Q4 2023 Market Update

The fourth quarter started with weak financial markets as fears over the path of interest rates dampened investor enthusiasm. However, improved inflation indicators in developed markets led to a strong year end rally across equity and bond markets. Investors were emboldened with the prospect that Central Banks would be able to reduce interest rates sooner than markets had priced in.

The year-end rally contributed significantly to the success of our portfolios in 2023 following a very challenging 2022.

Asset Class Returns (GBP)

EQUITIES	Performance
MSCI World (ACWI)	6.18%
FTSE 100	3.63%
S&P 500	6.19%
Eurostoxx 50	9.67%
Nikkei 225	6.67%
MSCI Emerging Markets	2.76%

BONDS	Performance
UK Gilts	9.79%
UK Index Linked Gilts	10.50%
UK Corporate Bonds	9.21%
Emerging Market Debt	6.05%

PROPERTY/ COMMODITIES	Performance
Global Property	12.12%
GOLD	12.84%
OIL	-14.40%

We expect global growth to be weak in 2024 as the lagged effects of monetary policy tightening filter through. Among advanced economies, the US will continue to outperform Europe. In China, the policy-induced recovery is set to continue in the near term however strong structural headwinds will put the economy back on a weaker path by the end of 2024.

The subdued growth environment should bring inflation down, meaning Central Banks should be able to cut interest rates almost across the board.

Looking back over Q4 2023, equities across the board generally saw strong returns. The best performing **equity market** in GBP terms was the Eurostoxx 50 (up 9.67%), and the poorest performing equity market was the MSCI Emerging Markets Index (up 2.76%).

UK **Bond markets** experienced strong growth over the final quarter of 2023, particularly in December. This is largely due to the recent soft UK wage and inflation data and growing expectations that the US Fed will cut rates soon.

The **Volatility Index** fell sharply at the end of October, before declining more steadily across the rest of the quarter. Overall, it finished the quarter 29% lower than the start.

Global property prices rose 12.12% on the quarter, following sustained falls since July. This is likely due to improved sentiment in the market in anticipation of rate cuts, as well as falling mortgage rates in the residential market boosting demand.

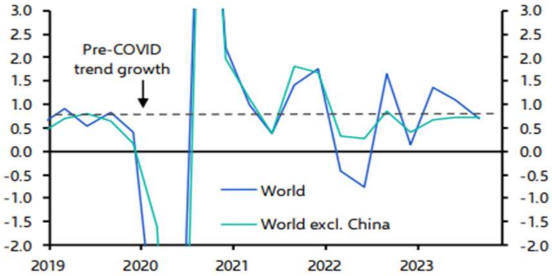
The price of **Brent Crude Oil fell sharply over the quarter**, finishing 14.40% lower, as doubts about the health of global oil demand re-emerged, while concerns about supply constraints and war in the Middle East eased.

Economic Outlook – Growth, Inflation, and Interest Rates to be lower than expected

Global – While the world economy should essentially experience a soft landing from this monetary tightening cycle, global growth could undershoot consensus expectations in 2024. With inflation set to fall close to, or reach, central bank targets in the coming year, 2024 should also be a year of broad-based cuts in policy interest rates.

Global GDP growth in 2023 is on course to be roughly in line with its pre-virus trend rate, at just over 3%. While this is flattered by China, growth in the rest of the world has been only a little below its trend rate, which is better than many others had forecast. But it is unlikely this resilience can endure, particularly in advanced economies.

Chart 1: Chart 1: GDP (% q/q)

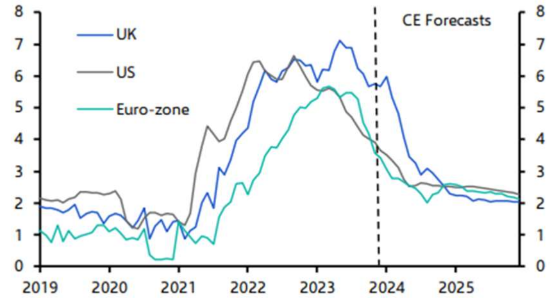


Firstly, monetary policy should drag on growth in 2024. Higher interest rates have already caused liquid money growth and bank lending to slow sharply. And higher rates are gradually feeding through to debt service costs.

Furthermore, manufacturers are left heading into 2024 with new orders contracting, but with no new help on the supply side to support production. Additionally, the demand boost from reduced saving has probably run its course. Consequently, the outlook for consumer demand will hinge more on income growth, which will slow as labour markets loosen.

The combination of tight monetary policy and fading tailwinds that propped up activity during this past year should lead to weaker growth across advanced economies. Below-trend growth, cooling labour markets, and a pipeline of falling goods price pressures will see core inflation drop close to 2% by H2 2024.

