6 MONTH REVIEW

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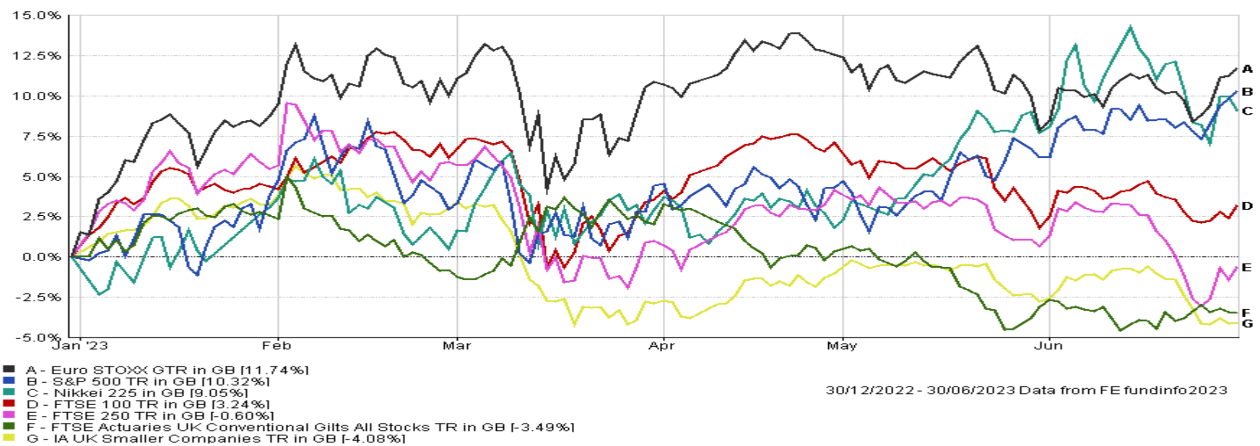
Friday marked a pivotal day for investors, bringing the conclusion of the month, second quarter and first half. After the woeful performance of financial assets in 2022, the recovery in equity markets in 2023 has come as welcome relief to investors. Much of this can attributed to little more than an improvement in sentiment. If you had told me at the start of the year that in 6 months' time, inflation would still be proving sticky and that the Fed and BOE would have moved interest rates over 5% with the promise of more to come, I would not have surmised that equity markets would be up. Yet up they are, with Europe, US and Japan all posting gains in sterling around 10% after the flourish at the end of last week. Our own UK markets didn't fair so well with the FTSE 100 dragged down by Oil and mining stocks over the last quarter and UK mid and small cap actually finished in negative territory, failing to maintain their recovery at the end of last year. Fixed income, despite being the asset class of choice for many asset allocators at the start of the year, did not fair so well, with Gilts leading to the downside.



So why has sentiment improved and how have equities proved so resilient over the last 6 months even with a crisis that threatened the US and European banking systems? The ongoing strength of the US consumer has had much to do with it. With wages going up, covid savings at their disposal and a robust jobs market, people kept spending. Lower energy costs , pandemic savings and high employment levels have also meant that the UK and European economies did not slip in to recession as expected. In fact, figures from the US last week showed that growth in Gross Domestic Product was actually much higher than expected, as the U.S. economy grew at a 2% annual pace from January through March, a sharp upgrade from the previous estimate

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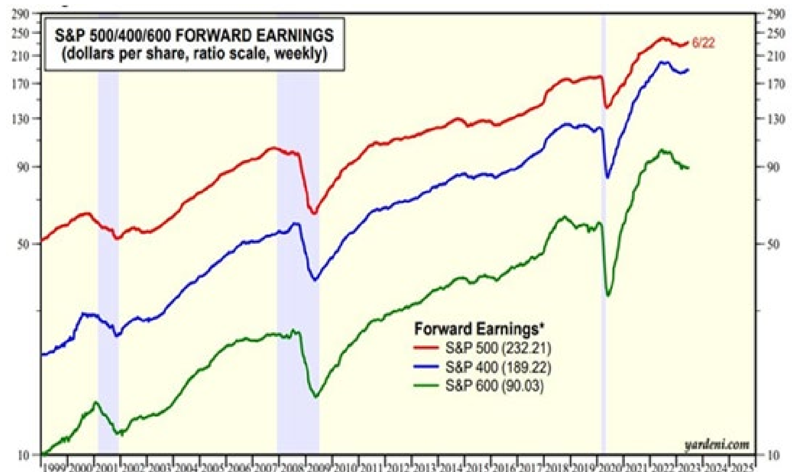


Now, that release could really have spooked equities – stronger economic activity means the likelihood of higher interest rates – but it didn't and markets rallied in to close on Friday, as investors took comfort that perhaps the economy is in a reasonable place to absorb higher rates.

