

Data released towards the end of September indicated that the UK economy had grown faster after the COVID-19 pandemic than economists had previously believed. However, optimism was tempered by the fact that the UK had still lagged behind the US, Canada, Japan and Italy over this period, with Germany and France being the only G7 nations it had outperformed.[13]

Data released earlier in the month revealed that the UK economy shrank by 0.5% in July, more than most economists had predicted, wiping out June's 0.5% growth.[14]

A widely followed survey of business leaders indicated that a recession – defined as two consecutive quarters of negative growth – may be approaching for the UK. The downturn measured by the Purchasing Managers' Index (PMI) survey is the steepest since the global financial crisis of 2008 and also signalled the sharpest fall in employment since 2009.[15]

The Bank of England (BoE) surprised investors by choosing to hold interest rates steady for the first time in almost two years, although they remain at a 15-year high. The central bank's decision to pause its rate hikes has raised hopes that interest rates have peaked, although its governor, Andrew Bailey, stressed that further hikes were possible.[16]

The European Central Bank (ECB) took a different approach, raising interest rates this month to their highest level since the launch of the euro. However, ECB President Christine Lagarde hinted that rates may have peaked.[17]

Preliminary data suggested that Eurozone inflation fell to its lowest level since October 2021 in September, reinforcing expectations that the ECB won't impose further interest rate hikes.[18]

However, a survey of business leaders indicated that the Eurozone economy stagnated in September, with output from the region's private sector falling for the fourth successive month. The rate of job creation is weakening and economic confidence in the region fell to its lowest level since November 2022.[19]

US

Data released at the end of the month showed that the Fed's preferred measure of inflation, which strips out volatile food and energy prices, rose at its weakest monthly pace since 2020. This raised hopes among investors that the central bank may decide against a further interest rate hike at its next meeting.[20]

On 20 September, the Fed announced that interest rates would be held steady, giving consumers struggling to repay loans some breathing space. This marked the second time this year that the central bank paused rate hikes. However, with two more meetings remaining before the end of 2023, Fed officials have indicated that they're willing to raise rates further unless they're confident inflation is falling sufficiently.[21]

The world's largest economy has maintained strong levels of growth. Data released at the end of the month revealed that a sharp fall in consumer spending during the second quarter was offset by an increase in investment into factories. However, an ongoing strike by auto workers is creating uncertainty about the US' economic prospects over the remainder of the year.[22]

Asia Pacific

China's economy is showing signs of recovery, aided by a number of measures by the Chinese government and central bank designed to bolster consumer and business confidence amid an ongoing property crisis. Activity around malls has increased, and traffic congestion in the week through 27 September was the highest of any week in 2022 and 2023, suggesting an uptick in consumer spending.[23]

Additional data released at the end of September further supported the idea of an economic recovery. China's factory activity expanded for the first time in six months, although weakness in the property sector led the Asian Development Bank to trim its 2023 economic growth forecast for China from 5.0% to 4.9%.[24]

Japan's government upgraded its estimates for company profits for the first time in 18 months in a monthly report on the economy. In its assessment, the government maintained its forecast of a moderate recovery in economic growth due to improving wages. It is planning a new economic stimulus package to protect consumers from price increases and encourage sustainable income growth.[25]

Investors have been on high alert for possible intervention by the Bank of Japan (BoJ) to prevent the yen from continuing to fall, relative to the dollar. The currency weakened to an 11-month low in September as the BoJ remains committed to ultra-low interest rates, whereas US interest rates have risen significantly. Higher interest rates led to more attractive bond yields, and the US dollar consequently performing better than the Japanese yen as investors sought dollar-denominated bonds. However, the BoJ has stressed the need for patience before raising rates.[26]

Outlook

We anticipate slow economic growth and a gradual decrease in inflation.

However, if inflation stays high and doesn't decrease as expected, central banks might raise interest rates again. This could lead to instability in bond markets and shares falling in value.

While valuations of shares appear fair, high yields currently make bonds more attractive and we remain cautious regarding shares. For these reasons, the funds are overweight bonds, relative to the benchmark, meaning they hold more of these assets than the benchmark. In contrast, the funds are underweight shares and cash as we believe that bonds are currently likely to provide greater returns.

While we generally are positive towards bonds, we have a slight preference for government bonds over company, high yield and emerging market bonds.

We believe bond yields are unlikely to rise much further, and when yields fall, bond prices rise. This creates an opportunity to sell the bonds for a profit, improving the funds' returns.

All data as at 30 September 2023.

[1] Reuters, 29 September 2023
[2] CNBC, 20 September 2023
[3] S&P Eurozone Sovereign Bond Index 29 September 2023
[4] S&P Japan Sovereign Bond Index, 29 September 2023
[5] S&P China Bond Index, 29 September 2023
[6] S&P UK Gilt Index, 29 September 2023
[7] Yahoo! Finance, 27 September 2023
[8] Politico, 11 September 2023
[9] CNN Business, 28 September 2023
[10] Reuters, 29 September 2023
[11] London Stock Exchange, 29 September 2023
[12] Reuters, 29 September 2023
[13] BBC, 29 September 2023
[14] Reuters, 13 September 2023
[15] S&P Global Market Intelligence, 22 September 2023
[16] The Guardian, 21 September 2023
[17] The Guardian, 14 September 2023
[18] Euronews, 29 September 2023
[19] HCOB Flash Eurozone PMI, 22 September 2023
[20] Bloomberg, 29 September 2023
[21] Fox Business, 20 September 2023
[22] Reuters, 28 September 2023
[23] Bloomberg, 28 September 2023
[24] Reuters, 30 September 2023
[25] Reuters, 26 September 2023
[26] Reuters, 29 September 2023

Asset Management

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