

Capital Markets Update

Autumn 2023

Global growth continues to defy prior downbeat expectations, but survey data suggest that activity weakened towards the end of Q3. Though headline inflation has generally fallen, core inflation remains stubbornly above central bank targets.

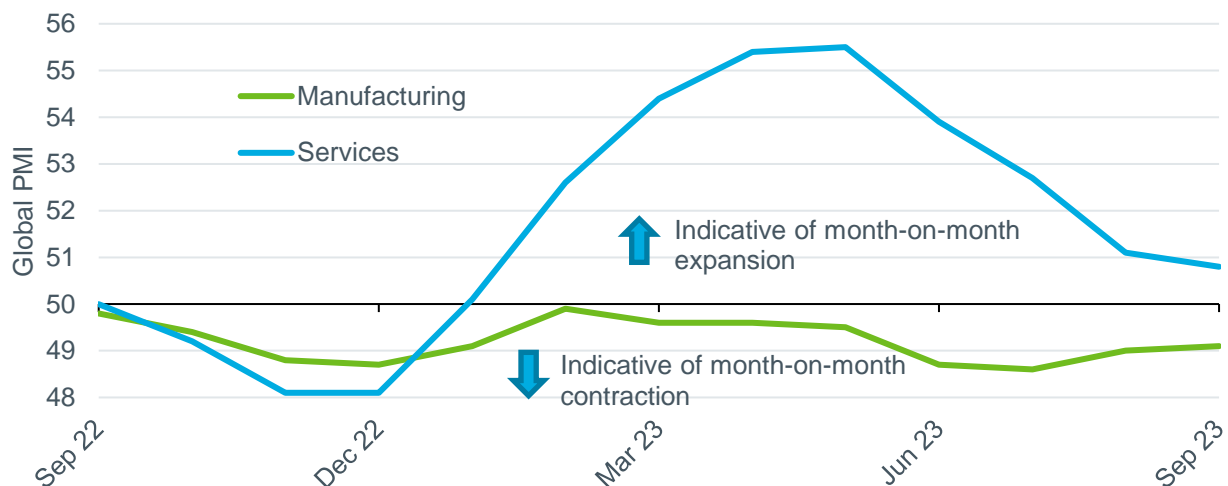
Global equity markets lost ground in Q3 and long-term sovereign bond yields rose, as markets anticipated a longer period of tighter central bank policy. Despite the weakening growth outlook, oil prices rose sharply on fears of a global supply shortfall.

Global themes

Global growth in 2023 has been subdued, even by post-Global Financial Crisis (GFC) standards, but more resilient than expected. Consumer spending exceeded expectations, particularly in the US; fiscal support dulled the impact of higher energy prices on European consumers; and China emerged from its zero-Covid restrictions earlier than hoped.

That said, purchasing managers' indices (PMIs) indicated that global growth eased throughout Q3 (Chart 1), as services activity 'caught down' with the contracting manufacturing sector. Consumer spending in developed economies has come under pressure as savings built up during the pandemic have been used, the delayed impact of interest-rate rises on disposable incomes grows, and the positive impulse from fiscal support wanes. As the Chinese post-reopening recovery faltered, the authorities unveiled modest economic stimulus measures, but the troubled property sector is weighing on consumer sentiment. Meanwhile, concerns about leverage limit the scope for debt-fuelled investment to support growth. Against this backdrop, we think growth is likely to slow further, due to the momentum of these factors.

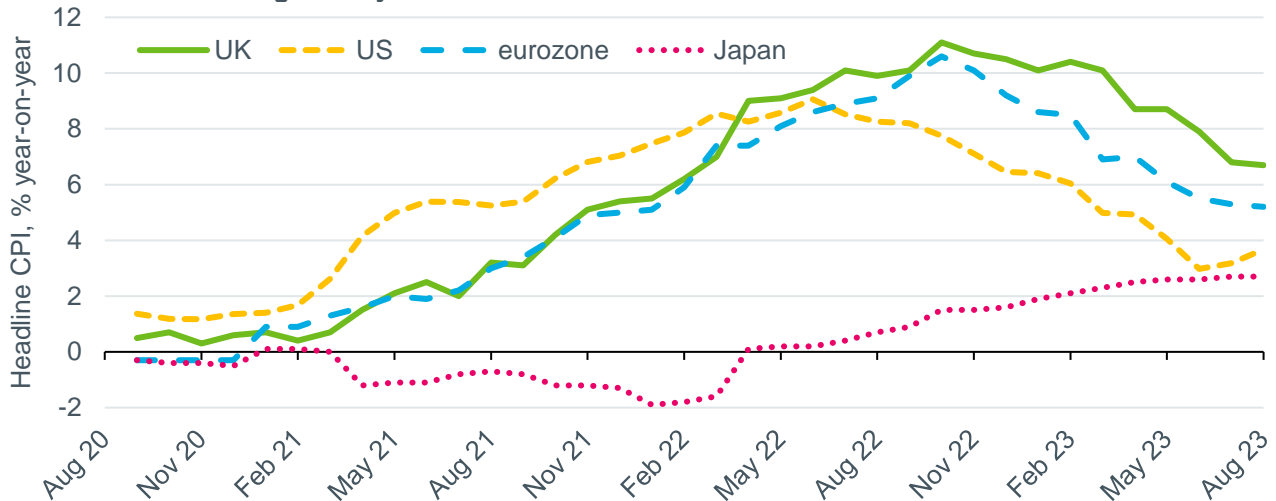
Chart 1: PMI data indicate that global growth slowed in Q3, as the services-led recovery lost steam



