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market outlook.

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Written by:

Peter Quayle
Fund Manager (UK)

Jonathan Wiseman
Fund Manager (Overseas)

Ciaren McShane
Fixed Income Analyst

The UK Economy

UK Equity markets provided positive returns in the first quarter of 2023 with larger companies continuing to outperform their mid- and smaller-sized peers. March was the only negative month this year, and whilst the detractors were broad, following the rescue of a handful of US regional banks and falling oil prices, the main detractors were Banks and Energy companies. That said, both sectors posted positive returns in April as regulators acted swiftly to prevent a crisis of confidence in the US banking system and OPEC announced surprise cuts in production which boosted oil prices. It should also be noted that UK-listed banks are in a much more resilient position relative to those that came under pressure elsewhere. Sentiment aside, first quarter results have been fairly resilient with few surprises. Corporates remain in good shape with robust balance sheets, which is encouraging given the less certain short-term outlook for consumption.

With inflation at 10.1%, the Bank of England is likely to raise interest rates once more. Following this, we expect a pause whilst headline inflation begins to fall, albeit largely due to base effects rather than recent monetary policy tightening. Changes in interest rates take time to impact consumers and subsequently feed into the economy, and so the full impact of recent hikes is yet to materialise. The UK labour market remains tight, yet wages have failed to keep pace with inflation. Faced with additional tightening credit conditions, consumers therefore continue to feel the squeeze on income. Consequently, many workers' unions have been compelled to take action.

The UK economy appears to have avoided a contraction in the first quarter but confidence in the outlook is waning. Should economic data deteriorate through the summer, the government could seize the opportunity to loosen fiscal policy and this would be an attractive policy response with an election on the horizon. There is a lot to play out in the UK economy for the remainder of 2023, however, the UK equity market is trading at a discount versus its own historic range and that of its international peers, which is appealing for long-term investors.

The Japanese Economy

In April, Kazuo Ueda took over as the Bank of Japan (BoJ) Governor. As an unknown quantity, expectations as to his approach were uncertain. In the past few weeks he has cited imported inflationary pressures stating the BoJ committed to yield control measures and current stimulus methods, with inflation remaining elusive.

Ueda expects inflation to cool, with tightening policy globally putting downward pressure on inflation. This is negative for the traction of Japanese inflation, and so backs current policy. Yield curve control will remain, as the Japanese yield curve normalised with the drop in global yields. Ueda said the BoJ won't hesitate to further loosen monetary stimulus if needed, but will remain data dependent and as such will avoid forward guidance to stem yield curve volatility.

Whilst real wage growth has remained elusive across the board, we have seen a number of larger companies commit to wage increase through 2023, with the likes of Uniqlo increasing some salaries by up to 40%. Whilst it remains to be seen if this is bonus driven or salary driven, the key data showing smaller company wage growth is due out mid-year. Despite the government's push for growth in earnings, real cash earnings fell by the most in almost a decade in April 2023 (4.1%), suggesting variable biannual bonuses continue to play a huge part in annual wages, which is not conducive to a self-sustaining inflationary environment.

Continuing monetary support coupled with the under research of the small to midcap space continues to favour companies outside of the large cap index, especially as China reopens and its travellers resume travel to Japan to spend money.

The Emerging Markets & Asia Economy

Many countries within the region stand to benefit from the jostling for economic power between the US and China. In many instances we have already seen countries playing the US and China off against each other. Brazil held talks with China after the US offered a meagre $50m to the Amazon Fund (a climate change fund designed to save the Amazon rainforest) in February. Not wanting to lose face on the global stage, the US revised their offer in April to $500m. South Korea has also benefitted from a nuclear defence pact with the US to aid with North Korean frictions, following US restrictions imposed on semiconductor supplies to China.

The Chinese Government set a relatively modest growth (GDP) target of 5% for 2023. With economic data year to date now providing enough information to calculate a more accurate expectation, research and news institutions such as Bloomberg are calculating forecast growth of approximately 6.3%. This suggests the Chinese government were as modest as we anticipated, and it is the release of the true growth number that could provide a further catalyst to its market expansion! We have already seen Q1 GDP outstrip expectation by 0.5%.

Whilst it is clear we have seen a lot of fear baked into Asian and Emerging Markets, little has supported the region's selloff, other than short-term westernised propaganda surrounding US and China frictions (frictions that have been apparent for decades). With valuations arguably more attractive than they have been for some time, a broader reopening story yet to fully play out, and the prospect of increased competition in areas such as renewable energy and electric vehicles, the outlook becomes arguably more attractive. It is easy to forget that amidst the tensions between the US and China, US imports from China grew by 6.3% year on year ($536.8bln) in 2022 (just below the all-time high). Meanwhile, US exports to China broke the all-time record, growing by 1.5% ($153.8bln).

The long-term outlook for India remains attractive, with demographics, skill sets and policy expansion all working in its favour. With valuations looking less than attractive in some areas when compared to historical averages, it is easy to forget that this measurement becomes largely irrelevant in isolation. With a growth in the middle-class tier, the expansion in areas such as video streaming and online gaming driven by 5G increases the data centre expansion requirements. As such, we have seen policy introduction by the government to support expansion. This type of support, when coupled with infrastructure support backing the likes of wind power expansion, and its largely self-sufficient agricultural sector, all allow for both a short-term and longer-term positive outlook. It must be remembered that the now most populus region in the world is still an emerging market economy, and with plenty of expansionary space and upside potential, valuation dynamics should be viewed slightly differently, especially for a country that remains foreign policy neutral, allowing them to maintain relations with the west whilst benefiting from discounted oil from Russia!

