



MARKET COMMENTARY - JUNE 2023

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There has been a notable decrease in market volatility in the last month, with global stock markets paring year-to-date gains. The MSCI All Country World Index declined 1% in May to leave 2023 returns at just under 11%.

Gauges of volatility on US stocks have fallen to their lowest levels in over two years, largely due to the avoidance of well-known risks materialising. Despite a game of brinkmanship, the federal debt limit was raised once again to avert a US default while fears around contagion in the US regional banking sector have also not transpired. This has caused futures markets to reprice the year-end Federal Reserve (Fed) funds rate to back above 5% - similar to the 5.25% currently - vs. 4% following Silicon Valley Bank's failure in March.

US stocks posted a 0.4% gain in May, boosted slightly for sterling-based investors by a roughly 1% drop in the pound against the US dollar. A growing level of hype

surrounding the benefits of Alternative Intelligence (AI) to workplaces and the broader economy caused sharp gains in some of the largest US stocks, with Nvidia hitting a market capitalisation of US\$1tn. Nvidia's stock surged over 30% in the days after announcing better than expected first quarter results and a sizable upward revision to its profit outlook, in the process becoming the sixth most valuable public company globally.

US first quarter earnings were also not as bad as feared, with a 2.1% year-on-year decline, better than the 7% drop forecast just a couple of months ago. US stocks were over 20% higher than the October 2022 lows in early June, fulfilling one definition of a bull market, but the lack of market breadth in the move has led to a growing number of commentators questioning the persistence of the rally.

Nvidia, along with just half a dozen other names, has accounted for almost all of the 12% return for US



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benchmarks in 2023. That these stocks are concentrated in the technology sector has led to natural comparisons to the dot-com bubble which burst in 2000, while sceptics with longer memories will recollect the “Nifty Fifty” boom that ended in the early 1970s. That said, besides these high-profile examples, periods of concentrated outperformance by the largest stocks have tended to be a good omen. Three-, six- and 12-month returns are all positive, on average, after five consecutive months of the largest five stocks outperforming the broader benchmark. While we believe market breadth is worth monitoring closely, we are not convinced that concentrated rallies are, in themselves, a negative sign for the broader market.

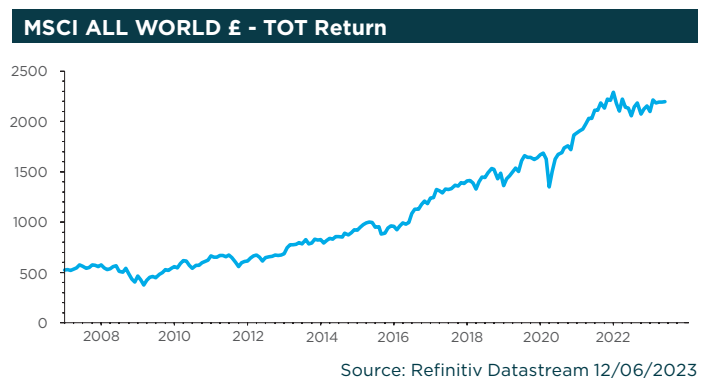
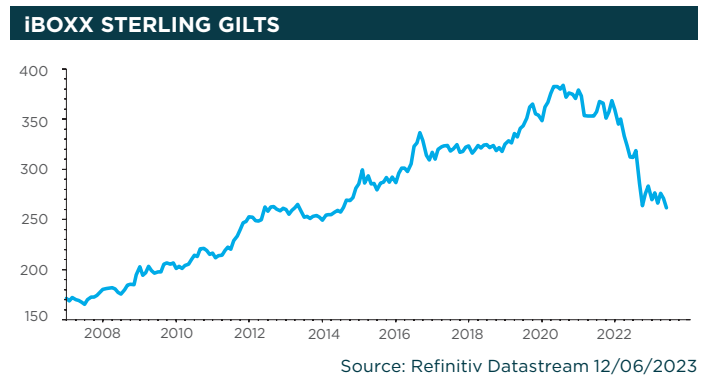
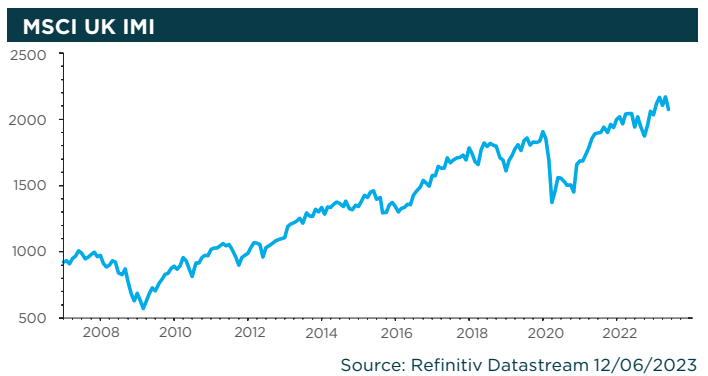
UK prices remain sticky

