



Market review: October 2023

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- **Equities and bonds decline for third consecutive month on continuing interest rate concerns and geopolitical turmoil**
- **US treasury yields reach 16-year high; European Central Bank pauses after 10 rate hikes**
- **Exposure mix to Japanese equities is changed in Explorer and Blended ranges**

Global equities and bonds drifted lower for a third consecutive month on continuing concerns over higher-for-longer interest rates and conflict in the Middle East.

Government bonds saw some flight to safety flows because of the fighting between Israel and Hamas but this dissipated. Yields on US Treasuries reached a 16-year high as questions were raised over the US' credit quality and the extent of its debt issuance.

We continue to be broadly neutral on fixed income. Yields should form a range around current levels but, as ever, their paths are unlikely to be linear. We retain exposure to bonds for their long-term diversification attributes versus equities, some level of inflation protection and latterly, substantial income. Over Q3, fixed income generally contributed more to our returns, with our active managers playing a key role. For example, leading contributors in the corporate bond sector included Royal London Corporate Bond for our portfolios and Man GLG Sterling Corporate Bond in our active funds. The former's stock selection has contributed to consistently delivering alpha versus its benchmark index and IA sector, while the latter's edge lies in its bottom-up focus on smaller issuers and the team's ability to extract alpha from undervalued credits that are overlooked by larger scale investors.

US equities breach correction level

The S&P 500 officially corrected in October, breaching a level more than 10% below its high earlier in the year.¹ The enthusiasm for artificial intelligence that drove the market earlier this year was forgotten and replaced by jitters over interest rates, a mediocre reporting season and geopolitical turmoils.

Uncertainty over the future trajectory of interest rates was exacerbated by surprisingly strong Q3 GDP data showing annualised growth of 4.9% and significantly stronger jobs data.² Headline inflation also ticked up from 5.3% in August to 5.4% in September, while the core rate remained at 4%.³ There were some high-profile earnings disappointments, with Alphabet, Google's parent, missing revenue forecasts in cloud computing sales. Microsoft beat earnings expectations but saw little share price uplift.⁴

In our last asset allocation rebalancing, we slightly increased our exposure to US equities in our risk level eight models. Funds we use here include AB American Growth, Artemis US Smaller Companies, Fidelity Index US, JPM US Equity Income and JPM US Small Cap Growth. Our view on the US equity market remains neutral but we are mindful of the strong run a small number of AI-related names have experienced in recent months. Clearly the recent correction will remove some of the valuation excesses from the market.

Neutral on European equities

After raising rates consecutively to an all-time high in September, the European Central Bank held them in October, ending an unprecedented run of 10 consecutive rate hikes. The need to tackle inflation was being weighed against rising concerns over eurozone growth.⁵ Headline inflation has dropped from a peak of 10.6% in 2022 to 2.9% in October, significantly below the 4.3% in September and the lowest since July 2021.⁶ Data also showed that the eurozone economy shrank slightly by 0.1% in the three months to September. A contraction in

Germany and Austria offset growth in Spain and France. Core inflation was 4.2%, down from 4.5% in September.⁷ We are neutral on the outlook for European equities.

Positive on UK outlook

In the UK, headline inflation remained at 6.7% annualised in September in line with August, increasing the likelihood that the Bank of England would hold the base rate for the second month running at its next monetary policy meeting in November. The chances of this were reinforced by latest data for England and Wales showing corporate insolvencies were 6,208, or up 10% on an annual basis, raising the possibility of a recession in the UK.⁷

From a stock market perspective, we are positive on the outlook for the UK, which has been overlooked by international investors for some years and we do not believe it will require much of a catalyst to release that value. One of the leading equity contributors to our fund and portfolio performances in Q3 was the JO Hambro UK Dynamic. We deem this fund to be 'value-lite' because it has strict disciplines around the types of businesses (dividend payers only) and allocation that prevents the resultant portfolio becoming concentrated in value traps or companies reliant on external catalysts for improvement. It should outperform in a risk-on market and, with a view to creating a balanced overall exposure to the UK, should be blended with a higher quality growth strategy.

Japanese equity allocation changed

In Asia, Japan took a significant step towards unwinding its historic monetary easing policy by ending its seven-year position of capping long-term interest rates at 1%. High yields on US treasuries have put pressure on Japanese government bonds and the yen. Weakness in the yen has exacerbated Japan's inflation rate, which reached 4.2% in September.⁷

We continue to monitor Japan closely to see whether its strong rally this year is over now, or whether it has scope for further outperformance versus the rest of the developed world. In the meantime, we have trimmed our exposure to Japanese equities in our highest risk eight level models, where exposure includes Baillie Gifford Japanese, Fidelity Index Japan, M&G Japan Smaller Companies and Man GLG Japan CoreAlpha Professional.

We have also changed our Japanese equity allocation in the Explorer and Blended ranges. We have sold our allocation to Man GLG Japan and moved our M&G exposure from small cap only to an all-cap strategy managed by the same team. We believe the new blend gives us a better balance of risks, market capitalisation and sector exposure in the region.

Elsewhere in Asia the Evergrande saga continued, with a Hong Kong judge giving the indebted property developer a last chance to formulate a revised restructuring plan for its US\$300 billion debts or face a potential liquidation order in December. Evergrande is seen by investors as a potential flashpoint for markets because of the significance of China's property sector, which accounts for around a quarter of the country's economy.⁸

A peak in the cycle?

As much as central banks are warning interest rates will have to stay elevated for some time, investors are increasingly confident that the current rate cycle may have reached its peak.⁹ They still have to tread a fine line between their fight against inflation and tipping economies into a significant recession, but we are encouraged to see inflation generally steadying or falling and we still believe any downturn is likely to be shallow. Uncertainty still pervades markets, and investors' sentiment remains fickle, but it could be that it means there is still a window of opportunity to put in place investments for the long term.

¹Source: FT.com, 27 October 2023

²Source: FT.com, 6 October 2023

³Source: FT.com, 13 October 2023/Bureau of Labor Statistics

⁴Source: FT.com, 27 October 2023

⁵Source: FT.com, 26 October 2023

⁶Source: FT.com, 31 October 2023 / Eurostat

⁷Source: FT.com, 31 October 2023

⁸Source: FT.com, 30 October 2023

⁹Source: FT.com, 2 November 2023

For a comprehensive list of common financial words and terms, see our glossary at:
<https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms>

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Past performance does not predict future returns. You may get back less than you originally invested.

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Liquidity Risk: If underlying funds suspend or defer the payment of redemption proceeds, the Fund's ability to meet redemption requests may also be affected;

Interest Rate Risk: Fluctuations in interest rates may affect the value of the Fund and your investment. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;

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