CHETWOOD

WEALTH MANAGEMENT

REFLECTING ON 2023 & PLANNING FOR 2024

Our thoughts on the markets

We have navigated a sea of economic challenges and uncertainties in 2023. The narrative in 2024 is likely to shift from the inflation cycle to questions concerning where we are in the business cycle. Markets will also have to grapple with both the UK and the United States elections, which promise to be some of the most hotly contested elections in recent memory. Heading into 2024, there are plenty of reasons to be optimistic.

As we leave 2023 behind us, it is very encouraging to see inflation has fallen significantly from the high levels seen at the start of 2023. In January 2023, Consumer Price Inflation (CPI) stood at 10.1%, 8.6% and 6.4% for the UK, Eurozone, and US respectively. In December 2023, the latest CPI readings have fallen to 3.9%, 2.4% and 3.1%. There is now a clear downtrend in inflationary pressures, and as long as the trend continues, central banks will be able to consider their first set of interest rate cuts in the first half of 2024.

We may look back and describe October 2023 as a turning point for markets as this was when the Federal Reserve (FED) announced that they would keep interest rates steady and pause on any further rises. This move was widely expected, but a significant shift nonetheless as this marked the end of the interest rate hiking cycle. The latest round of inflation data (CPI in both the US and UK) came in lower-than-expected, affirming the view that the FED and Bank of England (BoE) have finished their rate hiking cycle.

> *When interest rates do begin to come down and return to normal, this will be a tailwind for consumers and businesses. Lower interest rates make borrowing money cheaper. You could, therefore, be paying less interest on personal loans, mortgages, and business loans, but you may also be getting paid less for being in cash. These variables make for a fruitful growth environment, a tailwind for the property market and a desire to deploy cash back into markets. Expectations of interest rate cuts, therefore, provide a significant boost to market sentiment and help generate positive returns. An interesting year lies ahead.*

A look back at 2023

When 2023 started, we were hoping for a more conventional market recovery, but we were given more of the powerful and volatile trends that existed from the previous year – that of global central banks continuing to raise interest rates and war persisting around the world, with the Middle East joining Ukraine in the headlines. Inflation eventually started to fall, however it remained uncomfortably above the target of developed market central banks.

The rising interest rates continued to provide a headwind to the performance of bonds for the first three quarters, before green shoots of recovery to this much maligned asset class started to show in the final quarter and coincided with a change of rhetoric from central banks – who started to talk about rate cuts in 2024. Equities enjoyed a better year after a very turbulent 2022, although performance was concentrated for most of the year in a small number of large US technology stocks, which have commonly become known as the "Magnificent Seven" (Apple, Amazon, Alphabet, Nvidia, Meta, Microsoft and Tesla).

Performance of 'Magnificent Seven' vs S&P 500 Index

Source: Bloomberg, 12th December 2023.
Notes: Performance is total return GBP (rebased to 100 at start of period)

There was a brief but serious bout of banking sector instability in the US and Europe during the spring, which created further market volatility. This led to the collapse of several banks including Silicon Valley Bank (SVB) and the takeover of Credit Suisse by UBS. It forced a swift response from the US Federal Reserve (FED), unveiling a backstop facility to prevent further distressed asset sales and to protect depositors.

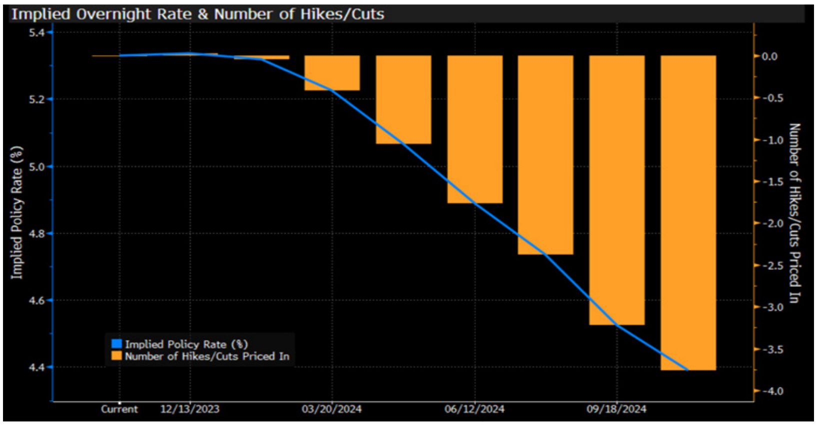
Despite inflation not falling to target, and indeed the new "target" may need to be revised closer to 4% than the current 2%, it is looking increasingly likely that we have seen the last interest rate hike from the key central banks during the current cycle.

