MONTHLY UPDATE

Latest views from the investment team

Not out of the woods just yet

When we sat down and wrote our February market update, we reflected on the bullish start to the year in equity markets. Investors seemed to feel more optimistic about the economic outlook and the corresponding policy response than in 2022. Expectations for a much fabled "soft landing" grew. Indeed, at their last meeting, the Fed slowed the pace of rate increases to 0.25% and released a more dovish accompanying statement. Fast forward to now, and the mood has changed again; February was considerably more muted as economic data has put the inflation and interest rate narrative back in the spotlight. This month serves as a reminder that difficult conditions are still present: the labour market is tight, stubborn inflation remains, and future policy is uncertain.

The release of US employment data on the afternoon of Friday 3 February could be seen as the moment where the mood changed. The print showed the lowest unemployment rate in over forty years, at 3.4%, and the labour market remains very tight. For markets, the big surprise was the figure for non-farm payrolls, which came in at 517,000, shattering economists' forecasts of around 200,000 payrolls being added. This shock was followed by further data, including disappointing US CPI (inflation print) and stronger than expected retail sales.

We find ourselves in a scenario where a major threat to equity markets is a *strong* economy – the reverse of what conventional wisdom may suggest. The paradox is driven by strong economic data acting as a signal that continuing, and increasingly restrictive, monetary policy is needed to curb demand, loosen the labour market, and bring inflation to target. This acts against equity markets which historically move inversely to bond yields (which have been rising). Indeed, yields rose in February as traders priced in the positive economic news. The US 10-Year Treasury yield approached 4%, the highest since November 2022. Similar events unfolded in Europe and the UK. The higher yields also prompted a bout of dollar strength. As we move into March, the market is less confident about the prospect of rate cuts in 2023. Instead, they expect the interest rates to be higher for longer.

Whilst this may sound downbeat, we believe that opportunities still exist. Previously important market headwinds have dissipated with the end to the zero covid policy in China and the success of European energy security. We remain cautious and selective in our approach as we attempt to grow capital over 2023, with bonds and equities representing much better value.

Month by numbers

Change in various markets over the month:

Asset		**Change**/Value
Equities		
UK	↑	**1.94%**
Europe	↑	**1.51%**
US	↓	**-2.44%**
Emerging Markets	↓	**-4.65%**
Japan	↑	**0.72%**
Bonds/Rates *Absolute change (%)		
UK Base Rates	↑	**0.50%**
		4.00%
Fed Funds Rate	↑	**0.25%**
		4.75%
UK 10-Year Yield	↑	**0.49%**
		3.82%
US 10-Year Yield	↑	**0.39%**
		3.91%
Currencies		
GBP/USD	↓	**-1.63%**
		1.21
GBP/EUR	↑	**0.13%**
		1.13
DXY (USD Index)	↑	**2.72%**
		1.11
Commodities		
Gold	↓	**-5.22%**
		$1827.22
Oil (Brent)	↓	**-0.71%**
		$83.89
Noteworthy		
Rolls Royce plc	↑	**31.11%**
Coal	↓	**-39.30%**

March

As of 28th February 2023

What does this mean for investors?

US equities fell in February as the mood changed and investors came back to reality following the exuberant start to the year. Emerging markets also fared poorly. Conversely, European and UK stocks gained in the month, driven by a comparatively large index weight for financials and industrials, combined with relatively lower technology exposure. Yields rose which could give us the opportunity to add fixed income duration across our portfolios. At the start of the year, we increased our equity allocation back to neutral across portfolios – a decision we believe was well timed as stocks have performed well year to date. We believe further upside remains in our overweight equity allocations in Emerging Markets and Japan. Emerging markets should be buoyed by the continuing full reopening of the Chinese economy. Moreover, Japanese monetary policy should eventually tighten, boosting the Yen and the GBP performance of Japanese equities.

Q&A

What's on your mind?

What shape is the UK economy in and how will that affect the UK market?

Most of our analysis is centered around the US due to its position as the largest and most important economy in the developed world, but as a UK-based investor, it is also natural to discuss the domestic outlook. Unfortunately, the UK has potentially the worst outlook of any major economy, and the general consensus is that there will be a recession at home. There are several reasons for this, but here we will discuss the UK mortgage market. Typically, mortgages in the UK are fixed for two or five years, much shorter than comparative developed countries, where rates can be fixed for decades. The result of this is that a greater number of homeowners will be suddenly exposed to the now meaningfully higher interest rates and the resulting higher mortgage payments. This hit to disposable income creates a relatively more severe negative demand shock for the UK economy. Whilst the outlook is relatively bleak for the real economy, this is unlikely to be reflected in UK equity prices, where the largest companies have very little exposure to the conditions of the UK economy.

What is "Growth" and "Value" Investing?

We regularly refer to either the "growth" or "value" style of investing in our updates and we wanted to take the opportunity to provide some clarity on exactly what is meant by this. In its most basic form, *growth* investing involves buying companies which are believed to have higher than average returns over the long-run due to exceptional corporate performance, these companies typically have higher valuations than the broader market. This style is associated commonly with tech stocks. *Value* investors buy companies they believe to be undervalued relative to the broader market or their peers. Examples can be found in energy or materials. The merits of each are subject to debate, and different fund managers have different preferences. Whilst *growth* investing outperformed in the period between the global financial crisis and the beginning of 2022, there is uncertainty over which style will prevail in the future. Higher inflation and tighter monetary policy appear to favor a *value* approach. Our portfolios are well diversified and offer exposure to both styles.

For more information, please contact your adviser.

Disclaimer

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