HYMANS ROBERTSON

Capital Markets Update

Winter 2023

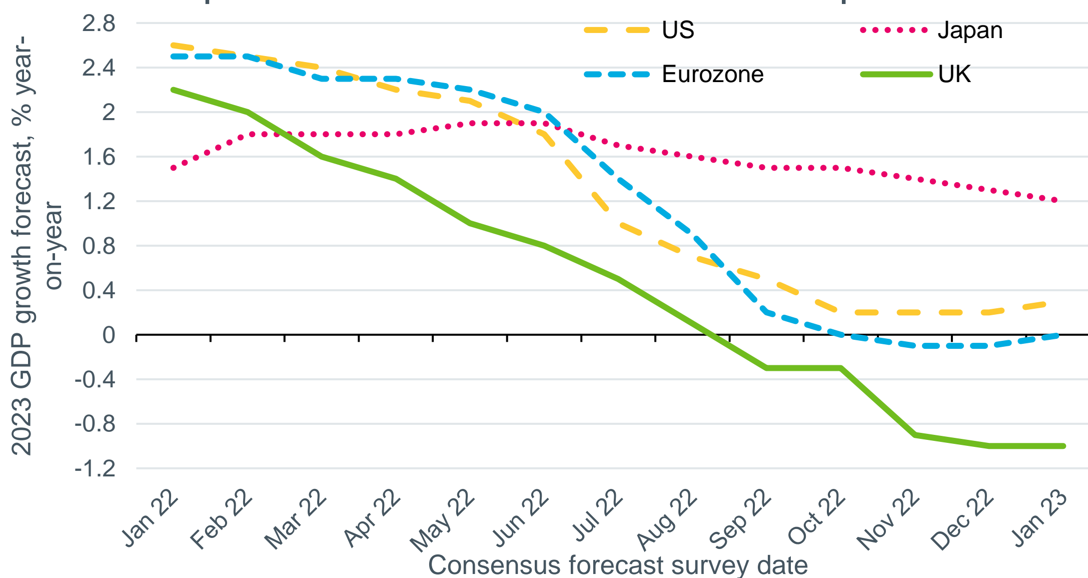
The fourth quarter brought resilient data on economic activity, a peak in headline inflation, reduced risk of European energy rationing and China's economic re-opening. This eased concerns about the downside risks to global growth this year.

Global equities rallied strongly from their October low, credit spreads tightened significantly, and the dollar fell sharply from its peak early in the fourth quarter.

Global themes

While economic data suggests a relatively weak outlook, recent figures have shown an unexpected resilience in the major economies. GDP growth forecasts for 2023 have stabilised in the last couple of months (Chart 1). The reduced risk of energy rationing in Europe and subsequent sharp fall in gas prices means not only that headline inflation has probably peaked in Europe, but also that the downside risks to the growth outlook have eased. Additionally, China's rapid re-opening is likely to support global demand later in 2023, even if potential disruptions to supply and consumer behaviour associated with a wave of infections pose a near-term risk.