Inflation has generally stayed on a downward trend, but the recent sharp rise in oil prices led to an uptick in year-on-year US CPI inflation in August (Chart 2). Declines in energy prices have been a key contributor to the reduction in headline inflation over the last year, and so any reversal could slow the

downtrend. Central banks might choose to ‘look through’ the immediate impact of a temporary, supply-driven increase in energy prices. However, the risk of second-round effects, alongside sticky core inflation and tight labour markets, are reasons why central banks may proceed cautiously with rate cuts.

Chart 2: Inflation has generally continued to trend downwards but remains elevated



The US Federal Reserve and the Bank of England both raised rates by 0.25% pa, to 5.5% pa and 5.25% pa, respectively, in Q3. The Bank of England surprised markets by leaving rates unchanged in September. The European Central Bank raised its deposit rate twice, to 4.0% pa, but its cumulative tightening is still less than in the US and UK. Both the tone of central bank comments and market pricing suggest that policy rates are at or close to peaking, but subsequent cuts will be gradual. This will limit the potential boost to growth from looser monetary policy in 2024 and 2025.

Against this backdrop, we do not expect growth to collapse, but expect it to fall to a very lacklustre pace in 2024, followed by a modest recovery in 2025. While consensus forecasts for global GDP growth in 2023 have risen to 2.4% from 1.6% at the start of the year, 2024 global GDP forecasts have fallen to 2.1% from 2.5%, and we think a poorer outcome is very possible.

Government bonds

UK gilt yields fell at shorter terms, while long-term yields rose sharply. This is consistent with expectations that rates may peak at a lower level than previously expected, but stay there for longer. It also likely reflects a fragile technical backdrop of heavy global sovereign bond issuance. Indeed, given the weak real growth outlook and expected declines in inflation, we think the fundamental outlook for gilts has improved. In the presence of an independent central bank, and in the absence of catalysts that augur higher long-term real growth, we think longer-term nominal, and, to a slightly lesser extent, real, yields are reasonably attractive relative to fair value.

Chart 3: Inflation will be sticky and rate cuts gradual, but forward nominal rates have risen too far

