Investment Outlook

A monthly round-up of global markets and trends

December 2023

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Investment outlook

"It's the economy, stupid!"

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Despite higher interest rates and conflicts in the Middle East and Ukraine contributing to global economic uncertainty this year, investors took comfort from an impressive set of company earnings in the third quarter of 2023. In the US, 83% of S&P 500 companies beat analyst earnings expectations, which was above the 10-year average of 74%. Importantly, they expanded on an annual basis for the first time in a year, led by double digit gains for the consumer discretionary sector[1]. European companies also unveiled a solid earnings picture, where Earnings Per Share (EPS) came in above trend.

To quote James Carville, a key political strategist for Bill Clinton's successful US presidential campaign in 1992, the reason companies have been able to deliver on the earnings front is largely due to "the economy, stupid!" The backdrop of third quarter US nominal GDP (real GDP plus inflation) growing by 6.3% from a year earlier proved conducive for companies to lift their top-line sales and beat profit expectations[2]. Companies have effectively turned a cost of living crisis into a corporate boom by raising prices, which in turn boosted revenues. All of this has been possible due to rising after-tax income from near full employment. Unspent 'excess' savings left over from government handouts during the pandemic plus pent-up demand have also helped consumer spending.

On the profit margin front, companies have been able to pass on greater wage costs to consumers. Non-financial US firms currently pay around 58 cents of every dollar of sales on labour costs, slightly lower than the pre-pandemic level in 2019 and below the peak of 66 cents in the fourth quarter of 2000[3]. Since then, workers' demands for higher pay have failed to keep up with business productivity gains that have arisen for several reasons. This includes tech-led investments made during the 1990s, which drove productivity growth. Furthermore, technology has increased the availability of labour supply in the global economy via outsourcing (for example, IT services in India) and the emergence of job search engines to efficiently match jobs with applicants. China's accession to the World Trade Organisation in 2001 also kept manufacturing production costs down through offshoring. The combination of these factors has structurally weakened workers' bargaining power over pay and enabled listed companies to maintain elevated profit margins.

Looking ahead, economists expect US nominal GDP to slow to around 4% in 2024 on lower predicted inflation. If these expectations are met, and companies maintain a tight grip on labour costs, listed companies should continue to report positive earnings growth. Nevertheless, stocks still face headwinds from three key areas that could place downwards pressure on valuations.

First, the bond market. The combination of restrictive monetary policy and sizeable government borrowing has driven US Treasury real yields (inflation adjusted) up to levels not seen in over a decade. Higher yields are typically a drag on equity valuations, as future cashflows are less valuable when a higher interest rate is used to value them.

Moreover, there is an argument that government bond yields could stay elevated due to public deficit financing needs. There is no sign that the US Congress is willing to materially scale back government spending. This comes at a time when the 2024 federal budget of $7 trillion would make the US Government the world's third largest economy – and when current total US public debt exceeds the GDP of China, India, Japan and Germany combined![5] It shouldn't be a surprise that Moody's, the credit rating agency, recently downgraded the US sovereign credit rating to reflect the country's deteriorating fiscal outlook.

Second, is the risk of a deep recession. The major challenge for markets is that interest rates have been hiked at breakneck speed and there are variable and unknowable lags between policy implementation and effect. Even so, corporates and consumers have benefitted from lower borrowing costs after central banks slashed interest rates to near zero during the pandemic. By borrowing smartly, many corporates issued debt at low rates and extended bond maturities, which is now insulating them from refinancing at the higher rates we are seeing today.

Similarly, for consumers the effective interest rate on outstanding five-year fixed rate mortgages in the UK is 3.2%, lower than the 5% rate available on new products[5]. When these existing fixed-rate mortgages end and households move into new higher-rate products, the average mortgage rate will increase. However, the full impact of higher rates on consumers could be avoided if inflation continues to decelerate, leaving the Bank of England (BoE) in a position to cut interest rates in 2024. This is looking possible, as UK October CPI annual inflation is down to 4.6%, its lowest rate since October 2021 – and is closer to the BoE's target rate of 2%[6].

