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Second Quarter 2023

It was a mixed quarter in financial markets, with momentum lost after a strong Q1 across equity and bond markets. Stock markets moved modestly lower in April before recovering in May and June, with fairly high levels of regional and sectoral dispersion. Artificial intelligence has quickly become a key theme in markets, and in May in particular there was a wave of investment into companies that are seen at the vanguard of developments, such as Google and NVIDIA. This helped technology stocks build on a strong first quarter, and as these tend to be US-listed the American market was an outperformer. In GBP terms, the S&P 500 gained +5.2% and the MSCI World rose by +3.2%. European markets were more lacklustre, with the FTSE 100 and the Eurostoxx 50 falling by -1.3% and -0.6% respectively during Q2. The Japanese stock market continued its strong run this year, with the Nikkei 225 adding +5.7% in GBP terms. The yen has weakened significantly in 2023, so gains in local currency are greater with investors seemingly convinced that corporate governance reforms are finally bearing fruit.

Equity market volatility fell during the quarter, despite concerns over economic growth, inflation and myriad geopolitical matters. Even the worries about US regional banks and Credit Suisse that flared in March passed fairly quickly. The bond market has exhibited more volatility, with yields highly responsive to the words and actions of central banks – an index of all-maturity UK government bonds produced a return of -5.4% in Q2 as it fell in all three months of the quarter. The UK 10 year yield rose by almost 1% to end June at around 4.4%, and the move at the shorter-end of the curve was even larger with a shift in the 2 year yield from 3.4% to 5.2% as it showed sensitivity to the Bank of England's actions.

On this topic, the central banks of the US, Eurozone and UK, amongst others, continued to raise interest rates during Q2. The Bank of Canada caused some surprise by resuming a hiking cycle, having paused earlier in the year. It is clear that there is little public appetite among policymakers for easing their fight against inflation, even if the end of this process may be approaching. The US Federal Reserve is expected to raise rates twice more this year, including in July, while the market expects the Bank of England (BoE) to increase rates a further 1% or so having reached 5% in June.

The BoE is in a particularly tricky position, as UK inflation remains at a high level and certain elements such as food and wages are showing little sign of cooling. There is little doubt that the BoE has been caught out and is still running to catch up. It is quite possible that goods inflation will fall significantly in the second half of the year, as energy price inflation has turned negative and this will feed into a number of other areas, but the strength of the labour market and general inflation psychology, particularly in services, are large impediments to the disinflation process. The US picture is more benign, as goods inflation has come down consistently even if challenges remain to get "core" prices to more acceptable levels.

For now, economic data remains reasonably strong – surprisingly so. Rising interest rates have exposed some parts of the economy but overall there has been limited impact so far, almost certainly thanks to the strength of the labour market and service-sides of many economies. It is unclear if this can continue to be the case for the remainder of the year.

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Outlook

There appears a disconnect between the speed and magnitude of interest rate increases over the past eighteen months and the strength of the global economy (and, this year, the stock market). It is not obvious to us that this will persist, especially if inflation is sticky and central banks have to hold rates around current levels rather than cutting them in response to weakening growth. As a result, we have become more cautious on the market outlook and where appropriate have sought to reduce equity weightings slightly.

Emerging markets (EM) present something of a conundrum. We have favoured exposure to EM equities on the basis that many companies are attractively valued and we had the powerful tailwind of Chinese "reopening" from Covid to look forward to in the early part of this year. The valuation argument still holds, but data from China has been underwhelming and consumers have not shown much appetite to resume previous spending patterns – unlike in the West. It remains to be seen whether the Chinese government will attempt to stimulate the economy more in the coming months – they have the flexibility to do so, as they do not have inflation to contend with – but it is unclear if the political will exists as previous programmes ended up fuelling wasteful investment. Nonetheless, there are a number of markets that can boast strong domestic stories, most notably India and other Asian economies with young populations, entrepreneurial spirit and relatively stable political environments, so there remain many attractive avenues for investment.

We remain well-disposed towards fixed income assets given the coupons available and the potential for capital gains if yields were to fall in a generalised manner. Our exposure is typically in shorter maturities which have similar yields to longer dated bonds but with less interest rate risk. We also see a key role for our Alternatives allocation if equity markets show signs of weakness, as they should be able to offer some protection and diversified returns.