Unlike their US counterparts, the Bank of England (BoE) is expected to have to raise rates significantly higher in a bid to curb stubbornly high inflation, according to futures markets. Year-end pricing has the official bank rate at 5.5%, compared to 4.5% in early June. Inflation data has shown some improvement with the consumer price index falling to 8.7% annually in April after seven consecutive double-digit prints, but there is still a long way to go before it is back at acceptable levels for rate setters.

What is more, the same economic release also showed the core reading hit a new peak for the cycle at 6.8%, as more volatile aspects of the index, such as energy, have now become a downward force for the headline figure. The International Monetary Fund (IMF) expects inflation to remain sticky and could take three years to return to the central bank’s 2% target. Meanwhile, the UK economy is holding up much better than feared, with the IMF joining the BoE in revising its forecast to now predict that a recession will be avoided.

UK government bond prices have drifted lower in response, particularly at the short-end of the curve as the yield on the two-year gilt has moved back up near 4.5% - around the levels seen last Autumn during the fallout from Kwarteng’s “mini-budget”. The yield on the 10-year gilt increased 46 basis points in May after starting the month around the same level it began 2023 and ending the month just below the 4.2% level.

UK stocks experienced some notable selling during May as benchmarks ended the month down 5%. One of the main contributory factors for the decline seems to be the re-emergence of market pessimism on Chinese economic prospects. Beijing’s easing of Covid-19 restrictions earlier this year caused a sharp upswing in sentiment, but this has ebbed away as 2023 has progressed with activity in the world’s second-largest economy failing to match lofty expectations, leading to the return of a more downbeat view among investors. This has adversely affected mining stocks and oil majors that comprise a significant weight within UK indices.



Along with concerns surrounding China, broader demand worries for crude oil have been stoked further by declining gauges of manufacturing activity. Brent, the international oil benchmark, continues to trade around its lowest level since the start of 2022 – lower than when Russia invaded Ukraine – in the mid US\$70s a barrel. The easing of recession fears in the UK, continental Europe and the US has done little to boost prices and in early June Saudi Arabia announced its second production cut in a matter of months in an attempt to support prices. Saudi Arabia finds itself as the de facto leader of OPEC+, due to its high-volume yet lost-cost production, and will cut its output to 9m barrels per day in July, down from approximately 10.5m barrels per day in April. Maximum output for the country is estimated to be in the region of 12m barrels per day.



Land of the rising sun

Japan is attracting a growing amount of interest from international investors after stock benchmarks returned to levels not seen since 1990. This strong performance has been underpinned by three key factors; a shift in corporate attitudes, the return of inflation and investors becoming more concerned with Chinese holdings.

Firstly, Japanese firms are starting to place a greater emphasis on satisfying shareholders, with increased pressure coming from authorities and activist investors, to focus on boosting market returns. Secondly, while the impact of inflation has caused sharply higher interest rates in much of the western world, the Bank of Japan has become something of an outlier, steadfastly maintaining its benchmark rate close to zero. The third pillar is that recent developments in China have caused a relative increase in the attraction of Japan as a market offering exposure to the Far East.

In summary, we believe the macro picture is not the clearest of late, with the strength of labour markets pleasing but optimism is tempered by manufacturing data pointing sharply lower. Inflation remains sticky, particularly in the UK but also to some extent in mainland Europe and the US. Physical goods demand has abated, as also seen in the slowdown in manufacturing activity although demand for services like eating out and enjoying experiences continues to be strong. This poses a bit of a dilemma for central banks as they are generally seen as nearing the end game in this rate increasing cycle. Market expectations are shifting towards interest rates coming back down more slowly, rather than more increases ahead. Equity valuations are modest but not that cheap on the whole and the euphoria surrounding AI is a potential cause for concern – as well as an opportunity. Fixed interest returns are as attractive as they have been in some time and from an asset allocation perspective, we maintain a fairly neutral stance.

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