GLOBAL MARKETS

MARKET OVERVIEW

1ST QUARTER 2023

BOWMORE
ASSET MANAGEMENT

FOR RETAIL CLIENTS
APRIL 2023

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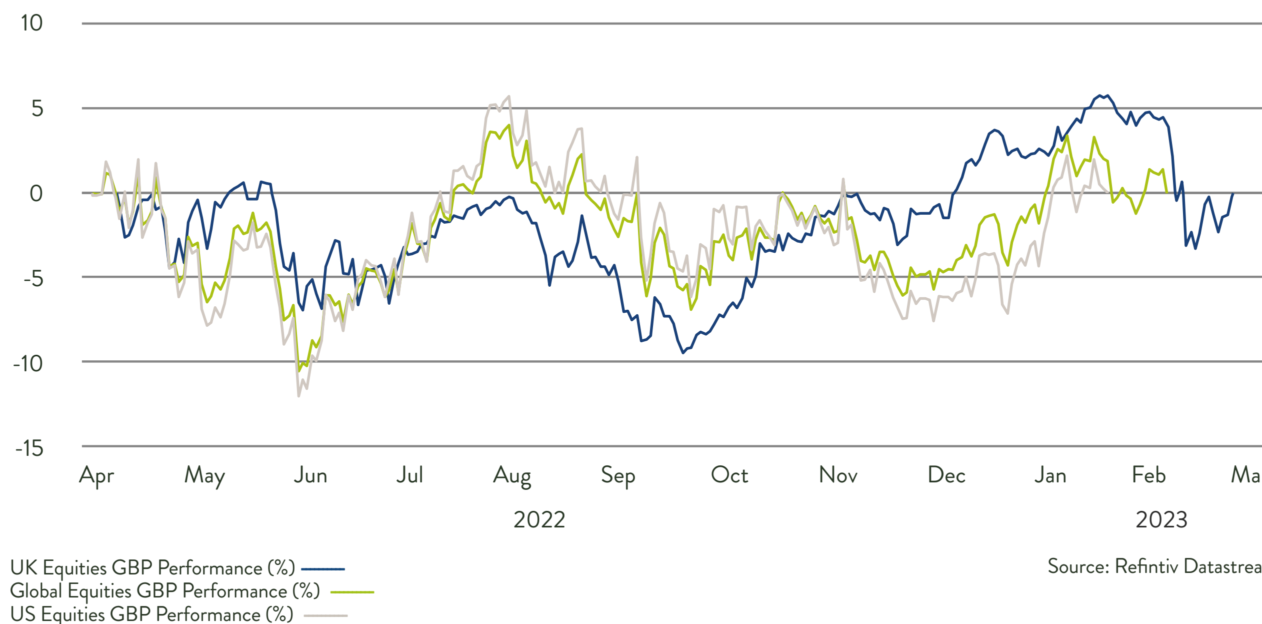
Equities

Welcome

Global Markets

After a volatile 2022, January began with a sense of renewed optimism. Inflation rates in the western world continued to trend downwards, although at different paces. In the UK, consumer price index (CPI) inflation fell to 10.5% in December, lower than previous months, but higher than in the Eurozone and US, where CPI inflation was 9.2% and 6.5%, respectively. This decline was largely due to a significant drop in energy prices, with European gas prices returning to pre-Ukraine invasion levels.

The improvement in sentiment gave equities some positive momentum, despite some occasional volatility. The chart below shows the one-year rolling performance of UK, US and global equities in Sterling terms. Global equities returned -2.63%, US equities returned -4.16%, while the UK achieved a positive return of 1.57%. Continuing the trend of the previous quarter, emerging markets broadly underperformed their developed counterparts. Global bonds returned 3.0% over the quarter, largely due to the improved performance of corporate bonds and the prospects for a quicker end to interest rate hiking programmes and perhaps even start cutting rates by the end of the year.



Source: Refintiv Datastream

The year's first interest rate decisions from the Bank of England (BoE), US Federal Reserve (Fed), and European Central Bank (ECB) came in the opening days of February. All three central banks raised rates, dashing hopes of pausing their rate hiking programmes, and confirmed the road back to normality could be longer than previously hoped. Despite this, the jobs market and consumer sentiment remained strong in both the UK and US, despite continued cost-of-living concerns.

