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Hymans Robertson Investment Services (HRIS)

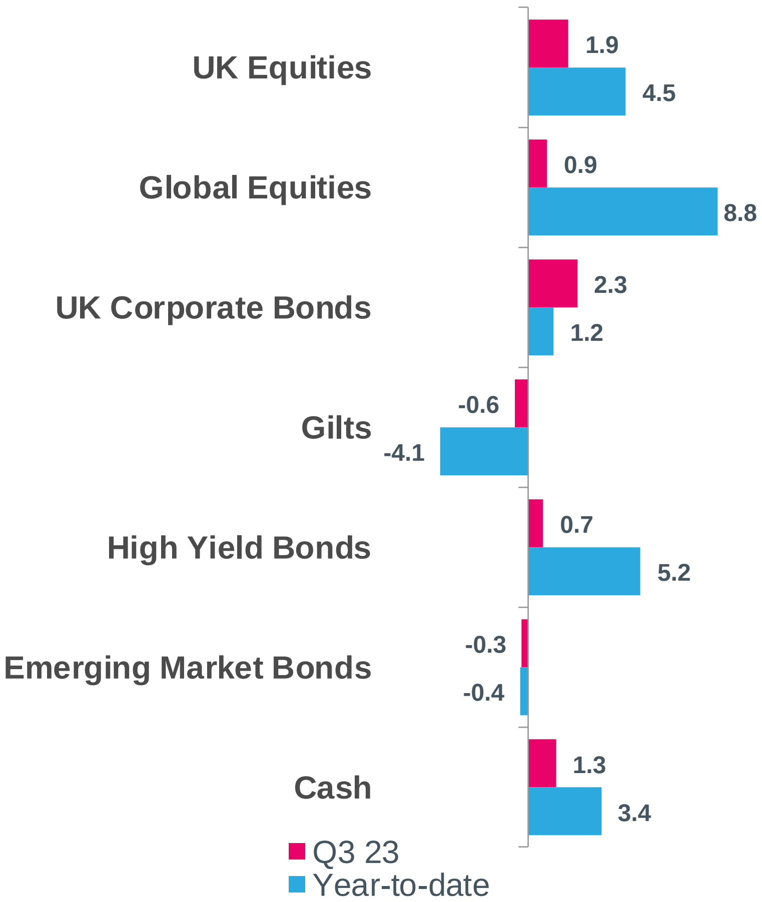
Market Digest

Q3 2023

Quarterly Highlights

- UK inflation fell by 2% over the quarter to 6.8%, a faster fall than expected. This allowed the Bank of England to hold rates at 5.25% at its September meeting, following a 0.25% rise earlier in the quarter.
- Global equity markets held onto a strong start to the quarter to generate a small positive return over the period. UK corporate bonds performed well with a 2.3% return.
- Most portfolios therefore generated a positive return over the quarter.
- Bonds in general outperformed equities over the period, providing greater returns for lower risk portfolios.

Asset class returns (%)



Source: Morningstar. Figures to 30 September 2023. Returns in sterling terms except High Yield Bonds which are hedged. EM bonds are 50% local currency denominated and 50% US dollar denominated bonds.

Market summary

- Our model portfolios are typically invested in a combination of the asset classes shown in the left-hand chart.
- A strong start to the quarter, in terms of returns, faded as the earlier optimism of central banks reaching the near-peak in rates was dampened as policymakers insisted that interest rates will be held high for longer than previously hoped.
- The UK was a bright spot as inflation fell by more than forecast, to 6.7%, bringing down short-term interest rate expectations significantly. This boosted corporate bonds which were the strongest performing asset class.
- UK equities outperformed other regions as the FTSE's large Energy sector exposure benefitted from a higher oil price. Japan also continued to perform well (see more detail below). Other equity regions struggled against a weak Chinese economic outlook and higher US bond yields.
- Bond returns were also mixed. Although UK corporate bonds performed well and High-Yield generated a small return, global bonds and emerging market bonds fell slightly as US bond yields rose.
- The Bank of England increased rates by only 0.25% to 5.25% over the quarter, pushing up returns on money-markets.
- At a portfolio level, bonds outperformed equities meaning lower risk portfolios outperformed higher risk ones over the quarter.

