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A Month in the Markets

MARCH 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in February. The optimism that investors had displayed earlier in the year was dashed by stubborn inflation.

Market Overview

A resurgence in inflation reversed the optimism investors had shown earlier in the year, as the prospect that higher interest rates would remain in place for longer caused global shares and bonds to tumble in a volatile February.[1]

Hopes that inflation had peaked and that the US Federal Reserve (Fed) would reverse course after eight interest rate hikes over the past year faded, as inflation proved more persistent than had been expected[2] and Fed Chairman Jerome Powell indicated that subsequent interest rate rises were likely.[3]

Bonds particularly suffered in response to this, with two-year UK government bond yields seeing their biggest February rise since 2005. US bonds fared even worse, with the yields on two-year Treasury bonds experiencing their largest February rise since 1981.[4] Bond yields and prices move in opposite directions, meaning that these movements drove bond prices down.

Nonetheless, the US dollar rallied for its first monthly gain since September. The dollar benefitted from speculation that US interest rates would remain higher for longer, which increases the appeal of assets denominated in this currency.[4]

Philip Lane, the Chief Economist of the European Central Bank (ECB), assumed the same line as the Fed in stressing that the ECB will continue raising interest rates until inflation has been brought under control.[4]

The overall picture for February was downcast. Global shares fell in value by 3.87% this month, erasing some of January's 6.94% gain.[5] The S&P Global Developed Sovereign Bond Index, which measures the performance of bonds issued by the governments of wealthy nations, fell by 1.82% in February in dollar terms.[6]

UK and Europe

Business activity in the UK began to grow again in February, ending six consecutive months of falling output.[7] Rising customer demand, fewer supply shortages and lower inflation likely contributed to this improvement.[8]

The Bank of England raised interest rates by 0.5% to 4% at the beginning of February, taking them to their highest levels since 2008.[9] However, the central bank indicated that it was open to a softer stance on future interest rate increases.[10]

Even after easing more than expected in January, UK inflation remains in the double digits, with continued pressure from labour shortages and the effects of Brexit anticipated to slow its decline.[11]

The FTSE 250 Index, which tracks the 101st to the 350th largest companies on the London Stock Exchange, rose marginally in February.[12] As companies listed on this index earn significant proportions of their revenue abroad, they may benefit from a weaker pound.[13] Meanwhile, bonds fared worse, with yields on 10-year UK government bonds rising during February.[14]

High levels of pessimism over the state of the UK economy dragged consumer confidence to its lowest level in 13 months in February. The gloom was driven by fears over price increases in food, fuel and utilities, as well as concerns regarding increased taxation and interest rate hikes.[15]

In Europe, business activity growth accelerated to a nine-month high in February, underpinned by rising demand, improved supply chains and renewed confidence. The upturn was led by the services sector, following a revival in financial services, tourism, recreation and media. The manufacturing sector also eked out modest gains in output.[16]

The ECB raised interest rates by 0.5% at the beginning of February and announced that it intended to do the same in March.[17] These developments followed four interest rate hikes in 2022, which brought Eurozone interest rates out of negative territory for the first time since 2014.[18]

On 13 February, the European Commission forecast that the European Union is poised to narrowly avoid a recession in 2023 as inflation eases and gas prices drop, although this outlook highly depends on the war in Ukraine.[19]

The MSCI Europe ex-UK Index, a measure of the region's stock markets excluding the UK, gained 0.79% in February.[20]

Global investors are finding shares in Europe more alluring than those of the US because of expectations that Eurozone interest rates will remain higher for longer than US interest rates.[21]

US

On 1 February, the Fed announced that interest rates would be raised by 0.25%[22], the smallest increase since it started hiking interest rates last March. This followed a 0.5% hike in December 2022 and 0.75% increases earlier in the year.[23]

The Fed's ability to pause or reverse course on interest rates is being restrained by a US economy that is holding up well, despite interest rates sitting at their highest level since 2007.[24] The job market is strong, with unemployment in January at a 54-year-low [25], retail sales running ahead of expectations[26], and consumer prices slowing less than expected.[27]

Another measure of inflation – and one preferred by the Fed – remained higher than expected, causing investors to anticipate that interest rates would remain higher, for longer, potentially weighing on company earnings.[28]

This pessimism was matched by consumers, whose confidence in the US economy slumped to its lowest level since July 2022 this month.[29]

The S&P 500 Index, which measures the performance of the 500 largest companies in the US, fell by 3.62% in February.[30] The Nasdaq, which favours technology shares, also declined by 1.11%.[31]

The S&P US Aggregate Bond Index – which tracks the performance of dollar-denominated high-quality bonds issued by the US government, municipalities, and companies – fell by 2.76% in February.[32]

