INVESTMENT UPDATE

OCTOBER 2023

FOR PROFESSIONAL INVESTORS ONLY

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Taming inflation is proving to be a drawn-out process, despite the sharpest interest rate rises in 40 years. The result has been a tough late summer period in which global equity markets fell back, bond yields soared - the 10-year US Treasury yield reaching its highest since 2007.

Inflation remains higher than central banks targets in all major developed economies. Rates may not be forced much higher, but there is little sign of them being cut any time soon. Spiking energy costs as we approach winter are another obstacle to be navigated. Let's get into the detail.

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The US economy is still the one to watch and the American stock market perhaps more so, consequently we should devote more time in this update to the United States. The ongoing saga around the US debt ceiling has troubled markets more over the summer following the Fitch downgrade of the superpower earlier this year.

Nerves jangled as the deadline of 2nd October approached. This date would signify a shut down in US Government spending, whereby civil servants do not get paid, bins are not collected etc, unless a resolution is found.

The Senate approved a late measure which effectively kicked the can down the road for 45 days until 17 November. Funding is in place for all eventualities including disaster relief at home but excludes further support for the Ukraine war.

The Federal Reserve kept rates on hold at their last meeting, a policy tactic which then rippled out across other global central banks. Despite hiking rates faster than any time in recent history, inflation has begun bubbling back to the surface once again provoked by higher energy costs. OPEC+ no doubt spurred-on by Mr Putin, agreed an oil productivity cut.

Acutely timed to coincide with the low point in the US Strategic Petroleum Reserve and the onset of a northern hemisphere winter – the oil price is up 24%, approaching $100 a barrel. That said, we are not persuaded interest rates have much higher to climb. The CME FedWatch tool shows a market probability of 25.7% that rates will rise again during November and a resounding 74.3% probability they will remain on hold.

Since the Federal Reserve have cancelled so-called forward guidance, utterances from key spokespeople are seized upon by markets. Jerome Powell (Federal Reserve Chair), at his most recent press conference stated rates will be around 5.6% by the year end, 5.1% by the end of 2024 and 3.9% by the end of 2025.

MEETING PROBABILITIES									
MEETING DATE	375-400	400-425	425-450	450-475	475-500	500-525	525-550	550-575	575-600
11/1/2023		0.0%	0.0%	0.0%	0.0%	0.0%	74.3%	25.7%	0.0%
12/13/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	55.1%	38.2%	6.6%
1/31/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	55.1%	38.2%	6.6%
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	6.6%	53.1%	34.4%	5.8%
5/1/2024	0.0%	0.0%	0.0%	0.0%	2.3%	22.7%	46.7%	24.6%	3.8%
6/12/2024	0.0%	0.0%	0.0%	0.8%	9.2%	30.8%	39.2%	17.5%	2.5%
7/31/2024	0.0%	0.0%	0.4%	4.9%	19.9%	35.0%	28.4%	10.1%	1.3%
9/18/2024	0.0%	0.2%	2.9%	13.3%	28.3%	31.3%	18.2%	5.2%	0.6%
11/7/2024	0.1%	1.6%	8.1%	20.8%	29.8%	24.8%	11.7%	2.9%	0.3%
12/18/2024	1.1%	6.1%	16.9%	27.0%	26.3%	15.7%	5.6%	1.1%	0.1%

