ROCQ CAPITAL

Third Quarter 2023

It was a negative quarter for financial markets, with equities and fixed income investments generally losing ground as a mixed summer gave way to a weak September. The MSCI World index fell by -3.8%, with losses of a similar magnitude for the US S&P 500 (-3.7%), Japanese Nikkei 225 (-4.0%) and MSCI Emerging Markets (-3.7%) indices. Beyond the largest US technology stocks such as Google, Microsoft and NVIDIA, stock market performance this year has been lacklustre.

Central bank policy has driven markets since the start of 2022, with interest rates being raised at every opportunity in attempts to arrest rising inflation. September marked a possible conclusion to this, with the US Federal Reserve (Fed) and the Bank of England deciding to keep rates unchanged, and the European Central Bank raising rates but signalling that it may be the final move in its rate hike cycle.

It is therefore possible that we have reached a peak in interest rates, though speakers from the Fed have been keen to emphasise that they could raise rates again should inflation turn out to be stubbornly high. In September the Fed's updated projections for the next two years indicated that it expects to cut rates much more slowly than had been priced in by investors; as a result there is a growing consensus around a 'higher for longer' interest rate cycle, as policy errs on the side of caution with respect to inflation. The yield on 10-year US Treasury bonds hit its highest level since 2007 after a rise of 0.50% in September; higher yields mean lower bond prices, representing a fall of -4.3% in value during the quarter. The Global Aggregate index, which also includes corporate bonds, declined by -3.6%.

Nonetheless, the evidence so far is that inflation is heading downwards in a meaningful way, particularly in goods – service sector inflation has been stickier though the labour market appears to be normalising after a period of high wage growth and strong hiring demand. The disinflation process is most advanced in the US, but in the UK and Europe developments have also been positive.

Saudi Arabia announced a 1 million barrel per day reduction in oil output in July, and in early September confirmed that this would remain in force until the end of the year. This strongly supported oil prices, with spot levels up around 25% in Q3. This presents a fresh challenge to the outlook for inflation, especially if current prices are maintained for a few months.

On the growth front, employment figures on both sides of the Atlantic still look robust with only small signs of slack emerging. This has been an unusual cycle as economies recover from lockdowns, and the impact of large monetary and fiscal transfers has perhaps helped mitigate the effects of higher interest rates so far. The US fiscal impulse this year has been remarkably high, driven by increased federal spending in various areas including inflation-linked social security payments and higher defence expenditure via commitments to Ukraine. These effects are likely to be far less pronounced in 2024, while the large government spending commitments in green technologies and the semiconductor industry will be spread over a number of years.

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Outlook

In such an uncertain environment, our uncorrelated Alternatives holdings remain a source of comfort and reasonable returns while also limiting the portfolio's overall volatility. Supplementing this, we continue to see a positive outlook for bond investments in most scenarios. While the rapid increases in central bank policy rates since the start of 2022 have caused significant sell-offs in equities and bonds, they have resulted in a situation where managers can access attractive coupons with good prospects for capital gains over the next year or two – particularly if central banks begin to cut rates in response to economic weakness. While current inflation levels are too high for comfort, most "core" measures have been subsiding and goods inflation in particular has fallen markedly. This presents the opportunity to lock-in current coupon and yield levels for what we expect will be a lower inflation environment, thereby delivering positive real returns in a low-risk, liquid manner. Returns would be less positive if inflation and interest rates do not fall but nonetheless the running yield of high-quality bonds is now high enough to make an allocation to fixed income attractive relative to other asset classes.

Indeed, the picture for equities is somewhat unclear after a summer in which performance fizzled out. A peak in central bank hawkishness could be a powerful positive for small- and mid-cap stocks, which have performed poorly as funding costs have risen. With inflation showing signs of subsiding, uncertainty over earnings outlooks should clear which could also be a positive factor. However, slowing economic growth is unlikely to be positive for equities so we need to be vigilant in our assessments as further data arrives in Q4. It would not be a surprise to see mounting evidence of a slowdown in economic activity.