This is certainly what the market is pricing in as 2023 ends with up to 4 rate cuts expected in 2024, this is despite central banks still talking tough about being prepared to hike further if inflation does not continue to fall.

Market expecting up to 4 rate cuts in 2024

Source: Bloomberg, 13th December 2023

Notes: Dates are scheduled meetings of the rate-setting Federal Open Market Committee during 2024.



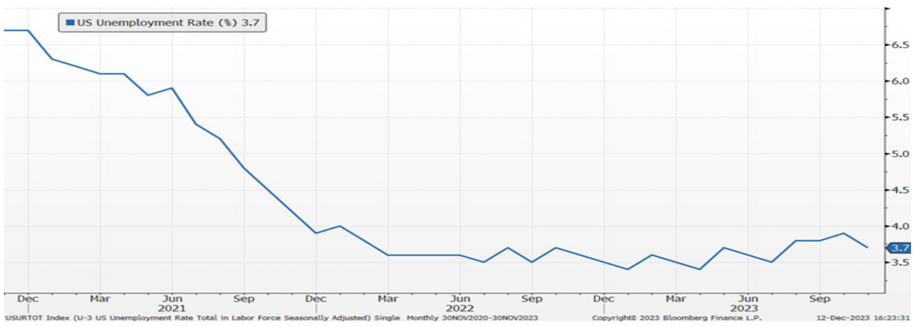
It is heartening that the global economy has proven to be so resilient in 2023. The much-predicted US recession has not materialised as the economy has been helped by strong consumer spending and pandemic-related stimulus. A strong labour market, pent-up savings and a desire to make up for the experiences missed during Covid appear to have outweighed the drag from higher costs and interest rates. A recession in the US is still a possibility as tight financial conditions begin to bite on consumption and business sentiment, but expectations have been pushed back to 2024 and we have plans in place to deal with this.

The resilient economy has come in the face of geopolitical risks remaining elevated during the year. War broke out between Israel and Hamas and the war between Russia and Ukraine continued, although so far these events have not had a sustained impact on oil prices.

The labour market remained robust for much of the year, supporting a strong economy, however weakening data in the latter stages of 2023 gave encouragement to bond markets that rates would not have to rise further as the delayed effect of previous interest rate rises started to be felt. The question is whether businesses will cut jobs in 2024 in the face of slowing growth. Usually, when profits come under pressure, firms quickly cut back on investment, and then staff, in a bid to repair margins.

US unemployment rate remained low in 2023.

Source: Bloomberg.
Notes: The US Unemployment Rate measures the percentage of total employees in the US that are a part of the labour force, but are without a job.



US equities outperformed their international peers, led by the Magnificent 7 technology stocks. The share price of chipmaker Nvidia rose particularly strongly because of excitement surrounding Artificial Intelligence (AI). This left the valuation of US stocks looking quite stretched and we have been managing this exposure accordingly. Within Europe, Danish drugmaker Novo Nordisk led the way, helped by the success of its two main products: Ozempic and Wegovy, which are prescribed for diabetes and weight loss. During the year, Novo overtook Louis Vuitton Moet Hennessey (LVMH) as Europe's most valuable listed company. UK equities underperformed until late on, but Chinese equities struggled even more, with the economic rebound from the end of Covid-19-related shutdowns being weaker than expected.

Bonds have historically been useful diversifiers in clients' portfolios – when equities struggle, the risk-off environment leads investors to sell equities and buy bonds. This is known as a negative correlation – equities go down and bonds go up. However, in a rate-rising environment, this has not happened as bonds have been just as much at risk as equities. The correlation between equities and bonds was actually positive in 2023 (they moved up and down together). We expect that as inflation levels get closer to central bank targets in 2024, bonds and equities should resume their more typical inverse relationship and this will help with portfolio construction and create a smoother client journey.