Outlook for 2023 and beyond

For some time and certainly not uniquely, I have been suggesting that there are essentially three economic outcomes from here that will affect global financial assets in very different ways, making the job of an asset allocator particularly challenging. Thankfully, for the AQ models we don't get too drawn in to the 'dark arts of asset allocation' as one of my colleagues describes this occupation. He subscribes to the view that even if you get a few calls right for a while, random events like pandemics or wars will in short order undermine even the most well thought out strategies. And right at this moment in time, given the very divergent range of possible outcomes, I am inclined to agree with him. In fact, that view is the exact ethos of the AQ approach where we believe that trying to add value through asset allocation can often be a fool's errand. Much better to focus one's efforts on driving outperformance through fund selection whilst keeping the allocation broadly in line with peers, it certainly gives you a greater probability of success. But I digress, these are the 3 possible paths for the US economy which will reverberate across the globe.

1. Sticky Inflation – despite the best efforts of central bankers, inflation refuses to just simply fade away any time soon having become entrenched in the psyche of the system well above 2% target levels. Dips will be followed by surges and monetary policy fluctuates in its wake. Not a good scenario for equities, although there will be opportunities to make gains but certainly not good news for bond investors. Think 1970s...

Figure 1: Cumulative equity and bond excess returns (December 1969 through November 1970)

Source: PIMCO, Bloomberg and FRED. Equity returns are based on total returns of the S&P 500 Index. Bond returns are estimated from 10-year government bonds using FRED 10-year Treasury Constant Maturity rates. Bills returns correspond to U.S. 3-month Treasury bills from FRED 3-month Treasury bill: secondary market rate.

2. Immaculate Disinflation / Goldilocks – this is most definitely the not too hot/not too cold path that Central bankers are aiming for, where we see inflation gradually glide down to the target 2% level, without causing too much damage to economic growth and employment. Such a scenario would probably see equities continue on their upward path, aided by gently falling bond yields as inflation recedes.

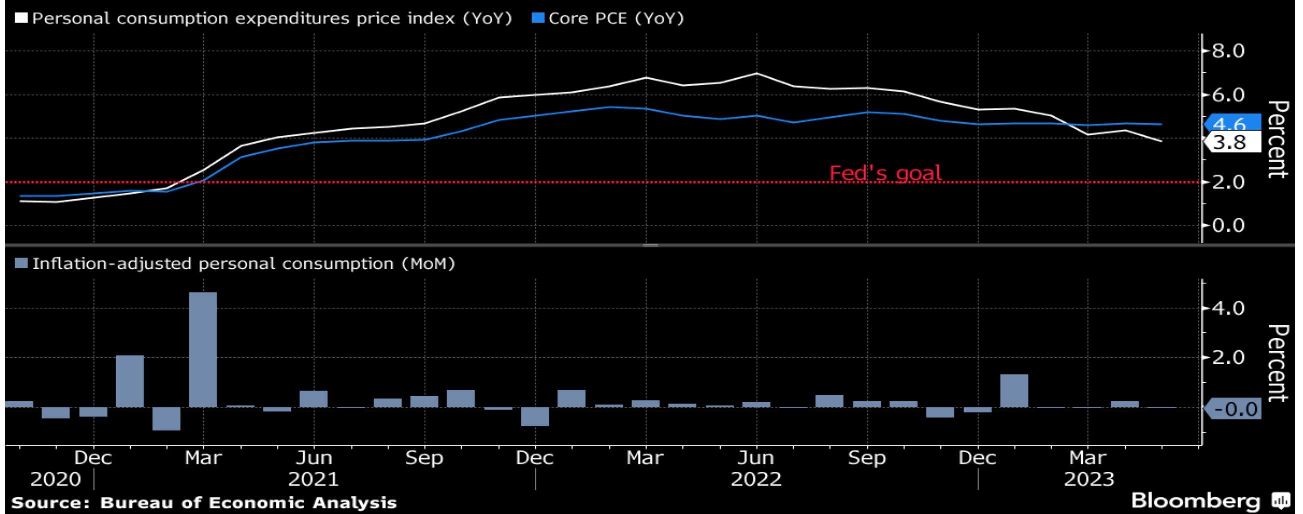
3. Recession – finally there still remains the possibility that all this monetary tightening, albeit with a lagged effect, finally curbs consumption, weakens the jobs market and drags the global economy in to recession. Fixed income would undoubtedly be the asset class of choice in such an environment as prices would move up driving yields down. Long term growth companies might hold their own but the more cyclical parts of the equity market would struggle.

