FE Investments

MARKET NOTE: MARKET REVIEW 2023 DECEMBER 2023

2023 YEAR IN REVIEW: INFLATION AND RATES DOMINATED MARKETS AGAIN

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The last 12 months have proved eventful as financial markets continue to deal with the fall out of Covid-era disruption. Markets have experienced elevated levels of volatility as a combination of high inflation and aggressive interest rate tightening by central banks drove investor sentiment. Changeable conditions made this a challenging year for investment managers but strong performance by equity markets and an end to interest rate hikes in western economies provided some respite for bond markets after a tumultuous few years. In this review, we consider the key trends, challenges and opportunities that shaped financial markets in 2023.

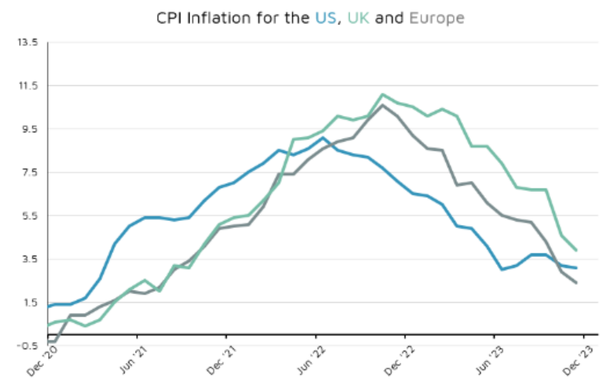
Inflation

The need to get inflation under control has been the driving force behind recent interest rate hikes from central banks around the world. Attention has been focused on the Federal Reserve, Bank of England and European Central bank but many other central banks have also aggressively tightened monetary policy over the last two years as Covid supply chain disruption and government stimulus pushed inflation to the highest that many countries had experienced since the 1970s and 1980s.

Headline consumer price inflation in the US peaked at 8.9% in June 2022 and at 11.1% in the UK and 11.5% in Europe later that year. Inflation has been slowing since then and the rate of decline has been closely watched as investors tried to gauge how far and how fast rates would rise.

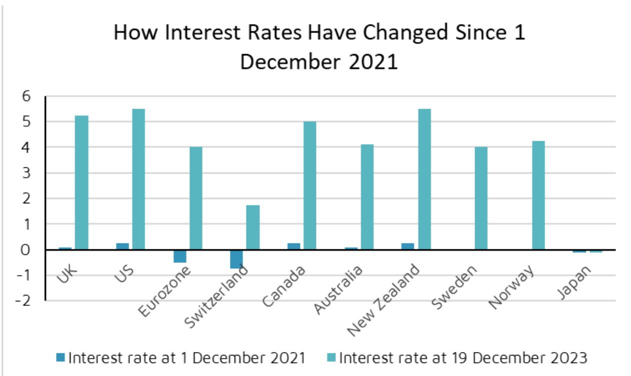
Inflation has proved more resilient than initially expected due to the sharp rise in the cost of services and rising wages, but the decline of goods inflation and sharp drop in energy prices since the second half of 2022 has seen inflation slow substantially in the final months of 2023. UK inflation has been more resilient than in the US and Europe but the rapid slowdown in October and November means UK CPI ends the year at 3.9%. As a comparison US CPI stands at 3.1% and European CPI is currently 2.4%.

Chart 1 - Inflation Has Fallen Steadily Over The Last 18 Months



Source: FE Investments, ONS, St Louis Fed and ECB. December 2023

Chart 2 - Interest Rates Have Increase Substantially



Source: FE Investments and national and central banks. December 2023

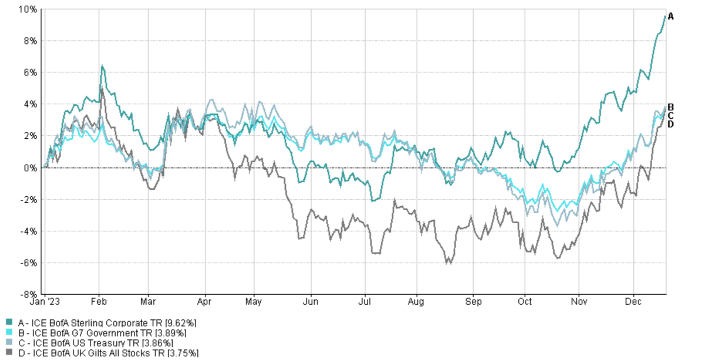
Central banks' rate hikes reach the end of the road

The swift decline of inflation in the latter part of 2023 allowed central banks to end the current hiking cycle. Central bankers are still warning markets not to get ahead of themselves as inflation is not yet back to its 2% target.

One of the most notable trends of the last two years has been the tension between where central banks indicate that rates need to be and where markets believe they are going to be. At times the two views have lined up but for much of the time the central bank narrative has been at odds with the outlook of bond investors. The higher for longer narrative has weighed on bond markets for much of the last two years and led to a sharp decline in bond values around March this year when investors seemed to capitulate and accept the central bank view.

Markets again appear out of sync with central banks as bonds have staged a strong rally in the final quarter of 2023 as they price in aggressive rate cuts next year.

