Investment Outlook

A monthly round-up of global markets and trends

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Investment outlook

The UK continues to labour over tackling elevated inflation

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The Bank of England (BoE) is struggling to bring down annual UK consumer inflation to the 2% rate set by the government. In June, the UK Consumer Prices Index (CPI) did come in lower than the consensus expected (7.9% vs 8.2%).[1] However, it remains considerably higher than the Eurozone at 5.5% and the US at 3.0%.[2]

The UK's poor inflation performance over the past few years can largely be traced to energy prices, which are now receding, and a labour supply shock following Brexit and the pandemic. This led to accelerated wage growth. Excluding furlough distortions caused by the Covid-19 outbreak, private sector wages (excluding bonuses) rose by 7.7% in May, the highest rate since the data began in 2001.[3] We believe that this is indicative of a tight labour market, since worker supply lags demand. We look at each below.

Labour supply

The UK's workforce has recovered far more slowly than other major economies since the pandemic. For instance, the UK's active labour force (those willing and able to work) is unchanged since the virus outbreak intensified in January 2020, compared to a 1.5% increase in the US.[4] However, the UK inactive labour force (those unable or not willing to work) has since risen by 3.4%.[5]

Part of the reason for this labour shortage lies in the growing number of workers classified as long-term sick. As of April 2023, there were a record 7.4 million people on the NHS waiting list for treatment.[6] That is 14% of the population, up from the pre-pandemic level of 8.3%, in what must be an unwelcome statistic for the government, particularly as the NHS celebrated its 75-year anniversary in July.[7] Capital Economics, a research firm, found that the lengthening NHS waiting list coincided with a rise in the number of people that reported being unable to work due to long-term sickness. The point here is not to blame the NHS service record, but rather to illustrate the correlation between the number of people that are unable to work for health reasons and the impact on the available supply of labour.

In January 2023, Prime Minister Rishi Sunak made cutting the NHS waiting list one of his top five priorities. This will be difficult to achieve in the near term. The decade of austerity following the Global Financial Crisis in 2008 and the Covid-19 pandemic has left the UK health system under resourced.

This crisis could be resolved by investing in overseas labour, although it's unlikely to be an immediate panacea. While net immigration to the UK was a record 606,000 for 2022, it was led by students and people on asylum schemes from Ukraine and Hong Kong who may not be immediately available to work.[8]

Nonetheless, the overall proportion of foreign-born workers in the UK is at an all-time high. Data from the Office for National Statistics (ONS) show this group currently constitutes 20% of total employment. This is up from 16.6% in the first quarter of 2016 (the quarter before the EU referendum) and has steadily risen from 7.3% in 1997, when the data series began.[9] Importantly, the mix of workers coming to the UK has changed since Brexit. Younger people from the EU, typically working in lower-skilled areas like hospitality have been replaced by highly skilled labour from non-EU countries. New visa requirements mean overseas workers are not eligible to fill many of the gaps in the lower-skilled jobs.

In short, the supply of UK workers has been hit and may not recover in the near-term.

Labour demand

In contrast, the job market remains healthy. Firms in the UK are still keen to hire. Job vacancies are historically high at over one million and employment continues to move up.[10] Solid labour demand has encouraged a 'virtuous circle' between consumers and businesses, where firms aim to balance profit margins by offering pay increases and expanding headcount, which in turn drives private consumption. This appears to be working: the Purchasing Managers' Index for services (a timely measure of demand) came in at 51.5 in July, above the boom-bust threshold of 50 to signify sector expansion.[11]

Recent polls from the Recruitment and Employment Confederation and BoE agents' surveys do point to some moderation in labour demand in the months ahead. Even so, the underlying picture is that labour demand remains healthy despite recent interest rate hikes.

The imbalance between labour supply and demand is conducive for high wage rates. The risk is that this contributes to inflation and that becomes entrenched, making it more difficult for the BoE to bring it under control. Indeed, at the July annual Mansion House speech, BoE Governor, Andrew Bailey, said his "pre-occupation at the moment is inflation", and noted "both price and wage increases at current rates are not consistent with the inflation target."

