LIONTRUST

MULTI-ASSET PROCESS

Market review: August 2023

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- **Global equity and bond markets pause for breath in August over interest rate worries**
- **MA team has cut fixed income target allocations and duration this year**
- **ECB president says a new playbook is needed for today's world**

Global financial markets corrected in August, pausing for breath in what has been a double-digit upward trend year to date for most of them. Investors' worries rose once again over inflation and higher interest rates, which was particularly detrimental for US and European government bonds. Overall fixed income target allocations have been reduced this year in all but our two highest risk levels, while the duration – or interest rate sensitivity – of our UK gilts exposure has been cut over the last year to reduce risk.

The US's Federal Reserve stressed again the upside risks to inflation, both in its latest minutes and in comments from chairman Jay Powell at the Jackson Hole Symposium. Other leading central bankers also warned it was too early to declare victory over inflation, raising the prospect of more monetary tightening.[1]

The comments wrong-footed some investors who believed that interest rates had peaked and so have returned to the fixed income markets this year to lock in higher yields. As investors adjusted their expectations for interest rate policies in the US and Europe, a sell-off in bonds pushed up yields on US treasuries, gilts and European government bonds to multi-year highs.[1]

The market moves were impactful for our lower risk funds and portfolios, which hold higher exposures to fixed income, but target exposure to global government bonds, which includes US treasuries, is just 2%. Our higher risk-profile solutions have materially less exposure to fixed income. Our fixed income exposure includes both short- and medium-duration gilts and investment and sub-investment grade credit.

Our overall view on fixed income is largely neutral, although we have raised our ranking on investment grade corporate bonds from a neutral three to a four in our Q3 Tactical Asset Allocation review. We believe that nominal yields are good and credit risks are low: 120-130 basis points over sovereigns looks to be an attractive trade and worthy of an overweight position in our funds and portfolios. In nominal terms, yields of 500bps-plus are now available on debt issued by very high-quality businesses.

Japan and US equities see shallowest declines

Global equities have recorded double digit gains so far this year, contributing positively to performances in all our Multi-Asset solutions, but especially those with higher risk profiles. However, equity markets fell single digits across the board in August, with Japan and the US seeing the shallowest declines and emerging markets and Asia ex Japan seeing the steepest. The underlying tone of markets has mellowed on stubborn inflationary pressures and worries about China's economy.

The positive performances have been led by the US technology giants, driven by surging interest in Artificial Intelligence (AI). Nvidia stunned markets with Q2 earnings results that smashed forecasts, becoming the highlight of an earnings season that saw S&P 500 companies exceed expectations but still receive a lukewarm response from investors.

We have exposure to the AI theme through US growth managers and index funds, especially in our higher risk solutions in which target exposure to US equities can be as high as 35%, but we remain careful. We maintain that value can still be found in the US beneath the technology behemoths and the US economy remains in relatively solid shape. While long-term earnings could be solid, we believe that active exposure is still warranted, with rotation of styles being a risk to market cap-weighted indices.

The inflation news has been better in the US than in Europe. Although US economic data has been generally stronger than expected, raising fears of more rate hikes being needed, the latest figure for headline annual US inflation was 3.2% in July[2], slightly up from 3.0% in June, while core inflation remained at 4.7%, the lowest level since October 2021.[3]

Inflation still a challenge in Europe

Across the Atlantic, Eurozone headline annual inflation stayed at 5.3% in August, but core inflation did fall slightly from 5.5% in July to 5.3%.[4] However, the latter figure remains significantly higher than the European Central Bank's 2% target.

In the UK, headline inflation continues to fall, but slower than elsewhere. Lower energy costs helped to push consumer price rises from 7.9% in June to 6.8% in July.[5] But core inflation remained at an annual 6.9% for July. The Bank of England raised the base rate by yet another 25 basis points in August to a 15-year high of 5.25% and markets expect another such increase in September.

The UK stock market has underperformed year to date, after having been the leader in 2022, but we believe it will turn versus the other majors. The UK has significant exposure to the energy and financial sectors. While the former has weakened this year from the highs it saw in 2022, we think that the latter is poised to do well and should benefit from a more forgiving yield curve and higher prevailing yields than we have seen for many years. It is hard to predict when the UK will turn, but we do not believe that it will require a major catalyst.

A new playbook is needed

Although the warnings over inflation by central bankers was a key takeaway at Jackson Hole, a more profound discussion was raised by Christine Lagarde, president of the European central bank, who stressed that the world was at an inflection point characterised by tighter labour markets, the transition to a greener economy and the breakdown of globalisation into competing blocs. She stressed that a new playbook was needed for today's world.[5]

We also believe the world today presents many challenges and opportunities for investors, which is why we introduced a new Strategic Asset Allocation (SAA) earlier this year. We want an SAA for the next decade, in which market drivers will differ from those of the last 10 years, and greater flexibility and access to more asset classes will be required for successful investing.

[1]Source: FT.com, 21 August 2023
[2]Source: US Bureau of Labour Statistics, 10 August 2023
[3]Source: Financial Times, 10 August 2023
[4]Source: Eurostat, 18 August 2023
[5]Source: UK Office for National Statistics, 16 August 2023
Source: FT.com, 25 August 2023

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