Chart 6: Core Inflation (%)



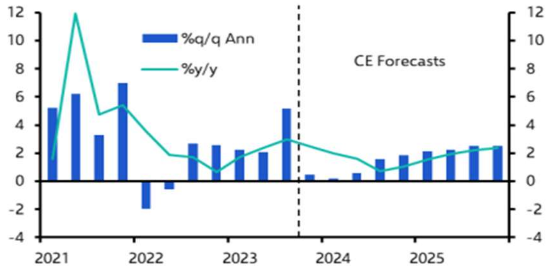
In turn, this should ultimately prompt more rate cuts in many DMs than investors currently expect, taking policy back to a neutral stance.

Aggregate EM GDP growth will enter a slower phase over the coming quarters. But there is unusually large variation in prospects at a country level. China's economy should continue its cyclical recovery in the coming quarters but the bigger story is that its structural challenges will prevent such rates of growth being sustained in future years.

US – The lagged impact of monetary policy tightening should push GDP growth well below potential in the coming quarters. This will help bring core inflation back to target by mid-2024, prompting the Fed to cut rates by more than investors anticipate, starting in March.

GDP growth is expected to be well below potential, as the delayed effect of previous monetary tightening continues to feed through for the next few months.

Chart 9: Real GDP



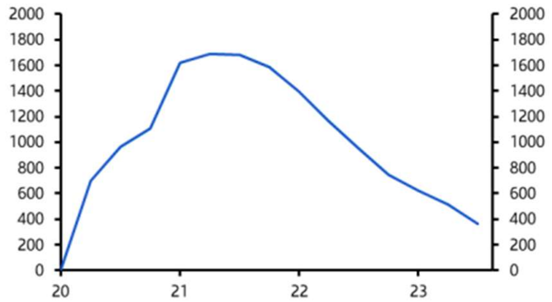
As GDP growth slows to a crawl, employment should all-but stagnate. With labour force growth expected to remain robust, that will push the unemployment rate up to almost 5%.

New credit growth has slowed markedly, but both households and businesses have benefitted from the legacy fixed-rate debt taken out at very low rates. Households have also enjoyed the cushion of excess savings built up during the pandemic, although those savings will be exhausted by early next year.

With the underlying Federal budget deficit rebounding to around 7.5% of GDP over the past 12 months, any fiscal stimulus next year to supplement monetary loosening is unlikely.

Despite the strength of demand growth, inflation has slowed sharply, as global supply shortages have eased and the domestic economy's supply side has

Chart 12: Households' Excess Saving ($bn)

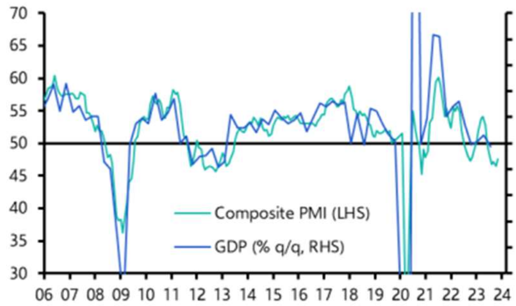


expanded rapidly. Core inflation should be back to the 2% target by mid-2024. and monetary policy likely to be impotent on the way down too, the Fed will have to cut interest rates more aggressively than markets currently believe. A cumulative **175bp in cuts in 2024 with a final 50bp coming in early 2025 is anticipated.**

Euro-zone – The euro-zone economy should broadly stagnate in the first half of 2024. And as core inflation continues falling to target, the ECB could start cutting rates as soon as April.

The euro-zone economy has flat-lined for four successive quarters, starting at the end of last year, and business surveys suggest things have deteriorated since the middle of the year. A technical recession is very likely.

Chart 17: Euro-zone GDP & Composite PMI



Household consumption looks set to remain sluggish for some time. Admittedly, real household incomes should increase in light of higher wage growth and falls in inflation. However, households have stepped up saving rates in recent months. Moreover, the cost of servicing household debt will rise steadily.

Meanwhile, only modest export growth is anticipated given the lacklustre outlook for the euro-zone's main trading partners, and fiscal policy will be tightened in most Euro-zone countries next year. Investment will be hit by a combination of weak demand and the rising cost of credit. All told, GDP is expected to contract in Q4 2023 and flatline in early 2024, followed by a weak recovery as interest rates fall and real incomes rise.

The labour market has been resilient so far and measures of wage inflation and vacancy rates remain high. However, surveys show declining employment intentions. The big falls in headline inflation from energy prices have passed, and it is likely to edge up to around 3% in December before trending down. Core inflation should decline steadily next year too.

