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# Market Update

July 2023

**Macro Backdrop**

As has been the case for some time now, markets remain fixated on inflation and what this means for interest rates. US headline inflation dropped to 4% in May, largely due to lower energy prices. Core inflation, excluding volatile items like energy and food, slowed to 5.3%, the lowest since November 2021. UK inflation fell in April to 8.7% (though above expectations) but was flat in May. Rising prices in air travel, recreational goods and services (especially admission fees to live music events, computer games and package holidays) and second-hand cars offset falling fuel costs and slowing food inflation; although the latter is still running at a fairly heady 18.3%. Crucially, core inflation reached 7.1%, the highest since March 1992 and above market expectations of 6.8%. Inflation in the Eurozone fell to 5.5% in June, down from May's 6.1% published figure, but core inflation also picked up to 5.4%.

Generally, whilst we are seeing price rises slowing in some areas, others are proving more stubborn and the path forward isn't necessarily a clear one. One reason could be wages, which have been moving higher and are supported by tight labour markets. Year-on-year wage inflation in the UK including bonuses was 6.5% in the three months to April 2023, and excluding bonuses 7.3%. Another reason could be that some, though by no means all, companies are using the inflationary backdrop to increase prices and improve profit margins.

Monetary policy has naturally followed suit, with interest rates continuing to rise worldwide. In June the Bank of England raised interest rates by 0.5% to 5% and the European Central Bank by 0.25% to 4%. Whilst the US Federal Reserve paused their hiking cycle it was notable they indicated rates may need to move higher later in the year. One important outlier to this has been China, which is flirting with deflation and actually marginally reduced rates in the last month of the quarter.

The full impact of high rates on consumers is still unclear. Savings made during the pandemic, coupled with higher wages may offset some inflationary effects, but these savings are being drawn upon and the delayed impact of higher mortgage rates could yet to have been fully felt. This will be very important for the global economy and corporate earnings in the quarters to come.

Recession concerns persist, with the Eurozone in a small technical recession and UK GDP only slightly rising in the first three months of the year. While some cracks are appearing in the US economy, strong consumer spending and a robust labour market indicate no immediate recession.

**Bond Markets**

Global bond markets have posted positive returns this year thankfully, after a dismal 2022, despite significant volatility in US Treasuries following the country's numerous regional banking issues. However, the UK government bond market fell on the disappointing inflationary backdrop and expectation that interest rates may need to either move higher than expected and/or stay higher for longer.

Central banks remain committed, at this point, to prioritising the fight against inflation over supporting economic growth. That being said, we believe the end of the monetary tightening phase is approaching and therefore the majority of valuation adjustment has already been seen in bond markets; as demonstrated by dramatically higher yields. Therefore, where appropriate, we have increased duration (a measure of interest rate sensitivity) in portfolios, to capitalise on this. This should prove beneficial when markets start to assume interest rates have peaked and/or need to be cut, especially if the economic outlook deteriorates.

**Equity Markets**

So far this year returns have generally been positive across the board. Japan has been the best performing major equity market in local currency terms, helped by a weak Yen, which is good for exporting companies but reduces returns for overseas investors. The US market has also been one of the best performing, although it has been narrowly led as AI (artificial intelligence) mania resulted in a favouring of the nation's very largest companies, such as Apple and Amazon. In fact, the returns from these few, admittedly colossal, companies have driven the majority of US market returns in 2023. After a healthy first quarter European markets had a quieter second, but are still firmly up this year. Nevertheless, a stronger pound, encouraged by the Bank of England's more forceful approach to monetary policy, dampened returns from Europe and the US for UK investors. The UK produced a muted return, with a limited technology related presence and lacklustre performance from mining and energy stocks. Asian and emerging market equities have lagged this year, largely due to disappointing Chinese economic data, where investors were anticipating a better reopening narrative.

Whilst a global recession does not look imminent, we do not expect the inflationary or economic journey to be a straight-forward one, and it may be a case of a recession delayed rather than avoided. This is particularly because interest rate increases are a fairly blunt tool with which to tame inflation, aiming to cool demand by making life increasingly expensive for consumers and companies alike. As such, there may be further corporate casualties to come, especially for the more indebted parts of the market, such as commercial property; not an area we are directly invested in. This is one of the reasons why low levels of debt are a characteristic we emphasise in our equity holdings. Yet, we balance this with the fact that equity valuations have improved and that the growth potential of stock markets means they are one of the few asset classes that can deliver returns ahead of inflation over the medium to longer term. Therefore, we are not positioned aggressively in equity markets, but retain what we would term a neutral level of exposure in portfolios.

**All data has been sourced from FE fundinfo, Refinitiv and Square Mile.**

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