

# Investment Views

NOVEMBER 2023

## Bonds are back, but don't write-off stocks

Will we witness the usual "Santa rally" this year or is the recent market pullback likely to persist and cause 2023 to finish on a down note?

After a decent first quarter most regional stock markets have struggled since early summer. Fears over China's beleaguered property sector coupled with concerns over "higher-for-longer" Western policy rates have bred uncertainty over a possible recession and dampened market sentiment. The result has been a six month slumber for equities with a few more downs than ups serving to frustrate investors still scarred from last year's hefty bear market losses.

There are, however, grounds for optimism as equities head into their typically strongest season. As Blackrock notes, dating back to 1957 the S&P 500 index has averaged a 4% gain in the final three months of the year, comfortably ahead of its average return for the other three quarters. With the index down just over 2% in October that infers a potential 6% rally over the next two months if the long-term quarterly average is to be achieved, but what could spark some festive cheer?

Starting with China, we maintain our view that fears over an economic meltdown are overblown. With property sales down 10%/y and more than half of the country's top 50 developers defaulting on their debts, the real estate sector will remain a drag for some time, but perversely this has become a boon elsewhere in the economy.

Faced with the risk of this developer distress spreading into the wider financial system, policymakers have overcome their prior caution to unleash a raft of stimulus that is starting to filter through. Nominal consumption growth has bounced back to its pre-Covid levels and, unlike in the West, these figures are driven by stronger activity and volume sales, rather than outsized price gains borne of an inflationary shock. Chinese service sector retail sales are currently expanding by 19%/y, forming a stable base for economic growth just as the manufacturing and trade sectors begin to perk up.

Further policy support should emerge over the coming months, likely extending what Gavekal Dragonomics have coined a "fragile stabilisation". The PBoC is the only major Central Bank consistently injecting liquidity into the financial plumbing and,

whilst this weighs on the currency, it significantly reduces the risk of an economic crash. Fiscal support is also intensifying with the recent issuance of an additional RMB1trn of sovereign debt helping to fund a growing list of local government investments, including infrastructure projects and targeted measures aimed at resuscitating property sales.

The general direction of travel for Chinese policy support is thus clear and the near constant drip feed of new initiatives, from both the monetary and fiscal authorities, suggests China's economy has the potential to surprise on the upside as we head into 2024.

Turning to the other major headwind that has weighed on markets of late; rising bond yields. We, like many, have been surprised at the resilience of private sector borrowers, given surging debt costs. US mortgage rates recently topped 8% for the first time in two decades, whilst the average APR on newly issued credit cards has reached a staggering 24% (source: lendingtree.com).

With total US credit card usage breaching US\$1trn for the first time ever, something will ultimately have to give and it already has in parts, judging by rising consumer loan delinquencies. However, at just 2.5%, the aggregate delinquency rate remains well below its 2008 high of 5%.

This is just one example that highlights how a robust labour market and, more importantly, a favourable debt rollover schedule (with many borrowers fixed in for years at ultra-low rates) argue against there being a sudden credit crunch. More likely is a steady drumbeat of re-financing pressures gradually emerging as those fixed-rate loans mature, but that trend could play out over several years and leave many economic actors (especially those with low or no debts) largely unaffected.

That's not to say the outlook appears rosy. Far from it as economic activity remains fragile across the globe and the risk of another inflation spike is growing. Few households or businesses could handle another surge in energy costs if the horrific events we are witnessing in the Middle East spread across the region and drive the oil price sharply higher.

Absent a second round of inflation, some relief could stem from a change in Central Bank policy. The rate hiking cycles are likely over in the UK and Europe, whilst Fed officials have in recent weeks been hinting that financial conditions are now sufficiently tight. One or two final US rate hikes are still possible, but the Fed's job appears almost done.

At the very least this would anchor short-term rates, which should limit the upside for longer-dated yields and comfort investors that the multiple de-rating that drove last year's market rout has run its course. This would leave a severe recession and profits contraction as the main threats to risk assets, but with China's economy set to rebound and higher borrowing costs failing to derail Western activity, the risk of a major downturn appears relatively low.

Even a modest improvement in growth expectations, that sees markets simply reprice the risks of a global recession, could be the catalyst for the normal year-end bounce and there is ample cash on the side-lines to fund it.

The latest Bank of America global fund manager survey (released in October) shows that the overweight bonds/underweight equities stance that has featured all year has become about as extreme as it's ever been. Furthermore, hedge fund positioning also remains largely "risk-off". Since the stock market correction began in late summer, influential CTA hedge funds (which adopt systematic and trend-following strategies) have shifted to one of their shortest exposures in US equities in over a decade.

If nothing else, such conservative positioning amongst large professional investors removes a key source of selling pressure and with money market balances at a record high (almost U\$6trn in the US alone), there is plenty of buying power to deploy whenever risk appetite returns.

On balance, there is a good case to be made for equity markets finishing the year on a firmer footing, but predicting such short-term trends is always fraught with danger. Looking at least 2-3 years out, there is a much stronger argument that equities remain one of the highest return prospects, but we also have sympathy with the view that a meaningful exposure to cash and short-dated bonds has merit, especially for funds that investors are likely to draw upon near-term.

However the next few months pan out, we will likely remember 2023 as the year in which bond investing returned to form and blending a long-term allocation to riskier equities with the decent "safe" yields now available on 2-3 year government bonds is a strategy that appeals given the uncertain economic and market backdrop.

## POLICY MATRIX SUMMARY

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high-level guide on where we stand at this time.

12-24 Month view	Equities	Bonds	Alternatives
+	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds	Inflation-linked US Treasuries Short-dated Paper	Gold, Volatility Strategies
-	European	European Japanese	

**MARKET PERFORMANCE**

All performance numbers show % changes except for bond yields which show yield changes.

	31st October 23	-1 Mth	-3 Mth	-12 Mth
<b>CURRENCIES (VS USD)</b>				
GBP	1.2153	-0.4%	-5.3%	6.0%
CHF	1.0984	0.5%	-4.2%	10.0%
AUD	0.6337	-1.5%	-5.7%	-1.0%
JPY	151.6800	-1.5%	-6.2%	-1.9%
EUR	1.0575	0.0%	-3.8%	7.0%
<b>BOND YIELDS (10 yr)</b>				
UK	4.51	0.07	0.20	1.00
US	4.93	0.36	0.97	0.88
Germany	2.80	-0.03	0.32	0.67
Australia	4.92	0.44	0.87	1.17
Japan	0.94	0.18	0.34	0.70
<b>EQUITIES</b>				
US. S&P 500 (USD)	4,193.80	-2.2%	-8.6%	8.3%
UK. FTSE 100 (GBP)	7,321.72	-3.8%	-4.9%	3.2%
MSCI Eur ex UK (Local)	1,529.02	-3.4%	-8.0%	6.8%
Japan. Topix (JPY)	2,253.72	-3.0%	-3.0%	16.8%
China. Shangai Comp (RMB)	3,018.77	-2.9%	-8.3%	4.3%
HK. Hang Seng (HKD)	17,112.48	-3.9%	-14.8%	16.5%
Australia. All Ords (AUD)	6,967.47	-3.9%	-8.6%	-1.2%
MSCI Pac ex Jap (USD)	1,152.84	-4.5%	-14.1%	0.8%
MSCI World (USD)	2,768.62	-3.0%	-9.6%	8.7%
MSCI World (GBP)	2,279.08	-2.5%	-4.4%	2.6%
<b>COMMODITIES</b>				
Oil (WTI)	81.02	-8.8%	0.8%	6.0%
Gold	1983.88	7.3%	1.0%	21.4%

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