Chart 1: GDP expectations have started to turn in the US and Europe

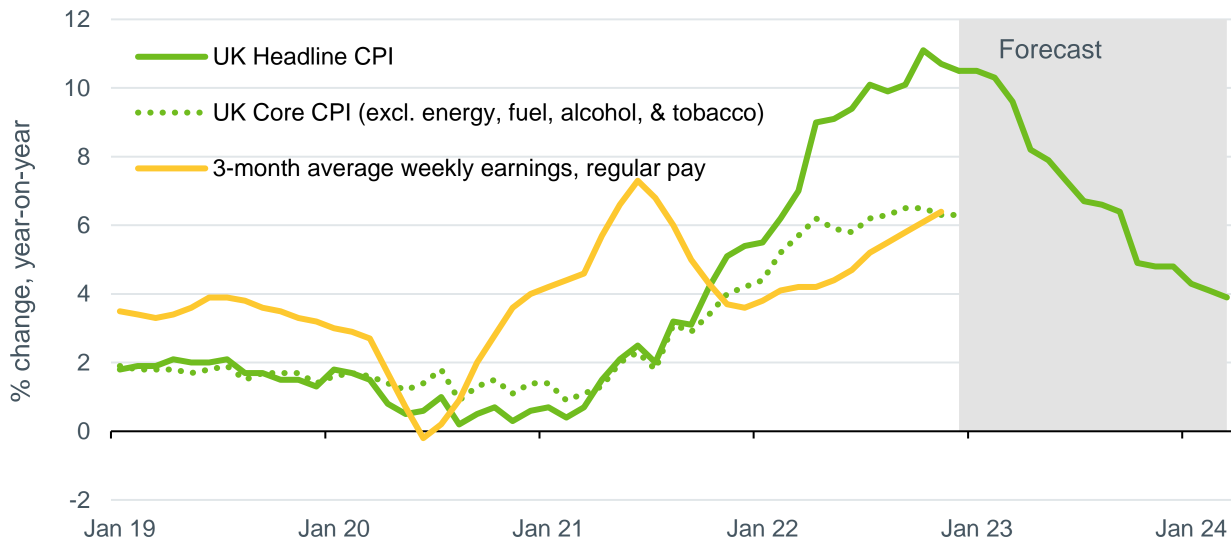


Nevertheless, 2022's soaring inflation and interest rates leave forecasts for 2023 real GDP growth looking relatively bleak. December's purchasing managers' indices (PMI) suggested the downturn in global manufacturing continued in late 2022, as the index fell to a 30-month low. However, the delivery times sub-index continued to improve, confirming other indications that supply-chain conditions are normalising. There are regional variations: PMIs showed signs of stabilisation in Europe and emerging markets, but US indicators continued to deteriorate.

The ongoing easing in input price inflation from high levels supports the idea that recent falls in headline inflation may be sustained. Indeed, recent downside inflation surprises suggest year-on-year inflation has peaked in Europe and is well past its peak in the US. Forecasters are confident that headline inflation will come down over the next few quarters, given falls in energy and food commodity prices (Chart 2). At an underlying level –

excluding food and energy – easing supply-chain pressures should contribute to a more general fall in goods inflation. Against that, tight labour markets are leading to strong wage growth on both sides of the Atlantic, and service-sector inflation is likely to be stickier. Core inflation is expected to remain above central bank targets for some time.

Chart 2: Headline inflation expected to fall, but wage growth keeps upward pressure on core inflation

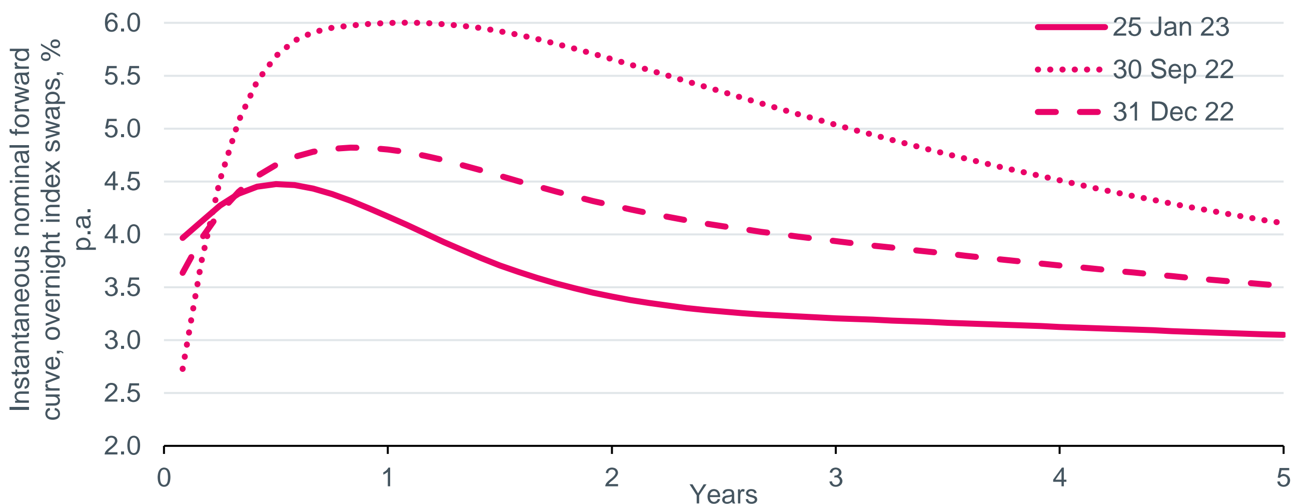


As a result, major central banks suggest further rate increases will be required. However, despite the short-term resilience of economic activity, the US Federal Reserve (Fed) has indicated a slower pace of tightening to take account of the lagged impact that earlier interest-rate rises will have on growth and inflation. Other major central banks are likely to follow suit. A pivot to loosening policy seems unlikely unless downturns are more severe than expected.