Political uncertainty will be high in 2024 with half the world (including the US and UK) heading to the polls. Central banks face a difficult balancing act as they need the labour market to weaken to drive down wage growth and inflation, but being the cause of rising unemployment is never something that central bankers relish. Having to deliver that outcome in the run-up to a national election makes life even more uncomfortable. Therefore, the focus in 2024 will be on when central banks, in particular the FED, pivot and start reducing rates and by how much and how quickly. A fast and sudden reduction in interest rates may spook markets, whereas an orderly and well-communicated gradual fall should be well received.

It has been a difficult couple of years for equity markets, however we are becoming increasingly optimistic that company earnings are poised to pick up in 2024, which should drive equity markets higher. Markets are forward looking so we have every reason to believe that a downturn is already being priced in. Also, despite their tough talk, we fully expect central banks to start cutting interest rates if the economy does decline, which should be supportive for bond and equity prices.

In the meantime, please find within the rest of the document our summary of how markets moved through each quarter in 2023.

1st Quarter 2023

The year commenced with optimism, particularly with China's removal of Covid restrictions, but this positive outlook was soon challenged by increased market volatility. Notably, the collapse of Silicon Valley Bank in March raising serious concerns about the robustness of the financial sector.

Throughout this period, central banks in major economies persisted with their strategy of incrementally raising interest rates. This approach was influenced by robust economic indicators and a moderate easing of inflationary pressures. Despite some fluctuations, the overall market performance at the beginning of the year was reasonably positive. However, the accuracy of economic forecasts, especially regarding inflation, continued to be a topic of considerable debate.

The narrative around the possibility of a recession in developed markets began to shift. The UK, for example, narrowly avoided a technical recession, with retailers such as Tesco and Sainsbury's reporting strong sales figures, suggesting a degree of resilience in consumer confidence and spending. Central bank leaders including the European Central Bank's Christine Lagarde and the FED's Jerome Powell indicated a continued commitment to rate hikes but also acknowledged the beginning of a possible disinflationary process.

US Core Inflation

Source: Bloomberg. 31st March 2023
Notes: Core inflation measures the annual change in the costs of goods and services but does not include those from the food and energy sectors, which can be more volatile.

The downfall of Silicon Valley Bank was a critical event, highlighting the risks associated with aggressive interest rate hikes and lax risk management in the banking sector. This incident led the FED to implement new measures to bolster the financial sector's stability.

Share price of Silicon Valley Bank

Source: Bloomberg.

As the quarter progressed, there was growing anticipation that central banks might soon pause their rate-hiking cycle, prioritising financial stability over inflationary concerns. This ultimately proved premature. In the UK, budget announcements reflected a broader economic strategy in these challenging times, including adjustments to pension allowances and initiatives to boost workforce participation.

In summary, the first quarter of 2023 was a period marked by cautious optimism, tempered with banking stresses.

2nd Quarter 2023

In the second quarter of 2023 both equity and bond markets struggled to gain substantial ground amidst the enduring inflationary environment, compelling central banks to adopt a firmer stance on raising interest rates and acknowledging unfinished work in curbing the inflationary forces.

The surge in demand for companies associated with AI had rekindled interest in growth stocks, signalling a shift in market preferences toward technology-driven advancements. The rapid growth of AI applications, highlighted by platforms like OpenAI's ChatGPT reaching one million users in just five days, underscored the significance and implications of AI's expanding influence, albeit requiring vigilant monitoring for long-term beneficiaries and potential losers. You can see below the outperformance of the tech focussed Nasdaq versus broader US equities.

