



Brewin
Dolphin

Q3 2023: Quarterly review

11 October 2023

At the end of the third quarter of the year, Guy Foster, our Chief Strategist, looks back at the events that have shaped the markets over the past three months.

2023 is turning out to be a year of two halves, with stocks performing better than expected in the first half, before losing momentum during the third quarter.

The first half of the year is better understood in the context of the painful year that went before. 2022 had been a year of shock, with inflation vastly exceeding the expectations of central bankers and most investors, and interest rates having to be raised aggressively to wrestle prices under control. As a result, 2023 began with anxiety over inflation, and concerns that monetary policy would drive a recession.

As it turns out, 2023 saw those fears ebb. Inflation slowed in many regions, including the US, and the economy proved resilient. Consumers who had accumulated savings and frustrations during lockdowns were keen to take advantage of tourism and leisure services. Shortages of goods from disrupted supply chains became shortages of service staff.

Stocks performed well as the twin anxieties of inflation and recession receded. Technology stocks, the most battered sector from 2022, led the gains. They received a further boost from the introduction of practical generative artificial intelligence (AI) tools, which suggested that potential profits from the technology sector could arrive sooner than had previously been estimated.

All change...

One of the defining trends of 2023 remains the extraordinary outperformance of a handful of the biggest US companies, including Apple, Amazon, Microsoft, Tesla,

Alphabet (owner of Google), Meta (owner of Facebook) and Nvidia (which makes graphics processors with multiple uses in AI and other technologies).

The third quarter of the year has been quite different though. Stocks lost momentum with the global market peaking in July (in dollar terms), interrupting a very strong rally that began last October for the US stock market. It came against a background of changing economic dynamics in the global market. The moderation in US inflation had seemed broad-based during the first half of the year, but was certainly aided by a lack of energy price inflation. In June, the oil price shifted sharply higher.

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Like most things, the price of oil is set by supply and demand. Demand is normally a function of global economic activity. Supply is more nuanced. When the oil price is high, companies will feel inclined to produce more oil, which can help to bring prices down. But it takes them time to increase their production. To try and prevent excessive price volatility, some oil producing countries operate as a cartel. The Organisation of Petroleum Exporting Countries, or OPEC, decides how much oil to

provide to the market in order to meet demand. Saudi Arabia is by far the biggest OPEC producer and, unable to secure agreement among members for cuts, Saudi Arabia voluntarily agreed to cut its own production in order to support the price amidst what it believed was a deteriorating economic outlook. Saudi Arabia was joined by Russia in restricting output in a move which will fuel higher prices and will antagonise US president Joe Biden on the eve of an election year.

In addition, supplies of oil from Iran are bound by sanctions. An agreement back in 2015 to ease those sanctions was reversed under the Trump administration during 2018. Under Biden, the US has sought to recover the nuclear deal, but negotiations have stalled for over a year.

Alongside lower supply from OPEC, producers globally have been nervous about investing too much in fossil fuel energy because of the risk that demand will be lower in the future. Their reluctance to invest means supply will be lower, which supports short-term oil prices. Ironically, consumers may view higher oil prices as a reason to switch to non-fossil fuels.

Economic outlook

The outlook for the global economy remains overcast. While consumption in the US has held up remarkably well, other regions are starting to see slowing demand. UK consumer activity has been slowing and jobs growth has started to slow. However, persistent wage pressures make it difficult for the Bank of England to provide relief. UK inflation will fall sharply after October as last year's huge jump in utility bills will no longer form part of the annual change. However, other costs faced by UK households remain high, most notably rent.

The costs of home ownership in the UK have been relatively slow to adjust to higher interest rates. This is due to the unusually high share of borrowers who currently have fixed-rate mortgages, and the unusually low share of homeowners who still have an outstanding mortgage balance to pay. However, this year saw an increasing number of borrowers needing to refinance their mortgages, and at rates far above the costs they had been paying previously.

The Office of National Statistics revealed in September that the overall size of the UK economy was likely higher than it had previously forecast, having underestimated various components during 2020 and 2021. Many

headlines were written bemoaning the UK's economic performance since Covid, as it lagged other members of the G7 group of rich countries. Those taking schadenfreude from the UK's relative improvement may feel that more acutely given that Germany has taken over the mantle of G7 laggard. But historic revisions aside, the more recent growth data reflects an economy with limited capacity to grow and house prices that are falling prey to higher borrowing costs.

Rate expectations...

UK mortgage costs reflect the outlook for interest rates over the next few years. Around the world these have been rising. For most of this year, longer-term interest rates were assumed to be considerably lower than the current rate set by the Bank of England. The same was true of the equivalent rates in the US and Europe. Most investors expect interest rates will fall from their current levels and stay low over the coming years. History would suggest that they are right and that directionally interest rates will fall over the coming years, if not months. The question is how much they will fall and over how many months. It seems likely that markets were too aggressive in expecting interest rates to decline.

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The improved long-term interest rates that markets are increasingly offering are becoming more enticing. In stark contrast to recent years, the UK inflation-linked bond market now offers guaranteed returns above inflation and, like most UK government bonds, careful selection can offer great tax efficiency (depending upon circumstances).

While very long-term interest rates also now offer higher yields, this part of the market requires care. The long-term outlook for the public finances of countries everywhere requires some hard choices. Elections taking place in the UK and US will bring into sharp focus the willingness of potential leaders to take those choices. After the UK's brush with bond market Armageddon in 2022, neither main political party is likely to seek election based on promises of big net increases in spending.

In the US, however, if the election is contested between Biden and Trump, it is hard to imagine either of them promising to restore fiscal balance. That role seems to fall to Congress, which has proven capable of restricting some spending by threatening to force the government into default (and later shutdown) at various times this year. The shape of Congress after the 2024 election will determine how fiscally responsible the next president ends up being. That decision may well be influenced by events taking place now as Republicans in Congress struggle to coalesce around a single vision for policy.

The temptation of policymakers is increasingly to give the public what they want in the short term, rather than addressing long-term problems. Over the long term,

providing more public services from lower tax revenues will be one of the many problems that AI may help us solve. In the meantime, it's easy to see the current predilection to short termism as a modern problem. There are earlier instances though...

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Lord, give me chastity and continence, but not yet!

Augustine of Hippo (354-430)

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Guy Foster, Chief Strategist

Guy leads RBC Brewin Dolphin's Investment Solutions team working to align our investment capabilities with the needs of clients. He also provides recommendations on tactical investment strategy to our investment managers and strategic recommendations to the group's Asset Allocation Committee. Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. He frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of RBC Brewin Dolphin.

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