MARKET COMMENTARY

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Executive Summary

August was another volatile month for markets, driven by rising government bond yields and a deteriorating outlook for China, where the faltering economic recovery was compounded by renewed stress in the property sector. Against this backdrop, global equities and bonds both lost ground, with concerns about the prospect of future rate hikes continuing to present challenges for the traditional 60/40 portfolio.

Inflation

Central bank policy continued to occupy the minds of developed market investors. In the spotlight once again was Jackson Hole, a small town in Wyoming which plays host to an annual symposium for central bankers. In general, those present struck a cautiously optimistic tone – during his widely-anticipated remarks, Federal Reserve (the Fed) Chair Jerome Powell indicated that he would 'proceed carefully' as the central bank weighed up the prospect of future policy adjustments. Despite also reiterating that the Fed would stick by its push to stamp out high inflation 'until the job is done', markets generally perceived the remarks as indicative that US rates are likely to be kept at their current level for the foreseeable future. Also speaking at the event and signalling a similarly cautious tone was Bank of England (BoE) Deputy Governor Ben Broadbent, who suggested that in the UK, rates might have to stay high 'for some time yet'.

We have moved into a new phase of the inflation story – having passed the peak in the latter half of 2022, for investors now the great unknown is how quickly, if at all, inflation might return to its target level. The US appears to be some way ahead of its developed market counterparts. Despite a slight uptick in the August report (July data), year-on-year headline inflation now sits at 3.2%, a substantial decline from last summer's peak of 9.1%. Core inflation, which strips out the effect of volatile items like energy and food, also fell month-on-month, and at 4.7% is the lowest since October 2021.

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In the UK, inflation has remained stubbornly high, exacerbated by a reliance on overseas food and energy markets and exceptionally strong wage growth. Despite July's data indicating a significant decline in headline inflation, at 6.8% it remains well above the Bank's 2% target. The fall was mainly driven by a slump in fuel prices, which continue to normalise following the spike in prices last year. Markets, however, were more concerned with core inflation, which remained static at 6.9%, suggesting the BoE has more work to do in getting prices under control. Market consensus is for another two 25 basis point rate increases by year-end, with rates topping out at 5.75% going in to Q1 2024.

In Europe, headline inflation was inline with the consensus estimate of 5.3%, representing no change month-on-month, while core inflation eased slightly. Markets now expect the European Central Bank (ECB) to hold rates steady when the governing council meets again in mid-September, but they are undecided on the likelihood of one further rate increase before year end.

The narrative is very different in China, where data released in August showed the economy officially falling into a period deflation (i.e., prices falling). Deflation is the latest in a series of data releases pointing to a general deterioration of the Chinese economy. July's activity data was much weaker than expected while retail sales also missed expectations by a wide margin. The ailing property sector also looks to have claimed a further casualty, with the once healthy developer Country Garden on the brink of default, following in the footsteps of property giant Evergrande, which filed for bankruptcy protection in the US in mid-August.

Markets

Moving on to markets, where the US was amongst the best performing major regions (in sterling terms) thanks to a recovery towards the end of the month, largely driven by Jerome Powell's Jackson Hole remarks. Aggregate US equities fell just shy of break even, while technology-heavy indices were static over the month. Japanese equities also outperformed on a relative basis, returning a muted loss of -0.5%. Japan remains the best performing major region year-to-date, with strong economic data and a healthy level of inflation pointing to further positive momentum in the months ahead.

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UK indices were weak, with easing headline inflation failing to offset concerns about further rate hikes. Aggregate UK large caps fell 2.4%, with similar losses for mid-cap companies which are typically more reflective of the domestic backdrop. European markets were similarly downbeat, with aggregate European equities giving up 3.1% in August. Banks were particularly weak after the Italian government announced a tax on ‘excess profits’, driven in part by banks perceived failing to pass on higher interest rates to savers.

Asia & Emerging Markets.

Turning to emerging markets, major indices were generally weaker than their developed market counterparts, weighed down by the outsized negative contribution from China – aggregate Chinese equities fell c.7% through August alone. Brazilian equities also suffered as investors weighed up the prospect of weak Chinese demand for key exports such as industrial metals, while markets in the Middle East were largely flat, supported by the strengthening oil price.

Fixed Income

For fixed income investors, August began with an announcement from Fitch, one of the three major credit rating providers, that it was downgrading the US government’s credit rating from AAA (the highest rating) to AA+, citing a ‘steady deterioration in standards of governance’. Fitch said that the recent debt ceiling impasse had eroded confidence, while the US Treasury called the decision ‘arbitrary’. For their part, government bond markets were largely unmoved. Investors were more interested in the outlook for the US economy, where a combination of better-than-expected economic data and strong debt issuance saw yields rise - global aggregate bonds fell a little over 1% through August. In the UK, the BoE raised rates by a widely anticipated 25 basis points, bringing the base rate to 5.25%, whilst noting that higher rates were working to slow the economy. Despite this, the yield on the 2- and 10-year government gilts both crept up. Corporate bond markets were largely weaker, with European investment grade in particular moving to price in a deteriorating economic outlook.

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Commodities

The aggregate commodity index was largely flat over the month, with moderate gains in energy offsetting weaker prices in agriculture and industrial and precious metals. Energy was the best performing component of the index, with oil making modest gains as Saudi Arabia and Russia announced ongoing voluntary production cuts. Following a precipitous decline from last year's record highs, natural gas supplies spiked almost 15% in early August, before falling back to end the month with a more modest gain of 3.6%. With Russian gas no longer flowing, the European Union's plan to achieve 90% natural gas storage capacity was achieved in mid-August, some two and a half months ahead of the November 1st deadline. With the tanks almost full, policymakers will be hoping to avoid a repeat of last years energy market volatility, though much will continue to depend on the weather.

| Whitechurch Investment Team | August 2023 |

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