

Hymans Robertson Investment Services (HRIS)

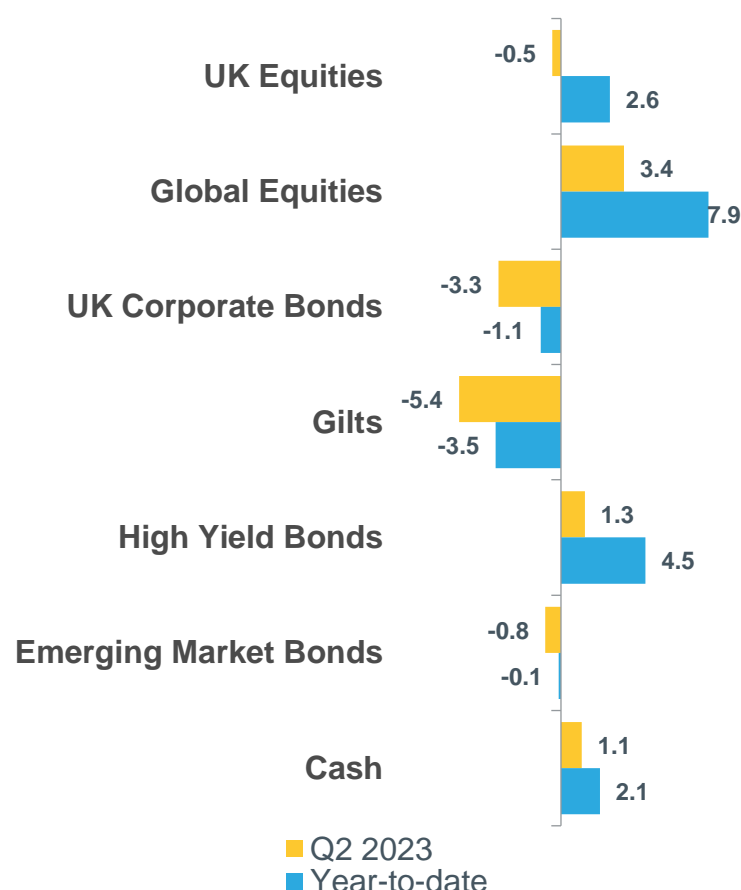
# Market Digest

Q2 2023

## Quarterly Highlights

- UK inflation fell less than expected, forcing the Bank of England to raise rates by a cumulative 1% over the quarter to 5%.
- Global equity markets were up over the quarter, but UK equities posted a negative return.
- 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.

## Asset class returns (%)



## Market summary

- Data continued to show stronger than expected economic activity for both the UK and US. However, this has provided a greater challenge for the central banks' task of taming inflation. For the UK in particular, inflation is falling back to target much slower than initially hoped (see next page) encouraging the Bank of England to accelerate its tightening by raising rates by 0.5% to 5.0% at its latest meeting in June.
- Our model portfolios are typically invested in a combination of the asset classes shown in the left-hand chart.
- Global equities pushed higher despite expectations of additional interest rate hikes. Market gains were largely driven by mega-cap tech stocks in the US. The UK lagged, following a stronger pound and weaker oil and commodity prices hurt the energy and mining sectors.
- Expectations of higher interest rates drove up bond yields and hurt bond prices, especially in the sterling market. Bonds markets with a more global exposure, like high-yield and emerging market bonds, held up better.
- Following the Bank of England's rate rises, the returns available on cash funds pushed higher. [Our article here discusses the merits of investing versus holding cash](#)
- At a portfolio level, equities outperformed bonds meaning higher risk portfolios outperformed lower risk ones over the period.

Source: Morningstar. Figures to 30 June 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.

## Outlook and topical market themes

- The US equity market has recovered well, returning almost 17% this year, but a tech stock rally has exaggerated the strength of the whole market. Some of this rally may be justified by a large increase in future earnings but other stocks may have just been caught up in AI-hype.
- Following further data releases, investors now expect interest rates to peak at around 6.5% next March. This has pushed the yields available on short-dated bond yields to new highs.

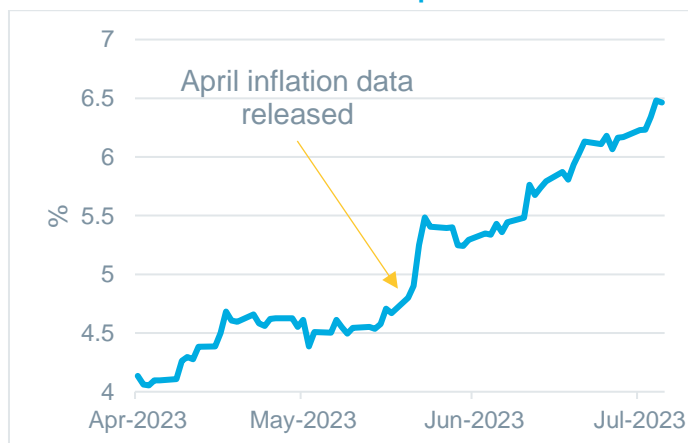
### Big tech is back

At first glance, the US stock market looks to have roared back to life in 2023. Following a dismal 2022, the S&P 500 has surged 16.9% year-to-date (though UK investors would typically have seen a smaller return owing to a stronger pound). However, under the surface, the recovery does not look as robust as it initially may seem. Almost all the gains generated so far have been generated by seven mega-cap “tech” stocks: Alphabet (Google), Apple, Amazon, Meta (Facebook), Microsoft, Nvidia and Tesla. The average return on these stocks is 89% while the remaining companies have averaged a return of 7.7%. This level of return has led the tech-heavy Nasdaq to its strongest first half of a year for over 40 years. Some of these mega-cap stocks, like Nvidia, have benefitted from the recent surge in interest surrounding artificial intelligence. These seven stocks alone make up over 27% of the S&P, underscoring the high concentration of the US stock market. For investors, it is key to recognise that just buying a passive market-cap fund can lead to a surprisingly high level of concentration. Our preference is for a blended approach which combines the use of market-cap and factor-targeting strategies while also utilising active managers in certain areas of the market, where appropriate.

### UK inflation shows more signs of stubbornness

Following smaller rate hikes of 0.25% at its March and May meetings, the Bank of England (BoE) took a more assertive approach to fighting inflation by implementing a 0.5% increase in June. This decision was prompted by recent data releases showing a concerning persistence to inflation. Firstly, labour data indicated a pickup in private sector pay to 7.6%. The BoE believes this level of wage growth across the economy is incompatible with a 2% inflation target. Then, just a day before the BoE meeting, May's inflation data unexpectedly showed no decline from April's 8.7% figure. Furthermore, core inflation, which excludes energy and food, continued to accelerate to 7.1%, a 30-year high. All the indicators that the BoE monitor (for signs of easing inflation), like wage growth and services inflation, have recently been heading in the wrong direction. Forecast year-end inflation is now 4.6% and interest rate swap markets imply investors now believe the BoE will raise rates to over 6% and will average 5.5% over the next 3 years (see below chart).

### Chart of the month – investor expectations for Bank of England base rate at the March 2024 meeting



Source: HRIS. Calculated from overnight index swap markets.

Investors have aggressively reassessed their view on the extent to which the Bank of England will raise interest rates to tackle inflation.

Investors now expect interest rates to peak at around 6.5% next March, this figure was around 4% just a couple of months ago. This has led to a fall in bond prices over recent months, meaning short-dated government bonds now yield over 5%.



**Jack Richards**  
Investment Manager

### Risk warning

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