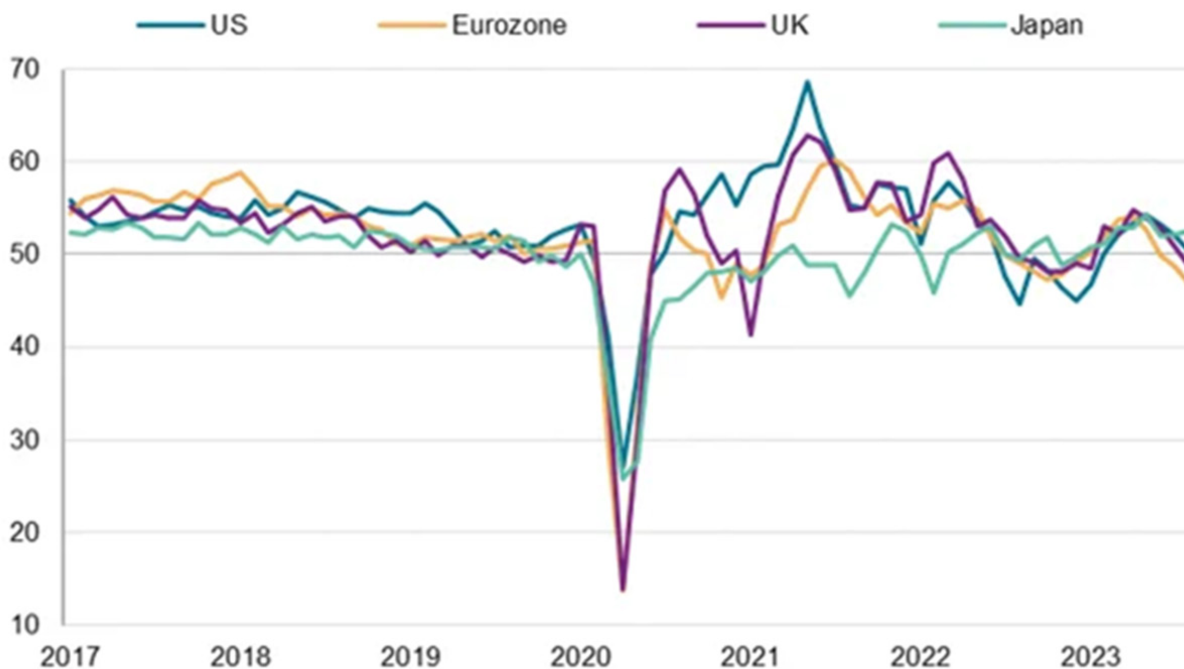
Source: CME FedWatch 2 October 2023

This marked a subtle but important tweak to monetary policy – rates to remain higher for longer, particularly throughout 2024. This coupled with higher energy prices in the face of winter gave rise to market volatility, particularly in the bond markets where the 10-year benchmark treasury yield rose to just shy of 5%, a high last seen in 2007. Rates being "higher for longer" is a narrative we have pedalled here and will be recognised by regular readers. Likewise, we anticipate inflation will remain stubbornly above the 2% target although not at elevated levels, for some time.

Weakness notably in the employment market, or an unforeseen credit event will be the trigger for the Fed' to begin cutting rates. A structurally higher dollar has been a by-product of recent market moves and, as previously, will act as a buoyancy aid to portfolio valuations with US exposures. Meanwhile the US equity market has performed well year-to-date at headline level.

Scratch the surface to see the "magnificent 7" technology behemoths have been responsible for almost all growth and the remaining 493 companies of the S&P 500 remain mostly flat. Consequently, valuations for the largest names are high but less troubling further down the capitalisation scale. Earnings forecasts remain robust for 2024, but seeing is believing. We see no reason to add further at this stage.

Major developed economies, output (manufacturing & services)



Data compiled Sept 5, 2023 including Aug PMI data.
PMI index value of 50 = no change on prior month, covers manufacturing and services.
Sources: S&P Global PMI, S&P Global Market Intelligence, HCOB, CIPS, au Jibun Bank.
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In Europe the European Central Bank (ECB) kept rates on hold last month. Germany moved into recession during the late summer with France not far behind. An over reliance on China, whose own recovery post Covid lockdown has stalled, is easy to criticise with hindsight although strategic foresight has been in short supply for some time it does appear. Despite the political and strategic malaise, there are many decent companies across Europe, plenty with internationally diversified earnings which have continued to prosper despite the colder economic forecasts domestically. The luxury house of brands LVMH and Novo Nordisk (the pharmaceuticals giant) is such an example.