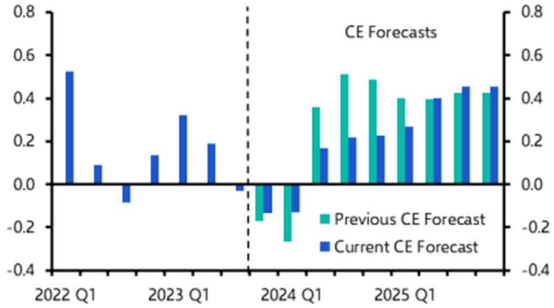
Policymakers will soon turn their attention to interest rate cuts. They should now be confident enough to start the easing cycle as soon as April. The deposit rate is expected to fall to 2.75% by end-2024 and 2.25% by end-2025.

UK – A softer landing in activity and continued restraints on supply, imply that lingering price pressures will prevent the Bank of England from cutting interest rates until after the Fed, the ECB and current market pricing of mid-2024.

The tiny fall in real GDP in Q3 2023 and potentially small falls in Q4 2023 and Q1 2024 suggest higher interest rates may have caused a small recession. But, much of the effect on households has yet to be felt. More fixed rate mortgages means the mortgage rate for existing borrowers has risen by only a third of that for new borrowers. As the drag from higher rates will occur over more time than previously thought, any recession will be shallower and GDP growth will be weaker for longer.

At the same time, there is little evidence the restraints on supply will fade quickly. As a result, the

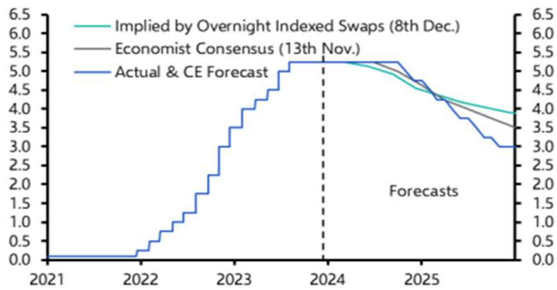
Chart 34: Real GDP (%q/q)



unemployment rate will likely only rise slowly from 4.2% in September to a peak of 4.8% in mid-2024, and the upward pressure on wage growth will abate.

Pay for new employees has been growing more slowly and pay deals for existing workers have probably peaked. But the lingering restraints on supply will mean domestic inflationary pressures will fade more slowly in 2024 than elsewhere. That's why the view is that the Bank of England will cut interest rates from 5.25% only late in 2024. That said, weak growth in 2023 and 2024, and some rebound in supply in 2025, may mean the Bank cuts interest rates to 3.00% in 2025.

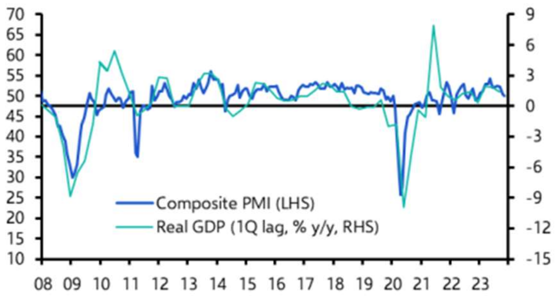
Chart 40: Bank Rate (%)



Japan – Economic activity looks set to slow in 2024. But early signs that wage growth will rise should convince the BoJ to lift rates out of negative territory and formally end yield-curve control next year.

After a strong annualised expansion of 4% in the first half of 2023, GDP fell by 0.7% q/q in Q3. That probably overstates the weakness of the economy given that the composite PMI still points to fairly healthy growth in activity.

Chart 25: Composite PMI & Real GDP



Nonetheless, the outlook for GDP growth isn't great. While wage growth has accelerated, it is still falling short of inflation. And the ¥1tn in transfer payments to low-income households included in the latest supplementary budget won't prevent real disposable income from falling until at least mid-2024. Consumer spending has already come to a standstill and with the savings rate now broadly back at pre-virus levels, it should stagnate next year.

The labour market has tightened a bit in recent months, but the weakness in new job openings suggests that won't last. Inflation is becoming more broad-based, with services inflation increasingly being driven by domestic factors. But with import prices now plunging, underlying inflation has started to moderate and this has much further to run. Headline inflation is expected to return to 2% by end-2024.

There are early signs that the cycle between consumer prices and wages the Bank of Japan has wanted has begun. The Japanese Trade Union Confederation (RENGO) has requested a larger pay hike in the upcoming spring wage negotiations (Shunto). And with corporate profits at record-highs, firms should oblige.

It's possible that the Bank will wait for preliminary Shunto results due in March before hiking rates. But given that RENGO's wage requests have been a reliable indicator of the actual outcome, the Bank should hike rates pre-emptively. It is now likely that inflation will settle at 2% over coming years, forcing the Bank to eventually lift its policy rate to 2%, too.

China – The step-up in policy support and an uptick in consumer spending should continue to drive a modest cyclical recovery at the start of 2024. But various structural headwinds mean the recovery won't be sustained. China's economy faltered during the summer. Although it has regained that ground recently, it's likely growth over the past two years has been far weaker than the pre-COVID trend or than official figures show.

