QUILTER CHEVIOT

Market commentary January 2024

A stellar last couple of months meant that global stock markets ended 2023 firmly higher, with the MSCI All Country World Index delivering a 16% return, in sterling terms. The Q4 rally was largely based on a growing expectation of a significant reduction in interest rates in 2024 as central banks look to change tack in the belief that they have done enough for now in the fight against inflation. The move in equities was supported by strong gains in bond markets, with UK investment-grade corporate bonds in particular delivering sizable returns of 9.7% on the year.

While the catalyst for recent gains has been a dovish shift among rate setters, a "soft landing" is only possible because most major economies have fared better than feared in the higher interest rate environment. The UK defied widespread forecasts for a recession, the US posted solid growth figures and even though the European Union may have slipped into a recession, if it has it has been pretty shallow thus far.

The US stock market has been the standout performer, boosted by a handful of large tech companies at the forefront of Artificial Intelligence (AI). The performance of Alphabet (formerly Google), Amazon, Apple, Meta (formerly Facebook), Microsoft, Nvidia and Tesla have underpinned not only US benchmark returns, but also global indices due to their large weighting to the US (approximately 60%). US stocks ended 2023 20% higher, in sterling terms, with the aforementioned so-called "magnificent seven" tech companies responsible for roughly half the return and leaving 72% of stocks underperforming the benchmark. These firms have a collective weighting of around a sixth of the MSCI All Country World Index, a larger proportion than the cumulative weighting for all UK, French, Japanese and Chinese stocks!

This is seen in some quarters as posing a systemic risk, with the hype around AI likened to the tech-driven dotcom bubble which infamously burst in 2000. While we are aware of these views and continue to monitor developments closely, we do not currently subscribe to them. The size, scope and dominant market position these firms occupy, along with their existing operations mean they are ideally placed and unlike the .com bubble there are significant barriers to entry in the AI space and established companies.

For much of the year the outperformance of these stocks, barring Nvidia, was less driven by money chasing the next hot thing and more the notion that these firms are all well placed to weather a higher interest rate environment and slowing economy. Despite their size these businesses remain remarkably nimble and can implement change rapidly – such as Meta's swift cost cutting measures in the latter stages of 2022.

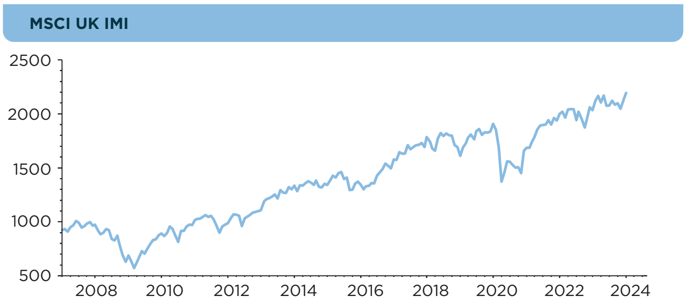
Pivot?

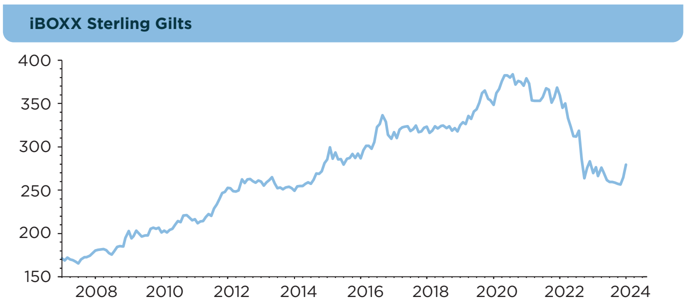
The US, as is often the case, is seen as the key player for global markets and interest rate futures are now pricing in a reduction in the Fed funds rate this year to under 4%, from its current 22-year high of 5.25%-5.50%. This, along with increased geopolitical tensions, has boosted the Gold price, which ended 2023 up 13.1% and near an all-time high, in US dollar terms.

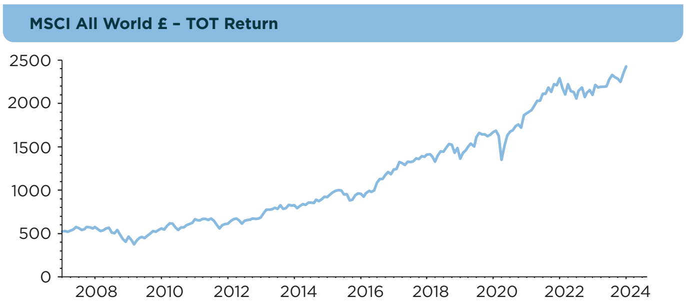
There is a risk that markets have gotten a little bit ahead of themselves in believing that once rates start being reduced, they will continue to do so. In our view, although inflation has moderated, core inflation is proving a little sticky and in the absence of deep recessions central banks will be reluctant to switch back to highly accommodative monetary policies.

Bank of England (BoE) rate setters have pushed back against these market expectations and this more hawkish stance, coupled with relative fiscal stability compared to 2022 has provided support for sterling with the pound to dollar exchange rate ending 2023 at 1.27, up 5.4%.

A stronger pound along with a slower than expected recovery in China weighed on UK stocks which lagged global peers with a 7.7% return. European stocks in general performed well, even if the 15% return of the MSCI Europe ex UK was slightly behind the global equivalent.







Source: Refinitiv Datastream 05/01/2024

UK bonds had a much more stable 2023 than the previous year, with gilt benchmarks delivering returns of 3.6%. The expectation that rates will stop rising and reductions are imminent has supported bonds and at current levels they are providing some ballast to portfolios. The long-end of the gilt curve and index-linked bonds underperformed slightly but still delivered positive returns while UK corporates thrived in an environment where economic growth surpassed expectations and rate cuts started to be priced in.

Conclusion

2023 was a good year for investors as pessimistic expectations were surpassed and financial markets priced-in not only an end to interest rate increases, but significant reductions in 2024. US equities were a clear bright spot as the world's largest economy recorded surprisingly good growth and large cap tech stocks benefitted from the growing interest in AI. While UK equities underperformed, they outperformed the previous year, and the rotation provides a good example of the benefits of holding a diversified portfolio.

After a tumultuous 2022, UK fixed income provided positive returns as the BoE paused its hiking cycle and interest rate markets began pricing in reductions from the middle of this year. Corporate bonds did best, thanks to the economy holding up better than expected.

Looking ahead, there is plenty of political uncertainty on the horizon with Britons set to go to the polls and the US election scheduled for early November. Signs of economic weakness are becoming more prevalent and we remain mindful that the full effect of higher interest rates may not yet be fully felt. Equity valuations are still fairly reasonable, although there is a concern that markets are still quite optimistic on earnings. Bond yields remain relatively attractive compared to much of the last 15 years and should economic growth slow further then they are well placed to cushion multi-asset portfolios.

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