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market outlook.

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The UK Economy

The past quarter presented challenges for global equity markets, and the UK was no exception to this trend. Nevertheless, it's worth highlighting that UK large-cap stocks are offering a glimmer of resilience, displaying strong performance when compared to other regions.

Despite a strong performance year-to-date, the British pound weakened over the quarter due to shifting interest rate forecasts and strengthening of the US dollar. This stands to benefit global companies listed on the FTSE 100 with international earnings favourably impacted as they are translated into sterling. The effects of elevated inflation and tightening credit conditions continue to impact the desire and ability of UK consumers to spend was reflected in poor retail sales data, while falling house prices further weigh on consumer confidence. Inflation is gradually easing yet it lags behind other economies worldwide. Given ongoing moderation in global food and energy prices, inflation should continue to fall. The Bank of England may be at or near peak interest rates, as policymakers held rates steady for the past two meetings. A stable interest-rate environment has the potential to boost consumer confidence. The UK has shown resilience in staving off a recession again this quarter thanks to a robust labour market where wages outpaced inflation. However, the outlook for 2024 remains uncertain, as the time lags associated with monetary policy means the full impact of higher interest is yet to materialise.

Many UK companies are performing well, with some seemingly unaffected by the challenging domestic conditions. These companies hold substantial potential when economic data normalises, as UK-listed international companies are currently trading at discounts compared to their historical averages and international peers.

The Japanese Economy

Currency weakness has prevailed over the period, with the Yen falling to its lowest level against the US dollar since the early 1990s (sliding to ¥151) as Bank of Japan (BoJ) policymakers maintain an ultra-loose monetary policy.

Following the Tokyo Stock Exchange's enforcement of new Price-to-Book rules earlier in the year, we saw money flow into the large-cap space, with companies forced to strive for sustainable growth and enhance corporate value. This was further compounded by Warren Buffett's investment in Japanese equities, which spurred a short-term rally.

Small caps, which are largely more attractive on a valuation basis, were left behind during the earlier rally in the year as many looked to make a quick, easy money trade. We continue to focus on small caps as they remain under-researched by analysts and represent a prime opportunity for investors to capitalise upon.

Japan's job-to-applicant ratio has followed an upward trend since the pandemic, despite the lack of domestically-driven inflation. However, it has fallen steadily this year and now sits at 1.29. The labour market might continue to loosen, meaning wage increases fall short of the BoJ’s expectations to stimulate inflation through demand. With much of Japan's inflation imported, the true level of domestically-driven inflation remains low.

The Emerging Markets & Asia Economy

China has taken big steps to bolster the property sector after the developer Evergrande’s bankruptcy and the financial vulnerability of Country Garden. Stimulus measures include relaxing home-purchase restrictions and cutting interest rates to boost confidence in the sector. Monetary easing stands in sharp contrast to the tightening measures in many Western economies. This divergence in policy is a key factor that bolsters our enthusiasm for investment opportunities in the region. In the wake of President Xi Jinping's unprecedented visit to the People’s Bank of China other measures, such as increasing the budget deficit ratio and issuing sovereign bonds have been implemented to stimulate economic activity. Despite short-term noise, it is crucial to acknowledge the government's active approach to policy adjustments, making China an attractive investment destination full of potential.

The recent conflict between Hamas and Israel is a humanitarian tragedy. As investment managers, we also need to consider the impact of short-term economic noise on financial markets which can lead to non-fundamental volatility. We believe the recent conflict in the Middle East poses a relatively low risk to global oil markets, though we may continue to experience short-term fluctuations and, ideally, witness a resolution to the conflict.

Looking ahead to India’s 2024 election, Prime Minister Narendra Modi continues to enjoy high approval ratings, a testament to his leadership and policies. This stability in his popularity is seen as a positive indicator for the markets. Consistency in effective governance provides a sense of predictability and confidence for investors and businesses.

Latin America continues to be an attractive region for investors. While its position in the commodity cycle has moderated since last year, the demand for commodities remains relatively strong. Brazil’s economic growth during the second quarter surpassed expectations, pointing towards a resilient and growing economy. Brazil’s energy sector is bolstered by Energy Minister Alexandre Silveira, who believes in achieving clean energy objectives whilst also acknowledging the country's oil-producing capabilities are a key asset. Meanwhile in Mexico, improving employment rates and wage growth are making it an appealing space for investment, especially as trade relations with the United States continue to expand. The 2024 election race to succeed President AMLO has started and there is hope that a new leader with a more business-friendly approach will be chosen, which would be a positive development for the country's economic outlook.

