HYMANS ROBERTSON

Capital Markets Update

January 2024

Welcome to our quarterly Capital Markets Update, in which I explore key themes driving the global economy and examine the prospects for individual asset classes.

By Chris Arcari, Head of Capital Markets

Q4 summary

- Global growth defied all but the most optimistic forecasts in 2023, despite the steep rate-hiking cycle of the past two years
- Business and consumer confidence is rising, as inflation fears recede and the prospect of interest-rate cuts comes in to view
- Bond yields fell sharply in quarter four due to expectations of earlier and larger rate cuts in 2024 than previously thought
- Falling yields alleviated concerns over debt affordability, and lent valuation support to stocks
- Credit spreads fell and equities rallied strongly

Key themes

At 2.6%, global growth exceeds expectations

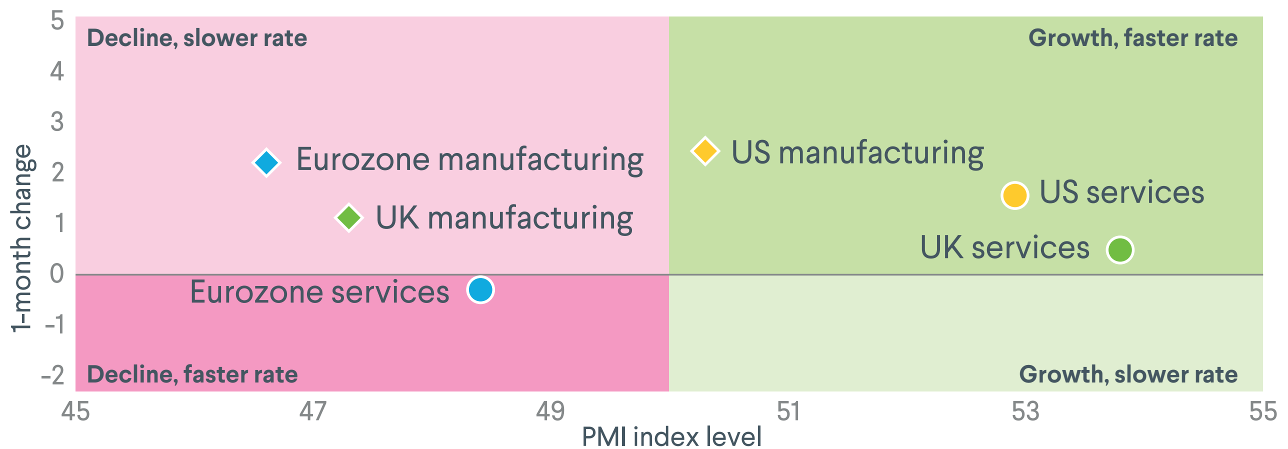
Global growth confounded expectations in 2023. Full-year real global GDP growth was around 2.6% in 2023, despite forecasts of a slowdown to 1.5% as higher interest rates, energy prices and a cost-of-living squeeze weighed on consumers and business. This is a large margin of error, even by the standards of economic forecasts.

Consumers spend pandemic savings

Forecasters underestimated the resilience of consumer spending and the extent to which consumers would use savings built up during the pandemic, particularly in the US. The US economy was expected to stagnate in 2023; instead, real GDP looks to have risen 2.5%, making the US economy the engine of growth among the major advanced economies.

Economists also underestimated the lag with which monetary policy would affect activity – more fixed-rate mortgages, fewer mortgage holders and larger debts concentrated among wealthier, savings-rich households, have been cited. To the extent that the full impact of interest-rate rises is yet to be felt, a degree of caution is still warranted. However, falling inflation and the prospect of interest-rate cuts in 2024 eases debt affordability concerns for consumers and corporates, and improves the balance of risks to the outlook.