The US Economy

Whilst we are seeing market expectation of the Federal Reserve (Fed) cutting interest rates, it must be remembered that it is likely that we will see some more rate hikes before this occurs. With the likes of the European Central Bank and the Reserve Bank of Australia not easing up on support, it is easy to forget that the Fed have always remained data dependent and will likely continue to be so! In addition, whilst an interest rate cut could happen over the coming year, there is a significant difference between an interest rate cut to control markets, and an interest rate cut cycle. One must remember that most western central banks will be incredibly reluctant to revisit policy measures of the past 15 years, whilst the Fed will also have one eye on dollar stability.

The collapse of Silicon Valley Bank (SVB) triggered a worry of contagion and a perceived banking crisis. SVB were a smaller-sized bank with a one-dimensional offering, which meant their capital adequacy and liability matching was poorly managed. The run-on withdrawals caused a liquidity event which also exposed that they were under insured, ultimately leading to its collapse. It is important to remember that this is atypical of the majority of banks and the fear of contagion was, and is, largely unwarranted. With that being said, the banking sector is not precluded from the workings of capital markets, and, as in any sector, poorly run institutions will likely 'run a cropper'. It is the importance of strong investment research that avoids exposure to businesses such as this (SVB, Credit Suisse etc). The run-on valuations has made good quality banks look more and more attractive, as markets continue to be blinded by sensitivities to worries of systemic weakness.

The US is due to hit its debt ceiling (the limit by which the government is allowed to lend by issuing bonds) mid-year. This is a regular event and typically results in temporary extensions until the House and Senate agree on the terms of an increased limit. Whilst we fully expect volatility surrounding these inflection points as the Republicans and Democrats butt heads on the terms of the limit and spending packages, ultimately neither side want to see a default, especially in an environment where the Federal reserve is trying to manage employment to combat inflation.

With the 2024 Presidential election looming, as expected, Incumbent Democratic President Joe Biden has announced his 2024 re-election bid. Seemingly less likely, despite battling a myriad of legal proceedings surrounding business fraud and 'hush money' accusations, Donald Trump is one of the front runners for the Republican nomination. Whilst the appetite for a rerun of the previous election within the US is minimal, the campaign trails have begun. Even though this may represent little noise in markets, any traction gained in states from specific candidates could see markets react either way to favourable/less than favourable policy pledges!

The European Economy

Following the default of SVB in the US, the statement from the Saudi National Bank to limit the funding of Credit Suisse caused a liquidity run on the bank and a fear of contagion. However, it is important to remember that this is not a rerun of the Global Financial Crisis in 2008, and the issues with these banks are specific to themselves. Credit Suisse was massively well capitalised, but has had inherent issues for many years, and the unique treatment by the regulators of AT1 (Additional Tier one) debt during its takeover by UBS furthered worry. However, the regulator has since made a statement that AT1 debt is secure and that the Credit Suisse treatment was unique in its structure. Again, to stress, whilst markets priced in a banking crisis, this is not the case!

The European Central Bank reconfirmed its commitment to curtailing inflation, whilst it is also clear it had its eye on the Euro/Dollar exchange. This, following the perceived 'banking issue' (mentioned above), saw them continue to increase interest rates by 0.5% which injected some confidence back into the banking sector and region again. It is worth noting that whilst there is talk of rate cuts in the US, the ECB are less enamoured at the prospect with their headline rate sat well below the historical median at 3.5%, and prospects of further increases! However, despite valuations being some of the most attractive globally, the unwarranted pick up in European stocks year to date, following a mild winter which eased energy price concerns, could be seen as a potential breeding ground for volatility heading into the second half of the year as investors take profit from the region, and positive sentiment potentially stems for the key sectors that make up the region.

China remains the top external trading partner of the European Union. Whilst this has been highlighted as a potential risk by the EU, the demand from China for European goods remains a staple of growth for the region, and at least over the short- to medium- term it seems unreasonable to expect anything will change. Let's also remember that the key for the EU is diversification of regional trade, not the elimination of Chinese trade. This can be seen by the development of the EU's Global Gateway project, a project connecting regional trade to compete with China's 'one belt, one road' initiative, of which the progress of both is positive over the long term.

Inflationary pressures have started to abate following a milder than expected winter. With inflation now sitting at 6.9% for the region, down from its 10.6% high last year, it is a sign that global pricing pressures are easing. Whilst this is positive for markets in general, European markets appear to have priced in an element of this easing due to its pre-2022 reliance on Russian imported energy, and the subsequent relief of the mild winter. It seems reasonable to expect European markets to normalise over the short term and expect to see potential volatility.

Fixed Interest

Bonds remain volatile. We have continued to see large moves in both government and corporate bonds driven by a range of macro, sector, and idiosyncratic factors.

Stickier than expected inflation in certain markets has caused repricing in government bonds, with prices falling as interest rate hike expectations increased. Particularly in the UK, government issuance is likely to remain high which could pressure yields further.

We have seen volatility in corporate bonds led by the financial sector due to the issues at SVB and Credit Suisse. Subordinated financials and particularly AT1 bonds issued by banks have been the hardest hit. Regulators acted swiftly to prevent contagion and we have already seen issuers return to the AT1 market.

Fundamentally, while economic data is likely to weaken in general, corporate balance sheets remain strong with good liquidity, and corporates should be able to navigate short-term economic weakness. This means defaults should remain contained and the higher yields now available on corporate bonds will offer some protection from any future volatility.

These higher headlines yields, which do look relatively attractive, must be balanced against the softening economies we are likely to see in developed markets at least.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on 0800 049 2011, Monday to Friday 9am-5pm or you can email us at affinity.advise@wealthatwork.co.uk

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