Third, and finally, there is a lack of market breadth. In the US, the market capitalisation-weighted S&P 500 stock market index is up 19% year to date, lifted by the likes of Microsoft and Alphabet (the parent company of Google)[6]. Both are up more than 50% thanks, in part, to the Artificial Intelligence (AI) theme[7]. In contrast, the equal-weighted S&P 500 index, where each company contributes equally to performance, has increased by only 5% this year[8]. This suggests that US stock performance has been narrowly based, and could be vulnerable to correction should investor sentiment sour on AI-related stocks. However, the longer the US economy continues to defy pessimistic forecasts, the greater the chance of a broadening to the rest of the market outside of the AI boom.

In summary, if inflation drifts back to lower levels and money market expectations are correct, it could mean that interest rates are cut in the US, UK and eurozone in the second half of 2024. This would reduce a key market risk and allow investors to focus on economic and company fundamentals. Carville's slogan about the importance of the economy remains just as crucial to investors today.

Sources:
[1,2,4,5,6,7,8] LSEG Datastream/Evelyn Partners
[3] Bloomberg

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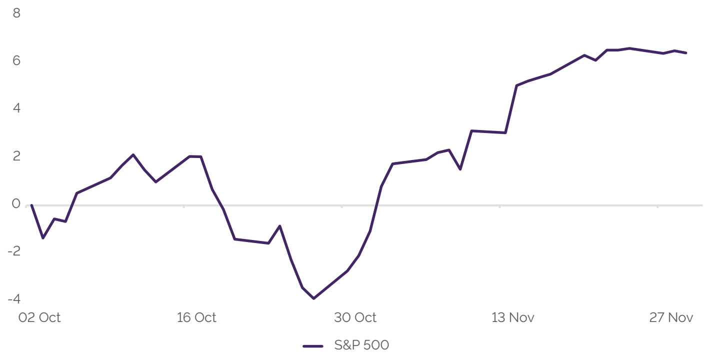
Market highlights

Equities

Investors have taken the recent run of softer economic data as confirmation that the US Federal Reserve's (Fed) interest rate hiking cycle has reached its conclusion. October's US employment report provided fresh evidence that demand for workers is cooling and wage growth is moderating towards a level consistent with the 2% inflation target. Meanwhile, US CPI inflation in October decelerated at a faster rate than markets had been expecting. As a result, money markets are no longer pricing in additional interest rate hikes and have instead started to anticipate rate cuts as early as March 2024. US equities responded favourably to this development with the S&P 500 rallying by 10% from its October trough. Lower interest rate expectations mean that future earnings are relatively more valuable, as they are discounted at a lower rate, allowing equity valuations to increase.

Performance of the S&P 500 (%, total returns, USD)

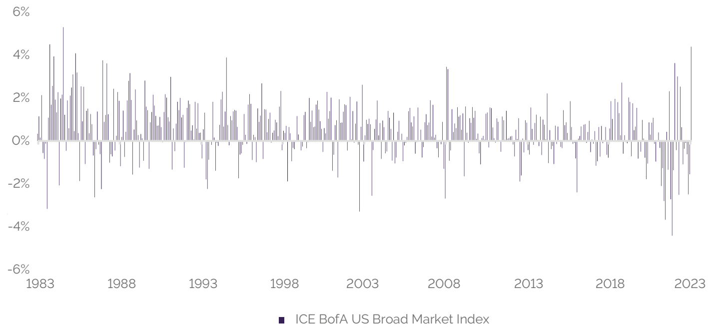


Source: LSEG Datastream/Evelyn Partners, data as at 30 November 2023
Past performance is not a guide to future performance

Fixed income

The downward movement in interest rate expectations also helped drive bond yields lower, with the US 10-year treasury yield falling nearly 75 basis points since the middle of October (yields move inversely to prices). This has been good news for fixed income investors more broadly. The ICE BofA US Broad Market Index, a measure of investment grade and USD denominated fixed income securities, gained 4.4% in November. This was the index's largest monthly gain since 1985 and provides a welcome respite to bond investors, who have been plagued by several years of negative returns. Since the first Fed interest rate hike in March 2022, the index has seen negative returns in 14 out of 21 months.

