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Market Review and Outlook.

2nd Quarter 2023

timeline
MONEY FOR LIFE

Economic Outlook & Market Commentary June 2023

As we approach the midpoint of 2023, it is hard to believe how quickly time has passed this year. With the fantastic weather and mention of the dreaded ‘partygate’ creeping into our vocabulary again, you’d be forgiven for having a slight sense of déjà vu.

Boris Johnson and Donald Trump have once again been splashed across national and international headlines for their own respective ‘antics’. Johnson resigned as an MP on the 9th of June after a report by MPs condemning him for lying to parliament over the Covid-19 partygate scandal. Despite this, Johnson has already been recruited as a columnist for the Daily Mail newspaper, so won’t be out of the public eye for long.

Across the Atlantic, the Republican Party primaries are in full swing with newcomer Ron DeSantis facing former President Trump for Presidential nomination. DeSantis’ campaign started on a ‘glitchy’ footing when he declared he was running at the Twitter Spaces event, which was hit by technical difficulties. Whilst Trump is currently facing 37 federal charges relating to official documents found at his Miami estate. They are both clear favourites for the election and it is likely one will face Biden in 2024.

Despite the political headwinds and turmoil, the equity markets have remained relatively flat across the UK in the second quarter. Inflation in the UK has remained high, however, with further rate increases potentially on the cards for the Bank of England as we continue through the year. With the increase in food prices and continued high energy costs across the country, there is continued pressure on UK household budgets. Inflation does seem to be showing some positive signs of deceleration for the latter half of the year.

The bull market present in quarter one of this year, for US equities, continued in the second quarter. The positive returns have mainly been driven by the seven largest companies. These seven stocks include Apple, Microsoft, Alphabet (Google), Amazon, Tesla and Meta (Facebook), and NVIDIA is a more recent addition. Collectively they outperformed the rest of the market and currently make up approximately 26% of the S&P 500’s weightings.

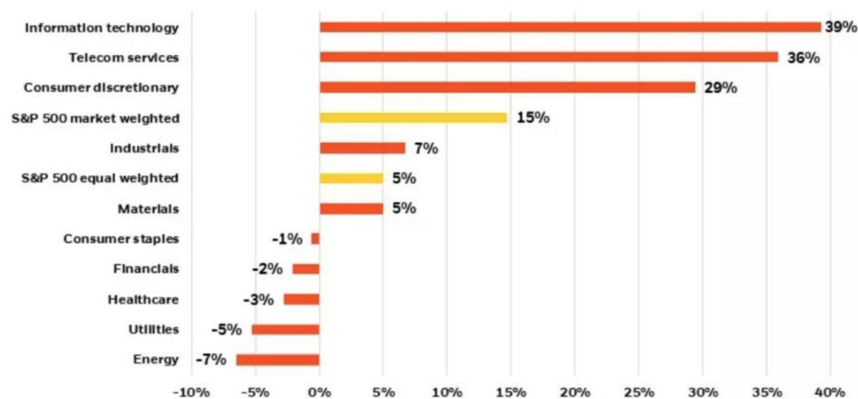
Investment Asset Class Returns

During the second quarter of the year, market movements seemed to be kept to a minimum with relative stability seen in the equity markets. Bond markets in comparison continued to struggle with the interest and inflation rates providing a drag on their relative returns.

Equities

In the first quarter, there were some positive gains across the equity markets, followed by the second quarter providing some stability for investors. Global equities returned 3.32% over the quarter, with certain regions driving positive returns. The US market was the standout, returning 6.99%. Most of these positive gains were attributed to a handful of stocks, specifically in the technology sector, which could suggest that near-term improvement in economic growth could be down to a bubble.

S&P 500 performance by sector, year-to-date 2023



Source: BlackRock Investment Institute, with data from Refinitiv, June 14, 2023. Chart shows the year-to-date return of the S&P 500 index both market-weighted and equal-weighted, in which each stock is proportioned at equal measure, and each sector in the index. **Past performance is not indicative of current or future results. Indexes are unmanaged. It is not possible to invest directly in an index.**

Source: BlackRock using Bloomberg data 2023[1]

Developed markets returned 3.56% while emerging markets were a dampener to overall global returns. This quarter, emerging markets returned -2.11% with China's reopening after Covid-19 restrictions failing to translate into broad economic strength. The impact on the surrounding markets that rely heavily on Chinese demand has caused more modest returns for the region.

Finally, UK markets have also seen lacklustre returns of -0.49% for the quarter. With inflation not reducing as quickly as expected, markets were left underwhelmed. The European markets also contributed a muted performance with returns of 0.59%.