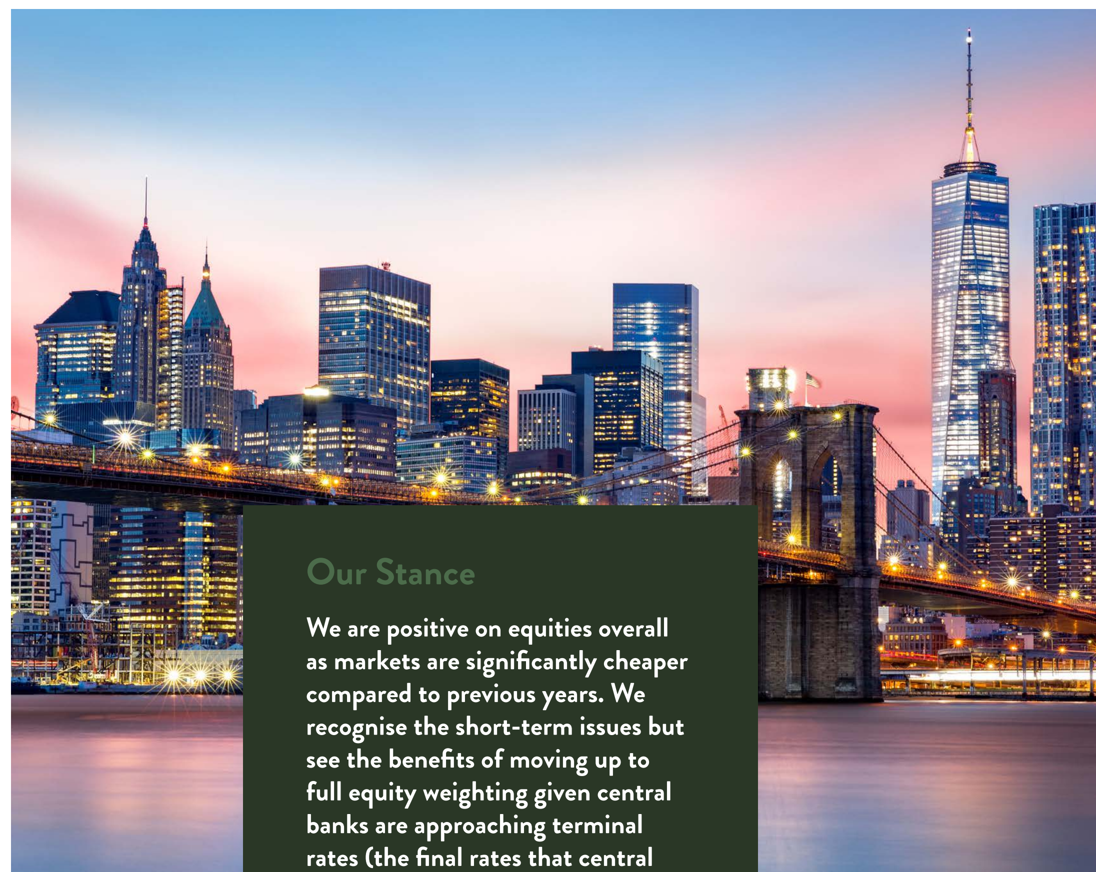
Investor confidence increased in China and other emerging markets over the quarter, despite growing COVID-19 infection numbers. The relaxation of lockdown restrictions in China and greater mobility for Chinese citizens, offered hope for a return to some form of normality for the world's second-largest economy.

Markets were shocked in March when Silicon Valley Bank (SVB) collapsed and US regulators took control of customer deposits, marking the largest US bank failure since 2008. Credit Suisse also faced financial struggles. Its shares dropped 30% in a day, causing a broader sell-off in European and US bank stocks, before being acquired by Swiss competitor UBS.

The deal was subsequently criticised after it emerged that holders of Additional Tier 1 (ADT 1) bonds would have the value of their bonds written down to zero, while Credit Suisse equity holders would be spared a similar fate.

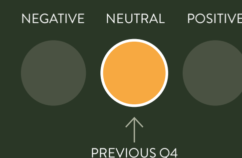
Later in March, the ECB kept to its promise of another 0.50% rate hike, but said future rate rises would depend on how the banking sector crisis unfolded. The Fed also raised interest rates again, albeit by a more muted 0.25%, as did the BoE. UK CPI inflation data showed a further increase from 10.1% in January to 10.4% in February, however, inflation data for the US and Europe was notably better, and showed falls to 6.0% and 6.9%, respectively.

Central banks faced the uncomfortable position of persistently higher inflation. This forced them to maintain their rate hiking policies, while at the same time acknowledging the rising rate environment was making life increasingly difficult for companies and institutions of all sizes, thereby amplifying fears of recession and stoking speculation of further corporate failures.



Our Stance

We are positive on equities overall as markets are significantly cheaper compared to previous years. We recognise the short-term issues but see the benefits of moving up to full equity weighting given central banks are approaching terminal rates (the final rates that central banks hope to achieve at the end of their monetary tightening cycle).

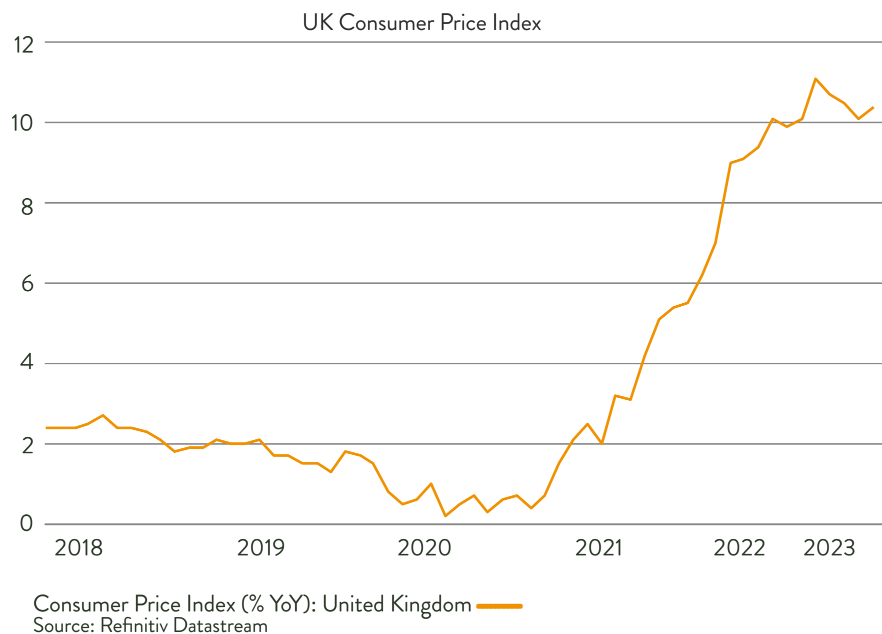


UK Equities

UK equities returned 2.1% over the quarter, with small and mid-cap companies outperforming large caps. UK growth stocks outperformed their value counterparts in Q1, returning 5.3% and 0.3% respectively.

After last September's disastrous 'mini budget', many thought a UK recession was inevitable. But the Office for National Statistics (ONS) reported 0.01% growth in the fourth quarter of 2022, avoiding recession by the slimmest of margins. GDP then grew by 0.3% in January, a faster recovery than expected and a firm move away from recession territory.

