HYMANS ROBERTSON

# Market brief

## December 2023 – highlights

- US economic growth was faster than expected in Q3, driven by robust consumer spending. Meanwhile, the UK and eurozone both registered mild contractions over the same period.
- The global composite purchasing managers' index (PMI) suggested that the global economy grew in December. However, there was a divergence in performance across sectors: the service sector activity accelerated, but manufacturing activity was weak.
- Inflation continued to fall across the major advanced economies in November. In the UK, year-on-year headline and core CPI came in well below market expectations.
- Falling inflation and updated Fed forecasts of three 0.25% pa rate cuts in 2024 caused market-implied interest rates to fall dramatically. Markets priced in around six such rate cuts each from the US Federal Reserve (Fed), Bank of England (BoE), and European Central Bank (ECB) over the next 12 months.
- As a result, sovereign bond prices rose sharply, and yields fell across the board. Credit spreads tightened, and equity markets ended 2023 with another month of bumper returns, making it their best year since 2019.
- Oil prices fell by a further 3.7% in December as strains within the OPEC+ cartel intensified and markets doubted the impact of production cuts on global supply, given the growing relative prominence of non-OPEC suppliers.
- A decline in expected interest rates and lower real yields saw the trade-weighted US dollar fall a further 1.4%.

### Market performance to end December 2023

| UK | December 2023 | Q4 23 | 2023 |
|---|---|---|---|
| **EQUITIES** | **4.5** | **3.2** | **7.9** |
| **BONDS** | | | |
| Conventional gilts | 5.4 | 8.1 | 3.7 |
| Index-linked gilts | 6.4 | 8.7 | 0.9 |
| Credit | 4.3 | 7.3 | 8.6 |
| **PROPERTY**** | **n/a** | **-0.7** | **0.3** |
| **STERLING** | | | |
| v US dollar | 0.7 | 4.4 | 6.0 |
| v Euro | -0.5 | 0.1 | 2.4 |
| v Japanese yen | -4.0 | -1.3 | 13.2 |

| GLOBAL | December 2023 | Q4 23 | 2023 |
|---|---|---|---|
| **EQUITIES** | **4.0** | **9.3** | **22.1** |
| North America | 4.6 | 11.8 | 26.5 |
| Europe ex UK | 3.2 | 6.9 | 17.3 |
| Japan | -0.5 | 1.9 | 28.2 |
| Dev. Asia ex Japan | 6.6 | 7.7 | 11.3 |
| Emerging Markets | 2.8 | 5.0 | 9.0 |
| **GOVERNMENT BONDS** | **2.8** | **5.3** | **6.9** |
| High Yield | 3.4 | 6.6 | 12.4 |
| Gold | 1.4 | 11.2 | 13.8 |
| Oil | -3.7 | -18.6 | -8.5 |

Percentage returns in local currency ($ for gold and oil). All returns to 29/12/2023, *apart from property (30/11/2023). Source: DataStream and Bloomberg. FTSE Indices shown: All Share, All World, W North America, AW Developed Europe ex-UK, W Japan, AW Developed Asia Pacific ex-Japan, Emerging, Fixed Gilts All Stocks, Index-Linked Gilts All Maturities, iBoxx Non-Gilts, S&P GSCI Light Energy, Crude Oil BFO, ICE BofA Global High Yield, Gold Bullion LBM , MSCI UK Monthly Property and BBG Aggregate Government Total Return.

# Fixed income markets

## Yields at a glance

### UNITED STATES

Benchmark US 10-year treasury yields **declined by 0.7% pa** over the quarter to **3.9%**

### UNITED KINGDOM

UK gilt yields **fell 0.9% pa, to 3.5%**

### GERMANY

10-year German bunds yields **fell 0.8% pa to 2.0%**

### JAPAN

Japanese government bond yields **fell by 0.2% pa to 0.6%**

Investors' enthusiasm that central banks will cut rates more and sooner in 2024 than previously thought saw bond prices rally and yield fall sharply. Developed market sovereign bond yields ended 2023 at, or below, where they started the year. Japanese yields fell less than their counterparts, given potential divergence in monetary policy between Japan and the other major advanced economies.

### Inflation expectations

UK 10-year implied inflation, as measured by the difference between conventional and inflation-linked bonds of the same maturity, fell 0.3% pa to 3.4% pa, as nominal yields fell more than real yields over the quarter. Equivalent US breakeven inflation fell 0.2% pa to 2.2% pa.

### Investment grade bonds

The sharp fall in sovereign bond yields over the quarter helped ease debt affordability concerns for corporate borrowers, with global credit spreads contracting as a result. Global investment-grade credit spreads declined 0.2% pa to 1.2% pa over the quarter, while global speculative credit spreads declined by 0.6% pa to 3.8% pa. Despite a larger decline in speculative-grade credit spreads, the longer-duration investment grade market outperformed given the decline in sovereign bond yields.

### High-yield debt

The trailing 12-month global speculative-grade default rate held at 4.5% in October, staying above its long-term average of 4.1%, amid higher-for-longer interest rates, tightened financial conditions and elevated inflation. While Moody's forecast that the default rate will trend higher, they expect it will peak at 4.8%, only slightly above current levels.

### Emerging markets

Hard currency emerging market debt, as measured by the JPM EMBI Global Diversified Index, returned 9.2% in dollar terms as underlying treasury yields fell sharply, and credit spreads tightened 0.4% pa. Local currency debt, as measured by the JPM GBI-EM Global Diversified Traded Index, returned 8.1% in US dollar terms, as yields fell 0.6% pa and index currencies, in aggregate, strengthened against the US dollar.

# Global equities

The FTSE All World Total Return Index returned **9.3% over the fourth quarter** in local currency terms.