Bonds

Bonds continued to have a rough run this quarter while inflation remains high and in a rising interest rate environment. Government bonds have also struggled in developed markets, and the European Central Bank reaffirmed the need to increase interest rates further before the end of 2023. With the UK interest rate increases, alongside the US debt ceiling issues earlier this quarter, most government bonds have been weak in this current environment.

[1] BlackRock (2023)

Other riskier, non-investment grade bonds are also continuing to struggle as tightening credit conditions, paired with increased costs to raise debt, have put pressure on returns. In terms of performance over the quarter, Global bonds (hedged to £) returned -0.46%, while UK government bonds returned -6.21% and overseas government bonds fared slightly better returning -4.29%.

US Debt Ceiling: The Never-ending Issue

The world breathed a collective sigh of relief as the US avoided a historic debt default at the beginning of June. Both sides of the bipartisan government managed to garner a last-minute deal to suspend the government's borrowing limit until 2025.

This is not the first time in recent history that the debt ceiling has had to be raised. In December 2021, President Biden signed into law the increased ceiling of $31.4trn, representing a $2.5trn increase. Naturally, a question often raised when we continue to face this issue is, what would happen if the US were to default on its debt obligation?

Simply put, the global economic fallout would be catastrophic. If the ceiling had not been raised, America would face either a sovereign default or drastic cuts to state spending. Both outcomes would create economic turmoil in the global markets. The rating agency, Fitch Ratings, warned that in the "very low probability event"[2] that should the US fail to make "full and timely payments on debt securities" it would qualify as a debt default. This would result in their 'AAA' rating being downgraded to a 'D'. By the US defaulting on its loans, it would then create irreparable damage to public faith and the spending cuts could trigger a recession.

Whilst the original premise of the US debt ceiling was the good intention of preventing government spending from running rampant, the current use is to provide leverage and act as a threat to whichever party does not control the Senate in each election cycle. This is perfectly illustrated by the new deal brokered, which cuts 'non-defence discretionary' spending and includes domestic law enforcement. The deal limits all discretionary spending to 1%, effectively creating a budget cut with current levels of inflation.

The issue is resolved for now, but inevitably government debt and spending will continue to increase over time. It begs the question, are there any solutions? Our research shows what could be done:

1) The 14th Amendment of the Constitution states that the president has the authority to order the nation's debts to be paid regardless of the debt limit. This route would brand the debt ceiling as 'unconstitutional' and allow the government free reign to repay its debts. This response would initiate a wave of legal responses along with a vitriolic backlash which would prevent this from ever being written into law.

2) The most straightforward solution would be that Congress simply agrees that the ceiling is damaging and suspends it in perpetuity. As mentioned above, neither side would agree to this due to the powerful bargaining chip the debt ceiling has become.

3) Perhaps the most absurd of the options is minting a platinum coin worth $1trn and depositing this in the Federal Reserve. This would then be used to pay for government expenses and operations. The government would no longer need to borrow from

[2] Fitch Ratings (2023)

public markets. Whilst an interesting premise, this idea has been dismissed by the treasury a number of times, with the U.S. Deputy Treasury Secretary, Wally Adeyemo, rejecting this idea as recently as May of this year.

Regardless of the options above, Fitch warned that platinum coins and other "non-conventional means" such as invoking the 14th amendment are "unlikely to be consistent with a 'AAA' rating". Until a more tenable solution is formed, this will continue to be an ongoing issue.

Mortgages and the Shaky UK Property Ladder

Other than savings accounts, the most noticeable vehicle to see the impact of the recent interest rate increases is the mortgage market. The outstanding value of all residential mortgage loans was £1,675.4bn at the end of Q1 2023.[3] This figure, however, has decreased since Q4 2022 for the first time since 2017. New mortgages in the first quarter of 2023 were down 16.1% compared to the previous quarter, and 40.7% less than a year earlier. The downward trend indicates that purchasing a property may be less obtainable in these current conditions, compared to recent history.

At the end of June, two-year fixed-rate mortgages in the UK rose to above 6%. This rise in interest rates has caused some lenders (e.g. TSB) to temporarily withdraw their mortgage offers sold via brokers to re-price these deals. With interest rates now having increased to 5%, housing affordability seems even further from reality.