Chart 1: Recent business surveys suggest activity is continuing to defy downbeat expectations

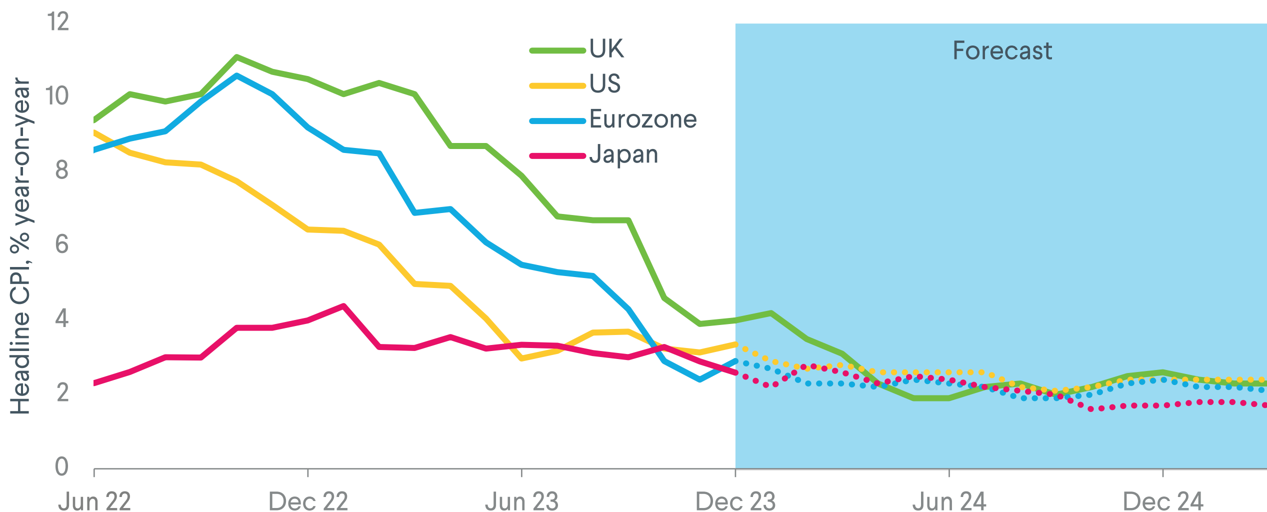


Source: Bloomberg

As you can see in **Chart 1**, recent PMI data point to a healthy US economy, positive momentum in the UK, and an easing (at least) of the downturn in the eurozone. Though, in aggregate, activity in the energy price and interest-rate sensitive manufacturing sector remains much weaker than in the more labour-intensive service sector.

And therein lies another key risk to the outlook. Further declines in headline inflation (**Chart 2**) should enable the major central banks to start reducing interest rates in the second half of 2024. But tight labour markets and strong wage and services inflation mean the pace of decline is likely to slow. Easy wins from falling energy and moderating food and goods prices are largely in the rear-view mirror. And here, too, there are risks, with developments in the Red Sea posing a threat to global supply chains and oil prices. However, for now, pandemic-era inflation feels unlikely, given weak manufacturing activity and a more manageable rise in freight costs.

Chart 2: Further declines in inflation, if realised, should allow central banks some breathing room in 2024



Source: Datastream

As effective interest rates continue to rise, real global GDP growth is expected to slow to a relatively subdued pace of 2.2% in 2024, before re-accelerating to 2.5% in 2025. However, better-than-expected economic data and falling inflation, bringing the prospect of interest rate cuts into view, mean the risks around the outlook are more evenly balanced. Negative inflation developments, which could rule out lower interest rates, leading to tightening of financial conditions via the financial markets, are a key downside risk.

