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Investment Management

Window on the world

OCTOBER 2023

Introduction

It has been a challenging 3 months for equity markets, with many developed markets entering correction territory, defined as a 10% fall from their recent highs.

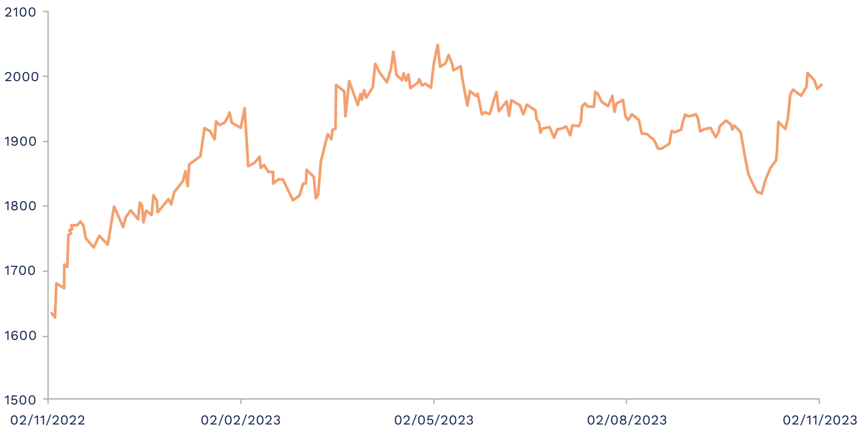
Drivers behind this move are multi-fold and explored in this edition of Window on the World. Whilst market setbacks are uncomfortable for investors, they occur quite frequently, with a 10% fall in equity markets typically experienced every 12-18 months. The moves we have seen over the past three months are therefore not an outlier, and history reminds us of the importance of remaining invested through the cycle to maximise long-term returns.

The Middle East

Geopolitical risk returned to the fore in October with the Hamas attack on the Israeli people and assets on Saturday 7th October, 50 years after the Yom Kippur War in 1973. Israel responded by declaring war and is undergoing a significant military response, principally via land and air rocket attacks into Gaza, although latterly with land-based excursions. To date, nearly 10,000 lives have been lost, in what is becoming a clear humanitarian crisis, with no obvious end in sight. It is the most serious escalation of Middle East tensions for many years.

The risks this presents to the global economy likely lies with energy prices. The Middle East region accounted for 33% of global oil production in 2022. An escalation in tensions across the region, and potentially bringing other countries into the conflict could raise risks to oil supply, leading to higher oil prices. Indeed, the knee-jerk reaction to the attack was a 4% move up in oil prices in its immediate aftermath. Gold, a traditional safe haven asset in times like this and which we hold in our multi-asset investment solutions, also rallied, up over 7% on the month (see chart).

/ Gold $/Oz



Source: Bloomberg

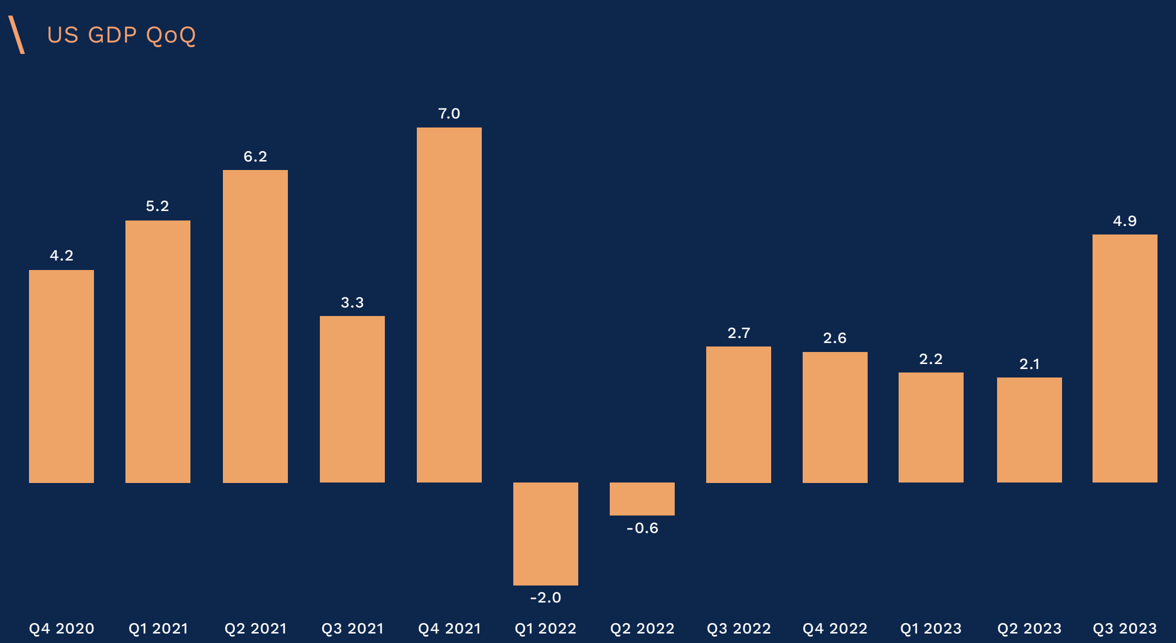
Clearly, some parallels can be drawn with the Russia-Ukraine conflict, which generated a significant upward move in both energy and food prices, and a key contributor to the inflation problem that Central Banks have been fighting for nearly 2 years. Whilst contributing to higher inflation, and likely tighter monetary policy, higher energy costs can weigh on economic activity, be it through lower corporate margins, or higher energy bills weighing on individuals' disposable income.