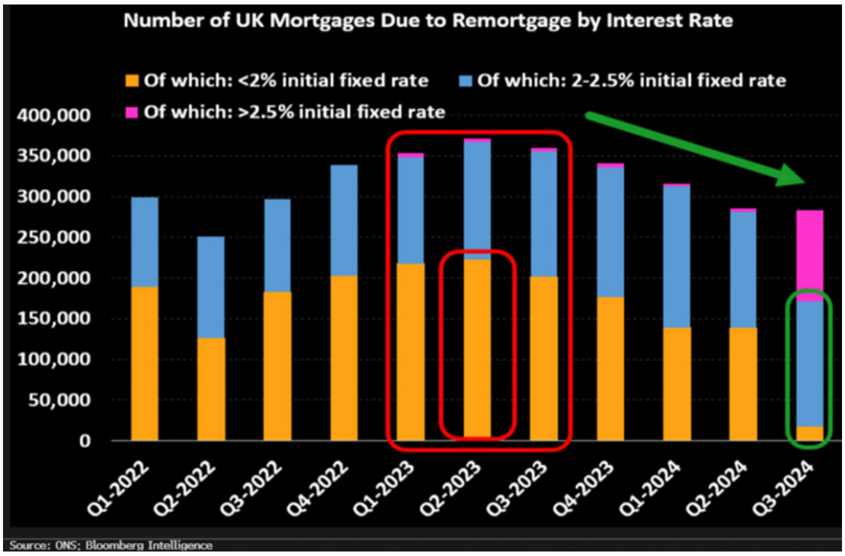
US Technology stocks on the rise

Source: Bloomberg. 30th June 2023
Notes: Performance of tech-heavy Nasdaq 100 Index vs the broader S&P 500 Index (Equal weighted and market cap weighted version).
Performance is total return GBP

Central banks faced challenges in controlling inflation, partly due to changes in the housing market and mortgage trends. In the UK, for instance, the shift towards fixed-rate mortgages slowed the impact of interest rate adjustments on household spending. This, combined with labour shortages and wage growth, particularly in the services sector, meant inflation remained stubbornly high and applied pressure to central banks.

Number of UK mortgages due to remortgage by interest rate

Source: Bloomberg
Notes: The majority of UK mortgages are fixed on a low rate of interest.



Banking sector strains started to ease, and global systemically important banks appeared well-capitalized and resilient to these tighter financial conditions. Central banks continued to navigate the fine line between combating inflation and avoiding recession. The FED paused its rate hiking cycle, indicating a cautious approach, but this did not last long. Despite the possibility of mild technical recessions in developed economies, global growth projections remained positive, with expectations of recovery in the 2.5%-3.0% range for 2023 and 2024.

Overall, while the economic scars from the pandemic would take time to heal, the medium-term outlook for the global economy appeared promising, offering a conducive environment for investment. The expectation was that less restrictive monetary conditions would eventually stimulate the economy, leading to a recovery in stock and bond markets. This was conceptually correct, but maybe a little early.

3rd Quarter 2023

The third quarter was a rapidly changing market environment focusing on central bank rhetoric and inflation remained a primary concern, being persistently high most notably in the UK. Central banks, particularly the FED and the Bank of England, were back raising interest rates in response to inflation.

UK Consumer Price Inflation

Source: Bloomberg

Consumer spending played a pivotal role, driven by excess savings accumulated during the Covid-19 pandemic. However, these savings were nearly depleted, and the impact of higher interest rates on consumer spending was expected to become more pronounced, especially as fixed mortgage deals expire and need refinancing at higher rates.

The annual Jackson Hole meeting in the US, a significant gathering of central bankers, focused on the transition from reducing inflation to maintaining control over inflation. Managing inflation is complicated - with factors like global supply chain disruptions, geopolitical tensions, and labour market changes under the spotlight.

Despite heightened recession risks, consumer and business finances stayed resilient, supported by low unemployment and healthy profit margins. Analysts anticipated a rise in corporate earnings over the next year, which would support equity markets and with this in mind equity markets slowly started to grind higher.

4th Quarter 2023

Yield on US 10 Year Treasury Bond

Source: Bloomberg. 12th December 2023
Notes: This shows the yield received for investing in a US government-issued treasury security that matures in ten years.

The anticipation of rate cuts, following a period of aggressive hikes, injected optimism into the markets. Fixed income markets mirrored these sentiments. The U.S. 10-year Treasury yield, after peaking in October, declined significantly as the FED signalled a potential pause in rate hikes.

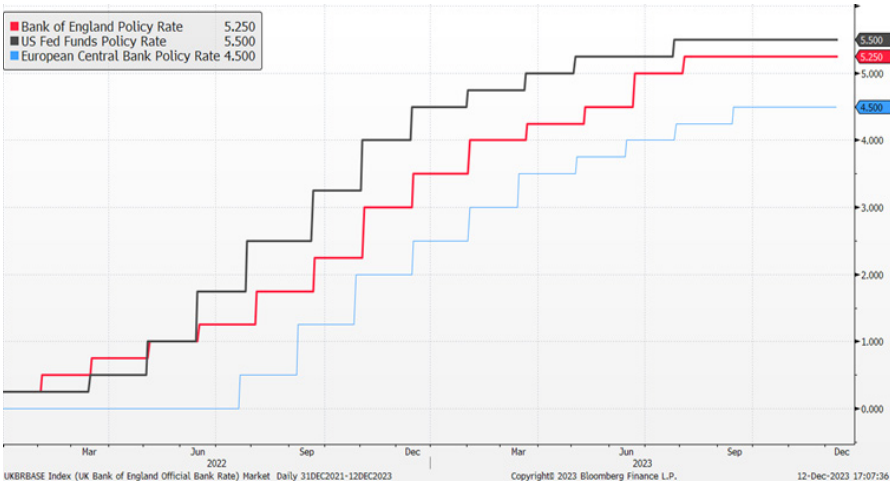
Remarkably, the global economy demonstrated unexpected resilience, underpinned by the surprising strength of the US economy.

The role of monetary policy in shaping economic outcomes continues to be a central theme. In the UK, the Bank of England's monetary policy tightening is expected to have a lasting impact on the economy, with only half of the effects of interest rate rises felt so far. Similarly, the FED's policy decisions in the face of slowing growth in 2024 will be a key factor for investors to consider.

We now have a situation where all four systemically important central banks — the Bank of England, Bank of Japan (BoJ), European Central Bank (ECB) and the FED — have paused their rate rising progress. It must be noted that all four central banks coupled a decision to maintain unchanged interest rates with an open door to the possible resumption of increases down the line.

Central Bank Pause

Source: Bloomberg
Notes: Chart shows key borrowing rates of Bank of England, ECB and Fed. The Bank of Japan kept their rate at -0.10% for the full period.



Even if this may now be the high point for rates, central banks dare not announce this yet as they have got so much wrong in recent years. All four central banks need to supplement their often-repeated "data dependency" with a clearer, forward-looking characterisation of the economic context and unless they can do that, they will not be able to restore credibility and enhance accountability. On the surface, all four central banks now have time to assess the impact of their past actions and internalise more data. While the data is largely going their way, the BoE, ECB, and FED feel that they still need to get a good handle on the cumulative effects of their aggressive hikes and tighter conditions in the market.

During the final quarter, Chancellor Jeremy Hunt delivered the UK Autumn Statement by aiming at future growth but highlighting the peculiar nature of managing public finances through surprise-laden, short-term annual budget announcements. This approach makes long-term planning challenging and creates uncertainty, especially with a looming general election in 2024 that could potentially reverse current policies, unsettling the economy further.

Adhering to the "Fiscal Rule," Hunt increased benefits, cut National Insurance, and maintained income tax thresholds despite persistent high inflation. Favourable tax receipts left him with £30bn in fiscal headroom, which he opted to spend. Allowing businesses to fully expense costs against taxable income is expected to boost company liquidity for investment. However, strained public sector budgets face a £20bn shortfall ignored in the Statement.

Some perceive the Conservative party's measures as addressing immediate concerns for voters and businesses without deeply considering longer-term growth, possibly leaving upcoming challenges for the Labour party post the upcoming elections.

Looking Ahead

After nearly two years of policymakers fighting inflation, 2024 will be judged on the balance between growth durability versus the stickiness of inflation. Despite over a year of restrictive monetary policy, the global economy — particularly in the US — has remained remarkably resilient. The global economy is entering a brief period of below-trend growth driven by recent monetary policy tightening, although this appears to have been already priced in by the markets.

As inflation softens and policymakers begin to introduce rate cuts, we look for risk assets to see renewed strength. Guidance suggests that inflation will be nearing central bank targets by the end of 2024. As inflation falls, we expect real policy rates to rise and, in response, central bankers to cut rates to ease any additional pressure on growth, employment and wages. We expect this easing to begin late in the first half of 2024. We anticipate that rate cuts — combined with falling inflation — will set the stage for a continued recovery, both in markets and the global economy.

As we look forward to 2024, embracing change with prudence will be our guiding principle. We will continue to leverage our expertise to analyse market trends, sector shifts, and policy changes, ensuring that your investments are positioned to capitalise on emerging opportunities as the interest rate regime starts to shift. As it stands today, 2024 looks like a year with abundant opportunity, particularly in fixed income markets and specific US equity sectors away from expensively valued technology stocks.

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