Government bonds

UK interest-rate expectations have fallen from the levels touched in the wake of September's 'mini-budget' and reflect a little more tightening by the Monetary Policy Committee (MPC) (Chart 3). We expect the MPC to pause soon, but even though the UK faces the worst 2023 growth outlook among the major advanced economies, the committee is likely to be cautious about easing policy while the labour market remains tight. Even so, weak economic activity should keep a lid on real yields, which remain at reasonable levels relative to long-term fair value.

Chart 3: Interest-rate expectations have fallen but still adequately reflect further tightening



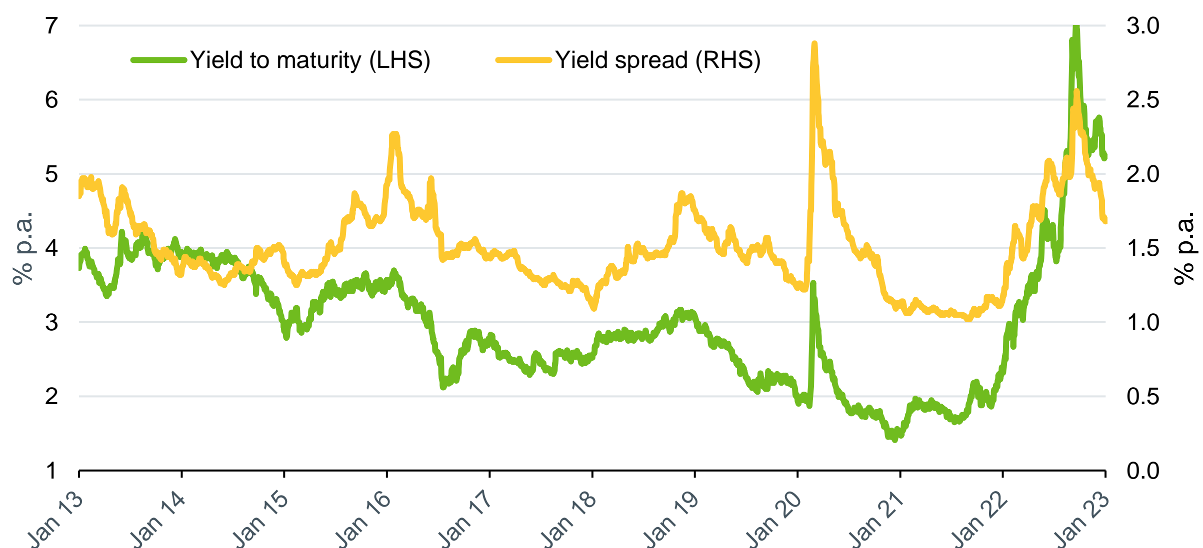
Persistent underlying inflation means that implied inflation – in the range 3.0–3.5% p.a. between 5 and 15 years –suggests nominal yields do not offer a great deal of protection. Therefore, we prefer index-linked gilts at the front end. At longer durations, an assumption of a return to target inflation and the indexation from 2030 of index-linked gilts to CPIH (typically 1% p.a. lower than RPI) tips the balance towards nominal gilts, even though implied inflation is in the same range.

But we are cautious about both nominal and index-linked gilts at the long end. Forward yields are low and may be vulnerable to high gilt issuance, both from government financing requirements and redemptions and the Bank of England selling gilts acquired through its asset-purchase facility, at a pace of £80 billion p.a. (a process known as quantitative tightening).

Credit

The fundamental outlook is still challenging for credit markets. Interest coverage is high, but higher absolute yields and slowing earnings growth are likely to weigh on debt affordability. The impact will be less severe and take longer to materialise in investment-grade markets relative to speculative grade: debt levels are lower and longer maturities mean lower refinancing pressures. Although credit spreads have fallen sharply since their October peak, we still see the possibility of attractive risk-adjusted returns at the current level of yields in investment-grade markets. Following tightening in fixed-interest corporate credit markets, the relative value offered by floating-rate asset-backed securities (ABS) has improved. High inflation and rising interest rates are weighing on consumers' real incomes and house prices, increasing default risk in the collateral pools backing consumer and residential ABS bonds. However, very low unemployment and a high proportion of fixed-rate mortgages mitigate these risks, and senior investment-grade ABS bonds remain well insulated against a potential rise in underlying defaults.