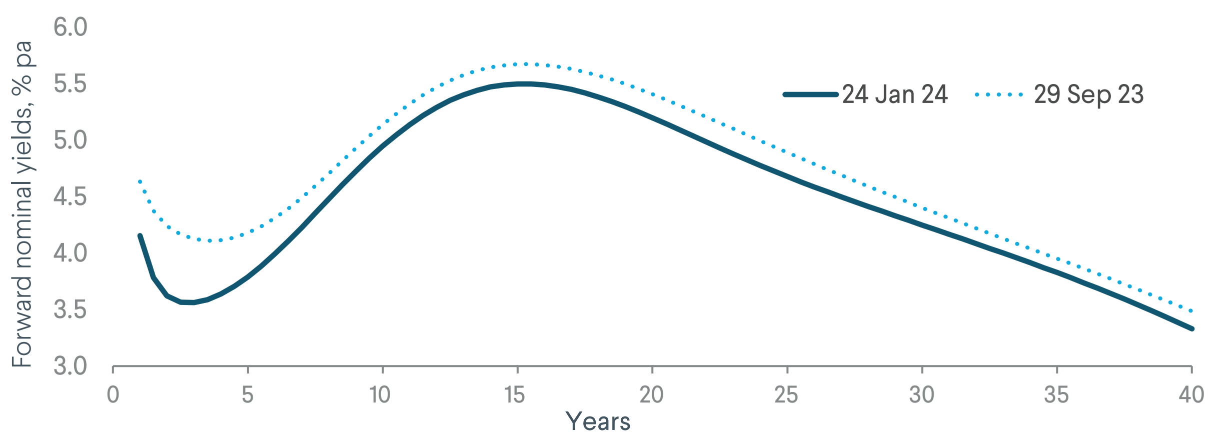
Asset-class views

Government bonds

Declining inflation, alongside lacklustre real growth forecasts for the UK economy, improves the fundamental outlook for gilts. Despite the recent rally, forward nominal yields still look elevated (**Chart 3**) versus our assessment of fair value, based on long-term real growth and inflation forecasts. It's true that there may be some indigestion if the extent of interest-rate cuts priced in to the front end of the curve fail to materialise in the near term, particularly at a time of heavy government issuance and Bank of England asset sales. However, falling inflation and the potential interest-rate cuts that follow may place further downwards pressure on yields.

While subsiding fears about long-term inflation to a certain extent reduce the fundamental support for index-linked gilts, real yields remain at reasonable levels at a time when real growth is expected to be barely positive in the near term. Gilt-implied inflation still looks slightly high relative to central bank targets, particularly after we allow retail price index and consumer price index (RPI/CPI) reform. However, investors with lingering concerns about longer-term risks to inflation may be willing to pay a higher-than-usual inflation risk premium.

Chart 3: Forward nominal yields imply cash rates well in excess of what we would consider neutral



