

Hymans Robertson Investment Services (HRIS)

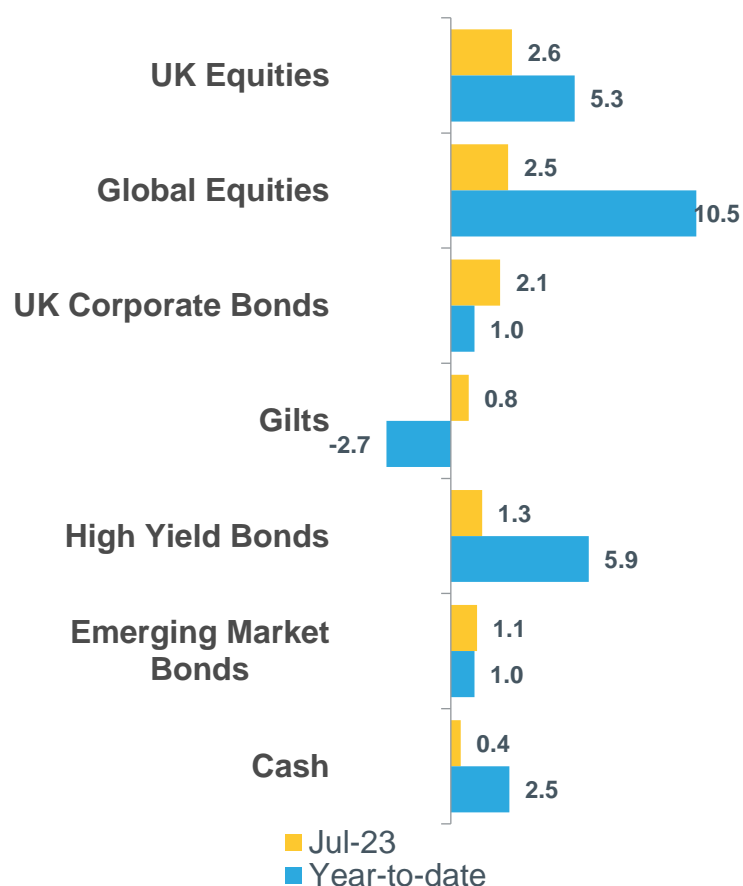
Market Digest

July 2023

Monthly Highlights

- July brought positive returns for all asset classes, especially equities, as investor optimism grew due to falling inflation.
- Model portfolios generated positive performance, benefitting from their broad set of market exposures.
- Corporate bonds (i.e. debt issued by companies) outperformed government debt, but both rose in value following a lowering in UK interest rate expectations as inflation fell to 7.9%.
- Central banks in the US and eurozone increased interest rates by 0.25%, while the Bank of England followed in the same vein just after the month end.

Asset class returns (%)



Market summary

- Our model portfolios are typically invested in a combination of the asset classes shown in the left-hand chart.
- Investor optimism is beginning to return to markets as data from the US is continuing to show signs of economic resilience. This is coinciding with the belief that central banks are nearing the end of their interest rate hikes, bringing with it the hope of a 'soft-landing' – where inflation is brought under control without a recession.
- In the UK, lower-than-expected inflation for June was welcomed after several months of stubbornly high inflation.
- Global equities generated a strong return over the month as a stock market rally, initiated by large tech stocks, has spread more broadly to other sectors. Emerging markets performed particularly well, as hopes of Chinese stimulus to boost its economy increased.
- The lower-than-expected UK inflation meant bond yields fell as markets priced in fewer interest rate hikes. This pushed up the value of gilts and UK corporate bonds.
- The Bank of England didn't meet in July but increased rates by 0.25% in August to 5.25%, pushing up cash returns.
- At a portfolio level, bonds underperformed equities meaning higher risk portfolios outperformed lower risk ones over the month.

Outlook and topical market themes

- Inflation in the US has fallen from a peak of 9.1% to 3.0%, while economic growth has remained strong pushing the S&P 500 up over 20% so far this year.
- Lower than expected UK inflation has reduced investors' expectations of peak interest rates to around 5.7%, driving up bond prices (prices rise as yields fall). However, the tight labour market remains an issue for the Bank of England.

Is a soft landing back on the cards?

The latest round of economic data from the US has reinvigorated the hope that the Federal Reserve (Fed) pulls off a 'soft landing'. That is, that they can get inflation back to their 2% target without causing a sharp slowdown in economic growth, leading to a recession. The perceived difficulty of achieving this has led to another term 'miraculous disinflation'. History shows that interest rate hike cycles as aggressive as this one almost always lead to a recession. However, the US economy has remained surprisingly resilient so far. Q2 GDP data showed an acceleration of growth to an annualised rate of 2.4%, higher than expected. Unemployment has remained at near record low levels despite inflation falling from a peak of 9.1% to 3.0%.

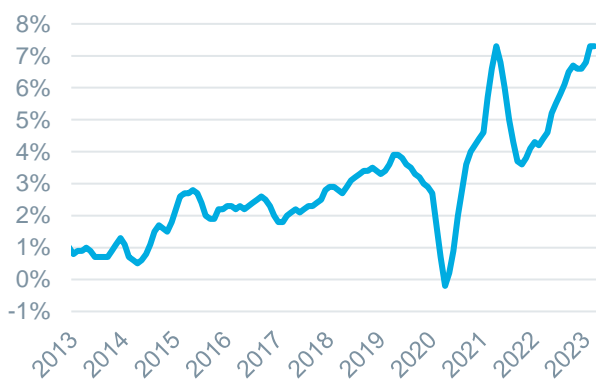
Both falling inflation and strong economic growth has led to added optimism in the equity market. The US market is up over 20% so far this year and while this was initially led by a few large tech stocks, it has become a broader rally, across other sectors, over July.

UK inflation finally cooling

UK inflation data for June, released on 19 July, showed inflation was falling faster than expected. A drop from 8.7% to 7.9% in May was better than the 8.2% economists had expected. The Bank of England (BoE) will be especially pleased with progress in services and core measures of inflation, which they believe gives a better picture of underlying inflation in the economy (core inflation excludes volatile items like food and energy). This allowed the BoE to slow down the pace of interest rate hikes to 0.25% in early August (a 0.5% increase had previously been anticipated).

Higher inflation is a bane for investors, so the lower inflation should be cheered. It is important though to remember not to rely on a single data point too heavily, especially after so many months of inflation remaining higher than expected. We would like to see further progress with the labour market (wage growth remains over 7%, see chart below) before the BoE can proclaim victory over inflation. Nonetheless, market expectations of the peak level of interest rates have fallen over recent weeks from c. 6.5% to around 5.7%. A similar fall in bond yields has helped boost bond prices but we still see good value in high-quality bonds.

Chart of the month – UK Regular pay growth (% p.a.)



Source: Office of National Statistics, HRIS

Although the BoE will be pleased with the progress made with the inflation data, they still believe pay growth is too high to achieve their 2% inflation target.

High wage growth is a key source of services sector inflation which is now the driving force in the overall inflation data.



Jack Richards
Investment Manager

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