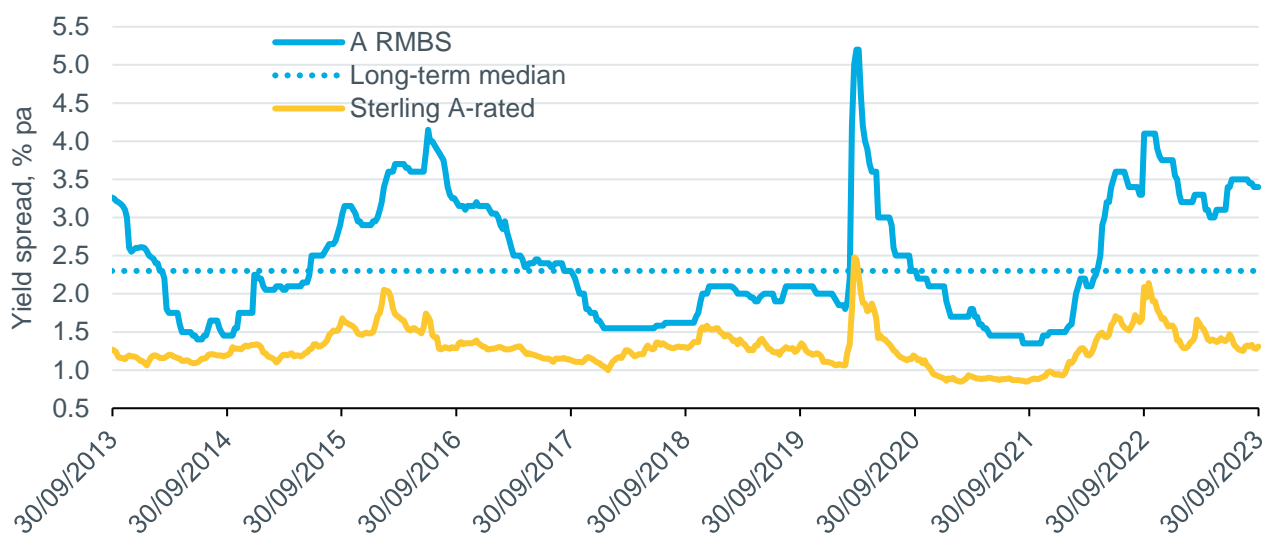


We have little issue with the near-term path of interest rates implied by the market, but we do not think interest rates will remain as high for as long as suggested by forward nominal yields (Chart 3). Given our belief that central banks will ultimately use the tools at their disposal to return inflation towards target, we also expect long-term implied inflation to fall. We think a decline in longer-term implied inflation is more likely to be driven by a fall in nominal yields than a rise in real yields.

Credit

With weaker corporate earnings and higher borrowing costs starting to make their mark on debt affordability measures – debt as a proportion of earnings is generally rising, while earnings as a multiple of interest payments is falling – the fundamental outlook for credit is challenging. However, expectations that growth slows but does not collapse, set against decent absolute levels for the aforementioned debt metrics, means that while defaults have risen long-term average levels, they are only expected to rise a little further, and default forecasts have been revised lower in recent months.

Chart 4: ABS spreads look attractive relative to their own history and equivalent corporate credit



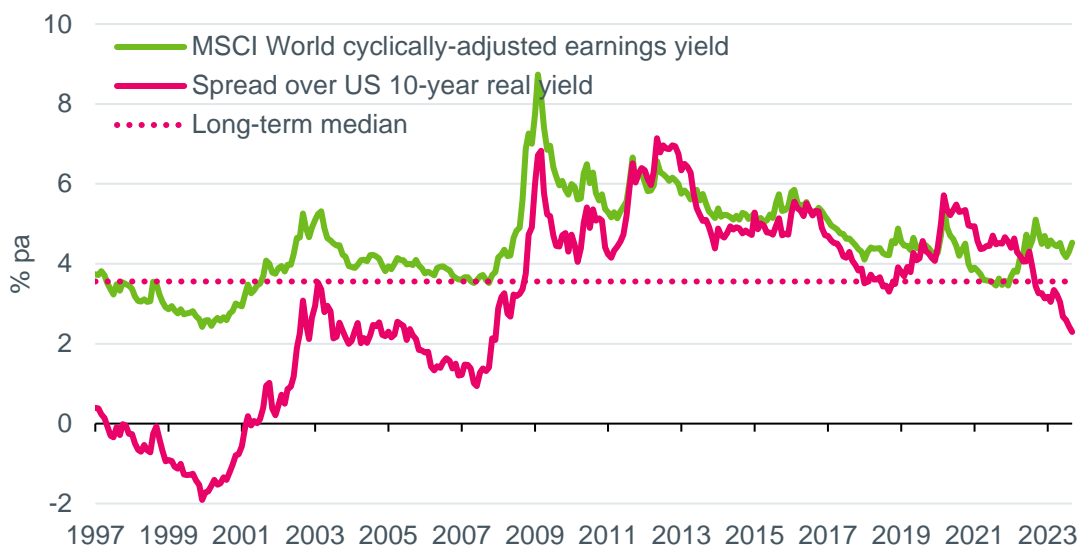
Credit spreads are close to long-term median levels in both investment- and speculative-grade markets and, given the weak outlook and balance of risks, we retain a preference for higher-quality credit. Given our view that near-term interest rates are largely fairly priced, we are agnostic between short-dated fixed and floating-rate exposure. However, better relative value (Chart 4) suggests a

preference for asset-backed securities (ABS) over investment-grade corporate credit in short-dated bond mandates. Investment-grade credit markets offer attractive yields, but this is largely a reflection of attractive underlying sovereign bond yields.

Equities

The FTSE All World Total Return Index fell 2.1% in local currency terms in Q3, as sovereign bond yields rose and survey data indicated an easing in economic activity. Amid the subdued, albeit better-than-expected, growth environment, forecasts for full-year equity earnings growth in 2023 have fallen from around 3% at the start of the year to 0% by the end of Q3. Over the same period, equivalent forecasts for 2024 and 2025 have actually seen slight upwards revisions, with full-year earnings growth a little above 11% expected in each of the next two calendar years. Slowing global activity is reducing corporate pricing power at the same time as borrowing costs are rising, creating a tough outlook for corporate earnings. Against this backdrop, these global equity earnings forecasts look vulnerable to potential disappointment.

