Investment Outlook

A monthly round-up of
global markets and trends

October 2023

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Investment outlook

Getting over an inflation shock

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Although inflation has slowed in most major developed economies this year, overheating concerns still linger in financial markets. The US 10-year government bond yield has edged up to a level last seen in 2007 amid solid economic growth—the Federal Reserve Bank of Atlanta currently estimates US real Gross Domestic Product (i.e. growth after inflation) of 4.9% in the third quarter, which is significantly above trend.[1]

To add to overheating worries, rising crude oil prices could lead to another inflationary wave. History shows that when inflation surprises on the upside it typically comes from the energy market. A recent paper from the International Monetary Fund (IMF), identified over 100 inflation shocks from both emerging and developed economies going back to 1970. More than half of those episodes came from the 1973 and 1979 oil crises, with the remainder connected to exchange rate depreciation and demand surges.[2]

Fast forward to today and after reaching a low for the year in June, the Brent crude oil price is up more than 30% to around $90 a barrel. This move has been driven by new Saudi and Russian voluntary crude oil supply cuts, which are in addition to reductions agreed by the Organisation of Petroleum Exporting Countries (OPEC+) in April.[3]

Supply cuts are happening at a time when the US Strategic Petroleum Reserve (SPR) is at its lowest level since the mid-1980s. The SPR is only supposed to be used in times of serious supply disruption and not for domestic issues; however, the Biden Administration tapped the reserve to lower gasoline prices ahead of last year's US mid-term election. At some point, the SPR will need to be refilled, which could drive crude oil prices higher. Nevertheless, economists have a benign view on inflation. The consensus forecast is for world Consumer Price Index inflation to slow to 4.3% in 2024, down from 6.0% in 2023 and 8.7% in 2022.[4] While the pick-up in crude oil prices could delay the deceleration in inflation, the downward trend remains intact.

Reassuringly, surveys of inflation expectations continue to ease. For instance, the YouGov household survey of one-year UK inflation expectations is currently 4.4%, compared to a peak of 6.3% in August 2022.[5] This suggests that inflation expectations are anchored down to lower levels, reducing the risk of inflation becoming entrenched. That should decrease pressure on the Bank of England to raise interest rates significantly from here.

A key market uncertainty is that interest rates have been raised at breakneck speed and there are variable and unknown lags between hikes and the impact they have on the economy. The Federal Open Market Committee raised its 2024 interest rates projections in its latest forecasts, indicating that rates would remain higher for longer – *see Market highlights*. While tight monetary policy is intended to slow the economy down, a recent paper from the Federal Reserve Bank of Chicago shows that most of the effects on output from policy tightening in this cycle have already happened. The analysis also finds that inflation can come back to the Fed's target range without causing a recession.[6]

On balance, while rising crude oil prices are a risk, inflation is still set to slow. This means central bankers should be under less pressure to raise interest rates next year. Given that global growth is holding up, and companies continue to deliver on earnings, equities could grind higher.

New 'BRICS' on the bloc

In the *November 2022 Investment Outlook*, we discussed how some countries from the emerging world were seeking to challenge Western economic dominance through the 'BRICS', an alliance of Brazil, Russia, India, China and South Africa formed in 2010. This contest between emerging countries and the West has intensified following the recent BRICS summit when the grouping was expanded to include six new countries—Argentina, Egypt, Ethiopia, Iran, Saudi Arabia, and the United Arab Emirates (UAE)—as full members from 1 January 2024. To put this in context, the expanded BRICS-11 bloc will account for 46% of the world's population and 29% of global GDP.[7]

The addition of Iran, Saudi Arabia and UAE is crucial. Collectively, the BRICS will now be a major energy producer (and consumer), accounting for 68%, 42% and 38% of the world's coal, crude oil and natural gas output, respectively.[8] Some commentators have argued that this expansion is a geopolitical move, giving the bloc the option to 'weaponise' energy against the West. Many of these countries were alarmed at how the US cut off the bulk of the Russian economy from access to the US dollar settlement infrastructure after its invasion of Ukraine. Some of the BRIC countries may be worried that they too could be subject to Western sanctions in the future. Essentially, the BRICS want to reduce dependency on the US dollar and carry out more bilateral trade in their own currencies.

