AQ UPDATE 75 (16.10.23) – MARKETS BRUSH OFF TERRORISM IN MIDDLE EAST

MIDDLE EAST

Not for the first time, I will open up this Market Matters with my deepest sympathy for those affected by the tragic events of military aggression. This time it is for the people of Israel and Gaza following the unprovoked attack by Hamas militants. It is not our place to offer political context on the reasons why, our job here is to assess the potential implications for financial assets following the events which were utterly barbaric but, we wish for nothing more than swift resolution with as little further tragedy as possible.

In response to the Hamas attacks, Israel has initiated extensive airstrikes in Gaza and is planning a ground invasion, under a unity government aiming to neutralize Hamas. Despite a concentrated military response and substantial troop mobilization, the strategy poses risks of escalating violence, potential emergence of new extremist factions, and unaddressed tensions with regional adversaries like Iran and Hezbollah. Sadly, it is likely to get even 'uglier', last longer than hoped for and ultimately not resolve the Palestinian issue, and probably leave Israel ever more isolated from its neighbours.

INDICES	1 WEEK %
Nikkei 225 in JP	4.26
FTSE 100 TR in GB	1.44
MSCI AC Asia ex Japan TR	1.36
MSCI Emerging Markets TR	1.23
MSCI China TR	1.18
MSCI Europe ex UK TR	0.63
MSCI India TR	0.62
S&P 500 TR in US	0.46
Bond: UK 10 Year Yield	4.38
Bond: US 10 Year Yield	4.62
Currency: GBP/USD	1.21
OIL: WTI $	87.72

Stepping back from the emotion, my observation is that investors have probably become a little too desensitised to geopolitical conflict. A sense that if we can get past a European War and a Global Pandemic, then we can surely get through a Middle Eastern conflict. That could explain why we had a decent week for global equity markets. It was the turn of Japan to lead the major markets with a gain of more than 4% in local currency, with the US equity market unusually bottom of the pack, still with a respectable gain of 0.46%. Much of the move in equities can probably be attributed to the rally in bond markets where yields finished the week lower, despite an indifferent inflation report out of the US. Oil, which had been trending lower, spiked higher on Friday but still far below the September highs of over $95 per barrel.

Both the Consumer price index, Core CPI (which excludes food and energy costs) came in a whisker above expectations and a long way from the Fed's 2% target. Digging into the numbers, the Services component remains by far and away the biggest detractor from bringing things down in to the target range.

And within Services, it's the cost of shelter – housing costs – that are proving the most sticky. Part of that is due to the lag effect of official data that doesn't keep pace with market trends. If you checked Zillow's rent index to see what's actually happening in the market, it points to steep drops over the last few months, although worryingly just recently they have begun to tick up.

I say worryingly, as for several months, the prevailing sentiment has been, 'don't worry about the inflation figures, falling rental costs are bound to bring the numbers lower'. If it looks like that assumption cannot be taken for granted, then we may yet see inflation prove

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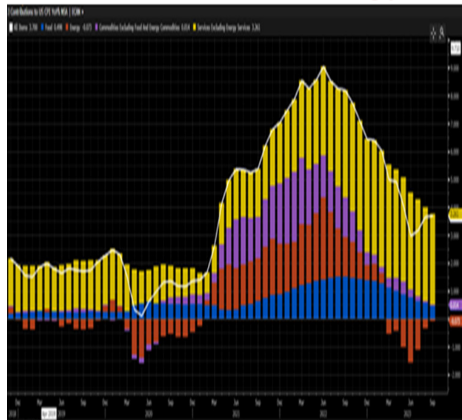
much stickier than hoped for by investors.

Despite a week which saw bond yields fall overall, the latest inflation numbers have increased the chance of an increase in interest rates at the next Fed meeting. That certainly wouldn't be what investors are hoping for, as there seems to be a general conclusion that the recent move higher in bond yields has done enough to tighten financial conditions, removing the need for further action from the Fed. That could yet prove to be wishful thinking, but it is a reasonable base case.

