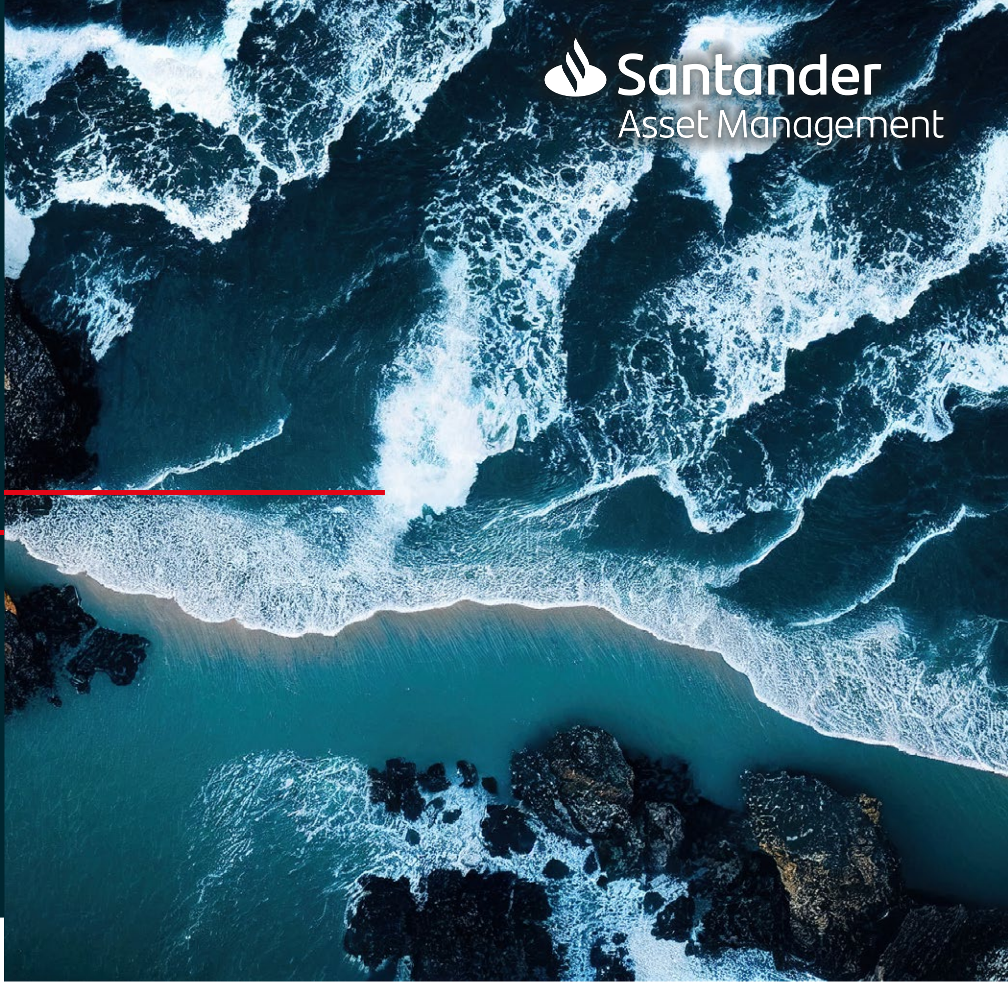


State of Play

Is the turning point in sight?

9 February 2023

After such a painful 2022, the start of this year has brought investors much cheer as all asset classes staged a strong rally. However, is this yet another relief rally or the start of serious momentum? This week we take a look at some of the evidence to try and see beyond the gloom. Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Key highlights from this week's State of Play

- Positive bounce in January
- Looking beyond the gloom
- Reasons for caution
- Is the turning point in sight?

Positive start to the new year

Despite the sobering economic outlook, investment markets have made a bright start to 2023. Even after the central banks as expected raised interest rates further last week, markets took this in their stride seeing light at the end of the tunnel as all major indices rose. So far this year (up till the end of January), virtually all asset classes have made positive returns, with the technology-dominated NASDAQ in the US gaining 10%, closely followed by both Chinese and European shares at 8% and 7% respectively.[1] The UK stock market has continued the modest returns of last year by gaining just over 4% in January. While bonds lagged behind shares, all major bond assets made positive ground with UK Corporate Bonds delivering over 4% returns including income.[1] This is in line with the much improved outlook for bonds that this update covered just at the start of January.

Looking beyond the gloom

Last week, when the Federal Reserve (Fed) announced a smaller rate rise than at the previous meetings in 2022, they also signalled the possibility that the US economy may be heading for a soft landing. This is where inflation begins to fall towards their target of 2%, after the various rate rises, without sending the US economy into recession. Given the events of the last year, where central banks wrongly predicted that rising prices would be temporary and then consequently increased interest rates aggressively in response, many were predicting that normalising rates so quickly at a time when consumers were battling through big rises in energy and shopping bills, would inevitably tip the US economy into recession.