Whilst the overall cost of purchasing a property is impacted by these mortgage rate increases, it is far from the full picture. Affordability of home purchasing has been a topic of discussion in recent years, with the number of middle-aged (45-64) tenants increasing by 70%.[4] Of this 70%, 4 in 10 would like to purchase their own home, and only 2 in 10 are actively saving for a deposit. The task of saving for a deposit can be difficult alone, but it is only part of the reason for the change in the property landscape. If you do manage to save a deposit, probably between 5-10% of the property price, the next step would be to secure a mortgage. This is perhaps the more challenging part of the equation.

According to the ONS, the average weekly salary in the UK for June 2023 was £630 (£33,280 annualised).[5] In 2022, full-time employees in England could expect to spend roughly 8.3x[6] their annual earnings buying a home. This multiple has been on the rise since 1997 and with the continued strain on the cost of living brought on by inflation, it looks set to continue.

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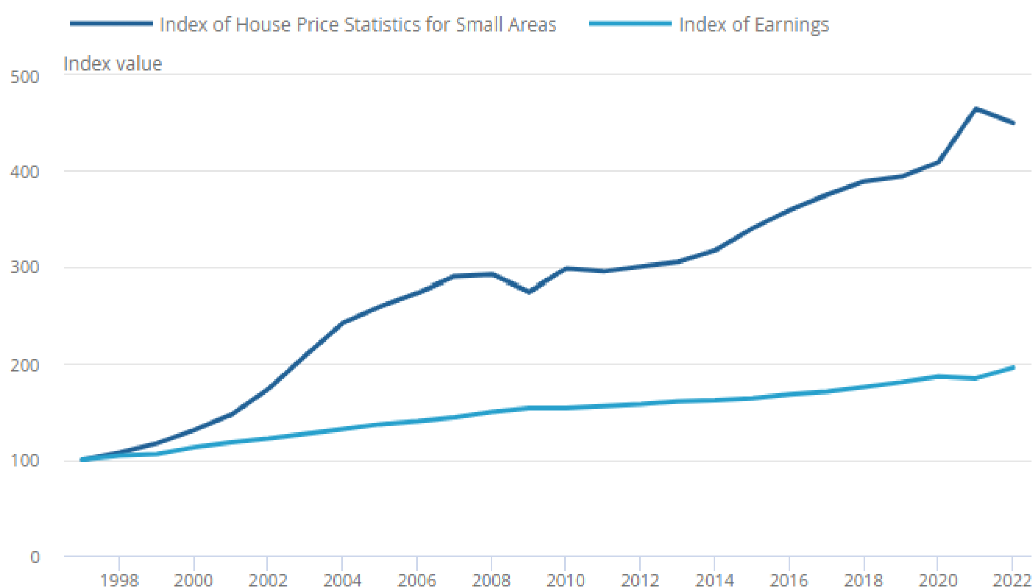
[3] FCA (2023)
[4] Paragon (2023)
[5] ONS (2023)
[6] ONS (2022)



Source: ONS (2023)

These multiples become alarming when you compare these figures to the 'rule of thumb' lending rule that a first-time buyer can borrow up to 4.5x their annual income.[7] This coupled with the gargantuan task of saving for a deposit in these current inflationary conditions leaves the prospect of home ownership unobtainable for some.

However, earnings growth has been relatively strong since the trough in June 2020. The whole economy's year-on-year, 3-month average earnings growth is currently 6.5%.[8] Whilst this still falls short of current inflation levels, one would hope that a prolonged period of this growth will help to narrow the margin for housing affordability.

Economic Outlook

Inflation is falling (to an extent)