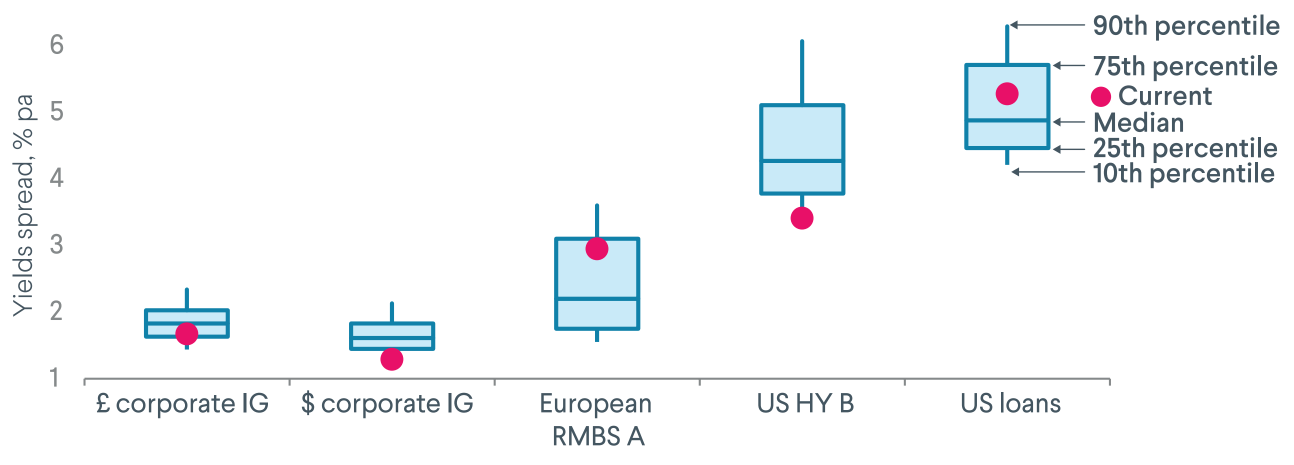
Source: Bank of England

Credit

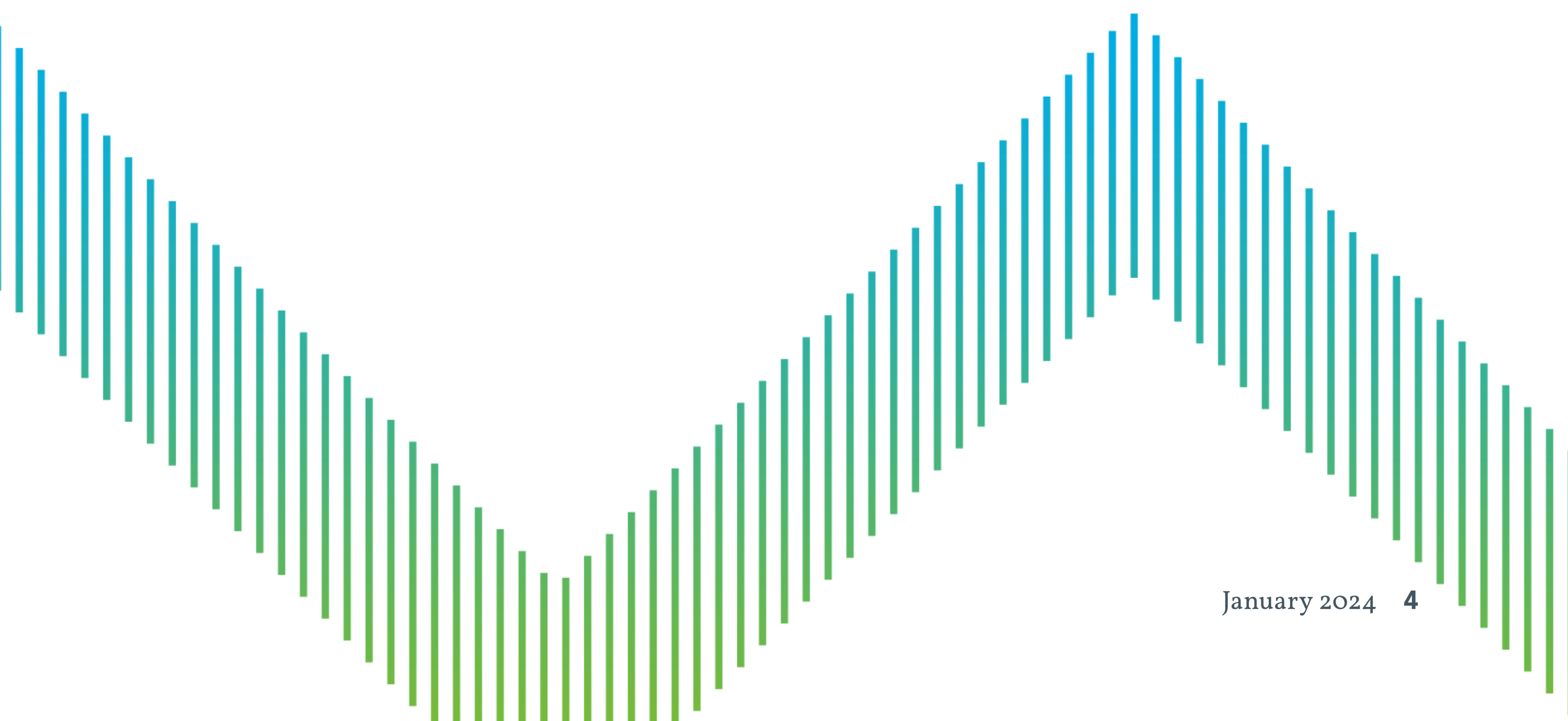
The prospect of interest-rate cuts and the recent easing in financial conditions, via lower sovereign bond yields, is a welcome development for credit fundamentals. Debt affordability metrics could deteriorate as effective interest rates continue to rise for some time. On average, current yields are above existing coupon rates, meaning maturing debt will be refinanced at higher rates. But the increase in debt costs will be gradual and looks manageable, given limited near-term refinancing pressure and the prospect of interest-rate cuts and improved corporate earnings in 2024 and 2025. Indeed, Moody's expects the default rate to peak at 4.9% in Q1 2024, slightly above current levels and not far above long-term averages.

However, markets have already priced in this benign outlook, and credit spreads have fallen sharply. Some of this may be justified, as default rates are close to peaking and attractive yields provide a cushion against potential spread widening and/or a back-up in underlying rates. But positive sentiment has driven corporate credit spreads well below long-term averages, particularly in fixed-interest markets, where investors have sought to lock in higher yields for longer. Credit spreads at these levels leave little scope for disappointment, and there may be better entry points ahead. We see better value in floating-rate asset-backed securities and loans in investment- and speculative-grade markets, respectively.

