

‘Higher for longer’ – how policy moves dominated markets in Q3



Quarterly investment update

July-Sept 2023

What moved markets over the quarter?

In the third quarter of 2023, investors globally were focused on the outlook for inflation, economic growth, and expectations of ‘higher for longer’ interest rates.

Inflation

Between July and September, inflation remained one of the key themes in financial markets and a huge issue for policymakers. Most advanced economies are gradually rebalancing supply and demand, allowing a steady decline in inflation pressures. Growth is also cooling, but at a slower rate than inflation is falling.

Interest rates

Investors watched policy changes closely, with central banks in the UK, US, Europe and Japan all either holding or raising interest rates. The trajectory of inflation and interest rates is uncertain. For instance, US Treasury bond yields are pricing in significant interest rate cuts next year, but this only seems likely if inflation and economic growth continue to slow.

In the UK, the Bank of England raised the base rate of interest during the August meeting, taking it to 5.25% - the 14th consecutive increase. Then in September it opted to hold rates, although it was a close vote by Monetary Policy Committee members. Higher interest rates are having the desired effect of bringing down inflation in the UK. Core inflation fell from 6.9% to 6.2% between July and August but this restrictive policy stance is also slowing economic growth, which we expect to continue.

Economic growth

Economic signals globally were mixed over the quarter. In the US, a strong job market was offset by a survey of business conditions which pointed to stagnation in economic activity.

In the UK, September's Purchasing Managers' Index (PMI), an indicator of business activity and therefore economic conditions, pointed to a contraction during the month.

How asset classes performed

Asset classes are the broad investment categories that make up portfolios. Here we talk through some of the trends we saw in various asset classes over the quarter.

Developed market equities fell over the period despite a good start at the beginning of July. This was largely due to the Federal Reserve communicating to the market its plans to keep interest rates higher for longer. Emerging market stocks fared slightly better compared to the previous quarter.

Both investment grade (the highest-quality corporate bonds) and government bonds delivered fairly flat returns and emerging market government bonds underperformed developed market counterparts over the quarter.

Listed infrastructure lagged the wider equity market and real estate investment trusts (REITs) slightly underperformed over the quarter. The failure of a few regional banks in the US had a major impact because they dominate the commercial real estate lending market, so the sector may now see a reduction in liquidity. Sterling weakened over the quarter relative to the US dollar, which helped support returns for sterling investors.

Equity market performance



All returns in GBP, time period is 01/10/2018 - 30/09/2023. Source: Morningstar.

Past performance is not a reliable indicator of future performance.

How did this affect portfolios?

A key driver of performance in the third quarter was global diversification as strategies heavily exposed to the UK struggled as a worsening economic outlook dragged down share prices.

UK stocks came under pressure from a deteriorating macroeconomic outlook, but even broad diversification would not have been a silver bullet because there was also a sell-off in global stocks and underperformance from emerging markets.

We expect to see economic uncertainty over the next couple of years, and currently we feel that markets are overly optimistic in their pricing of equities. In strategies that invest across both equities and bonds we had an underweight position relative to our benchmark on equities, and an overweight to bonds.

How do we view portfolio composition moving forward?

Below is a high-level outlook for each asset class. This is just an overview, and we may adapt our views as markets move.

Equities

There has been some turbulence in stock markets during the quarter over uncertainty in the outlook for inflation, interest rates and economic growth, plus concerns about stresses in the Chinese property sector.

Earnings estimates are falling but still remain at the higher end of our expectations for the next year or two. US stocks are very highly valued and we don't think they will deliver the exceptional growth forecast for the next five years. In the medium term, we see better value in the Japanese stock market.

Government bonds

Central bank guidance points towards keeping interest rate policy restrictive (meaning rates remain high) in the face of above-average inflation and a tight labour market (meaning there are plenty of job openings but workers to fill them are scarce).

Bond markets have been volatile on mixed and weaker economic data and falling but sticky inflation. We think volatility will continue, but right now the pricing of 10-year UK government bonds looks attractive.

Corporate bonds

Investment grade markets are pricing in a slightly above-average level of credit losses, which is broadly in line with our view. We think, at current levels, high-quality credit will deliver moderate returns above the equivalent maturity government bonds.

Alongside higher interest rates, markets are worried about high issuance of government bonds and political issues such as the threat of a US government shutdown.

Real assets

US commercial mortgage-backed securities are showing signs of stress. We are keeping an eye on the US commercial real estate market as we see a risk that some of its difficulties could spill over into the wider economy.

Overall

We are sticking to our guns by maintaining a diversified portfolio that uses risk protection and active management. We think this remains the best way to navigate uncertain times and maximise the chances of investing success.



Haig Bathgate
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