

# Capital Markets Update

## Summer 2023

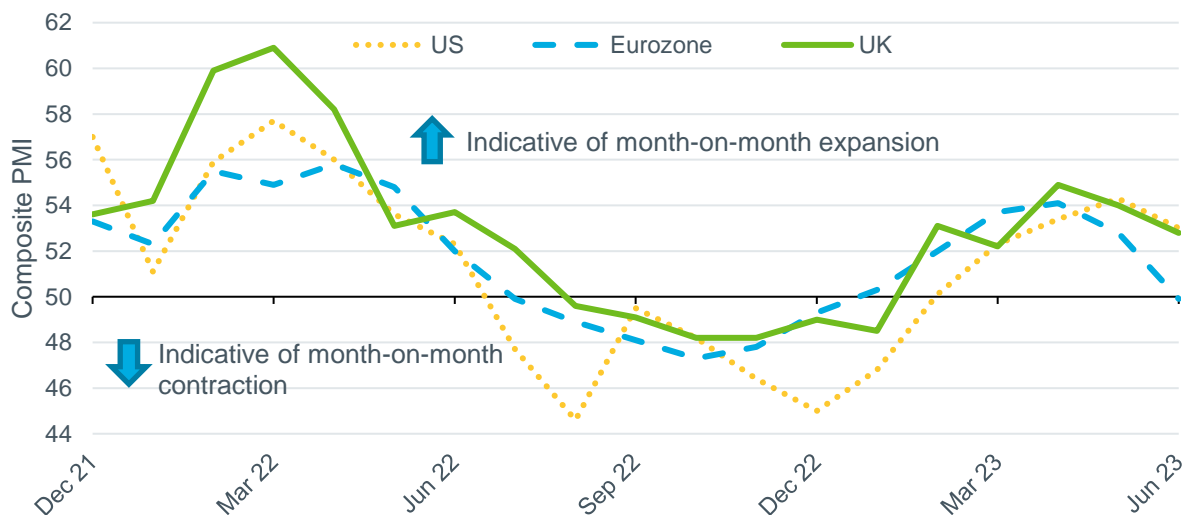
This year's unexpected economic resilience continued in Q2 amid strong labour markets and robust consumer spending. Meanwhile, core inflation fell much less than headline measures in the major advanced economies.

Global equities rose around 7%, taking year-to-date gains to over 14%, and credit spreads fell, while sovereign bond yields rose in anticipation of higher-for-longer interest rates.

### Global themes

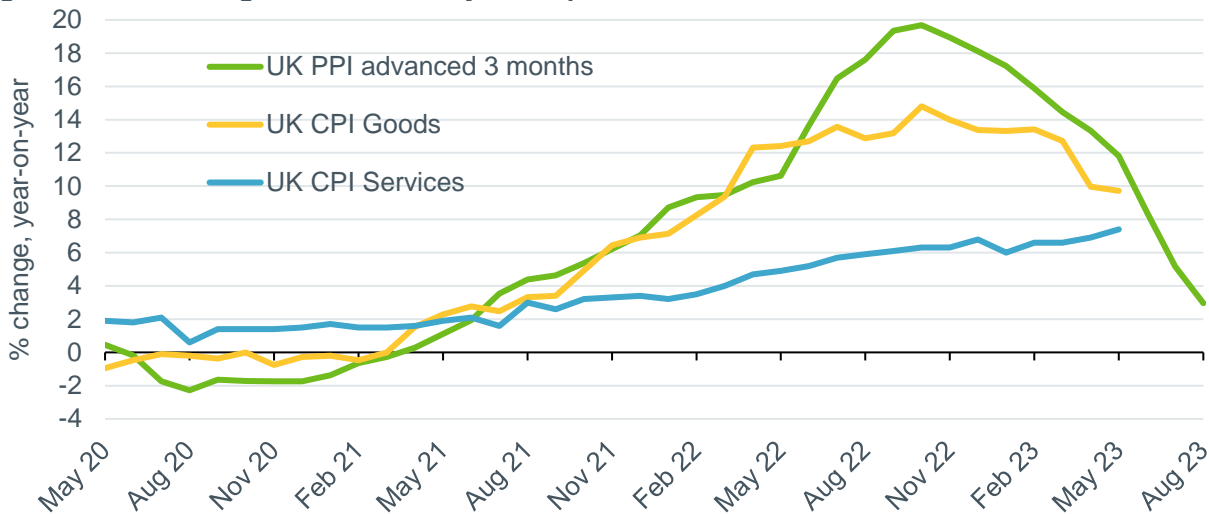
Global GDP growth forecasts for 2023 were revised upwards in Q2, given unexpected resilience in labour markets and consumer spending. However, there's still a stark divergence between strong demand in the services sector and an ongoing downturn in manufacturing. Higher inventories and weak global goods demand continue to bear down on the manufacturing sector. Meanwhile, consumer spending on services has been strong, supported by both the strength of labour markets and consumers using pandemic savings; spending is now more focused on services than goods. However, services growth has also started to slow, and June's composite purchasing managers' index (PMI) data suggest the recent upturn is easing (chart 1), particularly in the eurozone.

**Chart 1: June's composite PMI data indicate the recent upturn is easing**



The sectoral divergence seen in business surveys is also evident in inflation data. The UK's experience, shown in Chart 2 – goods price inflation declining as supply chains improve, while services inflation is still rising – is reflected across the major advanced economies. Overall headline inflation has fallen in the major advanced economies and is expected to continue to do so, as the large gains in energy and food prices of last year fall out of the annual calculation. Indeed, some of this impact is already being seen in sharp declines in producer price inflation. However, core inflation, which excludes volatile energy and food prices, is proving more persistent. Central banks are concerned that strong nominal wage growth is underpinning this persistence and think they will need to tighten policy further to rein it in.

**Chart 2: Falling producer price inflation augurs well for a further fall in goods inflation, but strong wage growth introduces greater uncertainty to the path of core inflation**



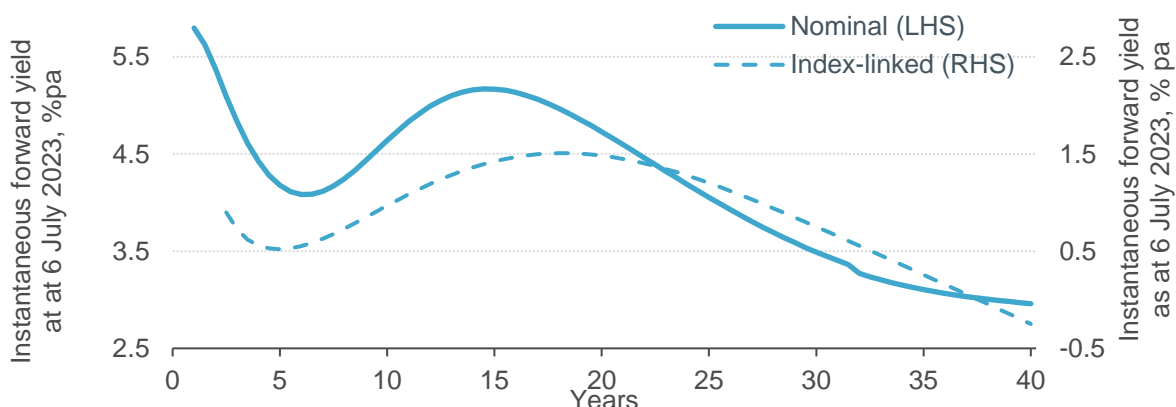
Against this backdrop, the Bank of England (BoE) has increased rates by a cumulative 0.75% pa, to 5.0% pa, including a surprise 0.5% pa rise in June. The US Federal Reserve raised rates 0.25% pa, to 5.25% pa, before pausing in June to assess the impact of prior monetary tightening, and the European Central Bank increased its deposit rate to 3.5% pa. Market expectations of rate cuts later in 2023 evaporated over the quarter, and rates are now expected to rise further and remain higher for longer across the major advanced economies.

With higher interest rates likely to slow consumer and business activity in the second half of 2023 and into 2024, the growth outlook remains relatively weak, despite upgrades to more gloomy forecasts made at the start of the year. Slowing global activity may reduce corporate pricing power, which will likely pressure margins and debt affordability metrics alongside rising borrowing costs. This makes for a tough outlook for corporate earnings.

### Government bonds

UK government bonds faced pressures both fundamental – disappointingly high inflation – and technical – heavy issuance and ongoing asset sales by the BoE; yields rose sharply across the curve in Q2. Not only are current inflationary pressures proving more persistent, but medium-term inflation forecasts have also been drifting higher. While this may be a knee-jerk extrapolation of recent uncertainties, forecasters do point to a range of plausible reasons. These include expectations of more persistent labour shortages, a greater prevalence of supply shocks, diminishing returns from globalisation, the transition to net zero, and looser fiscal policy than we saw in the period after the global financial crisis. These could explain why inflation, and interest rates, might be higher over the medium term.