At the very least, it probably means that more interest rates rises are needed to reduce the risk of overheating. For markets, expectations of elevated interest rates in the UK, against a likely pause in the US, has lifted sterling by more than 20% relative to the US dollar since its low last September.[12] From being supportive of the performance of stock markets in 2022, the pound is proving to be impeding progress for UK shares in 2023 as overseas' earnings made by UK-listed companies are worth less when translated back to sterling. Along with the downturn in commodity prices, where many large companies such as BP and Anglo American are exposed, this goes some way to explain why UK shares have underperformed their peers this year. Nevertheless, as inflation begins to subside across the pond, and US interest rates are expected to peak, this has given a lift to global stock markets. So, despite the difficulties UK policymakers face in tackling inflation, rising investor optimism around the world could well filter through to British stocks.

Sources:

1,2,3,4,5,9,10,11,12 Refinitiv, Evelyn Partners

6,7 Capital Economics, The link between the NHS waiting list and the labour market, 5 July 2023

8 HSBC, UK Migration Conundrum, 30 May 2023

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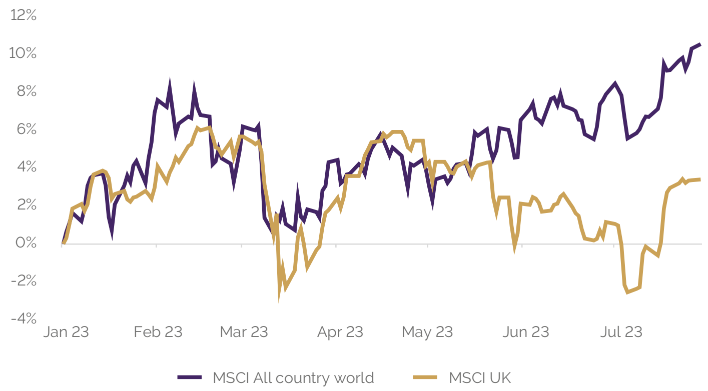
Market highlights

Equities

Global stock markets have made a strong start to 2023, with the MSCI All-Country World Index returning 10.5% in sterling terms. By comparison, the UK has been a laggard - at the start of July the MSCI UK was down 2.5% for the year. Despite this, as stock markets have continued to rally in recent weeks, some of this optimism has found its way back to the UK. This, coupled with a better-than-expected inflation print, has allowed UK equities to rally and begin to close the gap with the rest of the world. If some of the UK's domestic headwinds subside, this could allow UK equities to continue to catch up.

Return of global equities relative to UK equities in 2023

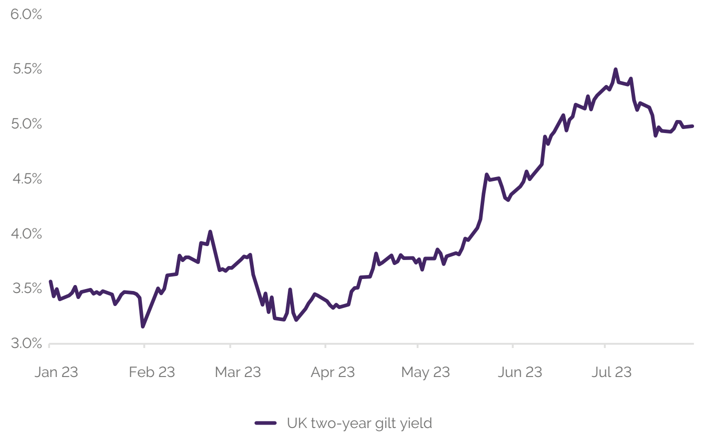


Source: Refinitiv Datastream/Evelyn Partners, data as at 31 July 2023.
Data is calculated on a total return basis in GBP.
Past performance is not a guide to future performance.

Fixed income

As UK inflation had remained stubbornly high, bond markets began to anticipate further interest rate rises from the Bank of England (BoE). This caused bond yields to rise, and prices to fall: the two-year gilt yield has risen by over 200 basis points since April to reach 5.5%, its highest level since 2008. However, June's data showed inflation decelerating at a faster rate than markets had expected. This provided some much-needed optimism to the market, with the UK's inflation picture looking slightly less bleak than previously feared. Bond markets rallied on this news, causing two-year gilt prices to rise and yields to fall to 4.9%. Despite this, UK interest rate expectations continue to remain higher than other developed markets. Bond markets currently expect the BoE to increase interest rates to a peak of 5.8%, which is higher than the 5.4% and 3.8% expected in the US and eurozone, respectively.