The prospect of an escalation of the crisis, and potential negative economic developments following that have contributed to the volatility we have observed in October. Thus far, oil prices have now fallen back to pre-conflict levels, whilst natural gas prices have risen. For now, the risks to the broader global economy and markets from the conflict should remain constrained but will remain an area of focus, particularly if the conflict widens or escalates.

The Economy

Economic activity has broadly continued the trend observed in the past few months, with some weakness apparent in Europe and the UK, whilst momentum has remained strong in the US.

In China, economic data has showed some improvement relative to expectations, albeit there remains a focus on the real estate sector. Stand outs during the month came in the US, where preliminary third quarter GDP growth confirmed that the economy expanded by 4.9%, more than double that seen in the preceding quarter (see chart below). A key component of this strength came from personal spending, up 4%, the most since 2021. One driver of this has come from the strength of the labour market, with employment data also remaining strong, although we are now witnessing some signs of cooling.



Source: Bloomberg

Elsewhere, the picture is somewhat more mixed. In the UK, a sharp decline in consumer confidence coupled with weak retail sales data (partly a function of the unseasonably warm weather in September) would signal that higher interest rates and concerns about the economy are curbing spending. In Europe, purchasing manager indices showed some improvement on the previous month, but remained at levels indicating that economic activity remains tepid at present. Chinese GDP data confirmed that the economy expanded 4.9% in the third quarter, surprising to the upside, thanks in part to stronger than expected retail sales and industrial production data.

The authorities continue to provide additional support and stimulus to the economy, in order to stabilise its property market and support investor confidence.

Despite this mixed data, with inflation remaining elevated across most regions, we remain of the view that rates will stay higher for longer, and this remained a key driver for bond yields over the month. The one central bank move of note came from the Bank of Japan, which announced a further tweak to its yield curve control policy, providing a further signal that the authorities are making further tentative steps towards normalising monetary policy.

Markets

A combination of geopolitical concerns and higher bond yields – a response to rates staying higher for longer – weighed on both fixed income and equity markets in October.

It was also a volatile period for the Big 7 Tech Stocks (Amazon, Apple, Facebook, Google, Microsoft, Nvidia and Tesla) as they announced earnings for the quarter ending September. These stocks have dominated market returns this year. Weak sentiment in Chinese equities continued to weigh on emerging market equities, which were 3.9% lower over the month. Japan, the standout performer this year, was 3% lower, and European equities fell by 2.6%. In our domestic market, equities fell by 3.7%, and in the US by 2.1%. In bond markets, UK government bonds on aggregate declined by 0.4%, but the move was more pronounced in the US, where government bonds declined by a 1%, and the yield on the US government 10 year bond rose to a 16 year high of 5%, albeit briefly.

3.7%
decline in our domestic market

5%
rise in US government 10 year bond

Outlook

Higher interest rates for longer are likely to result in a slowdown in the economic environment, and we are already observing this in areas such as Europe and the UK.

The US still remains an outlier, albeit forward looking indicators would suggest that activity could begin to weaken going forward. As such, we retain a broadly defensive stance within our positioning, Within fixed income, we have begun to turn more positive on duration, in recognition that we have likely seen the peak in bond yields. That said, our allocation within fixed income remains predominantly in shorter dated government and investment grade bonds. Any further weakness in equity markets is likely to present attractive entry points, with valuations outside of certain sectors or areas looking undemanding.

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