Chart 57: CE China Activity Proxy & Official GDP (2019 = 100)

The recent improvement can be attributed in part to household spending. Consumer confidence has rebounded and if sentiment continues to improve, households should feel comfortable spending more of their income. In addition, the adjustment to the current year's budget announced by the government in October will ensure fiscal support for the economy doesn't dry up. These funds could be channelled into infrastructure and other public projects over the coming months.

In terms of external demand, manufacturers have benefitted from an under-appreciated export boom. But with a weakening global economy, export volumes should fall next year.

Efforts to boost property sales have not succeeded so far but they continue to be expanded and could gain traction soon. But a sales rebound probably wouldn't translate into stronger construction. Instead, sales revenues will help speed up completions so that overall activity still falls.

Monetary easing has played a much smaller role than fiscal policy recently. One reason is the PBOC has been trying to prevent the renminbi from weakening much beyond 7.3/$. The recent reversal of the dollar has given the PBOC some respite, and policy rates should be lowered soon. But policymakers are still wary of stoking another credit boom, and so only 20bp of cuts by mid-2024 is expected.

There is good reason for this caution. While China's growth has disappointed this year, there isn't much evidence of substantial slack in the economy that stimulus could address. Instead, it seems China's sustainable growth rate has slowed. That's another reason to think faster growth over the coming months won't be sustained. China's economy should start 2024 growing around 6% y/y on the China Activity Proxy (CAP) measure but that growth will have slowed to below 4% by end-2024.

Asset Allocation Views

Bonds – Long-dated government bond yields in most DMs are expected to continue falling over 2024, although they'll likely settle at much higher levels than before the pandemic.

Corporate bonds – There is some near-term risk for corporate bonds, given how narrow their spreads are. Even without a recession, a slowdown in growth could see those spreads rise, and perhaps bring yields up with them. But by end-2024 the clouds should have cleared and corporate bond spreads and yields will be lower than they are now.

Equities – Equities have rebounded over this quarter, shaking off a rocky start as the "higher-for-longer" narrative has begun to unravel and bond yields have fallen. While the rise in equities has been broad-based, "tech" stocks have led the way. Given most "big tech" firms are listed in the US, the US stock market has largely outperformed equities in the rest of the world. Enthusiasm about AI should resume, and this will continue to benefit equities in the US disproportionately. The S&P 500 is forecast to rise from nearly 4,600 now to 5,500 at the end of 2024 and to 6,500 at the end of 2025.

Emerging market equities – China's struggling equities should recover in the near term, as economic growth there picks up. And stock markets there in addition to the rest of Asia might also benefit from AI enthusiasm, as the region is well placed to benefit from the technology. As a result, equities in EM Asia generally should fare far better next year than in 2023. At the other end of the spectrum, equities in Latin America may fare poorly in dollar terms, as currencies there weaken.

Commodities – Energy commodities – chiefly oil – have tumbled in price and industrial metals have also struggled. The weakness in oil prices largely seems to reflect concerns around the extent to which OPEC+ will follow through on announced supply cuts, as well as ongoing concern over how demand from China will evolve next year. A big rebound in oil prices is unlikely. On the demand side, GDP forecasts for most DMs are weak and there could be a faster-than-expected uptake of electric vehicles. On the supply side, rising OPEC+ output in Q2 2024 will support global crude supply. For other energy markets, a repeat of sky-high 2022 prices is similarly unlikely.

Industrial metals – Industrial metals prices have also dropped back amid concerns over demand, particularly from China. Looking ahead, modest gains are projected in most industrial metals prices in 2024. That reflects the view that economic activity in DMs will pick up over the second half of next year and that falling interest rates will stimulate demand in metals-intensive sectors such as autos and construction.

Precious metal – The price of gold spiked to a record intraday high of ~$2,120 per ounce in December, though it has since fallen back. The strong gains in the precious metals this quarter seem to be due to falling Treasury yields and a softening US dollar. A further fall in Treasury yields and a bit of a depreciation in the dollar should lift gold to $2,100 by end-2024. Those tailwinds will also support silver.

Final Word

2023 was another testing year for investors however the rally during the last 2 months of the year provided some respite. Eventually markets started to compensate investors for the risk they had taken on. It was always our view that our portfolios would recover quickly as markets rallied and this proved to be the case.

Looking ahead, whilst economic growth may fail to meet expectations, we expect financial markets to continue their path of recovery in 2024. In particular our positions in developed market equities and government bonds should provide competitive returns in the prevailing financial market environment as the last of the inflationary tailwinds support corporate profitability and interest rate cuts in developed markets bolster bond markets.

Clearly 2024 will not be a year to be sat on the sidelines as we expect strong returns from financial market assets.

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Sources: Capital Economics; Bloomberg; FE Analytics
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