The inflation outlook appeared brighter after Consumer Price Index (CPI) inflation eased from 10.5% in December to 10.1% in January, largely from falling energy prices.



However, UK households continued to feel the pain as food and drink prices rose at the fastest pace since 1977[1]. It was no surprise in early February when the BoE increased interest rates from 3.5% to 4.0% and noted the impact of higher-than-expected wage rises was the main driver[2]. Signs of a turnaround in consumer confidence lifted the S&P Global/CIPS UK Services Purchasing Managers' Index (PMI) survey to 53.5 in February, up from 48.7 in January[3].

News that inflation was back on an upward trend - climbing to 10.4% year-on-year in February - came as an unwelcome surprise in March, confirming the UK's persistent inflationary challenges while reinforcing the BoE's rate hiking narrative.

In March, Chancellor Jeremy Hunt delivered his first official Spring Budget statement. The biggest announcements were the scrapping of the Lifetime Allowance (LTA) (which stood at £1,073,100) and increasing the annual pension contribution tax-free allowance from £40,000 to £60,000. The tax charge will be removed from April and the LTA will be abolished from April 2024. Hunt's room for manoeuvre was bolstered by the Office of Budget Responsibility (OBR) announcing it expected the UK to narrowly avoid recession through 2023.

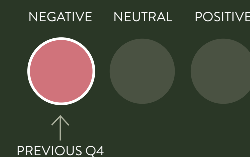
In our view, scrapping the LTA is unlikely to bring many back into work, and the Labour Party has already said it plans to reverse the decision should they gain power. Pensions therefore look set to remain complicated for some time to come.

[1] Office of National Statistic
[2] Gov.uk
[3] S&P Global

Our Stance

We remain slightly negative due to the UK's weaker economic growth outlook compared to the rest of the world. While economic news has been more positive in 2023, it is too soon to calculate the wider impact of banking sector troubles. With the UK a global financial hub, we continue to monitor the situation carefully.

NEGATIVE NEUTRAL POSITIVE



PREVIOUS Q4

US Equities

In the US, the broad large cap index returned 8.2%, while the tech-heavy NASDAQ returned 16.8%, its best start to the year since 2001[5].

It was a quarter of progressively stronger economic news from the US, as consumer sentiment bounced back amid falling energy prices, stock market gains and moderating inflation. CPI inflation fell to an annual rate of 6.4% in January, according to the Bureau of Labor Statistics.

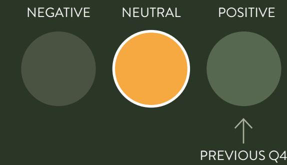
US retail sales surged past economists' expectations, showing an expansion of 3% in January, much faster than the 1.8% forecast. PMI data rose unexpectedly in February, ending a seven-month run of declines. The composite reading moved into expansion at 50.2, up from 46.8 in January[6]. The services sector showed the largest gain, rising from 46.8 to 50.5, while manufacturing PMI improved from 46.9 to 47.8, both ahead of expectations. Any reading above 50 represents expansion, whereas readings below 50 mean contraction.

As anticipated, the Fed raised interest rates by 0.25% in February, reaching a target range of 4.5%-4.75%, the highest since October 2007[7]. However, minutes of the Federal Open Markets Committee (FOMC) meeting suggested no let-up in the Fed's push to drive down inflation, with more rate hikes to come. A surprising report showed 517,000 jobs were added in January, confounding analyst forecasts of 185,000. This simply added fuel to the fire of 'higher-for-longer' borrowing costs.

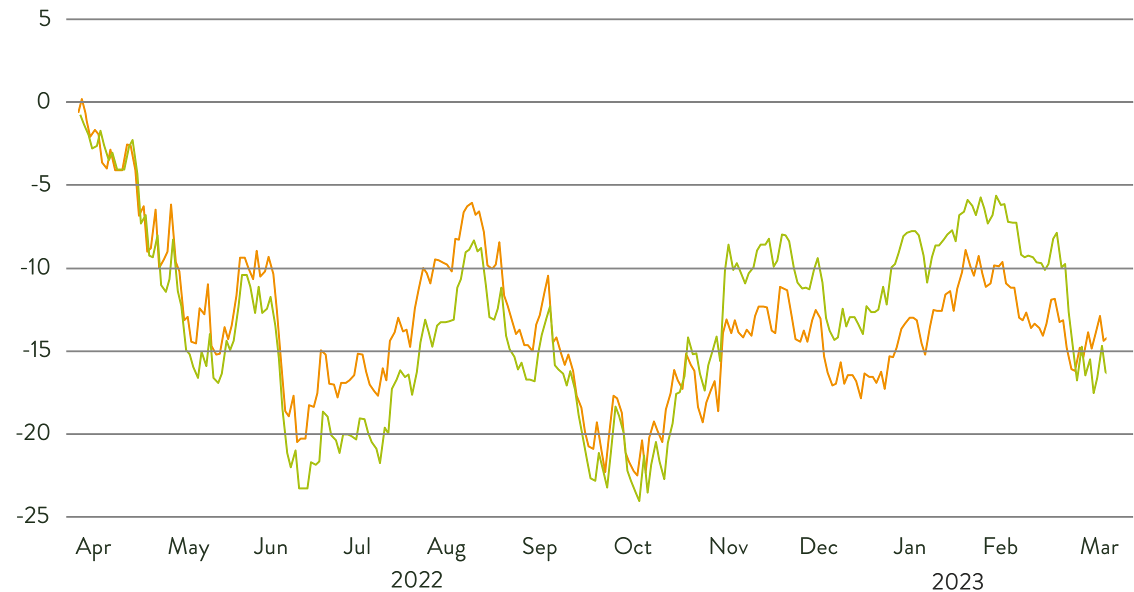
Towards the end of the quarter, attention turned to the collapse of SVB and the impact on the financial sector – as well as the potential impact on the bank's venture capital clients. However, swift actions from financial regulators calmed investor nerves and the financial sector staged a recovery by quarter-end after it became clear specific bank failures were not suggesting systemic risk across the entire banking sector. Consumer confidence turned negative in March (for the first time in four months), according to the University of Michigan, even while inflation expectations improved.

Our Stance

We have revised our stance to neutral in the short term, given the collapse of SVB, and continue to monitor for any signs of further contagion. That said, economic data was encouraging for most of the quarter and US equities should continue to perform well as the global outlook improves.



US 500 Versus US 500 Financials



US 500 Performance (%)
US 500 Financials Performance (%)
Source: Refintiv Datastream

[5] NASDAQ, 2023
[6] S&P Global
[7] Federal Reserve

European Equities

Economic data painted a more encouraging picture for the Eurozone, while inflation problems – particularly from higher energy costs and war in Ukraine – appeared to ease.

Europe's broad equity index returned 9.8%, with large caps faring better than their small and mid-cap counterparts. Growth stocks significantly outperformed value over the quarter, returning 12.4% and 8.6% respectively.

The European Commission used the Davos Summit to announce its 'Green Deal Industrial Plan', accelerating the scale-up of clean technologies across the European Union (EU). The plan will help EU-based companies reach net zero targets and contribute to Europe's own carbon targets.

The ECB echoed the BoE by raising interest rates 0.50% in February, moving the official borrowing rate to 2.5%. It also pledged to "stay the course" with a similar hike in March. February was also notable for sharply lower energy prices, largely due to a cut in energy demand following the milder-than-expected winter.

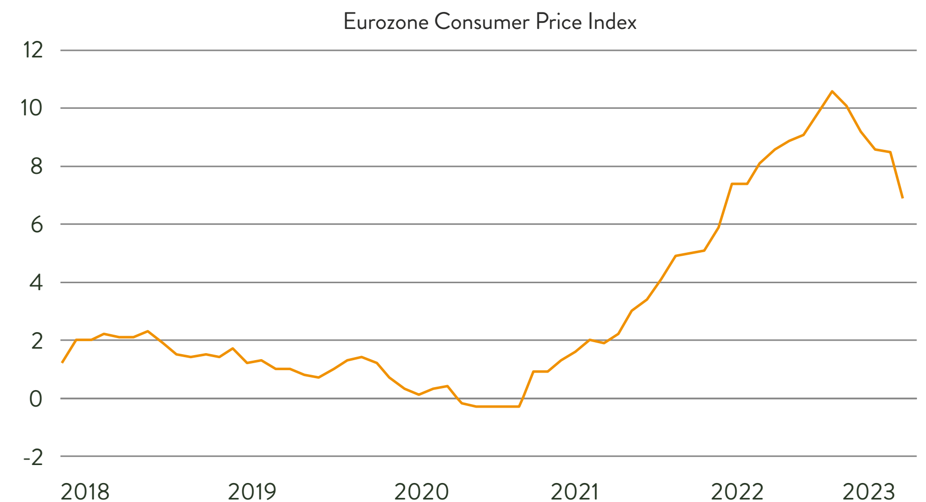
The EU and the UK agreed new trade rules in Northern Ireland. The deal – dubbed the 'Windsor Framework' will protect the flow of free trade between Great Britain and Northern Ireland by creating green and red lanes for goods flowing into Northern Ireland.

The framework, which was designed to address "the challenges...and the everyday issues faced by people and businesses in Northern Ireland, while supporting and protecting the Good Friday Agreement in all its parts", was formally adopted after a House of Commons vote towards the end of March.

The Eurozone's annual inflation rate – as measured by the Consumer Price Index (CPI) – was recorded at 6.9% in March, down from 8.5% in February according to Eurostat. However, core CPI, which excludes energy, food, alcohol and tobacco, rose by 5.7% over the last 12 months, up from 5.6% year-on-year in February, suggesting the fight against inflation was still far from over.

The collapse of SVB in March brought the challenges faced by Credit Suisse into sharper focus and increased speculation across the financial services sector. As promised, the ECB raised interest rates a further 0.5%, taking the official borrowing rate to 3.0%, the highest since 2008. However, ECB vice-president Luis de Guindos warned finance ministers that some EU banks were more vulnerable to rising interest rates.

One could argue the Swiss regulators took a misstep with their Credit Suisse bailout (and wipe-out of ADT1 debt). Credit Suisse's poor management over the years had been widely known and the decision only served to destabilise the capital structure concept (where bondholders have a priority claim over shareholders in the event of a corporate failure) and broadened investor mistrust in the banking sector as a whole.



Source: Refintiv Datastream

[8] Reuters

Our Stance

Higher interest rates could put more financial institutions under pressure. We are negative, but less so compared to 2022, and still believe active management is the best approach. It is likely that gas and refined oil replacement products will still be problematic for next winter, and the next few months will be key.

Japanese Equities

Japanese equity markets returned 6.0% over Q1, with large caps outperforming their small and mid-cap peers. Growth stocks (8.9%) outperformed value (3.4%) over the quarter[9].

Japan looks to have emerged from its deflation dogfight, and is enjoying a rallying equity market and a stronger currency. Tourism has been recovering too, and there is a light at the end of the tunnel for businesses heavily reliant on tourism, including hotels, retailers and services. The end of China's Zero-COVID policies should also help bring Chinese tourists back to the country.

In February, core inflation (which strips out the more volatile food prices, but includes oil costs) was reported as rising 4.3% in January, up from 4.0% in December, the highest level since 1981[10].

The flash release of the Composite PMI was 50.7 in February, matching January's reading and marking another month of expansion. In contrast, manufacturing sector activity deteriorated as firms struggled with high inflation and weak global economic growth.

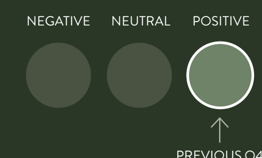
Prime minister, Kishida, surprised markets in February by nominating Kazuo Ueda as the new Bank of Japan (BOJ) governor, replacing Haruhiko Kuroda after the end of his 10-year tenure. Ueda could reverse some of the BOJ's current policies, including Kuroda's commitment to yield curve control (YCC) to help stimulate Japan's economy. YCC has long had its critics, but the policy has worked thanks to the BOJ's credibility and the stability of Japan's economy.

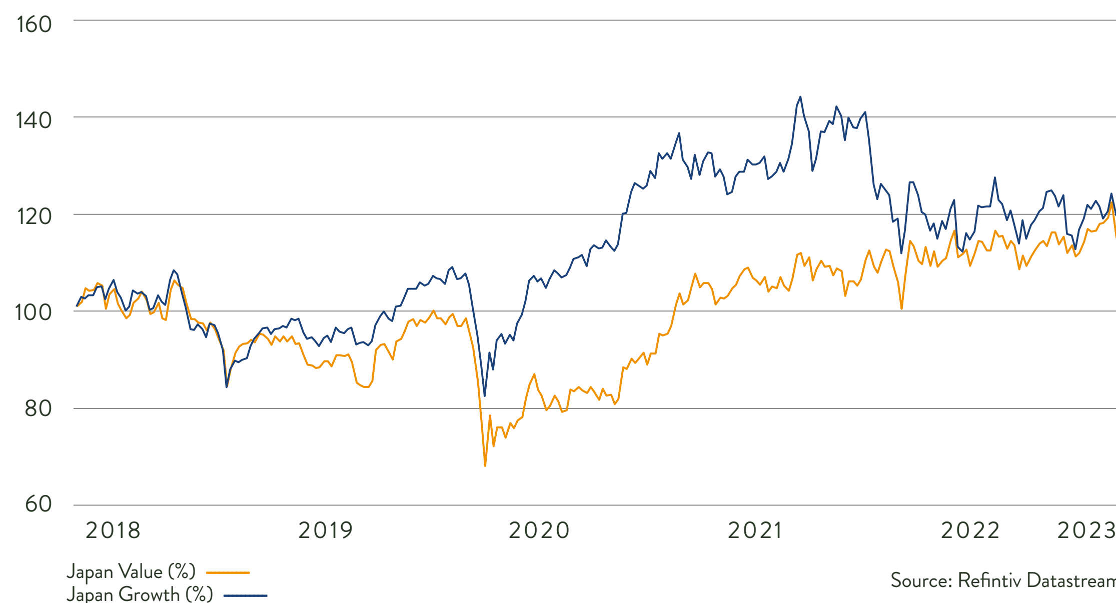
In March, CPI inflation in Tokyo, the leading indicator of nationwide pricing trends, rose 3.2% from a year earlier, slightly ahead of economic expectations of a 3.1% increase. Even so, the pace of price rises has slowed significantly from the 40-year high of 4.3% reached in January this year.

Japanese growth stocks have continued to outperform their value counterparts, increasing by 4.78% over the last 5 years versus the 11.6% gain for Japanese growth, which is a long term structural trend.

Our Stance

We expect Japanese equities to deliver due to yen appreciation, but also due to the country's spending power and its corporate sector has significant cash ready to deploy. With GDP rising and inflation still at elevated levels, we think Japan remains an attractive market.





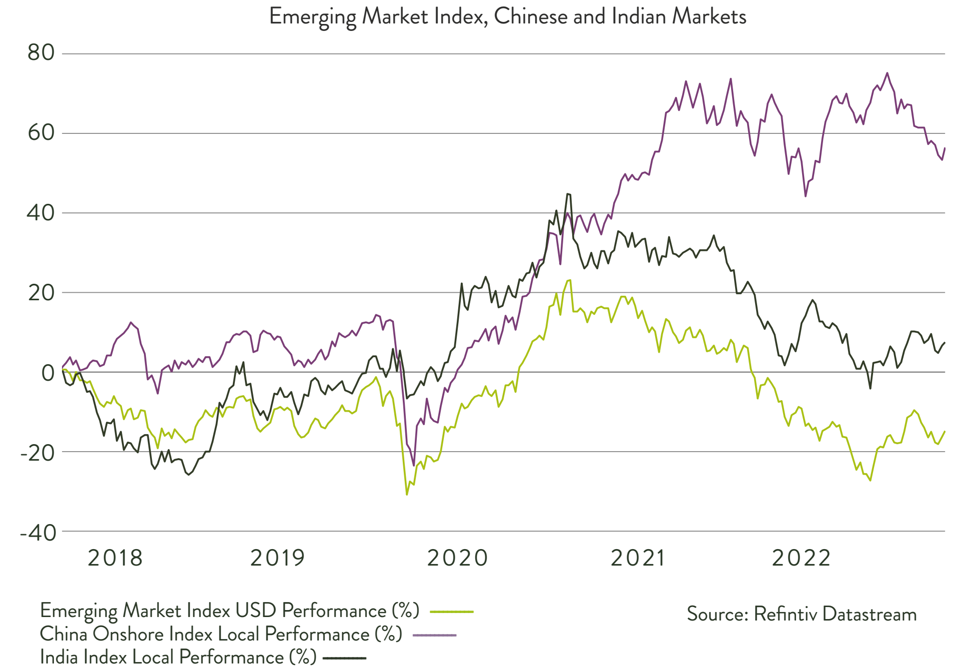
Source: Refinitiv Datastream

[9] Reuters
[10] Reuters

Asia and Emerging Market

China's post-COVID re-opening has improved the economic outlook for Asia and emerging markets considerably. This was reflected in the Q1 returns for China and the rest of Asia. China returned 5.0%, while Asia ex-Japan returned 4.6%.

We expect even better from the region in the months ahead: Chinese consumers accumulated huge amounts of personal savings during lockdown, and now that they are free to travel, spend and invest, they are expected to fuel a rapid consumption-driven recovery. However, other Emerging Market countries struggled during the quarter. Brazil and India were two of the biggest laggards, returning -8.0% and -7.2% in local currency terms.



Source: Refintiv Datastream

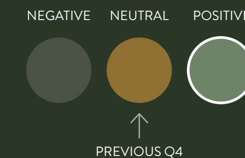
On the fundamentals side, the manufacturing PMI surged to 52.6 in February from 50.1 in January, the highest reading for the survey in ten years, while non-manufacturing rose 1.9 points to 56.3, underlining the case for a strong Chinese economic recovery[11]. The People's Bank of China (PBoC) vowed to boost private sector lending in 2023 by expanding financial support tools for private companies, and improving policy tools for inclusive finance, green development, and tech innovation.

In February, Brazil's central bank kept its policy rate unchanged at 13.75%, but its accompanying statement was hawkish, amid rising inflation expectations and comments from President Lula over central bank autonomy. The Reserve Bank of India (RBI) hiked its policy rate by 0.25% to 6.25%, in line with consensus. However, February's CPI inflation print reached 6.44%, above the RBI's upper tolerance limit. As a result, it is expected to hike its policy rate to 6.75%, to anchor inflation expectations.

[11] Reuters

Our Stance

We are positive towards Asia and emerging markets, as the weaker dollar and oil price should continue to be a tailwind. China's reopening is a significant positive development, especially for commodity exporters and Asian countries, and it is worth noting China is at a different stage to the rest of the world in terms of interest rate levels and the pace of inflation.



Fixed Interest

Government Bonds

Global government bond yields fell in January (meaning prices rose) on encouraging news of slowing inflation, particularly within the US. In the absence of any central bank meetings, the market began anticipating a slower pace of rate hikes by the FOMC. The Bank of Canada hiked rates by 0.25% but signalled a pause in its hiking cycle[12]. Meanwhile, the BOJ surprised markets in January by keeping the cap on 10-year bond yields at 0.5%, against consensus expectations of 1.0%. The BOJ decision led to a sharp but short-lived drop in US Treasury yields.

Global government yields were higher in February (meaning bond prices fell). The Fed hiked rates by 0.25% at the beginning of the month, but following stronger than expected economic data, markets grudgingly accepted that interest rates would likely remain higher for longer.

The market turmoil within the banking sector was supportive of a strong rally in bonds in March, with ten-year Treasury yields falling from 3.84% at the end of Q4 to 3.48% at the end of March. There were wild swings among two-year yields as investors tried to measure the effect of the banking sector's difficulties on short-term policy, and investors began to adjust future rate hike expectations amid the market turmoil.

[12] Reuters

Our Stance

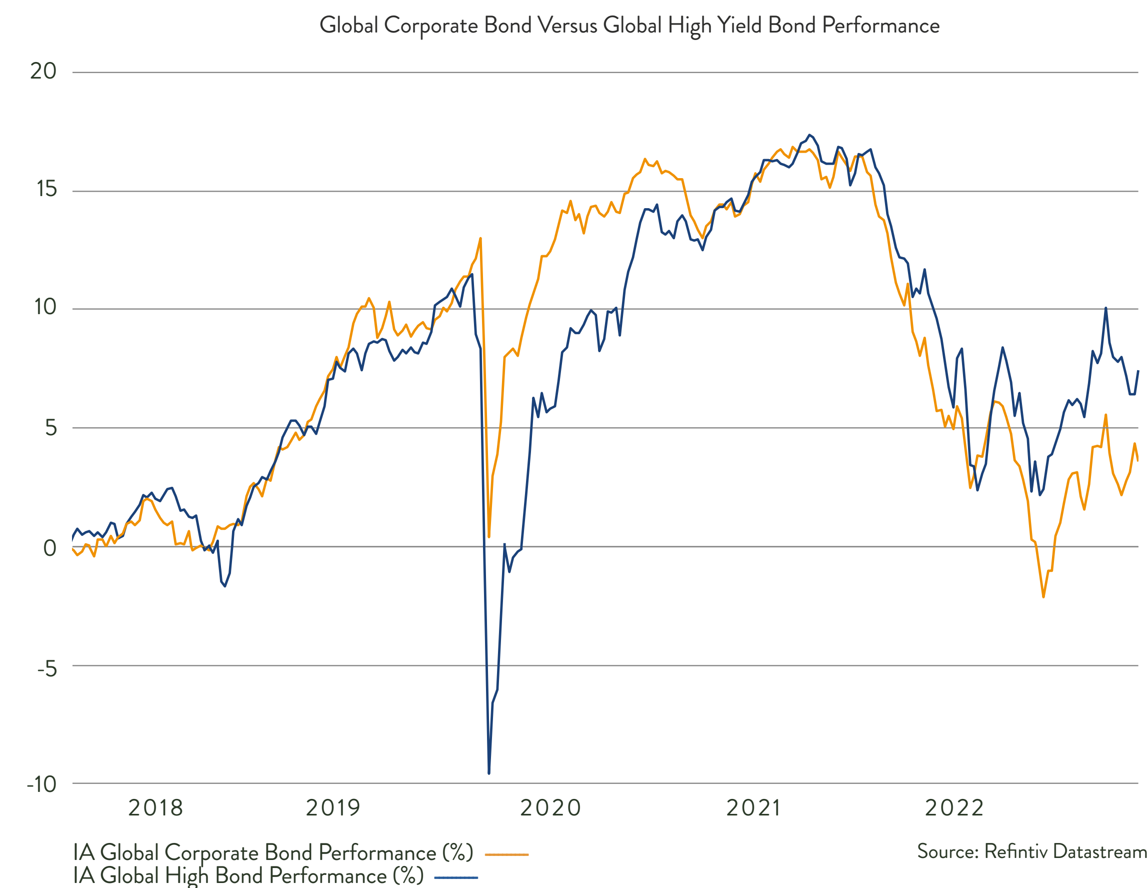
We are building up defensive elements in our portfolios now that rate hikes are moving toward an end point, and with inflation expected to fall. This will allow us to keep risk in equities. Bond investors have experienced a difficult few months due to rising interest rates, but should equities underperform in a recessionary environment, they still offer an important element of downside protection.

NEGATIVE NEUTRAL POSITIVE

PREVIOUS Q4

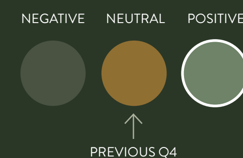
Investment Grade and High Yield

Both investment grade and high yield fared well in January, outperforming government bonds in the US and Europe. Over the quarter, global corporate bonds delivered 1.98%, with high yield delivering 1.88%. Risk sentiment improved as signs of easing inflation and better-than-expected growth (especially across the eurozone and China) gave investors reasons to revise some of their recession fears. However, the renewed confidence was short-lived and after central banks raised rates in February – and discussed plans for rate rises to come – credit spreads widened as investors anticipated higher rates for longer.



Our Stance

Yields at 20-year highs are presenting investment opportunities not seen for more than a decade. However, given the uncertain outlook, we own broad investment grade and short duration high yield, which reduces our exposure to rapidly rising interest rates. The reduced size of the UK's investment grade market makes this asset class positive to own and available at a decent yield. New issuance is also highly encouraging.



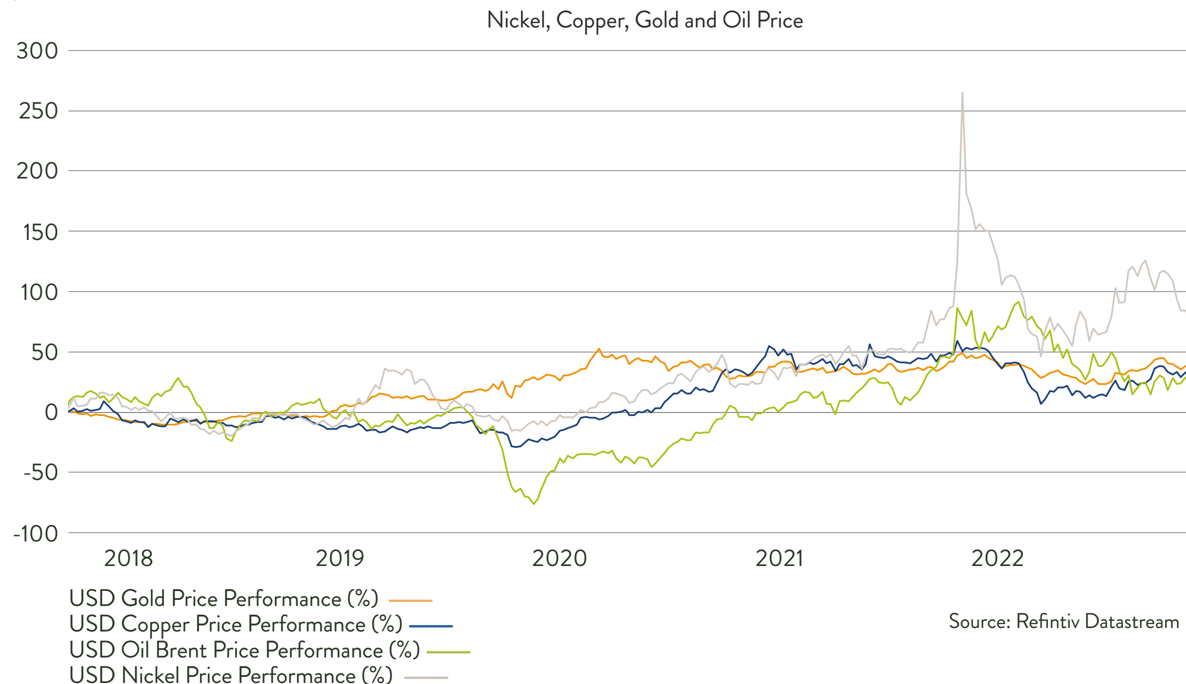
Alternatives

Commodities

The broad commodity index returned -6.47% over the quarter, again led by lower energy and metals prices. Oil prices fluctuated during the quarter, falling sharply amid heightened banking system fears, but rebounded just before the end of the quarter.

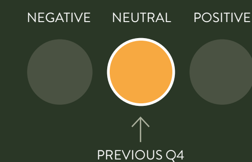
Commodities experienced a negative performance in January, with energy and livestock underperforming. While the price of nickel fell 23% over the quarter, precious metals achieved substantial gains. February saw a reversal, with declines in industrial and precious metals and falling energy prices, with some agricultural commodities also experiencing significant price falls.

Demand for commodities is still expected to fall in the short term, and energy prices have fallen from their elevated levels but may still be sensitive to lower demand. Despite low inventory levels, the global economy has reached a point of balance rather than undersupply for many commodities. Metal prices may prove more resistant due to increased construction and car production.