Goldilocks for now, but recessionary worries are building...

For the moment, the behaviour of the markets seems to suggest that investors have bought in to the Goldilocks scenario. US economic data released on Friday certainly added weight to that argument. A measure of US Core Inflation that the FED watch closely posted its smallest advance since July of last year. Personal consumption also slowed, but not too dramatically, although it may be an early warning sign of growth beginning to slow.

The fate of global financial assets over the second half of the year is now very much dependent on US economic data continuing to fit the goldilocks narrative. If goldilocks holds for the US, then it is also more likely to hold for other markets. But if there are any signs of inflation heating up, then equity and bond markets could get spooked. And conversely and I think more likely, if consumption and growth slow too fast, then expect a cooling off from stocks, although bonds would do well. If the US acted in isolation, then I would assign a high probability to its economy muddling through, avoiding a recession. But it is only one part, albeit by far the largest, of the global ecosystem. Whilst the US may be in the enviable position of being able to reduce inflation without causing too much economic damage, that may be the case for other economic regions. Evidence that monetary tightening is beginning to derail European and UK growth is building.

US Inflation Eases, Spending Stalls as Economy Loses Steam
Fed's preferred inflation gauge slowed in May from a year ago



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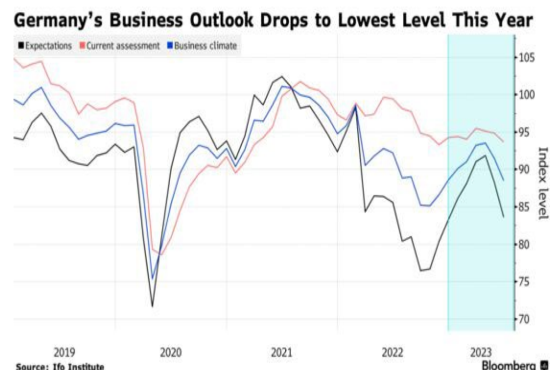
Germany's business outlook (the IFO survey) deteriorated to the lowest seen this year, providing soft evidence that Europe's biggest economy is struggling to cement a recovery. The IFO index fell last week to 83.6 in June from 88.3 in the previous month much worse than anticipated by any economist in a Bloomberg survey. Weakness in the manufacturing sector seemed to be the primary cause of the fall. Confirming that picture, a survey of purchasing managers published Friday showed that German economic activity lost much more momentum than anticipated in June, driven by a slowdown in services and sustained weakness at the country's factories.

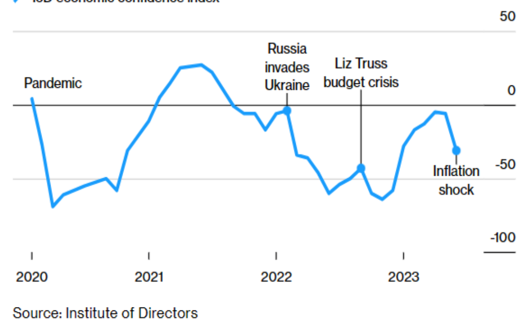


It is a similar picture in the UK, as business confidence has also suffered a sudden collapse in June following the 0.5% rate increase by the BOE. The IOD reported a slump with the economic confidence index reversing trend and turning sharply down to the lowest level this year. Again this is soft data by which I mean people's opinions rather than hard economic data and it was conducted just after the BOE news and as a surge in mortgage rates intensified. But, it now looks likely the BOE will boost its key lending rate to as high as 6.25% by December, a jump that threatens to tip the UK economy into recession. We are a nation much more sensitive to mortgage rates than elsewhere around the globe.