UK two-year gilt yield

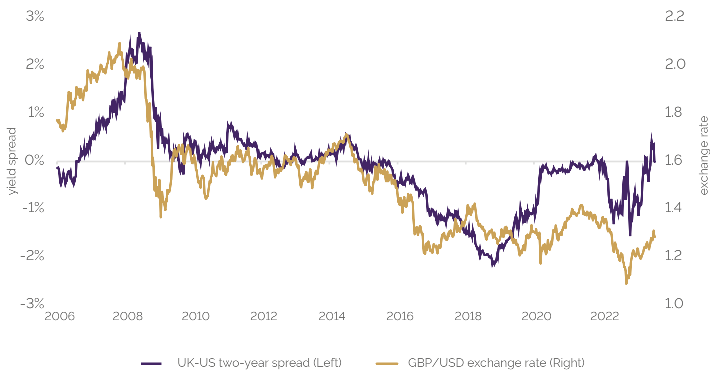


Source: Refinitiv Datastream/Evelyn Partners, data as at 31 July 2023.
Past performance is not a guide to future performance.

Currencies

Typically, when interest rate expectations in one country move higher relative to another country, it causes their currencies to appreciate and depreciate respectively. One way to measure this interest rate differential is in the difference between the yields available on government bonds, often known as a spread. The spread between the two-year UK and US government bonds had been negative since the start of 2022, when the US Federal Reserve began raising interest rates more aggressively than the BoE. This caused sterling to weaken relative to the US dollar. However, with inflation remaining more persistent in the UK—signalling more interest rate rises may be required—the spread has closed, causing sterling to strengthen.

UK-US two-year government bond yield spread and GBP/USD exchange rate



Source: Refinitiv Datastream/Evelyn Partners, data as at 31 July 2023.
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Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	2.5	6.1	7.3	55.2
MSCI UK	2.2	-1.9	6.8	20.4
MSCI UK Broad	2.6	-1.7	5.3	15.9
MSCI USA	2.2	8.5	7.0	80.8
MSCI Europe ex UK	1.8	0.0	16.1	40.1
MSCI Japan	1.8	6.7	9.3	24.3
MSCI Asia Pacific ex Japan	3.1	0.0	0.7	19.6
MSCI Emerging Markets	5.0	6.1	2.9	13.1
Bonds				
iBoxx GBP Gilts	0.8	-3.4	-17.0	-19.1
iBoxx USD Treasuries	-1.6	-4.6	-9.4	4.2
iBoxx GBP Corporate	2.4	-1.2	-7.1	-4.1
Commodities and trade-weighted currencies				
Oil Brent Crude ($/barrel)	14.9	7.7	-22.2	15.0
Gold ($/ounce)	2.7	-1.1	11.6	61.1
GBP/USD	1.2	2.4	5.7	-1.9
GBP/EUR	0.1	2.5	-2.2	4.1
EUR/USD	1.1	-0.1	8.1	-5.8
USD/JPY	-1.7	4.3	6.3	26.9

Market commentary

July was another strong month for equities, with all major regions providing positive returns. Emerging markets were among the best performers, returning 5% for the month. Renewed hopes of a Chinese stimulus package helped improve investor confidence in China and its neighbouring countries. Europe, excluding the UK, posted the weakest performance for the month, plagued by sluggish economic data. However, over the past 12 months, Europe, excluding the UK, has been by far the best performer, gaining 16.1%. The US dollar continued to weaken against all major currencies in July, as market participants anticipate the end of the US interest rate hiking cycle. Oil made a resurgence this month, with Brent crude gaining 14.9% as an improvement in the global growth outlook pushed demand higher for the cyclical commodity.[13]

[13] Refinitiv, Evelyn Partners

Key macro data	Latest	2023 Consensus forecast	Spot rates	31-Jul	Yields (%)	31-Jul
UK GDP (YoY%)	0.23	0.20	GBP/USD	1.29	MSCI UK	4.25
UK CPI Inflation (YoY%)	7.90	7.50	GBP/Euro	1.17	MSCI UK broad	4.13
Bank of England Base	5.00	5.65	Euro/USD	1.10	10 Year Gilt	4.31

The market commentary, values and charts as at 31 July 2023. Total returns in sterling.
Returns are shown on a total return (TR) basis ie including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Refinitiv Datastream/Bloomberg

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

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