Chart 4: Credit spreads leave little scope for disappointment, particularly in fixed-interest markets



Source: ICE Index Platform, Barings

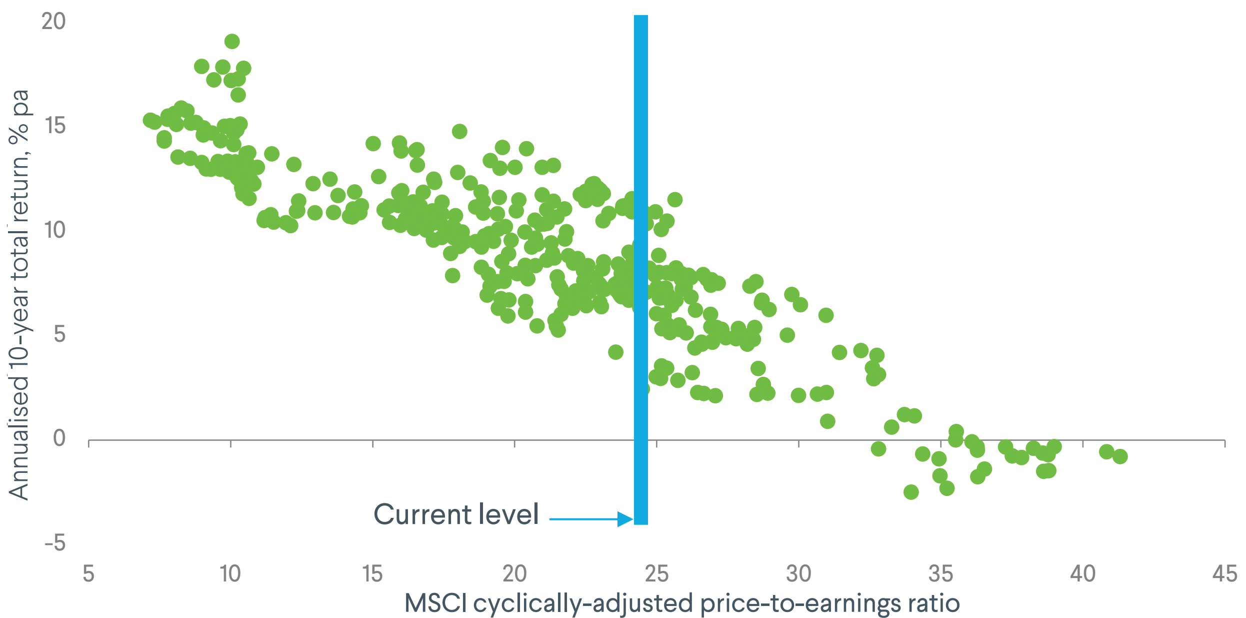


Equities

Following flat, full-year earnings growth in 2023, analysts' earnings forecasts for global equities for 2024 and 2025 are healthier, at 10% and 12%, respectively. However, there are risks to the earnings outlook as growth and demand slows. The expectation that global profit margins rebound towards their post-pandemic high may be challenged by higher effective interest rates and employment costs, and waning corporate pricing power. Market performance in the final couple of months of 2023 drove cyclically adjusted valuations above long-term averages – something that has historically augured periods of more subdued subsequent returns (Chart 5).

The underperformance of emerging markets over the past few years leaves valuations looking cheap relative to developed markets, even allowing for the usual level of discount observed historically. Emerging markets are forecast to experience the strongest earnings growth among the major equity regions in 2024 and 2025. Despite outperformance in 2023, Japanese equities still look relatively cheap, while relative earnings growth forecasts, and ongoing upgrades to those forecasts, remain supportive. US valuations are high, but look slightly less stretched in the context of usual premium commanded by the tech-heavy market and derive support from relatively strong potential earnings. We're most cautious on European and UK equities, where a relatively poor earnings outlook may more than offset the ostensible cheapness of these markets.