**Chart 3: Falls in forward yields beyond 20 years make us more cautious on longer-dated gilts**



However, even allowing for elevated near-term inflation, slightly higher inflation over the medium term, and the uncertainty associated with that outlook, 10-year nominal gilt yields of 4.6% pa look attractive versus our assessment of fair value of around 3.5% pa. Ten-year index-linked gilt yields have also risen to reasonably attractive levels of 1.1% pa. Very weak real growth forecasts and sticky inflation should help keep a lid on real yields. We see the best value in gilt yields at maturities out to 20 years, given a sharp fall in longer-term forward real and nominal yields beyond (Chart 3). Gilt-implied inflation, as measured by the difference between nominal and index-linked yields of the same maturity, indicates short-dated index-linked gilts offer decent value but suggests a relative preference for nominal gilts at medium-to-longer terms.

### Credit

In the major investment-grade markets, the benefit of a modest fall in credit spreads was offset by rising government bond yields. In sterling markets, the relatively large rise in gilt yields and a relatively small fall in spreads (Chart 4) led to a negative return. The speculative-grade credit markets fared better, given their shorter duration and, reflecting their greater sensitivity to recent economic resilience, a larger fall in spreads. These markets have also had a technical tailwind from shrinking supply: net credit rating migration from speculative grade to investment grade has been positive, there has been some repayment of debt raised during the pandemic, and recent issuance has largely been used to refinance existing debt.

**Chart 4: Despite recent tightening, investment-grade spreads remain slightly above long-term medians**



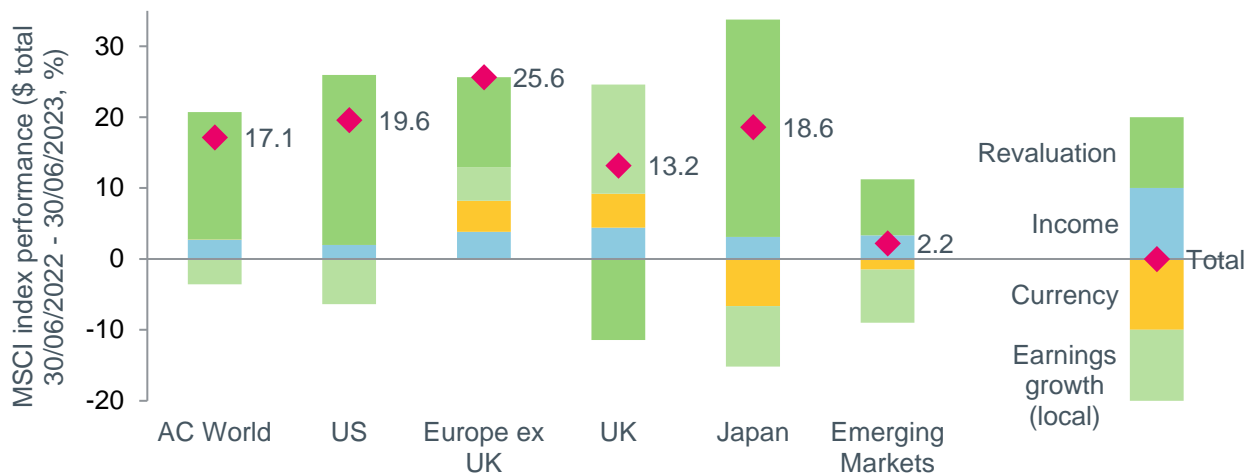
Default rates, realised and forecast, are rising from low levels. However, corporate balance sheets start from a strong position and defaults are expected to peak at lower levels than in previous slowdowns. Nonetheless, we retain a preference for investment-grade markets, where the deterioration in fundamentals is expected to be less severe and take longer to materialise than in speculative-grade markets. Despite recent tightening investment-grade credit spreads remain above long-term median levels, and the usual illiquidity premium on sterling- versus global bonds has returned to long-term average levels (Chart 4). Global high-yield bond spreads, below long-term medians, offer little compensation against downside risks. Loan spreads look more attractive, but loans are more sensitive to rising interest rates, and so defaults are expected to be higher in this market.

### Equities

The MSCI World total return index rose over 7% in local currency terms in Q2. Japan extended its year-to-date outperformance: yen weakness on the back of increasingly divergent interest rate policy between Japan and its major trading partners has boosted the value of overseas earnings in the exporter-heavy index. North America also outperformed, benefiting from the US market's disproportionate exposure to the technology sector which was buoyed by optimism about the impact of AI adoption on future earnings. In addition, US earnings in Q1, although flat compared to Q1 last year (according to IBES data), strongly outperformed downbeat forecasts made at the start of reporting season. However, expectations that earnings growth will accelerate to 8%

year-on-year in Q4, following a decline in Q2 and no growth in Q3, may be vulnerable to disappointment should economic growth slow as we expect.