Chart 4: Investment-grade risk-adjusted returns remain inviting despite a decline in yields



Speculative-grade credit markets are more exposed to the weak fundamental outlook. Relative to investment grade, credit spreads are not as compelling. Within speculative-grade markets, loans and European high yield offer better value than US high yield.

Equities

A 15% fall in 2022 left global equities looking a lot cheaper than they did at the start of the year. But the recent rally has taken cyclically adjusted valuations back in line with long-term averages. Furthermore, following the rise in risk-free yields, equities no longer appear cheap relative to bonds. The spread between the MSCI World's cyclically adjusted earnings yield and US 10-year real yield has fallen below both its post-crisis and

longer-term median (Chart 5). We believe that rate-hiking cycles are advanced but do not anticipate a dramatic easing of monetary conditions to boost valuations, given underlying inflation pressures. This leaves equities more dependent on earnings growth to make progress, which makes them look vulnerable to further downgrades in tough economic conditions.

Chart 5: Equity risk-reward looks less compelling in the context of higher risk-free yields

However, our caution is increasingly driven by the US, where valuation and earnings concerns are most acute. Elsewhere, valuations are significantly cheaper, and the pressure on current earnings expectations may ease as the European energy crisis subsides and China's economy re-opens. Indeed, we have seen emerging market and European economic indicators, such as the January flash composite purchasing managers indices, begin to stabilise as US measures deteriorate further. Surging energy prices and sterling weakness, which flattered the overseas earnings of the international UK market, helped the UK to be one of the best-performing regions in 2022. This outperformance might be expected to fade in 2023, alongside an ongoing decline in energy prices and a weaker US dollar.

Property

While nominal rental growth remains positive, the latest UK Commercial Property Market Survey by the Royal Institute of Chartered Surveyors points to a deteriorating occupational market: tenant demand is falling and availability of rental space is rising; rent expectations continue to decline; and inducements offered to tenants are increasing. This has done little to arrest what was initially a valuation-driven decline in capital values on the back of soaring interest rates.

Chart 6: UK commercial property market yields have risen sharply but remain relatively low

Capital values are now around 20% below peak end-June levels, with the largest declines observed in the lower-yielding industrial sector. This has resulted in a sharp rise in net initial yields, but they are still low relative to history. Unexceptional yields and weak fundamentals suggest the UK commercial property market may face further near-term pressure.

And technical conditions are also unhelpful: transaction levels are very low, but a large number of sales will be required to meet the flood of redemption requests from UK property fund investors. Many funds are deferring redemptions. Against this backdrop, brokers continue to suggest that holders may have to accept significant discounts to achieve sales in the secondary market. Listed real estate investment trusts (REITs) are also trading at significant discounts to net asset value (NAV). As a result, the secondary and listed markets may provide the best short-term way to gain exposure.

Conclusion

Recent economic resilience, along with falls in headline inflation, have reduced downside risks, but soaring inflation and interest rates in 2022 mean the global growth outlook is relatively weak. However, while we expect many major economies to enter recession in 2023, we anticipate relatively mild downturns given strong labour markets. Central-bank tightening cycles look fairly advanced, and falling commodity prices and weak economic activity should reduce pressure on central banks to continue hiking as 2023 proceeds. There is potential for more monetary tightening for longer than expected, with its subsequent impact on housing and equity markets and the real economy a key downside risk. However, this is not our base case.

In this environment, we continue to prefer government bonds and investment-grade credit to speculative-grade credit, equities and property. Quantitative tightening alongside relatively low long-term forward yields sees us retain a short-duration bias. Meanwhile, the weak growth outlook informs our high-quality preference in bond markets. Given the extent of recent tightening in corporate credit spreads, we see improved relative value in asset-backed security spreads.

Speculative-grade credit spreads may be vulnerable to widening as weak growth weighs on earnings and higher refinancing rates start to bite. Equity markets are not compellingly cheap, particularly in the context of higher risk-free yields, and may not yet fully reflect the potential extent of earning downgrades that is likely in a recessionary environment. Ultimately, we do not think investors are getting much compensation for the risk of owning equities or high yield credit versus lower risk bonds. Direct commercial property markets will stay under pressure, but the possibility of gaining exposure at a significant discount to current valuations may offer better longer-term entry points.

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