Indicator	Actual change	Median estimate
CPI (MoM)	+0.4%	+0.3%
Core CPI (MoM)	+0.3%	+0.3%
CPI (YoY)	+3.7%	+3.6%
Core CPI (YoY)	+4.1%	+4.1%

Services : Food : Energy



Earnings

Between now and when we next hear from the Fed on November 1st, micro issues are more likely to drive the direction of the equity markets and more specifically corporate earnings, as we have just entered the Q3 season. As per usual the big banks have opened up proceedings and so far, so good. JPMorgan, Wells Fargo and Citigroup each announced third-quarter earnings that outstripped the market's consensus predictions, momentarily lifting U.S. stocks, before escalating economic and geopolitical anxieties weighed on markets. The rhetoric accompanying the numbers wasn't quite as encouraging as the results. All three of the banking behemoths warned of impending difficulties ahead, with certain segments of their operations showing early indicators of strain largely as a result of the build-up in consumer debt.

Going in to this earnings season FactSet were looking for a decline of -0.2% for the S&P 500 which would be the fourth straight quarter of YoY declines. The positive start, albeit only for 32 of the 500 companies, has tilted Factset expectations higher and they are looking for earnings growth of 0.4%. That's hardly going to set the world alight at an aggregate level, but at a stock specific level we could see some large swings, with good numbers being handsomely rewarded and poor results punished. By the end of next week we will have a much better idea of how earnings are going to pan out as we have an avalanche of companies reporting, including Tesla, Netflix, Johnson & Johnson, United Airlines, ASML and Taiwan Semiconductors. To put a valuation perspective in to the market right now, the forward 12-month P/E ratio for the S&P 500 is 18.1 which is below the 5-year average (18.7) but above the 10-year average (17.5). (Factset numbers as at 13/10/2023)

UK

The UK economy just about returned to growth after figures released last week confirmed that there was marginal growth in August, with a 0.2% increase in GDP following the 0.6% decline in July which had been hampered by poor weather and strikes. However, it now looks as if we might avoid the G7 wooden spoon for 2023 as the IMF have Germany in pole position for that award. But before we get out the cakes and party hats, the IMF is still expecting the UK to be the sickly child for 2024.

Taking a closer look at the GDP figures released by the ONS last week, the growth was all down to the crucial services sector which was up by 0.4%, with both the production sector and construction down 0.7% and 0.5%, respectively. Looking at the services number, the main surprise is how well the consumer must be holding up in an economy that has been burdened by 14 successive interest rate hikes. Despite this slight uptick which broadly aligned with City predictions and will mean we should avoid a technical recession for the third quarter, I think the chance of us not dropping in to recessionary territory next year is still a coin toss. The silver lining here is that with growth only likely to be anaemic at best then the BOE is probably done with rate hikes.

Again, I wouldn't rush out and pop the champagne corks just yet, but in September, the UK housing market showed a little sign of resilience helped by the nudge lower in mortgage rates and new optimism that interest rates might have peaked. The Royal Institution of Chartered Surveyors reported that measures of new buyer inquiries and sales rebounded from their recent lows. Additionally, sales expectations for the upcoming 12 months showed a slight shift into positive territory! Property prices have come down and these findings support the notion that more affordable home loans

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Britain Is Expected to Post the Slowest Growth in the G-7 Next Year

GDP YoY	2023		2024
US	2.1	Canada	1.6
Japan	2.0	US	1.5
Canada	1.3	France	1.3
France	1.0	Japan	1.0
Italy	0.7	Germany	0.9
UK	0.5	Italy	0.7
Germany	-0.5	UK	0.6

Source: International Monetary Fund

are enticing potential buyers back into the housing market. We shall see, its all very well prices coming down a bit and better mortgage offers appearing, but you still need the people out there in a position to buy and tighter economic conditions will only diminish that number.

In Summary

As we reach the October mid-point, I am hoping for a good earnings season to improve sentiment for a while, but I suspect that feel good factor could be challenged by either geopolitical tension escalating or bond market volatility. Currently, cash and fixed income are our preferred asset classes and although we have thankfully resisted the urge to extend the duration of our bond weightings all year, that point does seem to be nearly upon us. In the meantime, we will continue to focus our efforts on what we do best, crunching the numbers and seeking to identify those funds that have the greatest probability of delivering relative outperformance.

For what it is worth, I still believe we could be in the embryonic phase of a new bull market that could yet parallel the 1982 – 2000 market. Just as the PC drove productivity gains and corporate profitability that seemed unimaginable back then, so it could be the confluence of the new digital technologies such as cloud computing and artificial intelligence that do the same this time. Perhaps that is just wishful thinking, as ever, only time will tell.

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