The last three months of the year saw strong total returns which have resulted in stocks being up 22% in 2023, their best year since 2019. Q4's gains were largely driven by a shift in rate expectations. Amid a plethora of lower-than-expected inflation releases, markets anticipated the positive impact on economic activity of a potential reduction in interest rates, while lower sovereign bond yields also lent support to equity valuations.

## Technology stocks outperform

Lower sovereign bond yields lent particular support to more rate-sensitive growth stocks, with technology outperforming the index and rising 15.7%. Given growth stocks typically offer very long-term earnings growth, a lower discount rate tends to lend them disproportionate valuation support. Industrials, financials, and utilities also outperformed, albeit it very marginally in the case of financials and utilities. All sectors delivered positive returns, apart from energy, but some of the more defensive sectors – consumer staples, healthcare, and telecoms – were the next largest underperformers, in that order. The energy sector notably underperformed, declining 3.4% over the quarter, amid a sharp decline in oil prices.

## Regional performance – North America leads the pack

Due to their high exposure to the technology sector, North American equity markets outperformed. All other regions underperformed, though did still produce positive returns. European equities were the second best-performing region, producing strong returns with the sectoral composition of the index (ie being underweight tech) the main driver of underperformance. Emerging markets underperformed but still produced decent returns, as falls in Chinese equities on the back of mounting growth concerns were offset by strong returns elsewhere, particularly in Latin America. The UK market more markedly underperformed due to its large exposure to the underperforming energy sector and sterling strength, which weighs on the high proportion of overseas earnings in the index. Japanese equities notably underperformed as they benefited less than other equity markets from the central bank tailwinds.

# Currencies, commodities and property

- Oil price **down 18.6%**
- Trade-weighted US dollar **down 3.1%**
- Gold prices **up 11.2%**
- Trade-weighted sterling **up 1.3%**
- Trade-weighted euro **up 1.0%**

Despite an OPEC+ agreement to make further production cuts, oil prices fell. This was partly due to the relatively subdued economic outlook, but also due to signs of ongoing strains within the OPEC+ group, the US reporting record-high oil stockpiles, and focus on the waning prominence of OPEC+ in global oil supply. Expectations of rate cuts and lower real yields contributed to a fall in the trade-weighted US dollar. These factors combined likely contributed to the rise in gold prices over the quarter.

The MSCI UK Monthly Property Total Return index declined 0.7% over October and November as income was offset by capital value declines in the retail and office sectors. On a 12-month basis, capital values are down around 18%, 7%, and 4% in the office, retail, and industrial sectors, respectively. The office and retail sectors continue to see largest month-on-month capital value declines. Capital values also fell marginally in the industrial sector over the month, following six consecutive months of growth before stalling in October.

# The global economy

## US growth expands; UK and eurozone contracts

Despite downwards revisions, December's final release confirmed that the US economy expanded by 1.2% quarter on quarter in Q3, driven by robust consumer spending. By contrast, UK and eurozone GDP contracted by 0.1% in Q3. This leaves the UK flirting with a mild technical recession in the second half of 2023 after more recent monthly data showed the economy contracted 0.3% in October, following a 0.2% expansion in September.

On the back of unexpectedly strong growth, US GDP growth forecasts for 2023 and 2024 were revised higher once more in Q4. Despite this, global growth in 2024 is still expected to ease to its slowest pace since the global financial crisis, excluding 2020. The 2024 growth forecast for the US stands at a below-trend 1.1%, and while there are tentative signs the worst might be over for the eurozone and UK, growth is still only expected to advance a very modest 0.5% and 0.3%, respectively. However, while consensus forecasts suggest global growth will slow, it is not expected to collapse.

The global composite PMI, which aggregates service and manufacturing sector activity, suggests global economic activity strengthened slightly at the end of 2023. However, the index remained below its long-run average and at a level consistent with only modest growth. Sectoral divergence also increased, as service sector growth accelerated, and the manufacturing downturn extended to its seventh consecutive month. On a regional basis, the weak performance of the eurozone contrasts with expansions in the US and China. A much better than expected UK composite survey raised hopes that the UK may evade technical recession. In December, average input prices increased at a slightly faster pace. Output charges also rose, but at same rate as a month earlier. Rates of increase in both were higher in the service than manufacturing sector.

## Headline inflation retreats

Headline CPI inflation fell more than expected across the major economies in Q4. A decline in energy prices and moderation in food prices were the main drivers, but core inflation, which excludes both of these, also fell more than expected. Year-on-year CPI inflation in the UK, US and eurozone fell to 3.9%, 3.1% and 2.4%, respectively, in November. Perhaps highlighting a degree of 'stickiness' in inflation, the respective core measures are higher, at 5.1%, 4.0% and 3.6% in the UK, US and eurozone.

## Interest rates set to fall

As expected, the major central banks left interest rates unchanged in Q4, but much bigger than expected falls in inflation saw markets price in earlier and larger interest-rate cuts in 2024. The Fed reinforced these expectations in mid-December as its revised policy projections suggested it will reduce rates in 2024. While the median Federal Open Market Committee member "dot-plot" points to three rate cuts, starting in the summer of 2024, the market expects more – pricing in six rate cuts in 2024, with a first cut in March. Despite the ECB and BoE reiterating that it's too early to declare victory over inflation, markets expect a similar scale and timing of interest rate cuts in Europe and the UK.

For and on behalf of Hymans Robertson LLP


Chris Arcari
**Head of Capital Markets**
Chris.Arcari@hymans.co.uk
0141 566 7986


Robert Kotlar
**Investment Research Analyst**
Robert.Kotlar@hymans.co.uk
0141 566 7793

# Additional notes

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London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk