GLOBAL MARKETS OVERVIEW

FOR RETAIL CLIENTS

2ND QUARTER 2023

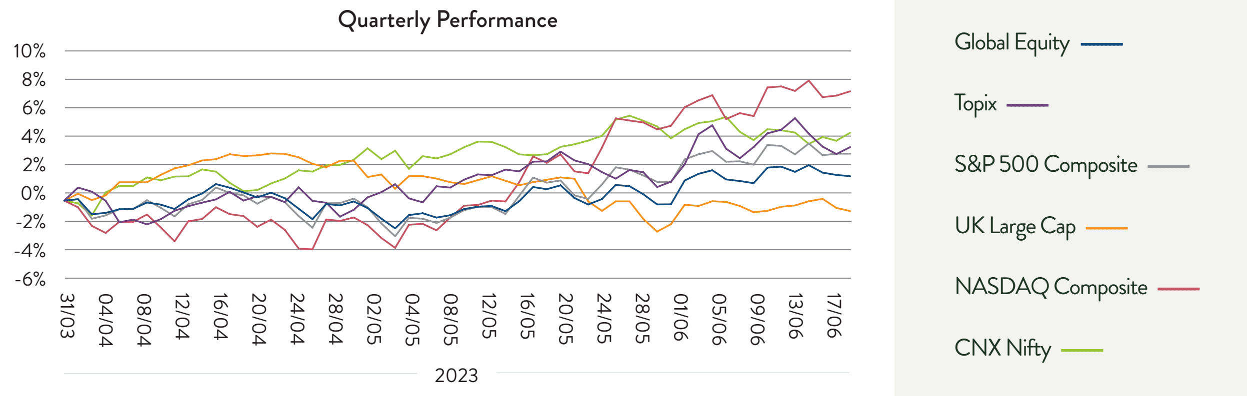
BOWMORE

ASSET MANAGEMENT

Key takeaways

Global Markets

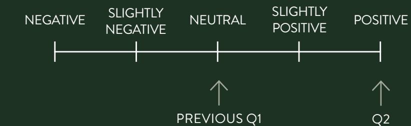
Our quarterly market overview provides a snapshot of recent activity within the world's financial markets. This quarter, we cover the rebound in US equities, the global interest in artificial intelligence stocks, the rise in UK bond yields, China's slow economic recovery, and more. We also highlight our views on the different areas of the market as we begin the second half of the year.



Source: Refinitiv Datastream

Our Stance

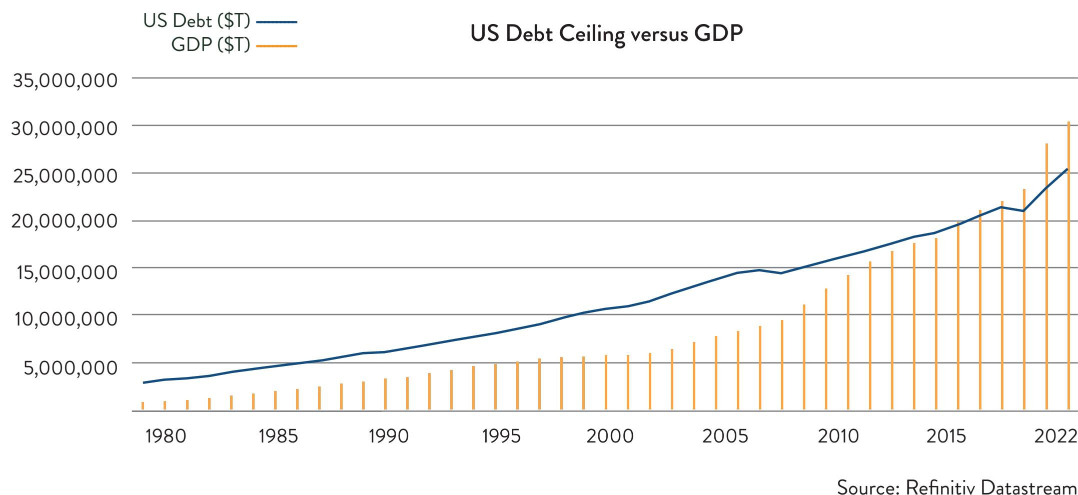
We remain positive on global equities as we head into Q3. Economic data is relatively healthy and currently indicating that developed markets may avoid recessions. Meanwhile, markets are not expensive from a valuation perspective.



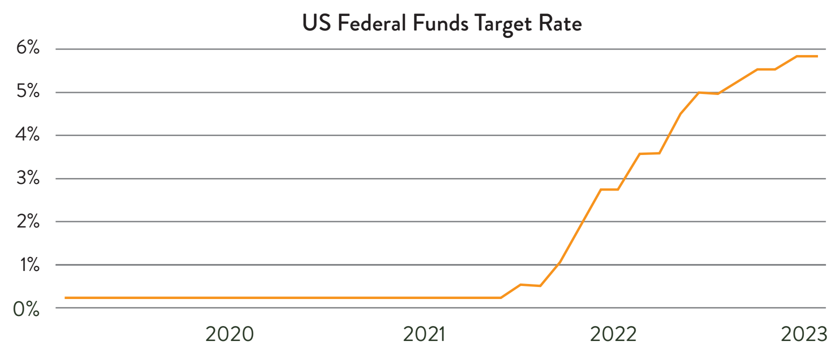
- US equities posted strong returns for the quarter. Gains were driven by large cap technology stocks, which benefitted from global interest in artificial intelligence (AI).
- Japanese stocks were the best performers during Q2, with the Nikkei 225 index rising to levels not seen for over 30 years on the back of strong consumption and investment.
- UK equities missed out on the global equity market rally. UK shares were hit by weak commodity prices as well as a rise in sterling and bond yields.
- Core inflation remains high across developed countries. Headline inflation is falling; however, core inflation remains sticky.
- Unemployment remained at historical low levels in the Eurozone (6.5%), UK (3.9%), and the US (3.4%), causing wages to grow faster than expected.
- The Bank of England (BoE) increased interest rates by 0.5% in June, taking the base rate to 5.0%. The European Central Bank (ECB) lifted rates by 0.25%, taking its benchmark rate to 3.5%.
- Higher interest rates are starting to be felt. Activity is currently trending downward, especially in Europe and Asia excluding Japan. We think interest rates are near peak levels in the UK, the US, and the Eurozone.
- The rise in interest rates is creating attractive opportunities in the fixed-income markets, with yields climbing to levels not seen for over a decade.
- Chinese macroeconomic data is showing a slowdown in activity after a strong first quarter.

Key takeaways

- Joe Biden and the House speaker, Kevin McCarthy, have reached a deal in principle to raise the US federal government $31.4tn debt ceiling.
- Since 1960, the debt ceiling has been raised 78 times.
- Potential consequences are credit downgrade, higher interest rates and cuts in social programs and US government services.



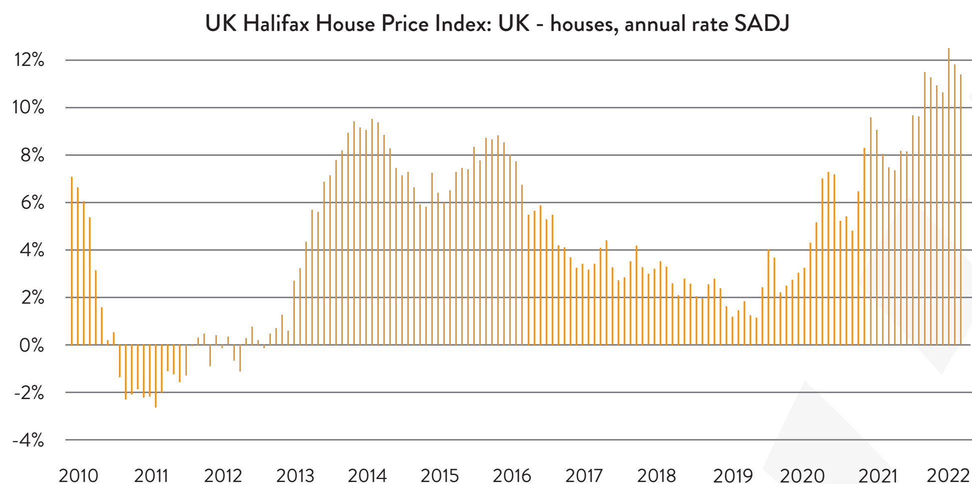
Source: Refinitiv Datastream



Source: Refinitiv Datastream

- US interest rates were raised to the highest level in 16 years; May saw the higher rates make it more difficult to buy a house, and to borrow to grow a business.
- Higher rates make it more difficult to buy a house, and to borrow to grow a business.
- Central banks, not just the US Federal Reserve, are pushing for higher interest rates in response to soaring inflation.

- UK house prices record first annual fall since December 2012.
- Property prices were 1 per cent down last month compared to May 2022.
- The Bank Of England said the average rate for new mortgages roses to 4.8 per cent in April, highest since 2008.



Source: Refinitiv Datastream

UK Equities

UK equities failed to participate in the Q2 global equity market rally, delivering a flat performance for the quarter.

The UK Equities All-Share index got off to a good start in April, posting healthy gains thanks to a rebound in bank stocks, which recovered from weakness in Q1 as fears over the health of US banks receded. Outperformance from energy companies, which rose after OPEC+ announced surprise oil production cuts, also fuelled gains early in the quarter.

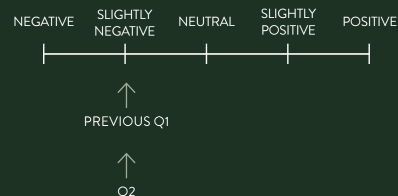
These gains were short-lived, however, as the index declined in May as cyclical stocks underperformed on the back of recession fears and lower commodity prices. Rising interest rates and strength in sterling also put pressure on UK stocks; higher rates have negative implications for a range of companies including housebuilders, utilities, and insurers, while a stronger pound means lower earnings for UK companies with international revenues.

An additional challenge for the UK equity market at present is competition from fixed income. With gilts currently offering very attractive yields, income investors – who in the past may have been seduced by the FTSE's generous dividend yields – now have alternative options. This has led to money flowing out of UK stocks.

On the plus side, it was encouraging to see UK banks hold up well in the wake of the US banking crisis. UK banks tend to have diversified client bases, and regulation introduced after the Global Financial Crisis has made them far more resilient than they were in the past. Additionally, mark-to-market rules in the UK mean that the balance sheets of our banks are more transparent than those of US banks. Under US accounting rules, banks are not required to provide the mark-to-market value of bonds classified as being held to maturity. The best performing UK banks were HSBC and Standard Chartered, which both posted double-digit gains for the quarter. Lloyds underperformed due to its exposure to the domestic economy and housing market.

Our Stance

We are still slightly negative on the UK market due to the country's anaemic level of economic growth. However, the market is extremely cheap relative to other international markets at present.

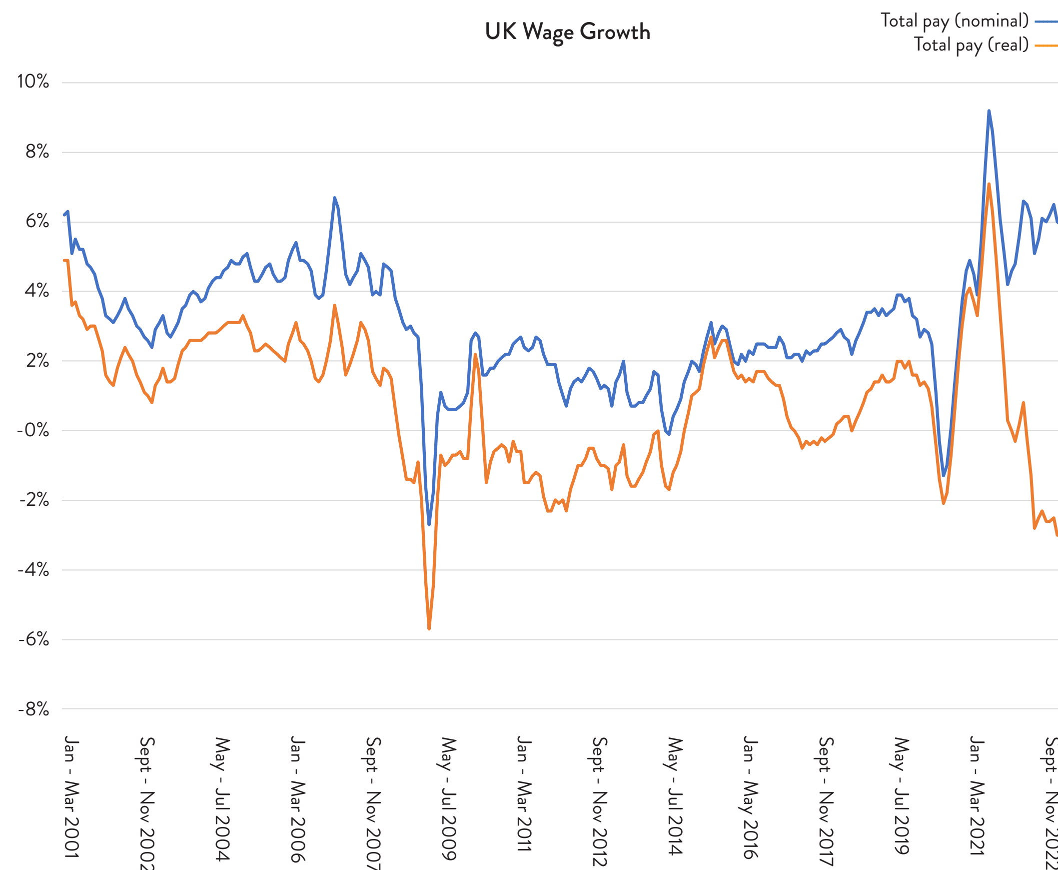


Inflation remains a problem in the UK. For May, core CPI – which strips out food and energy prices – came in at 7.1% versus 6.8% in April. This represented the highest rate since March 1992. Driving this inflation is strong wage growth. In mid-June, it came to light that both UK employment and wage growth jumped in the three months to April. Annual growth in wages excluding bonuses for the period rose to 7.2%[1] – the highest reading on record outside of the pandemic, when wage data was skewed by furlough schemes. The high level of wage growth is ultimately the result of a shortage of workers. To fill job vacancies, businesses need to offer higher salaries.

The Bank of England (BoE) continues to hike interest rates in an effort to bring inflation down and in June, it made a 'surprise' 0.50% increase, taking the base rate to 5.0% – the highest level since 2008[2]. Some economists believe that the central bank may have to take rates as high as 6.5% to really stamp inflation out.

In a positive development, the BoE said that it is no longer predicting a UK recession this year. It expects UK GDP to be flat over the first half of 2023 and then grow 0.9% by the middle of 2024[3]. The International Monetary Fund (IMF) is also not expecting a UK recession this year. In May, it advised that it expects the UK to grow by 0.4%[4] in 2023, helped by resilient demand and falling energy prices.

Looking ahead, the outlook for the UK equity market is likely to depend on commodity prices, UK interest rates and gilt yields, economic conditions, and the direction of sterling.



Source: Refinitiv Datastream

[1] Reuters [2] Financial Times [3] CNBC [4] CNN

US Equities

US equities delivered a strong performance in Q2, with the S&P 500 index posting a total return of 8.7%.

Solid Q1 earnings helped support the market early in the quarter. Banks were the first to report, and the results here were generally good, with major players such as JP Morgan and Citigroup beating estimates. This provided some comfort for investors after the turbulence within the sector in Q1. Results from Big Tech companies such as Microsoft and Meta Platforms – which have large weightings in the S&P 500 index – were also quite good, with the former reporting a reacceleration in cloud growth and the latter advising that it continues to focus on efficiency. Efficiency is a key theme within the stock market right now. Now that financial conditions are much tighter than they were, investors want to see organisations using their capital efficiently.

Corporate earnings continued in May, and it was chip designer Nvidia – a major player in the AI space – that stole the show here. Not only did it easily beat top- and bottom-line estimates, but it also provided guidance that was well above Wall Street's estimates. This sent the stock (which is held across all Bowmore portfolios) to new all-time highs and pushed the company's market cap up above the $1 trillion mark, making it the first chip company to achieve this impressive feat. On the back of Nvidia's strong guidance, many other semiconductor stocks outperformed.

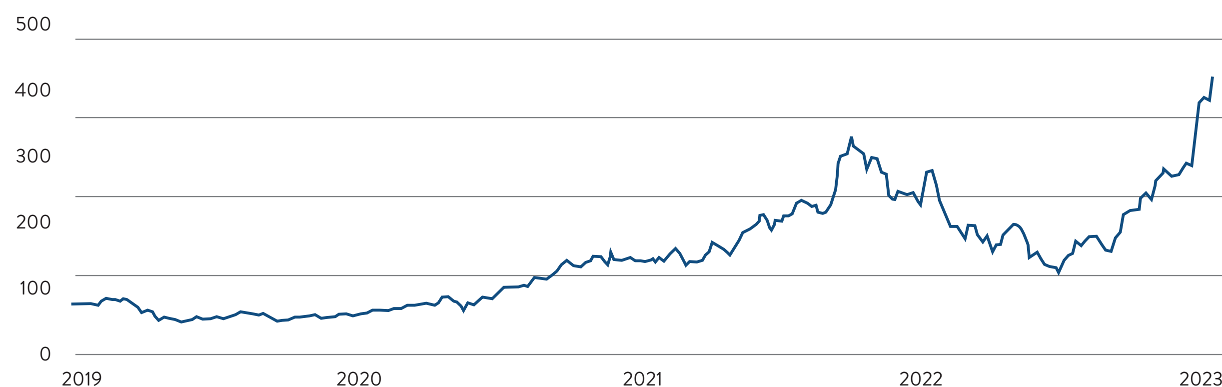
The excellent performance from chip stocks wasn't enough to power the US market higher in May as uncertainty over the US debt ceiling kept a lid on gains. The debt ceiling is the maximum amount of money the US government is authorised to borrow by law. When the debt ceiling is reached, the government cannot borrow any more funds to meet its obligations (social security, Medicare, etc.). The current debt ceiling of $31.4 trillion was hit in January, and for months, the White House and House Republicans could not reach an agreement to raise it. Yet late in May, a deal was agreed to increase the borrowing limit until after the next presidential election. This eased investors' nerves as a lack of deal could have had disastrous implications for the global economy.

It's worth noting that late in the earnings season, FactSet data showed that S&P 500 companies were recording their best performance relative to analyst expectations since the fourth quarter of 2021[5]. However, the index was still reporting a year-over-year decline in earnings for the second straight quarter. Looking ahead, the estimated earnings decline for the S&P 500 in Q2 2023 is -6.4%. If this is the actual decline, it will mark the largest earnings drop for the index since Q2 2020 (-31.6%)[6].

NVIDIA Corp

$421.90 582.35% +360.07

UTC-4 USD NASDAQ



Source: Google

[5] Factset

[6] Factset

During the quarter, the S&P 500 index entered 'bull market' territory, meaning that it had risen more than 20% from its most recent lows. This bull market has been quite unique, however, in that most of the gains have been driven by Apple, Microsoft, Amazon, Alphabet, Meta Platforms, Nvidia, and Tesla (aka the 'Magnificent Seven'), which delivered an average gain of nearly 90% for H1. This is reflected in the performance of the S&P 500 index versus the equal-weight S&P 500 index. For H1, the former returned 16.9% in total returns terms while the latter returned 7.0%.

As for why these seven tech stocks have done so well in 2023, there are several reasons. One is that they all operate in the AI space. This year, AI has been a dominant investment theme thanks to the success of AI-powered chatbot ChatGPT, which has racked up hundreds of millions of users globally since its launch (and become the fastest-growing internet app in history[7]). Due to ChatGPT, businesses across a wide range of industries are currently exploring how they can use generative AI to automate processes and reduce costs.

Another reason these stocks have outperformed is that at the beginning of the year, many investors were underweight with both equities and technology. Those who weren't positioned for a stock market rally have had to play catch up and flows into the US equity market have benefitted mega-cap tech stocks due to their large index weightings. Additionally, these technology companies have strong balance sheets and cash flows and significant long-term growth potential. These attributes are attractive in an environment of slowing growth. The excellent performance from these stocks helped the Nasdaq Composite index post its best H1 return for four decades.

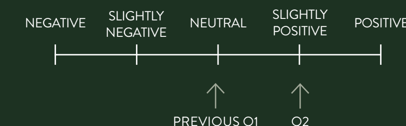
It's worth pointing out that throughout the quarter, there was some concern about the lack of breadth in the US market. There was evidence of an increase in market breadth in late May and June, however, with sectors such as Industrials and Materials showing strength. US small-cap stocks also outperformed late in the quarter as investors bet on the strength of the domestic economy. If this trend continues in the second half of the year, it could provide support for US equities.

While large-scale money centre banks weren't badly impacted by the turbulence within the banking sector, there was volatility at regional bank level in Q2. In early May, First Republic collapsed after depositors and investors abandoned the institution, and there was concern that other banks such as Western Alliance and PacWest may go the same way. Regional banks – which are the lifeblood of the US economy – have faced a range of challenges this year including higher deposit costs, fixed income losses, and higher loan default rates, and many investors have lost confidence in the sector.

On the economic front, US CPI inflation continued to trend down, coming in at 5.0%[8] for the year to March, 4.9% for the year to April, and 4.0% for the year to May. May's reading of 4.0% was the lowest rate in two years[9]. While US inflation is now well below its recent highs, it is still significantly above the level the Federal Reserve would like it to be. As a result, the Fed raised interest rates by another 25 basis points in May, marking 10 consecutive rate hikes – the most aggressive tightening campaign since the 1980s. In June, the Fed paused its rate hikes in order to assess the impact of higher rates on the economy. However, it signalled that there are likely to be more rate increases this year. With economic data – including strong new home sales in April and greater-than-expected employment gains for May – suggesting that the US economy is in relatively good shape, it is unlikely that the Fed will cut rates anytime soon.

Our Stance

We are still a little cautious on the US due to the recent turbulence in the financial sector and also because there is a chance that the country could still see a recession. However, we are starting to see more positive news around the country.



[7] Reuters [8] CNBC [9] Franklin Templeton

European Equities

While European equities drifted sideways for much of Q2, the Euro Stoxx 50 index managed to post small gains for the period.

European technology stocks such as semiconductor manufacturing equipment maker company ASML and software company SAP did well in Q2, thanks to improved sentiment towards the Technology sector. However, the region's exposure to cyclical companies – which suffered on the back of concerns over demand – kept overall gains muted and led to underperformance relative to US equities.

If tech continues to outperform, we would expect European equities to lag US equities as the Euro Stoxx 50 index only has a 16% weighting to technology versus 28% for the S&P 500. This lower weighting to tech is already impacting sentiment towards European shares. During Q2, European equity funds suffered their 16th straight week of investment outflows, taking total withdrawals to around $27 billion for the half year.

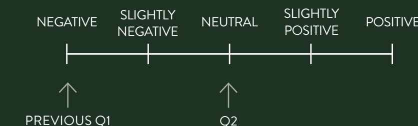
Inflation in the Eurozone is trending down thanks to lower energy prices. However, it remains elevated, with headline and core inflation coming in at 5.5% and 6.8% respectively for June. In an effort to combat inflation, the European Central Bank (ECB) increased rates by 0.25% in May and then by another 0.25% in June, taking the deposit rate to 3.50% – the highest in 22 years. Looking ahead, ECB President Christine Lagarde said another rate hike in July was "very likely". At present, markets expect a terminal rate of around 3.75%-4.00%. Like the Fed, the ECB is facing a robust labour market and strong wage growth, with average wages growing 5.2% year on year in the first quarter.

European economic data throughout Q2 was mixed. In April, the Euro area composite output PMI hit an 11-month high of 54.4, up from 53.7 in March[10]. This increase was driven by activity in the services sector, which benefited from the continuing reopening of the economy. However, late in the quarter, the European Economic Surprise Index, which measures how data comes in relative to expectations, fell sharply[11]. This index is often a good lead indicator for future earnings, so it is indicating that there could be downside risk ahead for corporate profits across Europe.

In June, the European Commission proposed stricter rules for ESG ratings providers. These rules should make ESG ratings less complex and opaque, and lead to further interest in sustainable investing strategies going forward.

Our Stance

We continue to be impressed by Europe's resilience. Economic growth is present and recent corporate earnings have been solid. Meanwhile, European stocks continue to trade at historically low valuations compared to US equities. We therefore move our slightly negative outlook to neutral but are closely monitoring energy prices as European countries are particularly vulnerable here.



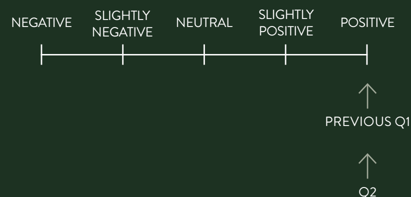
[10] Reuters [11] Morgan Stanley

Japanese Equities

Japanese stocks performed very well in Q2, with the Nikkei 225 posting strong gains. In mid-May, the index surpassed the key 30,000 level for the first time since September 2021. Then, in June, it broke through the 33,000 mark, hitting its highest level in 33 years. This tremendous performance from Japanese equities – which was driven by a surge in growth stocks as the AI theme infiltrated its way into the Japanese market – led to attractive returns from the Man GLG Japan Core Alpha fund, which is held in both our ESG and Core portfolios.

Our Stance

We continue to believe that Japan remains an attractive market for investors. Japan is in its own virtuous economic cycle due to positive GDP and inflation, which are rising thanks to healthy demand and investments. The Bank of Japan may have to temper this in the coming months.



After decades of stagnant prices and wages, Japan finally looks to have overcome deflation. Healthy tourism numbers have helped here – almost two million visitors arrived from overseas in April compared with less than 140,000 a year earlier – as tourism spending has put upward pressure on hospitality industry pay and prices. Inflation came in at 3.4%[12] for April – down from January's 41-year high of 4.2% but in line with market expectations – and 3.2% for May. In June, growth for the first quarter was revised higher to 2.7%[13].

It's worth noting that international interest in Japanese equities has increased after the Tokyo Stock Exchange recently requested companies trading below book value to come up with capital improvement plans. Warren Buffett may have also helped boost sentiment towards Japanese equities, as he visited Japan in April to announce that his investment company, Berkshire Hathaway, had increased its investment in five Japanese trading houses – Itochu, Mitsubishi Corp, Mitsui & Co, Sumitomo Corp, and Marubeni. These companies trade in a wide range of products and materials, and Buffett appears to be attracted to their earnings yields and potential for dividend growth.

The Bank of Japan (BoJ) held its short-term interest rate target at -0.1% – where it has been since 2016 – during the quarter, citing the "high uncertainties surrounding economies and financial markets". This pushed the Japanese yen to a 15-year low against the euro[14]. Looking ahead, the BoJ may scrap its yield cap policy this year now that inflation is above its 2% target. This yield cap has drawn criticism in the past for distorting markets by keeping long-term interest rates depressed.

Source: Refinitiv Datastream

[12] Reuters

[13 14] Reuters

Asia and Emerging Markets

Emerging markets underperformed developed markets in Q2.

Chinese equities fell in April, despite the fact that China's Q1 economic growth was better than expected. Ongoing tensions with the US and other Western nations over Taiwan was a driver of the weakness here. Chinese stocks then underperformed again the following month as investors became concerned that the country's post-Covid recovery was losing steam. In June, China's manufacturing PMI came in it at 49.0 after readings of 49.8 in May and 49.2 in April. These PMI figures indicate that the world's second-largest economy isn't experiencing the same kind of pent-up post-pandemic demand that other economies experienced after ending their lockdowns.

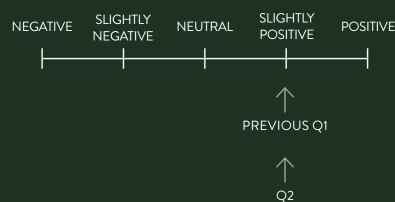
The weak recovery in China can be attributed to the fact that Chinese consumers are hesitant to spend right now. Chinese citizens did not receive the same kind of direct monetary stimulus during the coronavirus pandemic that citizens in other countries received. In contrast to policies in Western countries designed to directly support households and businesses, China spent heavily on anti-Covid apparatus, mandating mass testing, and imposing strict lockdowns. As a result, household balance sheets are not as robust as those in other countries were coming out of lockdowns. At the same time, youth unemployment remains very high. Recently, it rose above 20% – the highest rate since data was first recorded in 2018.

In June, the People's Bank of China lowered its key medium-term policy rate from 2.75% to 2.65% on the back of the country's loss of momentum. However, many economists believe that stronger action will be needed to reinvigorate the world's second-largest economy. It's worth noting that China's underwhelming recovery and its move to lower interest rates are deterring foreign investors at present.

Elsewhere in the emerging markets, Indian stocks outperformed during the period, with the Nifty 50 and BSE Sensex indexes ending the quarter at record closing highs. Indian companies' focus on the domestic market was a key driver of the outperformance here as the domestic focus means the companies are less vulnerable to a global slowdown caused by higher interest rates.

Our Stance

With the exception of China, we remain positive on emerging markets thanks to strong growth, attractive valuations, and generally declining inflation.



Government Bonds

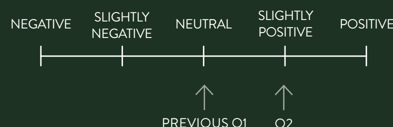
Early on in the quarter, yields on 10-year US Treasuries fell to around 3.3% on the back of recession concerns. They rebounded in May, however, thanks to stronger economic data and higher interest rate expectations, ending Q2 near 3.8%.

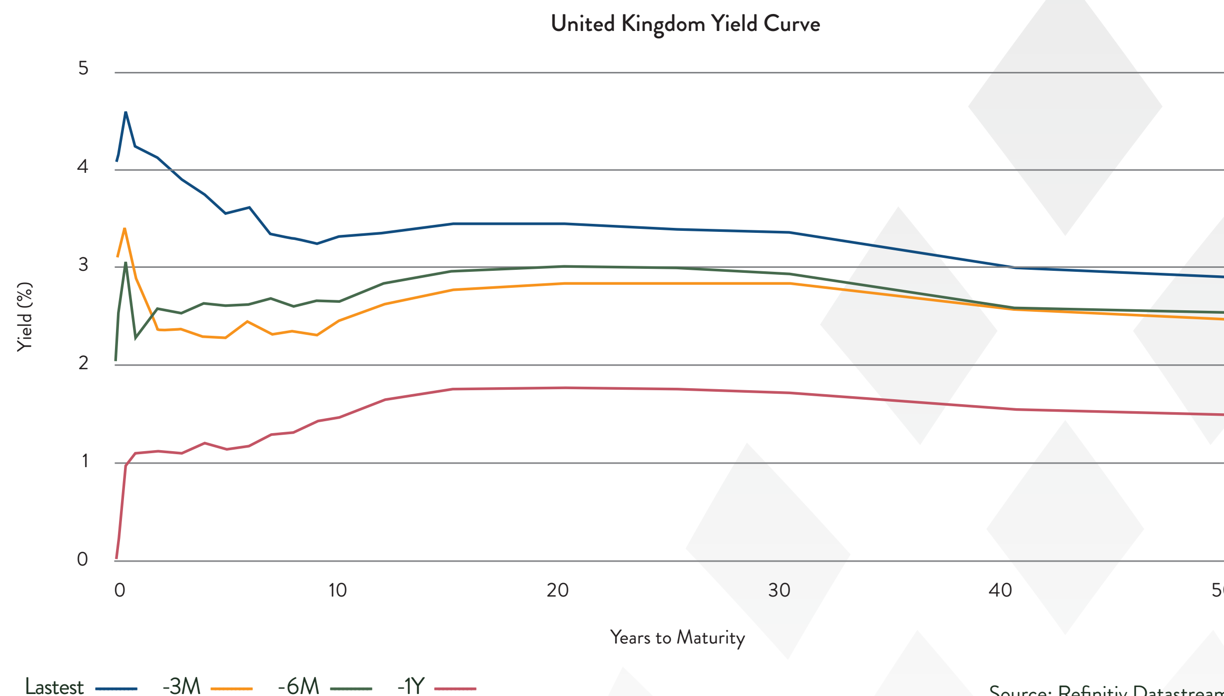
In the UK, yields on 10-year gilts rose to attractive levels during the quarter. Fears that high levels of inflation will force the BoE to continue raising interest rates were behind the increase in yields. Late in May, the gap between 10-year UK and German government bond yields rose above 183 basis points. Excluding the disastrous 'mini-budget' period in 2022, this represented the largest spread since the BoE became operationally independent of the government in 1997[15].

With the debt ceiling deal now in place, the US government could issue as much as $1 trillion in Treasury Bills over the next six months to refill its Treasury General Account (the largest issuance of T-Bills on record outside of a major crisis like 2008 or 2020). A risk here is that the issuance could syphon more money out of the US banking system, which has already experienced mass outflows this year. This could further stress the system.

Our Stance

With Gilts offering 5%+ yields, we believe that UK government bonds now offer an attractive risk/reward proposition for investors. The Fed and BoE will soon pause their tightening campaigns, which will provide support for government and investment-grade bonds.





Source: Refinitiv Datastream

[15] Reuters

Investment Grade and High Yield

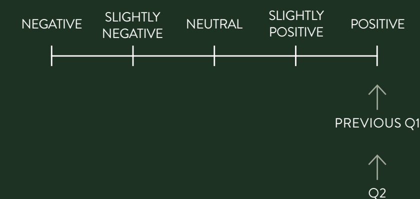
Yields remained high in the investment grade space during Q2 (1.5% standard deviations above the 20-year average), providing opportunities not seen for around a decade. We added a sizeable allocation to investment grade bonds in 2022 in order to take advantage of the attractive yields on offer.

High-yield fixed interest securities – corporate debt securities that pay higher interest rates than investment-grade bonds because they have lower credit ratings – also offered plenty of opportunities in Q2. Relative to investment grade securities, high yield bonds are less sensitive to interest rate risk but more sensitive to the economic outlook.

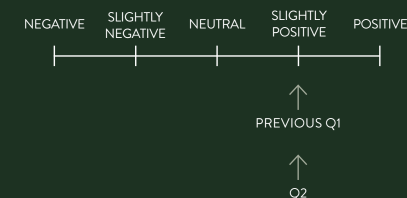
Our Stance

We currently favour short-duration bonds over high-yield fixed income as we are working to minimise our exposure to sharp increases in interest rates.

Investment Grade



High Yield



Alternatives

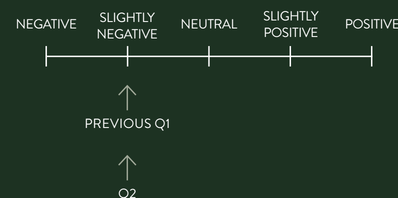
Property

Higher mortgage rates in the UK continued to put pressure on the property market in Q2. According to Nationwide, UK house prices have fallen around 4%[16] from their peak in August 2022. Many experts believe that prices could continue to fall from here, particularly if inflation keeps borrowing costs elevated. Some believe that the 6% mortgage rates today could cause the same kind of stress as 13% rates in the 1980s did, since homeowners now borrow far more money relative to their incomes than they used to.