UK Business Confidence Took a Sudden Dive in June

Net balance of optimism about economy in next 12 months

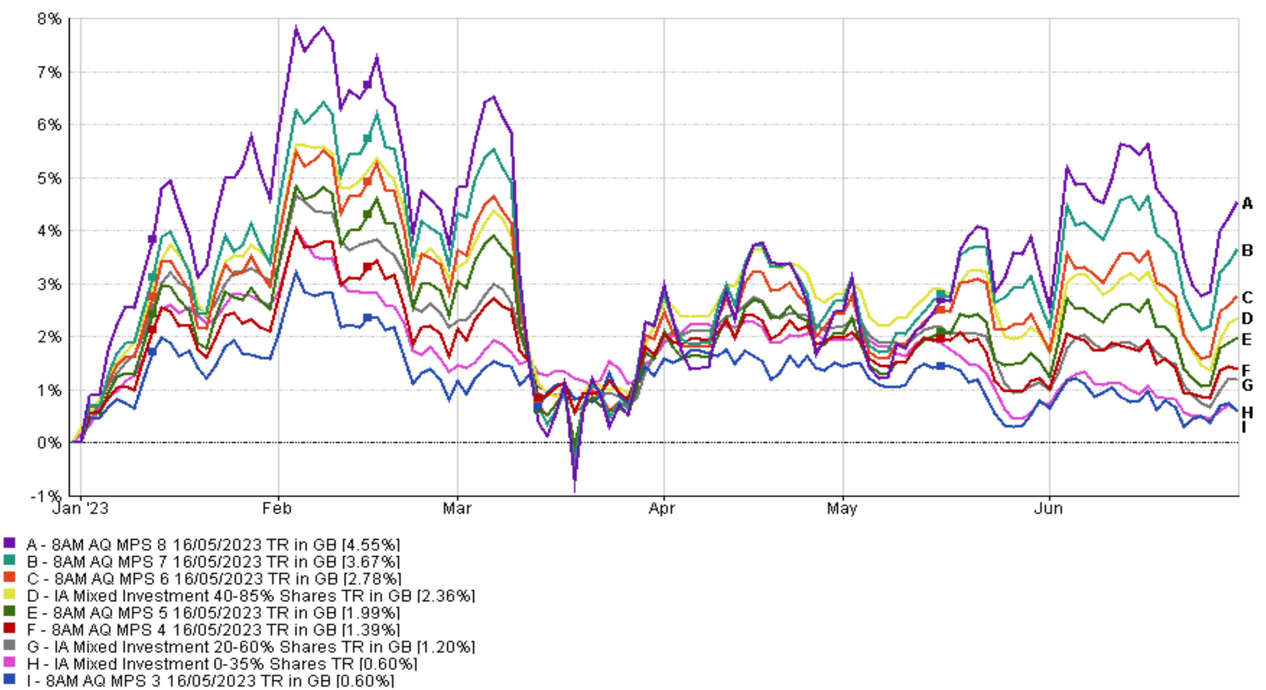
IoD economic confidence index



Source: Institute of Directors

And what of the great Chinese recovery, this was supposed to be China's year ? The country had finally reopened after three years of strict Covid Zero lockdowns, and as the economy roared back to life, it was going to power stagnating global growth. Unfortunately, halfway through 2023, there are few signs of the dragon breathing fire in to global growth. Sluggish consumer spending, a crisis-ridden property market, flagging exports, record youth unemployment and towering local government debt have come together to undermine China's economy.
Still the Chinese economy is set to grow at an enviable 5% this year and history has taught me never to underestimate the ability of the authorities there to surprise markets. China certainly has the monetary flexibility (inflation is not a problem) to unleash further monetary stimulus should they feel the need to and pressure is slowly building. China's great reflation package in 2009 did much to ensure the world economy was able to recover after the Global Financial Crisis in 2008 and on a smaller scale the same may be true this time round. Another great reason for optimism that markets have woken to, is the boom surrounding the opportunity that Generative Artificial Intelligence is creating for businesses. If harnessed properly, I don't think this is just a passing fad, it could simultaneously boost economic productivity and output, whilst alleviating wage inflation.

As ever, a case can be made for both bull and bear outcomes for equities and bonds. We will continue to stay diversified and concentrate our efforts on delivering outperformance through fund selection and I am delighted to report another successive 6 months of outperformance from the AQ models versus benchmarks.
AQ Models versus IA Sector Averages – 6 months to 30.06.2023



30/12/2022 - 30/06/2023 Data from FE fundinfo2023

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