Discrete monthly performance of US investment grade bonds (%, total returns, USD)



Source: LSEG Datastream/Evelyn Partners, data as at 30 November 2023
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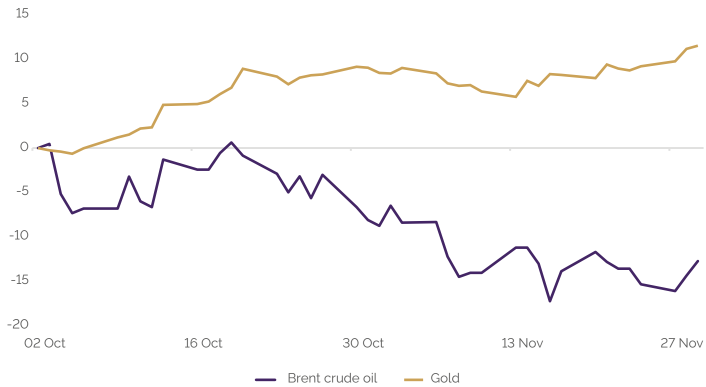
Currencies and commodities

The ongoing Israel-Hamas conflict has so far had a relatively limited impact on financial markets. Despite some initial price appreciation in global energy markets, the crude oil price has fallen back and is now trading significantly below its pre-conflict level. Gold, on the other hand, has appreciated. Heightened geopolitical instability and fears about a broadening conflict in the Middle East saw investors flock to the yellow metal, which has historically outperformed during times of uncertainty. Falling rate expectations have also provided another tailwind to the zero-yielding asset. The gold price has rallied by 11.6% since the beginning of the Israel-Hamas conflict, peaking just shy of $2,050/troy oz at the end of November.

Performance of gold and crude oil (%, USD)



Source: LSEG Datastream/Evelyn Partners, data as at 30 November 2023
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Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.7	1.8	5.9	59.4
MSCI UK	2.3	1.5	2.3	29.6
MSCI UK Broad	2.9	1.1	1.9	25.4
MSCI USA	4.9	2.0	7.5	81.9
MSCI Europe ex UK	6.3	1.8	10.0	51.5
MSCI Japan	4.1	1.7	9.2	28.3
MSCI Asia Pacific ex Japan	2.5	-0.9	-7.7	20.4
MSCI Emerging Markets	3.5	1.3	-1.6	15.3
Bonds				
iBoxx GBP Gilts	3.1	1.7	-6.3	-16.8
iBoxx USD Treasuries	-0.7	-0.1	-6.0	2.0
iBoxx GBP Corporate	3.5	3.6	3.1	1.0
Commodities and trade-weighted currencies				
Oil Brent Crude ($/barrel)	-7.8	-7.1	-5.5	37.4
Gold ($/ounce)	2.1	4.9	16.3	67.2
GBP/USD	4.3	-0.1	6.3	-0.8
GBP/EUR	1.1	-0.6	0.3	3.0
EUR/USD	3.2	0.5	6.0	-3.6
USD/JPY	-2.4	1.5	5.9	30.2

Market commentary

November was a strong month for equities, with the MSCI All-Country World Index returning 4.7% for the month[1]. Much of this strength likely came from market participants anticipating that the US Federal Reserve would cut interest rates sooner than they had previously expected. Despite a promising UK inflation print, which drove gilt yields lower, and prices higher, the UK equity market was the weakest of the major regions, but still expanded by 2.3% in November.[1] Falling oil prices drove the value of energy companies lower, of which the UK market has a high weighting. With US interest rate expectations declining relative to other economies in November, the relative attractiveness of assets in other global markets increased. This proved to be a headwind for the greenback, with the US dollar depreciating to $1.26 relative to sterling

Sources:
[1] LSEG Datastream/Evelyn Partners data as at 30 November 2023

Key macro data	Latest	2023 Consensus forecast	Spot rates	30-Nov	Yields (%)	30-Nov
UK GDP (YoY%)	0.61	0.50	GBP/USD	1.27	MSCI UK	4.13
UK CPI Inflation (YoY%)	4.60	7.40	GBP/Euro	1.16	MSCI UK broad	4.05
Bank of England Base	5.25	5.25	Euro/USD	1.09	10 Year Gilt	4.26

The market commentary, values and charts as at 30 November 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

Important information

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