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GMAPs

Quarterly Overview

31 December 2023

Overview

Market 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.

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.

Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields fell in November and December. The fall in yields was such that yields along the length of the curve ended the quarter lower than they started, and closed 2023 at roughly the same levels as they started. In the US, 10-year treasury yields fell from 4.57% to 3.88%, falling back from 15-year highs to reverse virtually all of the rise seen in the prior quarter. German 10-year bunds similarly saw material falls in the fourth quarter, falling from 2.84% to 2.01%.

UK government bonds produced strong returns due to falling yields, delivering an 8.1% return (FTSE Actuaries) over the fourth quarter with the benchmark 10-year gilt yield falling from 4.44% to 3.54%. The falling yield environment was helpful for longer duration assets, with longer-dated bonds outperforming shorter-dated bonds.

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.

Performance and activity

Asset allocation overview

At the tactical asset allocation level, we maintained an overweight position in equities over the quarter, having benefitted from this for most of the year. We also added to our position in bonds over the quarter, moving from underweight to overweight as softer data and dovish central bank comments saw markets reprice policy expectations for next year. Overweight positions in US equities and growth sectors also added value over the quarter. With much uncertainty around the macroeconomic environment heading into the new year, we continue to see great benefits in a well-diversified multi asset approach aiming to deliver positive risk-adjusted returns over the medium to long term.

Equities

Equity markets ended the year with another positive quarter to end the year up over 16%. Over Q4, the gains in equity markets were largely helped by a pullback in bond yields, as markets moved to expect more aggressive rate cuts next year. On a tactical level, we held a positive view on stocks for most of the year, viewing the underlying resilience of the global economy as supportive for the asset class. Our overweight position added value over the quarter.

Overview

Bonds

The tone from central banks over the majority of the year was certainly more on the hawkish side, this saw bond yields rise, with 10 US treasury yields even reaching 5% in October, their highest levels since 2007. However, as the year came to an end, more dovish commentary from central banks and downside surprises in economic data saw markets sharply move to expect more rate cuts in 2024, which led to a sharp move lower in bond yields. We entered Q4 being underweight bonds, but moved neutral over the first half of the quarter and then overweight into year-end as bond prices rose.

Equity regions

We have been overweight Japanese equities for most of 2023, which have benefitted from a weaker yen, loose monetary policy and improving corporate profits. We continued to prefer Japanese equities over the quarter, but reduced our overweight as yen started to rise on expectations of a policy shift by Bank of Japan, which weighed on Japanese equities. Our Japan position detracted value over the quarter. We re-established an overweight position in US stocks in Q4, as the region benefitted from a rally in growth sectors as interest rates fell; our US position added value over the quarter.

Equity sectors

The technology sector was the biggest beneficiary of the ‘2024 rate cuts’ rhetoric, followed by cyclical sectors. We increased our overweight position in growth stocks over the quarter. We also initiated an underweight position in the energy sector amid weakness in oil prices. Our sector positions continued to add value over the quarter.

Property

We remain positive on the long-term prospects for property within a diversified multi asset portfolio. However, in the near term, we see downside risks to the asset class as growth slows. We remained tactically underweight property on recessionary concerns. Commercial property was flat over the period. Elevated recession fears and the sluggish UK economy have continued to weigh on property, while hints of a potential BoE pause is seen as a positive signal for the asset class.

Outlook

While we expect headline inflation to continue to fall, but we are not expecting a return to the previous disinflationary world. We see a more normal new regime characterised by periodic spikes in inflation and short boom-bust cycles. Tactical asset allocation is important when business cycles are shorter given inflation causing more movement in interest rates. We benefitted from a positive tactical view in equities over most of 2023 as the macro backdrop proved resilient. However, risks remain, and markets have gone a long way into pricing in rate cuts and a soft landing. More defensive positioning could be necessary this year should growth weaken and the business cycle dip further into Reflation.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

The investment clock

TCFD climate report

Find out more

Royal London Asset Management's Outlook 2024 document and podcasts are both available on our website. In this year's Outlook document, our fund managers assess the challenges and opportunities in their respective asset classes for 2024. With an environment of falling inflation and modest recession, the benefits or risk for equities or credit is not so clear cut and knowing your companies is key. We analyse the areas of concern and potential growth within this environment.

In our Outlook 2024 podcast, Piers Hillier, CIO, looks ahead to 2024 and discusses the issues he believes will be prominent over the next 12 months, and where the key investment risks and opportunities may lie.

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

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