The US Economy

US Overweight In October 2023, the US 10-year Treasury yields rose above 5%, levels previously observed back in 2007. This resurgence prompted inquiries into the Federal Reserve's intentions regarding the continuation of their monetary tightening cycle. However, the continued volatility and uncertainty surrounding the yield curve has triggered a period of rise and fall in Treasury yields, making equities a compelling bond proxy play in various sectors.

In recent years, elections have meant fruitful bearings for equity markets, particularly in the 12 months after. This is something we may see again going into the 2024 election year. Often, presidential candidates looking to be re-elected will also construct fiscal policies that prioritise spending in order to avoid an economic downturn that would otherwise lose them public favour. In recent periods of economic uncertainty, US equities have provided bond proxy-like reassurance for investors, with the dollar's continued stability also meaning investors flock to the US as a defensive investment strategy during these times.

Debt within the US has been a talking point for the region this quarter, with worries about whether the US might default on their financial commitments. However, inflationary pressures in recent years have pushed government revenues higher, meaning that the region is able to continuously satisfy its debts. Although the Republican party has recently been placing pressure on President Biden's administration to cut spending – shoring up concerns about a government shutdown if terms are not agreed – it is unlikely that either party will allow any crucial payments owed to be missed. Additionally, a US default would trigger far more severe problems than those affecting the stock market, again reducing the likelihood of this happening.

After tilting our portfolios to growth in the summer of this year following the failure of some regional banks within the US, we noted that banks had performed particularly well during earning's season and that money was now flowing back into value names. As a result, we neutralised our value/growth position in the US. Despite external noise from economists and financial commentators about the future of monetary policy within the region, the Fed are almost at their 2% target and are not likely to make any rash moves owing to policy decisions they have made that take time to feed into the economy. This, in turn, suggests that there will be stability in the dollar. Such misinterpretations by the market present us with buying opportunities as they lead to mispricing.

The European Economy

European equities have shown decent performance in early 2023 when measured in sterling terms, and the region has for the most part successfully averted major economic shocks. Valuations remain appealing, but the market is currently seeking a catalyst to initiate a market correction or a pullback. The region could soon face challenges given slowing growth, tight monetary policy and a rise in energy demand as the colder winter months set in.

One of the complicating factors in this region is the fragmented nature of the banking sector, which adds an extra layer of complexity for European Central Bank (ECB) policymakers setting interest rates. This could have longer-term consequences, as many banks have been relatively slow to pass higher interest rates on to consumers.

We witnessed the ECB pause its rating cycle in October for the first time in more than a year. The Central Bank's actions are not entirely linked to those of the Federal Reserve in the US as both countries find themselves in different phases of their policy cycles. It's important to note that a pause doesn't indicate the end of monetary tightening, as policymakers' decisions remain heavily data dependent.

The ECB has stated its commitment to bring inflation back to the 2% target by 2025, but it is expecting economic growth to remain weak through 2024. This scenario could present a welcome buying opportunity for investors, provided we witness compression in valuations.

Fixed Interest

While government bond curves continue to exhibit an inverted shape, it's worth noting that this inversion is not as pronounced as it was in the recent past. Interestingly, this phenomenon has occurred more due to the long end of the yield curve experiencing a sell-off, rather than any significant rally at the short end. This can be attributed to various economic factors and investor sentiment, which continue to shape the bond market.

A notable development is the widening of spreads and higher yields of government bonds, which undoubtedly makes Fixed Income more attractive to investors.

Despite the challenges posed by economic uncertainties, the fundamentals of corporate balance sheets remain robust. Corporations have maintained their financial strength with ample liquidity. This strength positions them well to weather any short-term economic downturns that may arise. The ability to navigate adverse economic conditions is a testament to the resilience and prudence exercised by many businesses, further underpinning the appeal of corporate bonds as investment options.

Whilst we continue to seek opportunities in the space, it's important to keep a watchful eye on corporate bonds, as certain risks persist. A significant supply of government bonds entering the market has the potential to exert further pressure on longer-dated corporate bond issues.

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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