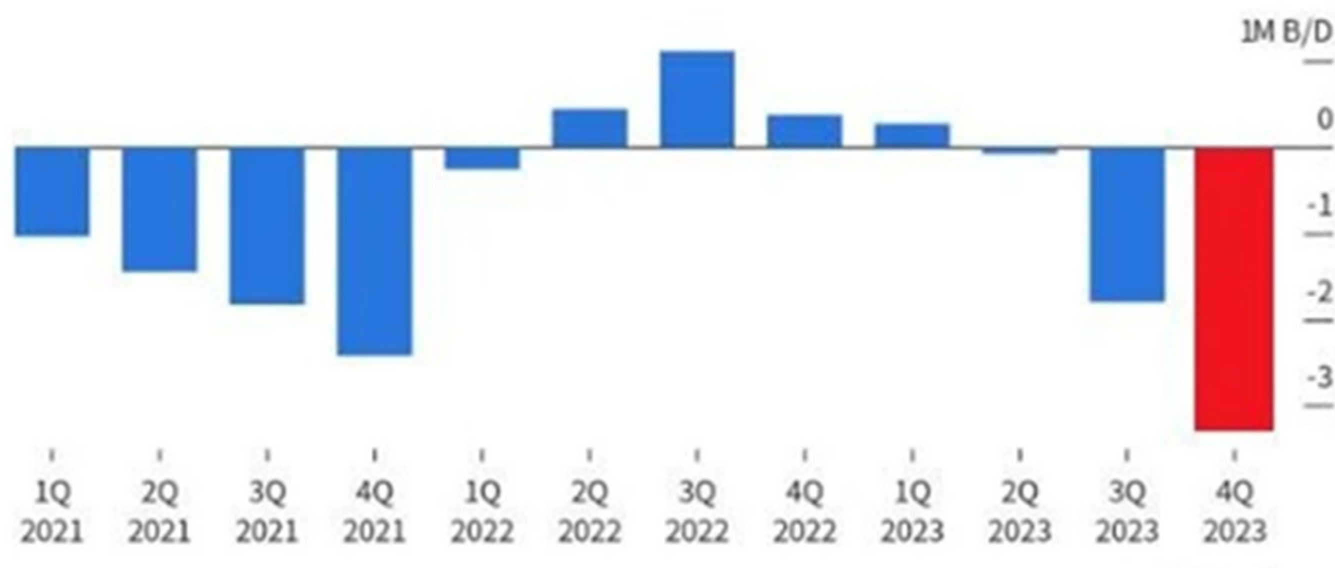
Meanwhile at home in UK, inflation fell further than the Bank of England expected, allowing base rates to be left unchanged over the period. UK stocks remain attractively priced and with upward moves in commodity prices once again we may see a recovery in a tight band. UK Gilts point to a stagflation risk with the strong potential for a weaker economy at home and inflation remaining higher than Bank of England targets. The benchmark 10-year stock yields 4.46%. In Asia, China remains weighed lower by structural issues including huge debt bubbles in the real estate sector a demographic profile ill-suited to her ambitions and an economic recovery which has stalled post-Covid.

Interest rates and currency strength are massaged lower to provoke growth. However, technological advances notably in the form of 7 nanometre silicon chip technology could prove to be a game changer over time for the fast-developing superpower. Meanwhile the strongly positive case for Japanese equities remains in situ with supportive monetary and fiscal policies enabling progress. A weak Yen facilitates exporters. Geopolitics is one area of the global macro puzzle that remains finely balanced and impossible to model. As the northern hemisphere winter approaches, we would expect Russia and her allies to continue and accelerate the weaponisation of hydrocarbons and food wherever possible.

The production cuts implemented by OPEC+ have pushed oil 24% higher with almost impeccable timing. The Saudi and Russian voluntary cuts are on top of the April cut agreed by several OPEC+ producers, which extends to the end of 2024. Russia joining Saudi Arabia in extending the voluntary curbs allows the Kremlin to collect more revenues amid its war in Ukraine and despite European Union attempts to limit Moscow's income with a cap on Russian oil prices. Most Russian oil is trading above the price cap.

Clearly the provision of a carbon neutral baseload energy which is both reliable and affordable is critical. We expect modern nuclear to play a pivotal role over time.

Oil Supply Squeeze
OPEC data indicate a growing supply shortfall



Source: OPEC

Bloomberg

At portfolio level we remain unchanged on last month. Our position being bolstered by secure yield and capital values in money market strategies. Equity held has allowed for portfolios to enjoy the expansion of AI-led valuations in the US whilst our UK position will enable an uptick, should it arrive, from the surge in commodities and energy. Japan equity exposure continues overweight and performing well. Fixed income duration remains overwhelmingly cautious with an overall short duration although, the move along the yield curve to explore longer duration and the convexity-driven benefits on offer as rates peak and eventually begin to fall remains firmly on the agenda. Timing is not immediate.

As ever we thank clients and their investors for their support and performance relative to the pack continues to show up in our favour.

Written by the Alpha Beta Partners Investment Team

All sources Bloomberg unless otherwise stated.

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