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GMAPs

Quarterly overview

30 September 2023

ROYAL LONDON
ASSET MANAGEMENT

Overview

Market overview

The third quarter was characterised by mixed data around the world, with central banks coming towards the end of their rate hiking path, but with cuts still seemingly a while away. The global economic picture is rosier now than it was at the start of the year, but global growth is spluttering again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust.

Inflation has fallen significantly and, although higher energy prices threaten a widespread revival in headline inflation, other factors – including a weak economic activity backdrop – should pull inflation lower still. With taming inflation still the priority for central banks, there is still a possibility of further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but peak rates look to be near, with real rates now well into positive territory.

The outlook is still lacklustre in the UK. A technical recession is still assumed for the UK in the next 12 months, but a modest one. There are still risks from the housing sector and consumer spending has yet to respond fully to tighter monetary policy. GDP growth has been weak since late 2021 and PMI business surveys point to deterioration, falling into recessionary territory over the summer. Inflation should fall significantly at headline level, but domestically driven inflation continues to look strong, despite higher interest rates. The labour market is starting to look less tight and lead indicators of wage growth suggest some slowing ahead but so far, pay growth remains much too strong to be consistent with hitting a 2% inflation target.

In the US, the real economy has been surprisingly resilient in the face of tighter credit conditions. However, the fourth quarter looks set to see a few growth challenges, monetary policy is restrictive and employment growth has slowed. A number of recession indicators are still flashing. Business survey data paints a mixed picture, with PMIs consistent with flattish growth while ISM surveys look more upbeat. Employment gains have slowed on the non-farm payrolls data and job openings have fallen a long way from their highs consistent with a less tight labour market. Housing-related activity remain subdued.

The euro area economy may already be in mild recession and forecasts continue to pencil one in. Business surveys have deteriorated and look consistent with falling private sector output. Tighter monetary policy will still be feeding through to the real economy. Bank lending conditions have tightened and loan growth has slowed. High domestically driven inflation continues to point to the balance of risks being in the direction of further hikes.

The sterling investment grade credit market (Non-gilt) returned 2.26% over the quarter, as the negative impact of higher government bond yields was offset by tighter credit spreads and the greater proportion of short-dated bonds (which performed well relatively to longer-dated equivalents) in credit indices. 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 1.48% to 1.38% (iBoxx). Banks and insurance bonds performed strongly in the quarter while senior insurance debt also enjoyed an impressive quarter. No sector saw negative returns, but real estate was broadly flat, and healthcare and transportation lagged other sectors. By rating, there was no standout performer in investment grade, with all bands posting returns between 1.8% and 2.5%. High yield bonds, however, saw a strong quarter, seeing returns of 3.7%. In duration terms, shorter-dated maturities performed significantly better than longer-dated equivalents.

Equity markets made losses over the period under review on fears that policy will remain tighter for longer than expected, which saw equities drop to their lowest levels since early June. Growth sectors have outperformed year to date but struggled against the backdrop of rising rates. The technology sector has fallen for three consecutive weeks during September. Japanese equities remain attractive relative to the emerging markets.

For the third quarter, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) produced negative returns for the quarter in US dollar terms. Looking at national MSCI indices, the strongest market was Japan, while the weakest was Eastern Europe. In terms of style, the MSCI World Growth Index produced weaker returns versus the MSCI World Value Index.

The price of Brent crude oil soared by 27.3% to $95.3 a barrel. Copper futures also declined a further 1.2% 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 3.5% against the yen, by 3.2% against the euro, and by 4.1% 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.

Overview

Performance and activity

Asset allocation overview

At the tactical asset allocation level, we moved towards a more neutral position in equities over the quarter but maintained our underweight in bonds as markets moved to price in higher interest rates for longer than previously expected. Our overweight position in equities has added value over the year so far but did lead to some losses this quarter. However, these losses were offset as our preference for Japanese stocks continued to add value at the regional equity allocation level, as did our preference away from defensive stocks at the sector level. Despite the current difficult macroeconomic environments, we see great benefits in a well-diversified multi asset approach aiming to deliver positive risk-adjusted returns over the medium to long term.

Equities

Global equities fell from year-to-date highs over the period, driven by fears that monetary policy will remain tighter for longer than previously anticipated, while worries around a potential US government shutdown compounded the sell-off in stocks. Our Investment Clock model stayed in its equity-friendly Recovery quadrant, that it entered earlier this year, with easing inflationary pressures accompanying “less bad” global growth data. We started the quarter overweight equities due to this more positive macro picture, but reduced positions towards neutral into the quarter end as volatility rose and equities lost momentum. Our initial overweight position saw us detract value in equities over the quarter.

Bonds

We were underweight bonds for the entirety of the quarter. We have maintained an underweight position in bonds as interest rates continue to rise which have been positive for our performance as rising yields leads to falling bond prices.

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, and increased our positioning as the quarter progressed, which added value over the period. We further re-established our underweight positions in emerging market and Asia Pacific shares, as economic data in China continued to surprise on the downside. These positions added value over the quarter.

Equity sectors

We maintained a broad preference for growth stocks over the quarter, although we took some profits on this position following strong profits year to date. We increased our underweight position in defensive sectors, which proved beneficial as these sectors continued to lag.

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, 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 have been overweight equities in the multi asset funds we manage since the Autumn 2022. While we have moved to more neutral positioning recently, we could look to buy dips should investor sentiment deteriorate further into depressive territory.

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

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. Notable publications in the third quarter include our annual Climate Report, as well as our annual Assessment of Value reports, available from the home page of www.rlam.com.

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