Although there are plenty of disagreements within the BRICS-11, the group's rising economic standing is a challenge to the Western-led world order. The war in Ukraine and resulting sanctions have strengthened relations between Beijing and Moscow. Only time will tell if these new BRICS on the bloc are made of the right stuff!

Ultimately, geopolitics will play an increasing role in shaping market risks (for example, higher inflation as firms move supply chains onshore), but it also creates opportunities for investors (for example, defence spending) – See *Implications of a changing world order* in our Megatrends series for more details on what this could mean for investors.

Sources:
1,3,5 LSEG/Evelyn Partners
2 IMF, One hundred inflation shocks: seven stylized facts, Anil Ari, Carlos Mulas-Granados, Victor Mylonas, Leve Ratnovski, and Wei Zhao, September 2023
4 Bloomberg
6 Federal Reserve Bank of Chicago, Past and future effects of the recent monetary policy tightening, Stefania D'Amico and Thomas B. King, Sept 2023
7,8 What I learned this week, 24 August 2023

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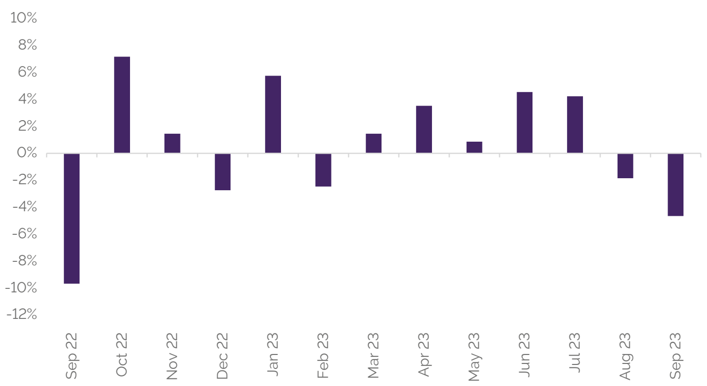
Market highlights

Equities

The S&P 500 posted its worst month of 2023, with the index falling 4.7% in US dollar terms.[1] Some of this weakness may be attributed to the US Federal Reserves' higher-for-longer stance on interest rates. Higher interest rates typically weigh on equity valuations as any future earnings are discounted at this higher rate. This means investors require lower share prices as future profits become relatively less valuable. Despite this weak monthly performance, the S&P 500 is up 12% for the year.[2]

S&P 500 discrete monthly performance

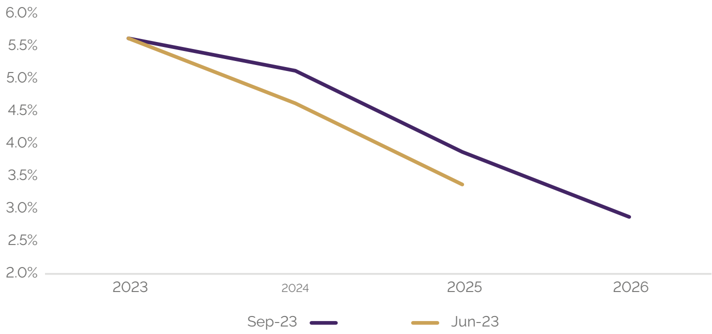


Source: LSEG/Evelyn Partners, as at 2 October 2023
Performance calculated on a price return basis in US dollars.
Past Performance is not a guide to the future..

Fixed income

The Federal Open Market Committee (FOMC), who are responsible for setting US interest rates, met in September and kept the upper bound interest rate unchanged at 5.5%.[3] Despite the seemingly good news of the long-awaited interest rate 'pause' materialising, the forward projections issued by the committee startled markets. The FOMC members' median interest rate projections were revised up by 50 basis points for both 2024 and 2025 compared to June's projections. A key driver of these revisions is the US economy, which is performing more strongly than expected. This higher-for-longer stance means interest rates are expected to remain above 5% throughout 2024. The revised guidance has helped push government bond yields higher, with 10-year treasury bond yields reaching 4.75%, their highest rate since 2007.[4]

