HYMANS ROBERTSON
INVESTMENT SERVICES

Hymans Robertson Investment Services (HRIS)

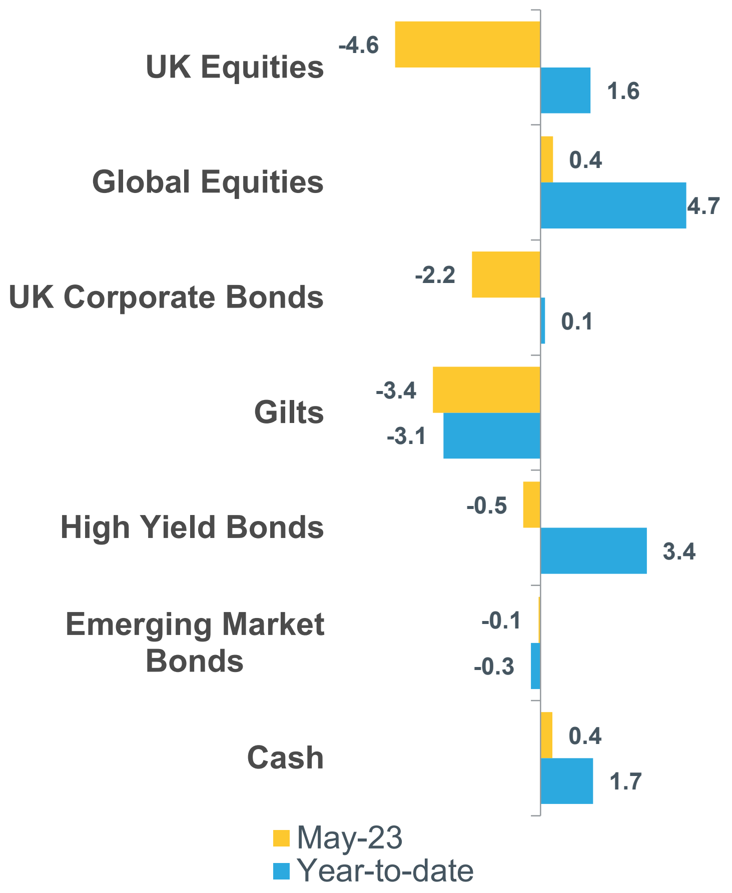
Market Digest

May 2023

Monthly Highlights

- Global equity markets were mildly positive over May, with the US driving returns. UK equities had a more challenging month largely due to inflation concerns and falling commodity prices.
- Corporate bonds (i.e. debt issued by companies) outperformed government debt, which fell in value after interest rate expectations increased on the back of strong inflation data. Alternative bonds with more of a global focus, like High Yield and Emerging Market Bonds proved more resilient.
- UK CPI inflation fell by less than expected from 10.1% to 8.7% (see comment on next page).
- Higher risk portfolios outperformed lower risk ones over the month.

Asset class returns (%)



Source: Morningstar. Figures to 31 May 2023. Returns in sterling terms except High Yield Bonds which are hedged. EM bonds are 50% local currency denominated and 50% US dollar denominated bonds.

Market summary

- Economic data showed a robustness to the UK economy, especially in the Services sector. However, this strength was also reflected in the inflation data for April which, despite the headline figure falling from the previous month, fell by less than expected and showed an accelerating rate on other measures (see next page).
- Our model portfolios are typically invested in a combination of the asset classes shown in the left-hand chart.
- Global equities were relatively flat over the month as uncertainty over the US debt ceiling drove caution. However, the sight of a deal at the end of the month provided some relief to US equities. The UK market was a notable underperformer driven by stubbornly high inflation and weaker commodity prices (the UK market has a sizeable allocation to mining stocks).
- The higher-than-expected UK inflation pushed up bond yields which weighed on gilt prices. The short-dated nature of corporate debt meant it was impacted less, especially High Yield bonds which are less sensitive to changes in interest rates.
- The Bank of England followed other major central banks and increased interest rates (by 0.25% to 4.5% p.a.) 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

- Despite a large drop from 10.1% to 8.7%, the higher-than-expected UK inflation data pushed up interest rate expectations significantly. Investors are now pricing in a peak interest rate of over 5% later this year.
- A deal to raise the US debt ceiling was agreed by US lawmakers just days before the Federal Government was due to run out of cash. Now this saga has ended, investors will turn their focus back to inflation.

US debt ceiling reaches resolution

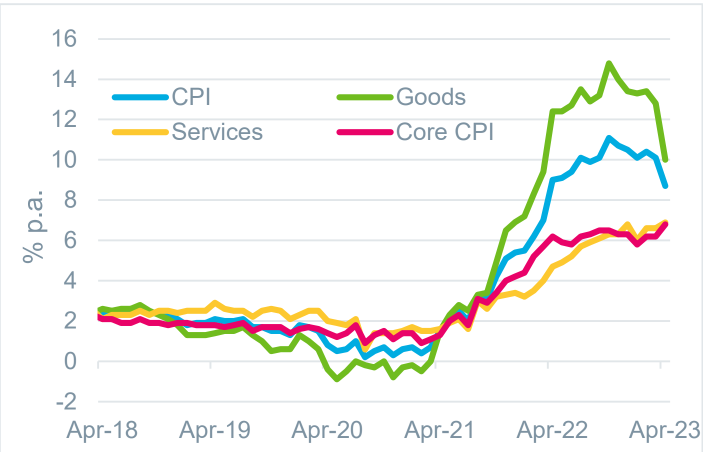
In early June the US congress agreed a deal to raise the debt ceiling, avoiding a default on US Treasury Bonds which could have been a matter of days away. Although a deal was always the most likely outcome, the severity of the situation if one wasn't reached meant that in the weeks preceding the agreement markets were tense, with the greatest impact being felt in the short-dated Treasury market. The deal looks to be a win for the Democrats who had to give only relatively minor concessions on spending reform to the Republicans, who had made large demands. The market responded positively as it became clear a deal was going to be reached, although the impact of this saga, barring a default event, was always going to be short-term in nature.

For more information on what the debt ceiling is and the impact it has had on markets please read our article on it here.

Persistent UK inflation

April's inflation data, released in late May, marked a large nudge down from 10.1% to 8.7% (this is the first time inflation has been below 10% since last August). However, at closer look the data is less positive than at first glance. Energy bills contributed 1.4% to the drop meaning the entire fall in inflation was due to so-called "base effects" as the huge energy bill increase of April 2022 fell out of the data set. Other measures of inflation which give a better indication of domestically generated price rises in the economy looked much stickier. Core inflation, which excludes energy, food, alcohol, and tobacco, accelerating from 6.2% to 6.8%, while Services CPI rose from 6.6% to 6.9% (telecommunications being a big driver as phone contracts were uplifted). The Services CPI, in particular, will be a concern to the Bank of England (BoE) who will fear the start of a wage-price spiral. Following the inflation data release, expectations on how far the BoE will hike interest rates rose, which pushed up bond yields (i.e. bond prices fell). Government bond yields are now over 4.5% and almost 5% for very short-dated bonds providing a potentially attractive entry point for bond investors.

Chart of the month – breakdown of UK inflation



Source: Office of National Statistics, HRIS

The start of this bout of inflation, in 2021, was largely a Goods story, driven by global factors. Headline inflation has now started to fall as the Goods "basket" comes back down. Despite this, the Bank of England is likely to continue to increase interest rates. This is because Services and Core inflation, both better gauges of underlying inflation driven in the economy, continue to rise.

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