In the commercial property space, we could be looking at a major supply and demand mismatch in London. Nearly 10 million square feet of space is due to be delivered in the capital this year if all projects remain on schedule – more than in any other year over the last two decades[17]. Yet demand for London office space is falling amid more flexible hybrid working arrangements.

Our Stance

The impact of higher rates is still being felt in the property sector. However, with central banks near the end of the tightening campaigns, property could be set to become more attractive. Office attendance is increasing, but is still way below pre-Covid levels and we are mindful of new build capacity coming online.



[16] Financial Times

[17] Evening Standard

Commodities

There were some notable developments in the commodities space during Q2.

Early in the quarter, oil prices rose after OPEC+, a group of 23 oil-exporting countries, announced production cuts of around 1.2 million barrels of oil a day – equivalent to approximately 1% of global supply. However, oil prices fell in the second half of April and during May on the back of recession fears, ending May around 40% lower than the level they were at a year earlier. Recession fears also had a negative impact on industrial metals such as copper and nickel.

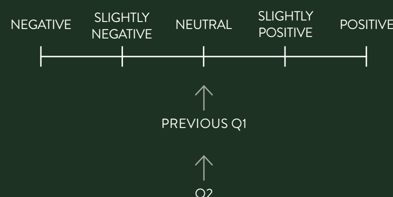
The price of lithium – which is used in electric vehicle (EV) batteries – continued to decline early in Q2. Deteriorating sentiment towards the Chinese EV sector was a key driver of the weakness here. However, lithium prices found some support in late April and rose throughout May. Lower lithium prices are a good thing for the EV industry as they will reduce battery costs, which in turn, will reduce vehicle costs.

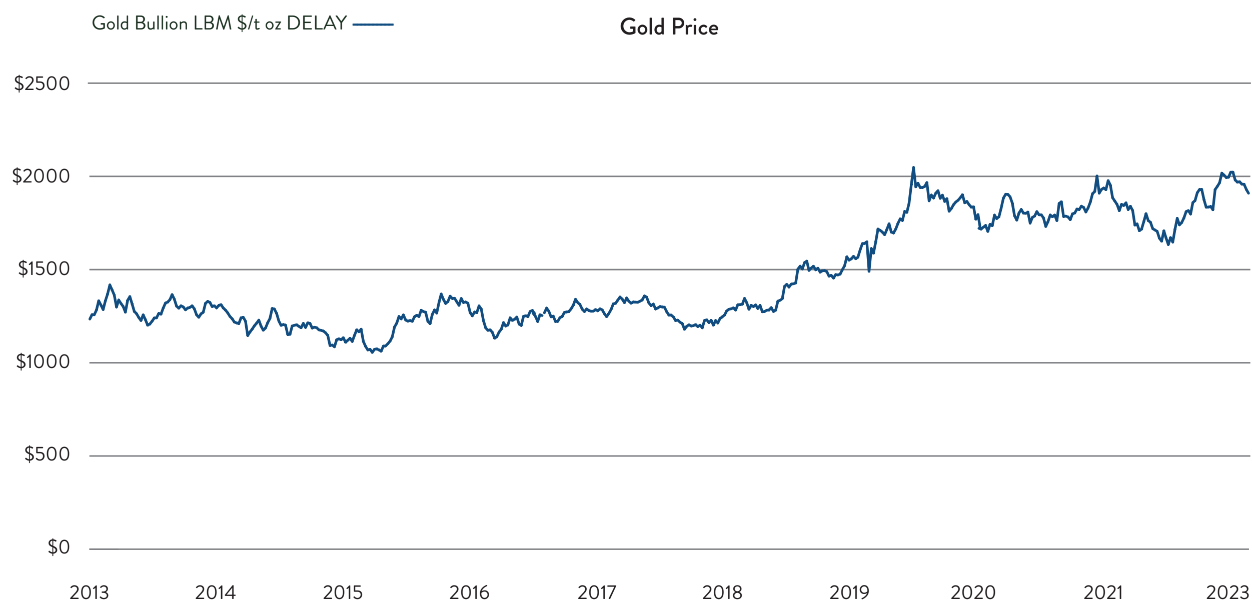
As for gold, it shot up above $2,000 per ounce in early May – hitting its highest level since 2020 – as a result of demand for 'safe-haven' assets amid recession fears. However, it pulled back in late May due to strength in the US dollar and continued to decline in June.

Structured products
With interest rates at their highest levels in over a decade and credit spreads continuing to widen, there are attractive opportunities in the structured products space at present. This asset class could provide support should equities fall.

Our Stance

Commodity markets have experienced some weakness in recent months and will continue to be cheap during the summer. There is a risk of price increases in the autumn months, especially in Europe, which is dependent on Russian gas.





Source: Refinitiv Datastream

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