Our Stance

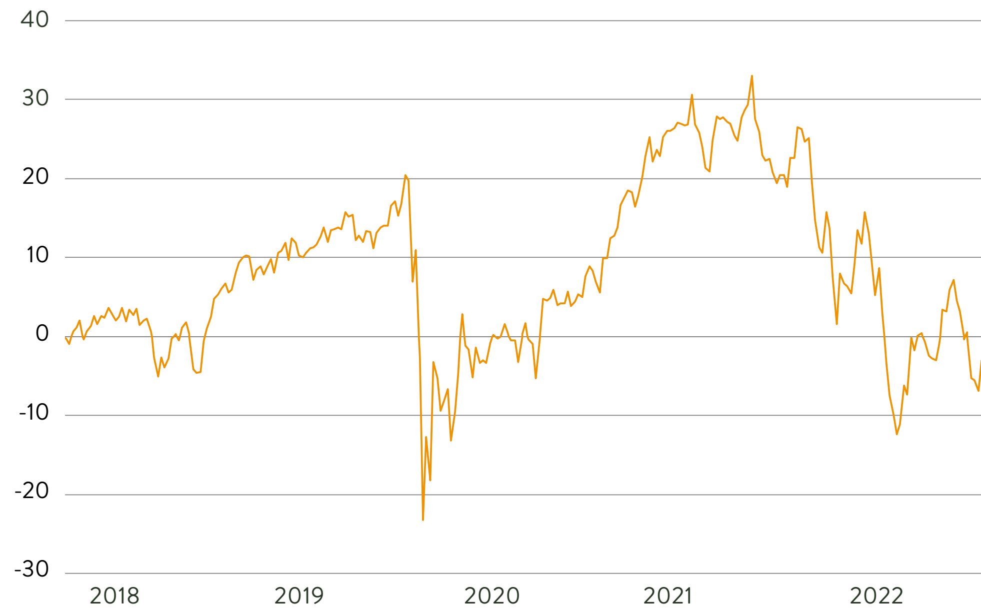
Our stance remains neutral due to continued volatility. However, we anticipate a stable outlook for 2023 with mild positive global demand and prices underpinned by China's resurgence.



Property

Global real estate fell 2.75% over the quarter. We remain less optimistic about the outlook for property, given the impact of higher interest rates on liquidity. Although there have already been setbacks within the sector, our focus on closed-ended and listed assets means that liquidity is less of an issue than might otherwise be the case. Strong relationships between managers and tenants also provide security.

The long-heralded return to offices for city workers now seems to be picking up, but property as an asset class is still not behaving as we have grown used to. Trading more around bond yields and given the slow nature of property sales, managers need to be really active when moving in and out of sectors - which is both costly and hard to do. As yields stabilise and workers return, a quick uplift of discounts is possible.



Our Stance

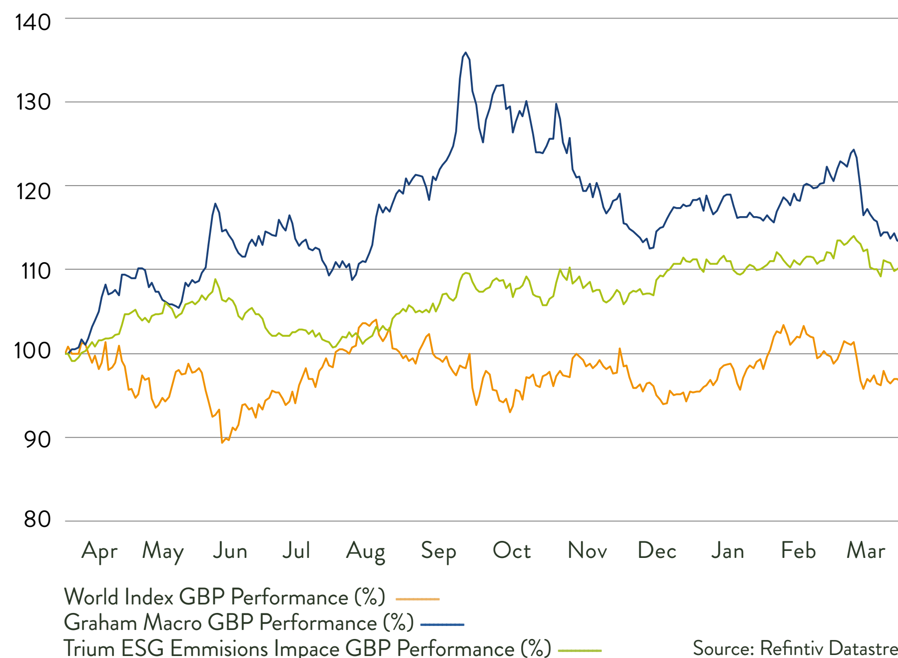
The backdrop for both commercial and residential property still looks challenging. Terminal rates are approaching but recent market financial turmoil has affected debt market due to CS rescuer and concerns over debt levels. We will hold our weighting and monitor closely. Higher rates should continue to cause liquidity concerns for some real estate investors.

PREVIOUS Q4

Structured Products and Hedge Funds

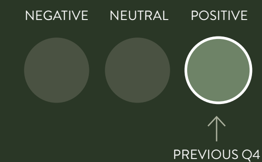
Volatile markets present hedge funds with the best opportunity to help portfolios and is being viewed by us as portfolio insurance while we have not been able to rely on fixed income. Within structured products, most underlying credit is with banks, but most of this has moved to the government debt market.

Within the sector, macro-driven strategies performed the worst, declining by 4.23%, while global markets gained 4.34%. Despite short-term banking sector troubles, overall the asset class presents investors with a known pay-off profile which moves income (dividends) into capital gains, which for most is beneficial.



Our Stance

The volatile nature of short-term lending markets has resulted in more opportunities to exploit pricing, with the added bonus of protection from equity market volatility. But with volatility expected to continue, exposure with downside protection is preferred.



Bowmore Asset Management
Birchin Court
20 Birchin Lane, London
EC3V 9DU
Tel: +44 (0)203 617 9206
Email: enquiries@bowmoream.com
bowmoream.com

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