Chart 5: There is strong correlation between equity valuations and subsequent medium-term returns



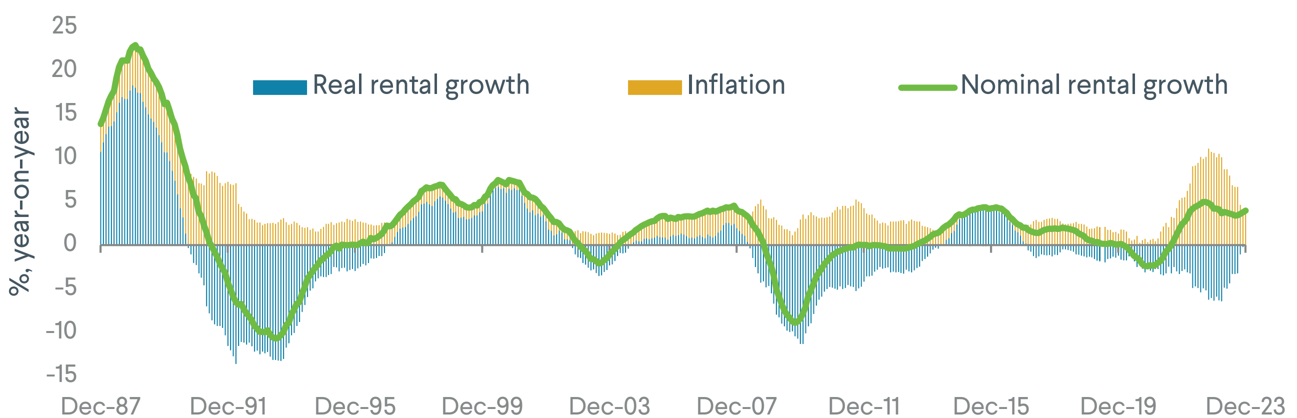
Source: Datastream

Property

As inflation has fallen sharply, real rental growth has risen (Chart 6), slightly improving the fundamental outlook for UK commercial property. However, a further 2.6% decline in the MSCI UK Monthly Property Capital Value Index in the three months to end-December highlights the structural challenges facing the office and retail sectors. The Royal Institute of Chartered Surveyors' latest survey points to ongoing falls in occupier demand and rent expectations, and rising availability and inducements offered to tenants in both of these sectors. On a longer-term view, we expect tenant demand for quality, and more energy and environmentally efficient buildings, to attract tenants and command higher rents. We feel that tenants and owners will increasingly focus on achieving higher EPC and green standards which may cause a divergence in the market in the future.

Given the 24.4% fall in MSCI UK Monthly Property Capital Value Index since its June 2022 peak, and decent nominal rental growth over the same period, net initial yields, based on current rental income, have risen to 5.5% pa. Gross reversionary yields, based on estimated rental value, have risen much more, to 7.2% pa, perhaps highlighting the increasing asset-management opportunities available in the market. Meanwhile, the technical picture remains challenging, and many UK pooled property funds continue to defer redemptions, with 'gating' in place since the second half of 2022.

Chart 6: Real rental growth is rising, given decent nominal rental growth and declining inflation



Source: MSCI UK IPD Monthly

Conclusion

While global growth is forecast to slow to a relatively subdued pace in 2024, recent resilient economic activity, declining inflation, and easing financial conditions point to a more benign outlook. Moreover, corporate fundamentals look well placed to absorb the ongoing rise in effective interest rates, while consumers will welcome easing inflationary pressures and falls in short-term market interest rates.

However, risk assets have more than moved to price in an easing of downside risks. Credit spreads leave little scope for disappointment, and global equity valuations are now substantially above long-term averages. The fundamental outlook for property markets might have slightly improved and valuations no longer look demanding, but structural issues remain, and the technical picture is still challenging.

There may be better entry points to risk markets ahead, and, in addition to employing usual rebalancing discipline, we would be more comfortable with slightly higher allocations to government bonds and cash than strategic considerations might require. The former still offer decent forward nominal yields and should provide substantial ballast in a more severe downside growth and inflation outcome. The latter now provides a real return to sit on the sidelines and would be the funding asset of choice should inflation disappointment and re-evaluation of interest-rate expectations cause correlated repricing of bond, credit, and equity markets.

Contacting us

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Additional notes

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