Winter 2023

market outlook.

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The UK Economy

UK equity markets were amongst the best performing globally in 2022 and encouragingly, they have had a strong start to 2023.

Appealing to investors recently has been the excess returns generated from businesses operating in the energy and commodity sectors. Additionally, retailers fared much better than anticipated over the Christmas period, partly as consumers were less impacted by covid versus prior years. However, retail sales were supported by poor weather and we anticipate a couple of tough quarters ahead. Winter has been tough for consumers, and 2023 is unlikely to see much improvement, as wages continue to lag inflation and higher interest rates feed through to higher mortgage payments.

Nevertheless, we remain confident we are near the latter stages of the interest rate cycle, which will remove some of the uncertainty still weighing on sentiment. In time, excess returns will moderate, as supply and demand imbalances fade and the economic backdrop improves. Consequently, there remains plenty of opportunity in depressed areas such as; retailers, travel & leisure, house builders, consumer goods and industrials. In the meantime, the UK is home to many companies operating in defensive sectors such as telecoms, pharmaceuticals, insurance and utilities.

2022 was a difficult year for UK policy makers, particularly politicians whose rash policy errors caused unnecessary investor anxiety. The quick and decisive action to reverse decisions and adopt a conservative fiscal approach has been well received and led to a recovery in Sterling and in time, will likely increase the appeal of UK domestic companies.

The Japanese Economy

The head of the Bank of Japan (BoJ), Haruhiko Kuroda, is set to finish his term and retire in April. With Kuroda being seen as one of the founding fathers of modern day Japanese monetary policy, the market is speculating a more hawkish stance from the BoJ going forward. However, this could be seen as an anomaly creating opportunity in the Japanese markets, as current monetary support underpins the little inflation that Japan has managed to achieve in the past 15 years.

Following the BoJ tweaking its bond yield control programme in December, it has emphasised that this is no indication of them taking a more hawkish stance and reducing policy support. The bank reaffirmed its long term 2% inflation target, and with stimulus at world record levels, yet current inflation sitting at a meagre 4% (consisting mainly of imported commodity driven inflation, and Yen weakness), any shift to policy tightening will likely breed deflationary pressures once again.

Historically, Japan has had a high turnover in leadership, seeing 10 leaders in the past 20 years, and seeing how Former Prime Minister Abe's longest term represented 8 years of that… its record of stability is fractious at best. Current Prime Minister, Fumio Kishida has seen his approval ratings dropping significantly in a mere 4 months since being elected due to defence spending plans. The plan is to increase defence spending by 60% over the coming 5 years, funded by the taxpayer. This comes ahead of the Lower House debating the next fiscal year's budget, which could put further pressure on Kishida's leadership.

The Yen (Japanese currency) has seen excess volatility in recent months on speculation of policy normalisation. With the BoJ allowing a 0.5% shift of the 10 year bond yield either side of its 0% target in December, since then, the broader market has been less devoted to the BoJ's commitment to support. In our mind, whilst the broader Japanese economy appears in disarray, the domestically focussed business can stand to benefit from the anomalies… as, whether December's shift was to control the currency or to test the waters of policy tightening, the result suggests the BoJ will continue with its record stimulus, despite the market assuming to the contrary.

The Emerging Markets & Asia Economy

The Indian markets were amongst some of the strongest in 2022, despite fears of valuations sitting higher than historical averages. However, with funding remaining progressive, and with current valuation metrics developing with the economy, the outlook remains attractive. With Government debt continuing to build with enhanced policy, the support looks set to only increase ahead of the 2024 elections as Prime Minister Modi seeks to garner the favour of the public. We have already seen over $122 billion committed to infrastructure spending for the next fiscal year and a further £4.3 billion to energy transition and security. With the country now registering as the most populous nation on the planet (overtaking China), these stimulus packages support a strong outlook for businesses.

Whilst it has been clear that China has been deviating from its hard lockdown policy for many months, in the past quarter we have seen President Xi Jinping formally drop its lockdown policies. Whilst many believe this came in the wake of the December protests from the Chinese public, China has slowly been reopening for months. With the Peoples Bank of China openly diverting its commitment and focus towards growth, valuations looking as some of the most attractive globally, and domestically-focussed policies pushing for capital to remain onshore, this stands to benefit the domestically-focused growth names over 2023.

It would be amiss for us to ignore the political tensions between the US and China. In recent months we have not only seen the restriction of semi-conductors into China from the US, partial Chinese Semi-conductor supply bans have also been imposed by Netherlands and Japan. However, it must be remembered that China is striving to develop its own hardware on the global stage. In addition, whilst US restrictions are harsh (which has seen China issue an 'unfair trade practices' complaint to the World Trade Organisation), Japan continues to enjoy strong economic ties with China on an industrial level, whilst European markets will be relying heavily on the China reopening story for consumption of consumer discretionary/luxury goods amongst other things.

January saw Lula Da Silva, the newly elected Brazilian President, take seat in office. Despite the mass protest from supporters of former President Bolsonaro causing a compression in the Latin American markets in the first few days of the year, this was merely noise for markets, seeing them become some of the strongest since. With Lula's previous leadership seeing him preside over similar issues that he faces today, his steps in appointing pro-business ministers in education, proposals to increase minimum wage, and also increase social spending (amongst other things) implies his new term could be as effective as his last.

The US Economy

2022 saw the US Federal Reserve (Fed) push through a rate rise cycle, arguably using external inflationary pressures as rational (despite interest rate rises having little effect on imported inflation). With interest rates in the US now sitting at 4.75% (upper bound), and natural inflationary pressures easing prices (CPI 6.5% year-on-year), the Fed have stated that they will remain data dependent, but all things being equal will set to reduce the pace of rate hikes. It could be thought that this may ease upward pressure on the USD (whilst keeping it stable), at the same time as easing recessionary pressures… all of this being said, it would be wise to expect pockets of volatility as markets digest economic data releases month to month, and try to predict the resulting Fed policy adjustments. Looking through this noise is key!

November saw the US midterm elections, as we expected, churn out a split house and senate. Whilst the Democrats retained control of the Senate, the Republicans took control of the House of Representatives. Historically, a split house/Senate has favoured US equity markets, as this has often meant change has been hard to push through… and given the volatility seen in the markets in recent years, lack of change could breed stability, which could again be seen to support equity markets. This, coupled with the circa $1.7 trillion federal funding package that was signed into law in December, will aid in not only supporting the domestic consumer, but also bolsters foreign aid to Ukraine.

US President Joe Biden (Democrat) has met with the Republican House leader, Kevin McCarthy, to discuss the mid-year debt cliff that the US face. Whilst in theory the US could lose the ability to refinance its debt as soon as June, effectively reaching its 'debt ceiling'… the reality is this is something that occurs regularly. Whilst talks are suggesting they will reach an agreement to increase the 'debt ceiling' which will prevent the shut down of national parks/monuments/public sector work etc., it has often been the case that an extension has been added prior to a twelfth hour agreement following. Whilst it is difficult to anticipate what will occur, it is likely there will be volatility in US markets mid-year (and at any juncture following an extension). So, even though US markets appear robust, it would be prudent to remain aware of the backdrop closer to the time.

With yield curve pressures creating uncertainty in the bond markets over the shorter term, it could be argued that the bond proxies of the past 15 years will be leaned on for stability by investors. In this scenario, despite valuations looking toppy, US stocks could potentially have a strong year driven by demand and an economy that is further along in the economic cycle. As, with cyclicality driven by the Fed and the economic cycle favouring value names, bond proxy treatment of growth/mega cap names, and government funding favouring small caps, the outlook appears to support stability… especially with the Fed policy arguably restricting deep recessionary risks.

The European Economy

Whilst it has conceivably been a quieter period for European markets compared to most, certainly from a political standpoint, 2023 has seen the European Central Bank (ECB) largely set out its intent. Whether driven by a weakening Euro/USD exchange rate, or by easing imported inflationary pressures, one could think that the window for raising interest rates significantly is narrowing. The ECB has clarified its intent at recent policy meetings that it will likely raise rates successively, and whilst it states persistent inflationary pressures as a reason (despite imported inflation easing), it also seems prudent to assume that the ECB has half an eye on what the US Federal Reserve has done, whilst also assessing currency pressures on inflation.

Valuations in Europe remain arguably the most attractive globally, however with the catalyst to release much of the upside likely to centre around the commodity pressures driven by the region's reliance on Russian gas (amongst other things), the short-term opportunity set could sit with specific sectors. With a rate rise cycle apparent, and the financials making up a large proportion of the European market, the banks stand to benefit from higher rates and lower valuations.

Even though global inflationary pressures are arguably easing through natural means, with Continental Europe's reliance on Russian gas seeing Germany reopen coal power stations and Spain impose energy usage restrictions (amongst other things), the mild winter appears to have masked the pricing pressures that the region is set to endure at some stage.

European markets have started 2023 robustly, largely off the back of the expectation of the Chinese consumer coming back online. However, one must continue to be aware of the remaining risks that are more apparent in the European markets than elsewhere. With energy pressures, tightening policy, consumer uncertainty, and an apparently more insular Chinese consumer, the short-term outlook for European markets is one of uncertainty.

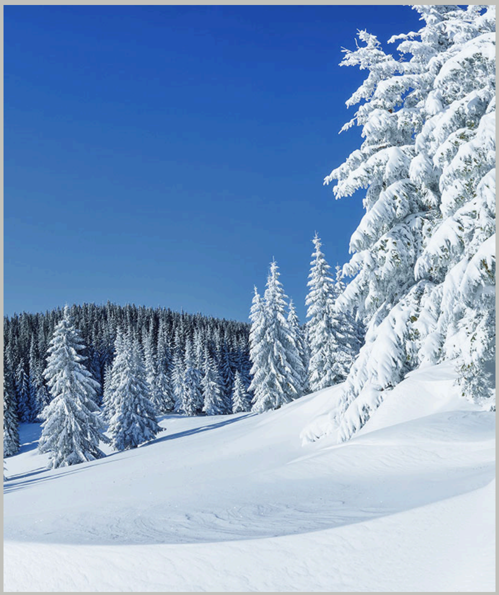
Fixed Interest

Government bonds have remained fairly volatile, but have rallied recently, as inflation has started to moderate across developed markets. It remains to be seen if central banks can keep interest rates at the levels they are still publicly saying they will, with a disconnect forming between central banks and market expectations. 2022 was a terrible year for corporate bonds, however they have performed well over the quarter, with bond prices recovering considerably. This has been particularly pronounced in the UK market, which was still digesting the mini-budget at the start of the quarter.

Looking at the year ahead. It seems like it will be a heavy year of issuance of government debt, particularly for the UK, so this technical factor could pressure UK bond markets.

For Corporate bonds, headline yields started the year much higher than they have for a number of years, and company fundamentals have improved in recent years. Investment grade companies look well positioned to navigate economic uncertainty in the short term. Many high-quality companies have already refinanced their debt needs for the coming year, so massive supply from these issuers is unlikely, particularly if the market weakens. Default rates for corporate bonds are still low, but unlikely to remain at the levels seen in recent years.

Overall, headline yields for corporate bonds do still appear relatively attractive, and areas of the market do still offer good value, but this must be balanced with the technical picture, and weakening developed market economies.



If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on 01423 501 401, Monday to Friday 9am-5pm or you can email us at info@mzltd.co.uk

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