Chart 3 - Bonds Have Risen Swiftly As Inflation Has Fallen Back



Source: FE Analytics. Total returns from 1 January 2023 to 20 December 2023 in local currency

Equity markets dragged higher by the magnificent seven

This year has been very positive for global developed equities. The warm weather last winter helped Europe avoid an energy crisis and European equities led the rally as recession was also initially avoided. The sustainability of US economic growth was also questioned but robust consumer spending and a very hot jobs market helped sustain positive momentum as US large tech firms helped lift the S&P 500. The US equity rally then picked up steam as investors saw opportunity in the rapid development of artificial intelligence. The rally was driven by a handful of stocks which were nicknamed the Magnificent Seven for their contribution to US markets this year. It is hard to overstate the effect that Apple, Alphabet, Nvidia, Microsoft, Meta, Tesla and Amazon have had on US and broad global share indices.

Chart 4 - US Tech Stocks Have Dragged Global Equities Higher

Source: FE Analytics. Total returns from 1 Jan 2023 to 20 December 2023 in local currency

Japanese stocks had their best year in some time as a combination of inflation rising back to target, signs of sustained wage growth and steady economic growth helped generate positive investor sentiment. The decline of the yen also helped attract overseas investors.

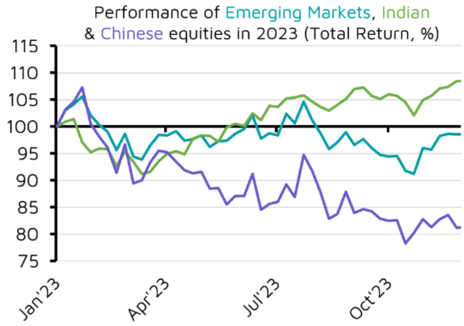
The expectation that central banks will soon begin cutting interest rates provided a considerable boost to equity markets and all sectors and regions were lifted by the broad equity rally in the final months of the year.

The UK lagged other developed markets as it continues to be dogged by higher inflation, declining exports and weak economic growth. Some sectors of the UK did well as firms able to pass on higher costs did well and rising interest rates boosted bank profits. There was a significant divide between the performance of large companies and of small and mid-sized firms and large caps outperformed for most of the year. However, mid-caps closed the gap as they benefited the most from the strong year-end rally. There was a split between different stock factors as cyclical and growth stocks have outperformed value and defensive stocks for most of the year. The end of year rally lifted most styles but cyclical stocks were the biggest beneficiaries and defensive stocks lagged as they fell out of favour among all the positivity.

China's stuttering economy dragged on emerging markets

Emerging market equities have struggled for most of 2023. The strength of the dollar drove up the cost of servicing corporate debt and increased the cost of many raw materials. In addition, global trade is yet to recover to pre-pandemic levels. This is particularly an issue for China and many of its biggest trading partners in south-east Asia.

Chart 5 - Chinese Equities Struggled As Indian Stocks Gained



Source: FE Analytics. Total returns from 1 January 2023 to 20 December 2023, in local currency

In addition, Chinese economic growth has been patchy. It remains on track for the official target of 5% GDP growth this year but this is a significant downward revision from previous years and is below what was expected 12 months ago when stringent anti-Covid measures had just been lifted. The country's property developers remain mired in difficulty as falling prices, uncompleted developments and problems accessing funding have eroded trust among potential buyers.

There were some positives among emerging markets as robust economic growth helped fuel a big rise in Indian equities. Latin

America also made strong gains due to steady economic growth in major economies such as Mexico and Brazil and cooling inflation allowed central banks to stop raising rates.

Commodities and real estate lagged

Rising interest rates always create a difficult environment for real estate and this year has been no different. Overall, commercial property values have fallen but there is considerable dispersion. Demand for the best industrial units remains robust but retail properties have not yet recovered from the Covid pandemic and rents are lower as demand remains depressed and there is a lot of availability. Office values have also fallen and the increasing numbers of people who work from home, at least some of the time, have further depressed demand. However, premium offices in the best locations remain sought after.

Commodities have had a mixed year. Many industrial metals have come under pressure due to weaker demand as global economic growth slows. Energy prices have seen little additional disruption from the ongoing war in Ukraine and from the outbreak of war in Gaza and the price of oil has fallen over the course of the year. Opec countries have attempted to restrict global supply to push up prices in the face of falling demand but supply from non-Opec countries means this had only limited success. The price of natural gas has fallen from the sky-high levels of 2022 as Europe has mostly replaced Russian exports with imports of liquified natural gas from the middle east and the US. UK and European prices are still considerably higher than pre-pandemic levels but are making progress back towards their long-term normal range.

Gold has made steady progress this year but the long-held view that it offers a good hedge against inflation does not really stand up to scrutiny. However, the potential for the Bank of England to reverse some of its recent rate cuts have given it a late boost and means the traditional safe haven asset is set to finish the year with a small gain.

Cash

The rapid rise of interest rates means risk averse investors have been able to benefit from some of the best returns available from the money market in some time. And as inflation falls below 4% returns have even turned positive in real terms.

Summary

The long equity rally of 2023 has repeatedly defied expectations. Fears of recession and that consumer demand would fade as pandemic-era savings are used up have failed to appear. Corporate profits have generally matched expectations and tech firms with exposure to AI have even managed to keep up with aggressive valuations.

The decline of inflation has been welcomed by financial markets as central banks are now expected to reverse some of the recent interest rate hikes.

As yet another volatile year draws to a close many investors will be able to reflect on an increase in the value of their investments. Investors with exposure to higher risk assets have benefitted from the strong run from US equities. The rally in government bonds in the second half of the year means that many investors with exposure to defensive assets will also end 2023 with significant gains. Markets are likely to remain volatile and the potential for a slowdown or recession still exists, but the sentiment in financial markets is much more positive at the end of 2023 than it was at the start of the year.