Chart 5: The 'equity risk premium' looks stretched

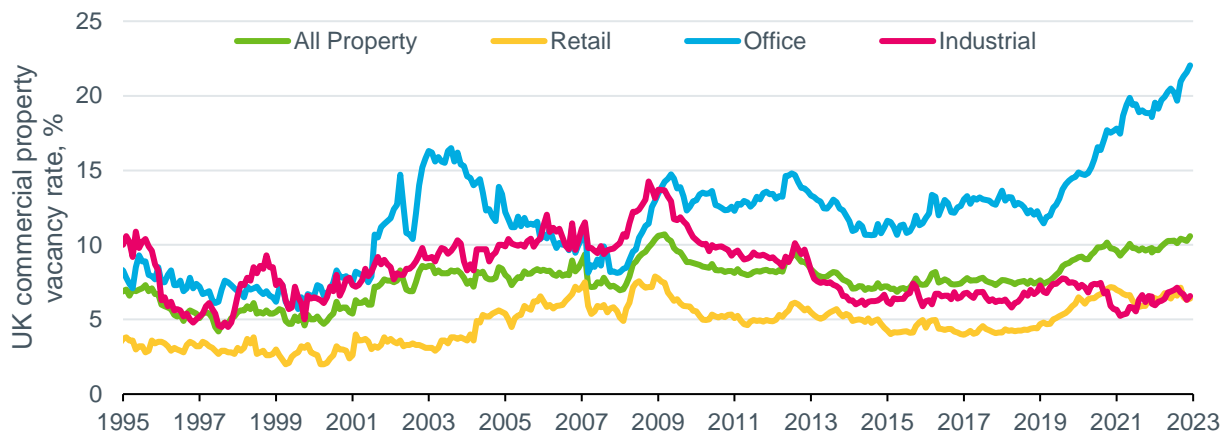


Cyclically adjusted global equity valuations, which are in line with long-term averages, look reasonable in absolute terms. However, valuations look stretched relative to 'safe' assets, with the equity risk premium, proxied by the MSCI World cyclically adjusted earning yield less 10-year US real treasury yields, as low as it has been since the GFC and well below historic averages (Chart 5). Valuation pressures would be eased by a decline in real yields. While we think that is quite likely, we expect the impact to be limited as we do not anticipate yields to return to the very low levels experienced in the post-GFC era. A background of declining yields is, in any case, likely to be associated with pressure on earnings.

Property

Our caution that a stabilisation in capital values in Q2 reflected a lack of transaction activity rather than a fundamental improvement has proved well founded. Though capital values in the industrial sector have now risen for seven consecutive months, continued declines in the office and retail sectors led to a modest 0.2% fall in the MSCI UK Monthly Property Total Return Index in Q3. On a 12-month basis, capital values are down around 14%, 23%, and 20% in the retail, office, and industrial sectors, respectively.

Chart 6: Record-high vacancy rates in the office sector highlight ongoing fundamental challenges



Property yields have risen significantly from a low in late 2022, but remain below long-term average levels. As with equities, valuations relative to safe assets are stretched – as expensive they have been since the GFC. This feels like scant reward given a challenging fundamental outlook. Real rental growth is rising as inflation declines, but is still negative. The modest improvement in sentiment highlighted in the previous UK Commercial Property Market Survey by the Royal Institute of Chartered Surveyors has also reversed more recently: the latest survey showed renewed falls in occupier demand and rent expectations as availability across industrials and office continued to rise. Highlighting the ongoing impact of the seismic shifts in post-pandemic working patterns, office vacancy rates hit a record-high of 22% in August (Chart 6). This is compounded by ongoing technical weakness as there's a substantial amount of selling pressure in the market, with thin transaction activity and some pooled funds deferring redemptions till 2024.

Conclusion

Global growth in 2023 has outperformed the downbeat forecasts made at the start of the year, but its pace has been subdued and we think it's likely to slow further. Weak growth and rising borrowing costs make for a tough outlook for corporate earnings, so the fundamental outlook for equity and credit markets is challenging. We maintain our defensive positioning, preferring 'safe' assets – sovereign bonds, cash and high-quality credit – over 'risk' assets – equity, speculative-grade credit and property.

Inflation is likely to be sticky, and we expect central banks to proceed cautiously, but long-term forward nominal yields now look very high. At these levels, a return to our assessment of fair value would provide significant capital appreciation, in addition to income. Investment-grade credit looks better value than speculative-grade credit, but with spreads close to long-term medians, the attractions largely reflect decent underlying sovereign bond yields.

A challenging, and arguably still-deteriorating economic outlook puts pressure on equity earnings and UK commercial property rents. In absolute terms, global equity valuations are neutral and UK property valuations are still a little stretched. Both look expensive relative to 'safe' assets, and so any future reduction in real yields might provide only limited relief.

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