Asia Pacific

China's economic recovery is gaining momentum after a sudden reopening from strict COVID-19 lockdowns boosted commodity prices, as well as China's stock market.[33] Home sales rose for the first time in 20 months in February after lower mortgage rates helped draw buyers back into the market.[34]

The International Monetary Fund (IMF) forecasts that China's economy will probably expand by 5.2% in 2023, from 3% last year.[35] However, China's CSI 300 Index, which tracks shares of the largest companies listed on the Shanghai and Shenzhen stock exchanges, declined by 3.01% in February.[36]

While Asian shares rallied sharply in January[37], the MSCI AC Asia Pacific ex Japan Index only posted modest gains in February, rising by 1.12%.[38]

In Japan, the manufacturing sector shrank in February as output and new orders plummeted at their quickest pace in two-and-half years. In contrast, the services sector expanded for a sixth consecutive month following the relaxation of COVID-19 measures, which boosted demand.[39]

Figures released this month revealed that, while the Japanese economy avoided a recession in Q4 of 2022, business activity slumped and growth was less than expected.[40]

The fragile economic recovery comes as pressure builds on the Bank of Japan (BoJ) to end its policy of maintaining negative interest rates in a bid to stimulate spending.[41] Kazuo Ueda, who has been nominated as the central bank's next governor, has indicated that he is open to raising interest rates.[42]

The Nikkei 225, which measures the performance of the 225 largest listed companies in Japan, eked out small gains in February.[43] Meanwhile, the MSCI EM Asia Index, which measures emerging markets across the region, saw its biggest monthly decline since September – and market signals suggest that more may be to come.[44]

Outlook

Our view is that the global economy will probably continue along a path of low growth, although it is unlikely to dip into a recession. We believe that high inflation will persist for longer, so 2023 may be another challenging year for investors.

Job markets in major developed countries, especially those in North America and Europe, remain strong even after their central banks raised interest rates aggressively. Upward pressure on wages and the continued strength of consumer spending represent a threat to taming inflation.

This may prompt central banks to question whether they've done enough to win the fight against inflation, or whether further interest rate rises may be required. Central banks and the words of their staff will be closely scrutinised for any change of language regarding where inflation and interest rates may be going in their respective economies.

The war in Ukraine is still creating uncertainty. There have, however, been some positive signs regarding the normalisation of supply chains and the resumption of travel, following the easing of COVID-19 restrictions.

Given how markets performed in 2022, there is room to add some risk slowly and selectively to portfolios by carefully picking shares and selecting bonds that take longer to reach maturity.

All data as at 28 February 2023.

[1] Reuters, 28 February 2023
[2] Bloomberg, 28 February 2023
[3] CNBC, 7 February 2023
[4] Reuters, 28 February 2023
[5] MSCI ACWI, 28 February 2023
[6] S&P Global Developed Sovereign Bond Index, 28 February 2023
[7] CIPS Flash United Kingdom PMI, 21 February 2023
[8] Yahoo! Finance, 21 February 2023
[9] Bank of England, 28 February 2023
[10] Reuters, 2 February 2023
[11] Reuters, 15 February 2023
[12] FTSE 250, 28 February 2023
[13] Forbes Advisor, 24 February 2023
[14] Trading Economics, 28 February 2023
[15] GfK, 25 February 2023
[16] S&P Global Flash Eurozone PMI, 28 February 2023
[17] European Central Bank, 2 February 2023
[18] European Central Bank, 28 February 2023
[19] European Commission, 13 February 2023
[20] MSCI Europe ex UK Index (GBP),28 February 2023
[21] Reuters, 27 February 2023
[22] Federal Reserve, 1 February 2023
[23] CNBC, 1 February 2023
[24] Trading Economics, 28 February 2023
[25] Reuters, 3 February 2023
[26] Trading Economics, 15 February 2023
[27] CNBC, 14 February 2023
[28] FXStreet, 24 February 2023
[29] CNN, 28 February 2023
[30] S&P 500 Index, 28 February 2023
[31] CNBC, 28 February 2023
[32] S&P U.S. Aggregate Bond Index, 28 February 2023
[33] CNN, 27 January 2023
[34] Wall Street Journal, 28 February 2023
[35] IMF, 3 February 2023
[36] CSI 300 Index, 28 February 2023
[37] CNBC, 22 February 2023
[38] MSCI AC Asia Pacific Index ex Japan, 28 February 2023
[39] au Jibun Bank Flash Japan Composite PMI, 21 February 2023
[40] Reuters, 14 February 2023
[41] South China Morning Post, 3 February 2023
[42] Financial Times, 24 February 2023
[43] Nikkei 225, 28 February 2023
[44] Bloomberg, 28 February 2023