FOMC median interest rate expectations

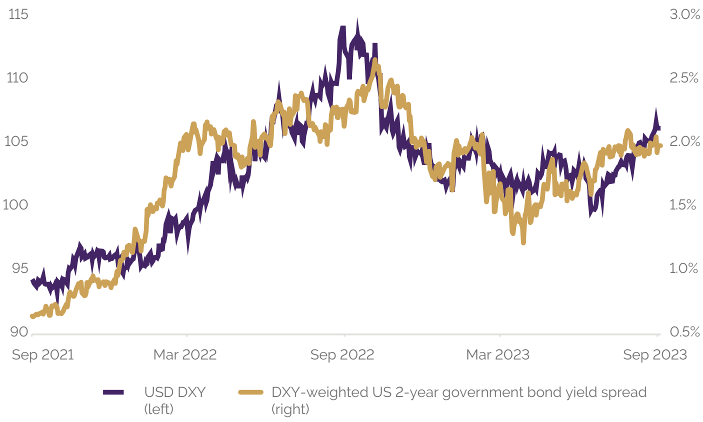


Source: LSEG/Evelyn Partners, as at 2 October 2023
Past Performance is not a guide to the future..

Currencies and commodities

While the 'higher for longer' interest rate stance has been unfavourable for equity and bonds valuations it has boosted the US dollar. 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. The 'spread' between the two-year government bonds from other developed economies (eurozone, UK, Japan, and Canada) and US government bonds has widened in recent months. This caused the greenback to strengthen as demonstrated by the US Dollar Index (DXY), which measures the value of the US dollar against a basket of global currencies.

US DXY and US DXY-weighted* 2-year government bond yield spread



Source: LSEG/Evelyn Partners as at 2 October 2023.
**Includes eurozone, UK, Japan and Canada*
Past performance is not a guide to future performance.

Sources:
1-4 LSEG Datastream/Evelyn Partners

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-0.4	0.7	11.0	49.8
MSCI UK	3.0	2.6	14.2	23.2
MSCI UK Broad	2.4	2.4	13.9	18.1
MSCI USA	-1.1	1.0	11.2	71.1
MSCI Europe ex UK	-1.2	-2.0	20.0	37.4
MSCI Japan	1.8	2.7	15.6	20.5
MSCI Asia Pacific ex Japan	0.6	-0.8	1.2	17.3
MSCI Emerging Markets	1.1	1.3	2.6	11.9
Bonds				
iBoxx GBP Gilts	-1.0	-0.8	-2.4	-19.2
iBoxx USD Treasuries	1.3	0.7	-9.5	6.2
iBoxx GBP Corporate	0.2	2.5	8.7	-3.6
Commodities and trade-weighted currencies				
Oil Brent Crude ($/barrel)	9.9	28.1	8.3	15.3
Gold ($/ounce)	-4.4	-3.1	10.9	55.8
GBP/USD	-3.7	-4.0	9.3	-6.4
GBP/EUR	-1.3	-1.1	1.2	2.7
EUR/USD	-2.5	-3.0	8.1	-8.8
USD/JPY	2.5	3.2	3.1	31.4

Market commentary

Oil had another strong month with Brent Crude rising 9.9% in September as previous OPEC+ supply cuts and a stronger US growth outlook helped push prices higher.[1] This rise in oil prices was good news for the UK equity market, which is tilted towards 'old world' energy stocks, with the MSCI UK index gaining 3% for the month in sterling terms.[2] A weakening sterling was also favourable for UK equity values - sterling fell against the US dollar and euro as the Bank of England surprised markets by deciding not to hike interest rates at their September monetary policy meeting. Gold slipped 4.4% for the month, as the FOMC's higher-for-longer stance weighed on the zero-yielding asset, leading to the yellow metal's worst week in two years to round out the month.[3]

Sources:
[1-3] LSEG Datastream/Evelyn Partners

Key macro data	Latest	2023 Consensus forecast	Spot rates	30-Sep	Yields (%)	30-Sep
UK GDP (YoY%)	0.56	0.40	GBP/USD	1.22	MSCI UK	4.05
UK CPI Inflation (YoY%)	6.70	7.50	GBP/Euro	1.15	MSCI UK broad	3.98
Bank of England Base	5.25	5.35	Euro/USD	1.06	10 Year Gilt	4.44

The market commentary, values and charts as at 30 September 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: LSEG Datastream/Bloomberg

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