**Chart 5: Revaluation has been the main driver of equity performance over the past year**



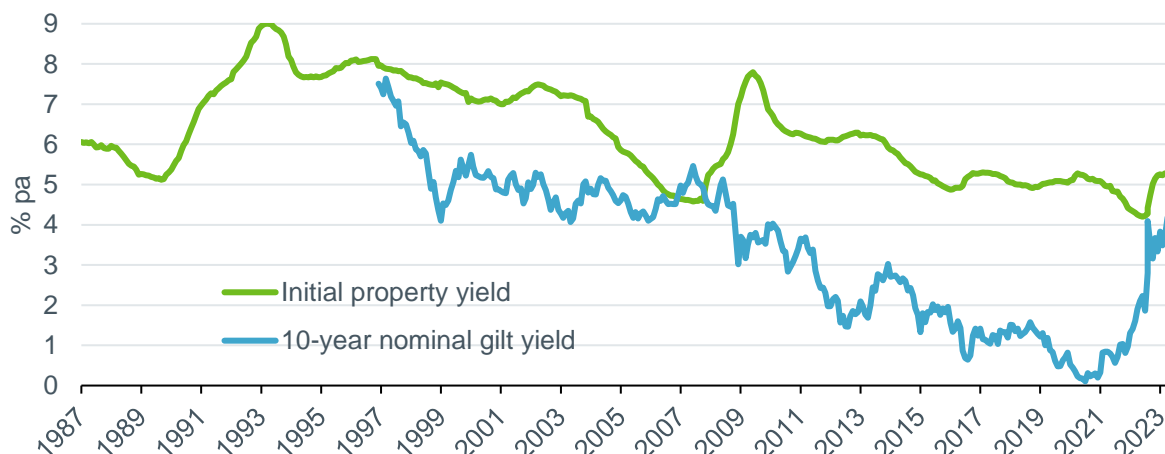
Indeed, across the world, with the UK being a notable exception, strong equity performance over the past year has been driven almost entirely by revaluation – an expansion of price-to-earnings multiples – rather than earnings growth (Chart 5). This is particularly true of the US, where returns have been driven by a small number of mega-cap technology stocks. Recent price performance has taken cyclically adjusted valuations further above long-term averages, leaving limited scope for revaluation to drive equities higher against a challenging fundamental background. Furthermore, recent sharp rises in real yields leave equities looking very expensive relative to risk-free assets.

**Property**

In aggregate, UK commercial property values, as measured by the MSCI UK Property Index, had fallen by over 20% in the 12 months to the end of May. Capital values have stabilised in recent months, with a modest rise in the retail and industrial sectors, although office values continued to decline in May. Alongside income, this led to a modest positive total return from the market over the quarter until the end of May. However, we don't have a great deal of confidence that this is anything more than a temporary hiatus in the downturn.

Transaction volumes are low and those deals that have completed have generally been for industrial properties, where the demand picture is more positive than the market as a whole. The economic backdrop and higher interest rates could easily force more sellers to market.

**Chart 6: Yields have risen sharply from their trough in June 2022, but remain low versus history, and increasingly so relative to gilts**



The latest UK Commercial Property Market Survey by the Royal Institute of Chartered Surveyors points to a modest improvement in sentiment in the occupational markets: occupier demand and rent expectations have picked up and inducements have declined, but sentiment is still subdued. Meanwhile, real rental growth remains negative, and we expect nominal rental growth to come under further pressure as affordability becomes more challenging for tenants.

Although yields have risen sharply over the last year (Chart 6), they remain low versus history, and don't yet reflect adequate compensation for the risks. Furthermore, the yield premium on commercial property versus gilts suggests property looks increasingly expensive relative to risk-free assets.

## Conclusion

The economic growth outlook remains relatively weak, despite upgrades to more gloomy forecasts made at the start of the year. Slowing global activity and rising borrowing costs make for a tough outlook for corporate earnings and hence the fundamental outlook for equity and credit markets is challenging.

This suggests a more favourable fundamental outlook for 'safe' assets, such as sovereign bonds, cash and high-quality credit than for risk assets, such as equity, speculative-grade credit, and property. Although inflation is proving more persistent, and interest rates may have to rise further and remain higher for longer, higher sovereign bond yields provide a degree of protection against this. Credit spreads are unexceptional, particularly in speculative-grade markets, where the fundamental risks are greatest, which reinforces our fundamental preference for higher-quality credit. Recent equity performance has pushed valuations further above long-term median levels, and earnings forecasts look vulnerable to the economic downturn that may be required to quell inflation. We're not convinced that the stabilisation in property capital values represents a fundamental improvement rather than simply a lack of transaction activity. Here, too, valuations are not yet attractive, and we are still cautious.