ROYAL LONDON ASSET MANAGEMENT

Quarterly Market Review and Outlook

Quarterly Report
31 December 2023

Overview

- Economic attention over the quarter has been on inflation. At the start of the quarter investors focussed on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

- In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period. The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

- Data released in the UK in the fourth quarter painted a picture of sluggish economic activity, with falling inflation and more signs of softening underlying domestic inflationary pressure. Third quarter GDP fell 0.1% quarter-on-quarter after 0.0% quarter-on-quarter in the second quarter. PMI business survey data signalled some improvement in private sector activity though, with the composite PMI indicator rising back above the 50 'no growth' level. Inflation fell, and tended to surprise on the downside at headline level versus expectations: Year-on-year CPI inflation fell from 6.7% for the August release to 3.9% for the November release, largely due to year on year base effects. Core inflation fell from 6.2% to 5.1% over the same period. By the end of the quarter (the October data release) regular pay growth figures were showing more sign of slowing, at 7.3% for the 3-months to October (from 7.9% three-months earlier). The Autumn Statement saw the Chancellor add more fiscal stimulus (tax cuts) than expected, spending the 'windfall' from the impact of high inflation on tax revenues.

- The Fed kept rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, but with inflation continuing to cool. As of their December meeting, the median forecast of participants had 75bp of rate cuts in it for 2024 with a further 100bp of cuts pencilled in for 2025. Over the quarter, CPI inflation fell from 3.7% year-on-year in August, to 3.1% in November. That is still above June 2023 levels, but core continued a more consistent drift lower over the period. The core PCE measure of inflation fell over the quarter and month-on-month was only 0.1% in November. Third quarter GDP recorded a strong 4.9% quarter-on-quarter annualised growth. More timely economic activity indicators were mixed over the fourth quarter. The House passed a spending package that pushed the effective next government spending deal/shutdown deadline into early 2024.

- Over the fourth quarter, the ECB kept rates on hold. Going into the December meeting, various ECB speakers had already broached the topic of rate cuts, effectively opening the door for cuts in the second half of 2024 while pushing back on the chance of a near term cut. President Lagarde said that they did not discuss rate cuts in December and that "between hike and cut there is a whole plateau – a whole beach – of hold." Euro area CPI fell to only 2.4% year-on-year in November from 5.2% in August. Core CPI fell sharply over the same period too to 3.6%. The euro area economy (GDP) shrank by 0.1% quarter-on-quarter in the third quarter after recording only 0.1% GDP growth in both the first quarter and the second quarter. Germany's constitutional court put hurdles in the way of additional German government spending, ruling against the transfer of borrowing authorised during Covid to the Climate Fund (that decision was taken in 2021), in the name of protecting Germany's constitutional debt brake.

Global and UK government bonds

- Global government bond yields continued their upward path at the start of the fourth quarter of 2023 – a trend that began in mid-2020. This rise in yields reflected market views that persistent inflation would necessitate yet higher interest rates. With inflation starting to come down in the latter part of the year, expectations of rate cuts in 2024 meant that bond yields fell in November and December, ending 2023 at roughly the same levels as they started. In the US, 10-year treasury yields ended the year only modestly higher, at 3.88%, despite rising for most of 2023. Nonetheless, this represented a significant fall from the 15-year highs seen in the summer. German 10-year bunds similarly saw material falls in the fourth quarter, plummeting to 2.01% at year-end from a peak of 3% in early October.
- UK government bonds produced decent returns due to falling yields, delivering an 3.7% return (FTSE Actuaries) over 2023. This performance but this was heavily skewed to a strong final quarter, where returns topped 8.1%. In this fourth quarter the benchmark 10-year gilt yield fell to 3.54% from 4.44%. The falling yield environment was helpful for longer duration assets, with longer-dated bonds outperforming shorter-dated bonds in total return terms. However, when looking at changes in yields, 5-year maturity bonds were the best performing area, and the curve steepened.
- UK index-linked markets performed strongly over the quarter, returning 8.72% (FTSE Actuaries All-maturities). Falling inflation and expectations of rate cuts in 2024 helped push real yields lower. Real yields on UK 10-year bonds fell from 0.60% to 0.17% with 30-year real yields dropping from 1.48% to 0.95% while yields on US 10-year index-linked bonds fell from 2.23% to 1.76%.

Global credit and HY

- Global corporate bond markets saw a strong rally into year-end but this could limit performance from spreads in 2024. December continued in a similar vein to November with spreads and rates continuing their declines leading to another month of healthy returns – allowing 2023 to report double digit returns. Over the fourth quarter, the ICE BofAML US Corporate Index returned 7.91%, while in the euro zone and UK, the ICE BofAML Euro Corporate & Pfandbrief Index and iBoxx Sterling Non-Gilt indices returned 5.49% and 7.35% respectively.
- In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 6.47% in the quarter as spreads hit 400bps. At the end of the period, the index's yield-to-worst stood at 7.05%, having fallen from 8.20% at the start of the year. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 400bps, with a yield-to-worst of 7.7%. Over the course of 2023, high yield new issuance has totalled $175bn up from $106bn in 2022.

UK credit

- The sterling investment grade credit market (iBoxx non-gilt index) returned 7.35% over the quarter, helped by lower government bond yields and tighter credit spreads. The underperformance compared to the gilt market is the result of the shorter duration of the credit market index. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightened from 1.38% to 1.15% (iBoxx). Given the fall in yields, sectors with a greater proportion of long-dated bonds performed well, including utilities and social housing. Supranationals was the worst performing sector, while in financials, banks lagged slightly but insurance bonds modestly outperformed the market.
- Issuance was relatively low in the fourth quarter, reflecting usual seasonal patterns. For the year as a whole, sterling issuance was £63.9 billion, or £28 billion in net terms, compared with £51.5 billion and -£2.7 billion respectively in 2022. In euro markets, total issuance in 2023 was €608.3 billion, or €165.7 billion in net terms, compared to €536.9 billion and €94.9 billion respectively in 2022.

Equities, commodities, and FX

- Going into December, equities had sharply rebounded from their October lows as investor sentiment recovered thanks to the ‘bad news’ of weaker growth and inflation data, raising hopes of early and deep rate cuts in 2024.
- For the fourth quarter, the MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) produced positive returns for the quarter in US dollar terms. Looking at national MSCI indices, the strongest market was Sweden, while the weakest was China. In terms of style, the MSCI World Growth Index produced stronger returns versus the MSCI World Value Index.
- The price of Brent crude oil plunged by 19%, to $77.04 a barrel. Copper futures also declined a further 1.4% in dollar terms on the back of warning signs emerging of a weakening in global demand as China’s economic rebound stalls.
- The US dollar appreciated by 5.85% against the yen, by 4.34% against the euro, and by 4.44% against sterling. On a translational basis, sterling’s strength against the dollar impacts sterling investors in overseas assets as it lowers the returns over the quarter. However, the weaker dollar will benefit any emerging markets countries and companies that have borrowed in dollars.

Cash markets

- UK money market rates were generally flat during the quarter, with longer-dated rates generally falling slightly, reflecting changing market expectations – particularly after he lower-than-expected inflation print towards the end of the quarter. SONIA started the quarter at 5.18%, and remained at this level throughout the quarter, with no changes to UK base rates from the Bank of England. ICE Term SONIA three-month rates started the period at 5.29%, falling back marginally to 5.20% by the end of 2023, while two-year gilts, often seen as a proxy for market expectations of BoE rates, fell from 4.66% to 3.98%. Reverse repo rates were also steady over the quarter, at around 5.20% for high quality names.

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