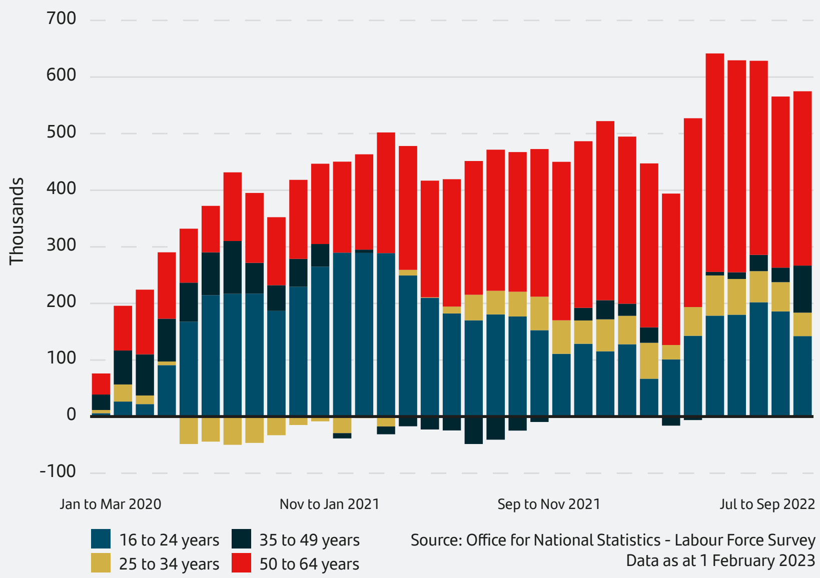
To believe that the US economy could weather such a storm after reversing 15 years of low interest rates in less than a year seemed fanciful. However, the US has benefited from being more independent than most as it relies less on imported raw materials and energy supplies. In addition, the strength of the US job market has been somewhat of a minor miracle, highlighted again at the end of last week as the latest payroll numbers showed over half a million jobs were added in January. This takes the US unemployment rate to 3.4%, bucking the trend at the end of last year as jobs growth began to slow.[2]

In many respects, the strength of the job market has been cited by the Fed as one of the factors for continuing to raise rates over concerns that a high number of vacancies makes for a competitive hiring marketplace, driving up wage settlements and exacerbating inflation in the process. If the Fed does indeed pause rates in the coming months to assess the health of the US economy, and if inflation falls sharply alongside the labour market easing, the dream of a soft landing may become a reality.

Reasons for caution

Whilst the improving outlook for the US is good news for investors, the same cannot be said across other major economies. The UK is scheduled to release economic data on Friday (10 February), with many predicting a drop in December but not enough to trigger a technical recession, which many define as two quarters of negative growth. The latest inflation figures for both the UK and the Euro Zone are falling, albeit gradually, which is good news, but other indicators show higher prices and higher interest rates are starting to bite. On Monday (6 February), the latest EU retail sales figures for the in December were down 2.8%, slightly worse than forecasted, following on from a fall of 6.8% for the UK. Next Tuesday, the GDP economic numbers for the EU are expected to show flat numbers, but importantly avoiding recession, for now.[3]

UK economic inactivity by age



Source: Office for National Statistics - Labour Force Survey
Data as at 1 February 2023

One aspect concerning both the Bank of England and the European Central Bank is the employment market. In the UK, vacancies currently remain above 1 million, with a significant drop in those active in work.[4] The UK is somewhat of an outlier from their international counterparts, as the fall in those available to work during the pandemic was due to some taking early retirement, a larger proportion becoming long-term sick and an increase in younger people choosing to study instead of looking for work.[4] Where other countries have seen a return to similar activity as prior to the pandemic, the UK has lost a significant proportion of workers, making it increasingly difficult for employers to recruit staff to fill vacancies or grow their businesses. The Bank of England expressed concerns about the impact on wage settlements as earnings rose by 6.4% at the last count, which is likely to feed into consumer demand and make bringing down inflation quickly more challenging. Hence the latest rate rise by the Monetary Policy Committee (MPC) last week was an additional 0.5%.

Is the turning point in sight?

Despite such a positive January, investors remain nervous. At the time of writing, all markets were falling, including bonds. Yields rose in the early part of this week in response to some concerns that investors may be over optimistic about the end of rate rises. Ever since the early part of October, UK Gilt yields have fallen gradually from over 4.6% to a low last week of just over 3%.[3] The sharp rise early this week is a reminder of how uncertain the future is as market participants await further evidence that both inflation and wage settlements are continuing to fall.

Also, last week saw some of the largest companies post their latest results, with Alphabet (owner of Google), Apple, Amazon and META (formerly Facebook) all updating investors. As expected, most companies missed expectations, although Amazon did post an unexpected rise in revenues, while their earnings fell because costs have risen significantly. All but Apple are embarking on significant job cuts in an attempt to respond to slowing consumer demand.[2]

However, despite some disappointing results, the slowdown so far appears muted. In previous slowdowns, the economic backdrop has almost always been accompanied by much higher unemployment, which provides a dilemma for central banks. If, as in the US, the unlikely possibility they manage to avoid recession, will the aggressive increases in interest rates over the last 12 months have been too much, too soon? Common sense dictates that if goods are 10% higher than they were a year ago, unless your wages keep pace with this, you are unable to buy the same number of goods and services as you used to. In many ways, the fall in consumer demand caused by price increases does the job for central banks without the need for rates to be normalised as quickly.

Only time will tell whether the normalisation of rates has been just enough to slow demand without tipping economies into recession or if the most recent rises were a step too far. One consistent theme of last week's increases by the Fed, ECB and BoE, was their update signalling that they are close to pausing rate rises so they can evaluate the impact on consumer demand and rising prices. This expected pause will test investor confidence. It will be interesting to see how investors react to the expected poor economic numbers and disappointing earnings as the slowdown filters into company results. If the market is always looking to the future, we should expect them to celebrate the end of normalisation, but of course we cannot be sure how the dice will fall. As we have explained in previous updates, emotions often get in the way of rational thinking.

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 7 February 2023.

[1] FE Analytics, 1 February 2023
[2] Financial Times, 2 February 2023
[3] Investing.com, 6 February 2023
[4] Office for National Statistics (ONS), 17 January 2023