Outlook and topical market themes

- The Bank of England seems to prefer a lower peak in interest rates. However, this may require interest rates to be held at higher levels for longer.
- The Bank of Japan's ultra-loose policy stands out from other developed market central banks. This has had a significant impact, both on the yen, which has fallen by over 15% against the pound but also the Japanese equity market which is the standout performer year-to-date.

The Bank of England prefers the "Table Mountain to the Matterhorn"

The Bank of England's (BoE) Chief Economist, Huw Pill, was speaking in South Africa when he compared two possible paths the Bank could take with interest rates. Rate setters could opt to take an approach analogous to the Table Mountain in Cape Town - a low but flat and broad peak. Alternatively, the Matterhorn within the Alps, which rises to a sharp peak before quickly falling back down. Pill indicated a preference for the Table Mountain approach and the majority of his BoE colleagues agreed with him at their September meeting as they narrowly voted to hold rates - its first hold since November 2021.

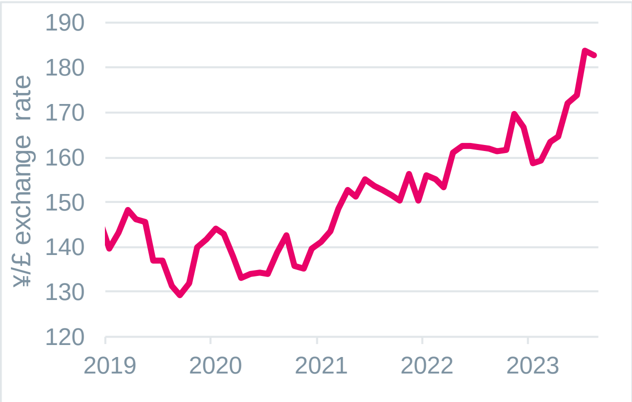
As a result of a preference for this path, and some favourable inflation data, the expected peak in interest rates has fallen by about 1% over the past quarter. The consensus now is that we've reached the top at 5.25% or if not, we will at 5.5%. This is welcome news to investors. However, the sting in the tail is that interest rates will stay at elevated levels well into next year.

The Bank of Japan stands on its own

The standout region so far this year, in terms of equity returns, interest rates levels, and currency movements has been Japan. While other developed central banks have responded to high inflation with sharp increases in interest rates, the Bank of Japan (BoJ) has stuck with its ultra-loose monetary policy of negative interest rates and yield curve control, or Quantitative Easing "infinity". The BoJ has been attempting to fight off a deflationary environment for decades so is very cautious with killing off any inflationary pressures, as long as it doesn't remain persistently high. Inflation in Japan peaked at 4.3%, compared to 11.1% in the UK, but has since fallen to 3.2% without any interest rate increases. This divergence in monetary policy has had a significant impact on the yen. Lower relative interest rates encourage foreign and domestic investors to leave their money elsewhere, which tends to weaken the currency - the yen has fallen by around 15% so far this year.

The BoJ's supportive policy has ensured the economy has continued to perform strongly since covid. This, along with the weaker yen, which boosts exporters' earnings, has meant Japanese equities are up by around 25% so far this year in local currency terms. This case study is a useful reminder for investors to stay globally diversified as not all economies and financial markets move in lockstep.

Chart of the month – The yen has weakened as Japanese interest rates have become less attractive



Source: Morningstar.

As the BoJ continues to retain its ultra-loose monetary policy, the difference in interest rates between Japan and other developed economies, continues to widen, increasing selling pressure on the yen. This has accelerated in 2023 as the Bank of Japan continues to hold rates low.

Jack Richards
Investment Manager

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