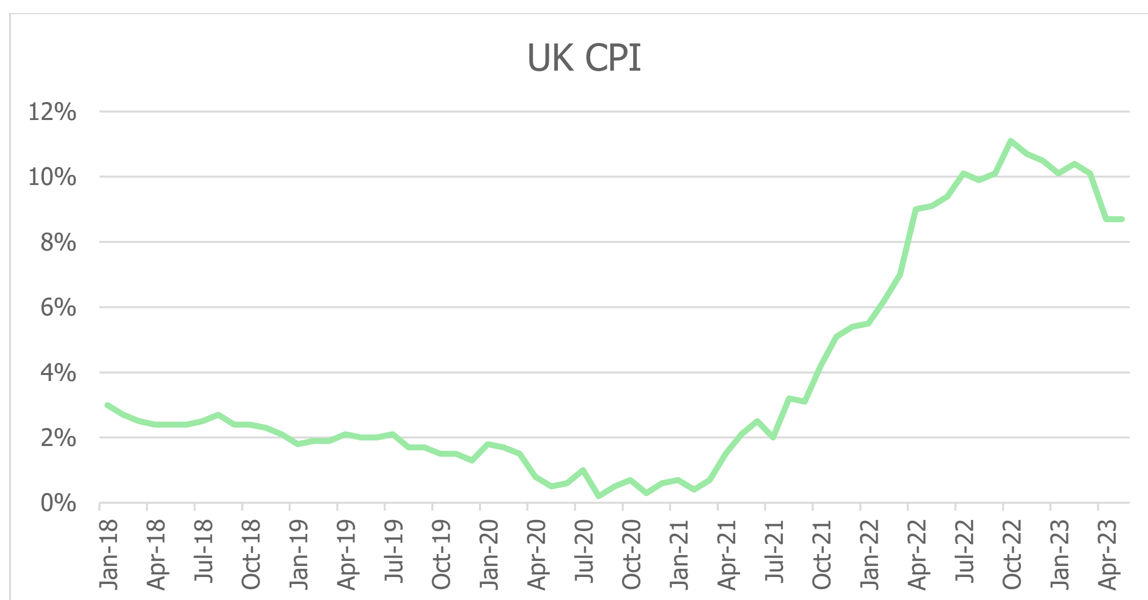
Inflation has remained stubbornly high so far in 2023 in part due to energy prices, but mainly continued supply chain issues which have pushed up the price of food. Food inflation had risen by 19% in April 2023[9] which was the highest sector in that month. This unrelenting rise in food costs has meant that whilst inflation has dropped slightly, these decreases are less than originally expected. Inflation in the UK currently sits at 8.7%[10] compared to 10.4% at the end of Q1, whereas in Europe inflation fell to 6.1% in May 2023.[11] The US has continued to fare better than Europe and the UK with its current inflation sitting at 4% at the end of May 2023.

Despite the doom and gloom associated with the high levels of inflation, there are some positive signs that UK inflation may decelerate for the remainder of 2023. The Bank of England has named three changes that might influence inflation over the coming year.

[7] Forbes (2023)
[8] ONS (2023)
[9] Statista (2023)
[10] ONS (2023)
[11] CNBC (2023)

Firstly, wholesale energy prices falling considerably - which may not have filtered through to energy bill savings yet - will have an impact on inflation.
Secondly, the Bank believes that supply chains will become more efficient, leading to a sharp fall in the price of imported goods.
The final disheartening factor is that individuals will have less money to spend, so there will be less demand for consumer goods and services in the UK.[12]

At the start of the quarter UK interest rates were 4.25%, and on the 22nd of June, the Bank of England made the bold choice to hike interest rates to 5%. The hope is that the increase in interest rates will lead to reductions in inflation, with the Bank of England expecting inflation to fall quite quickly to around 5% by the end of 2023. This optimism is not mirrored across the market with The National Institute of Economic and Social Research (NIESR) estimated annual CPI being 5.4% at the end of 2023. This forecast is pessimistic in comparison to forecasts from the Bank of England and the government's budget watchdog.[13]



Source: Office for National Statistics (2023)

The immediate knock-on effect on the markets was a drop in response to the rate increase. Whilst rate increases were expected, the single 0.5% jump was higher than most expected and had been priced into markets. Since December 2021 to the end of June 2023 the Bank of England had made 12 consecutive rate increases.

[12] Bank of England (2023)
[13] Reuters (2023)

Final Thoughts

As we reach the halfway point of 2023, we are encouraged by the positive returns so far this year. However, inflationary and interest rate increases continue to put pressure on both returns and household budgets. With mortgages and food prices continuing to rise, the monthly budgets for households are becoming much tighter. Unfortunately, these headwinds do not show signs of significantly easing just yet. That said, predictions suggest that this may change towards the end of 2023, hopefully creating positive conditions in early 2024.

The second quarter continued the trend of relatively calm waters in the equity markets. This has helped investors recover from the volatile markets seen throughout 2022. However, it does not mean that volatility should be ruled out for the year just yet. With continued disruption in the bond markets due to high interest rates and US primaries around the corner, choppy investment waters could yet emerge.

Regardless of the current market conditions, it is important for investors to remember that investing is a long-term endeavour. Market volatility is a natural part of the investment landscape, and it is normal to experience ups and downs over time. Focusing solely on short-term market movements can lead to unnecessary anxiety and harmful investment decisions. Remembering the financial plan and the reason for the investment strategy, which is aligned to the plan, should help clients see past the near-term waves and reflect on the calmer ripples on the horizon.
We build and manage financial plans, and tailor investment portfolios to give clients the best possible chance of achieving their financial goals.

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