Life \ Pensions \ **Investments**

September 2023
Quarter in Review

more **INVESTED**

HIGHER FOR LONGER

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The global macro backdrop in the third quarter continued to suggest that inflation remains sticky, while activity data was somewhat mixed. The divergence between a resilient US economy and signs of slowing in the Eurozone persisted. Central banks continued to hike interest rates and emphasised that policy would need to remain restrictive for longer in order to tame inflation. The prospect of tighter financial conditions – 'higher for longer' rates – weighed on global asset markets.

US

Price pressures have stayed elevated in the US, with consumer prices up by 3.7% year-on-year (y/y) in August and core prices rising by 4.3%. The former was largely driven by a 5.6% month-on-month increase in energy prices.

At its July meeting, the US Federal Reserve (Fed) raised its key rate by 25 basis points (bps) to a range of 5.25-5.50%, with minutes showing that "most" monetary policy members saw "significant upside risk to inflation, which could require further tightening of monetary policy". Fed Chair Powell's speech towards the end of August at Jackson Hole was somewhat hawkish too, as he stated: "We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down." The monetary policy committee's updated forecasts show a median projection of one more rate hike in 2023, which would bring the federal funds rate to a range of 5.50-5.75%. Only two 25bps rate cuts are expected in 2024.

US labour-market data remained strong. August US non-farm payrolls showed 187K jobs added, above the 170K expected. And while unemployment unexpectedly rose from 3.5% in July to an 18-month high of 3.8%, this was largely due to a rise in the participation rate. Moreover, initial jobless claims fell to 202K during September, the lowest level since January, in a sign that the labour market remains strong.

Disagreements between the Democrats and the Republicans in relation to a spending plan for the current fiscal year led to concerns of a government shutdown. On 30 September, an agreement was voted for by the Senate to fund the government for 45 more days, but this issue is likely to come up again in early-to-mid-November.

Europe

Data in the Eurozone continued to disappoint, with second-quarter GDP revised down from 0.3% quarter-on-quarter to 0.1% amid weak consumer spending, while July German industrial production declined by 0.8% month-on-month, more than the 0.5% expected and the third consecutive monthly fall. The Eurozone composite PMI for September increased to 47.1, with services rising to 48.4 and manufacturing falling to 43.4, although both remain in contractionary territory.

The European Central Bank (ECB) unexpectedly raised its deposit rate by 25bps at its September meeting to a historical high of 4.0%. It suggested the move was the end of the current tightening cycle, stating: "interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target". Eurozone consumer prices rose by 4.3% y/y in September, below market expectations of 4.5% and the slowest pace of increase since October 2021. Core inflation also fell by more than projected, to 4.5%, the lowest since August 2022. This suggests that price pressures are easing but inflation remains more than double the ECB's 2% target, justifying the central bank's stance of keeping rates higher for longer'.

The Italian government announced a surprise plan in August of a 40% windfall tax on excess (net interest income) bank profits. However, following an adverse market reaction, the government re-traced somewhat by placing a cap of 0.1% of each bank's assets on the proposed tax in an effort to ease shareholder concerns. Italian Prime Minister Giorgia Meloni plans to use proceeds from the tax to support households and small businesses.

UK

In the UK, after weaker-than-expected consumer-price inflation – headline fell to 6.7% y/y and core to 6.2% in August – the Bank of England unexpectedly decided to keep its policy rate at 5.25%. Subsequent September PMI data supported the decision, with the composite PMI falling to a 32-month low of 46.8. It was a close decision, with 5-4 voting in favour – and there was a hawkish tilt. The Bank stated: "Further tightening in monetary policy would be required if there was evidence of more persistent inflationary pressures" and that the pace of quantitative tightening would rise from £80bn/year to £100bn in the next fiscal year (March 2024 to February 2025).

Commodities and currencies

Saudi Arabia unexpectedly announced in September that it would keep oil production at 9m barrels per day (b/d) for the rest of the year, after a 1m b/d cut in July. Russia also stated that its 0.3m b/d export reduction would stay in place until end-2023. This pushed Brent crude oil above $90/barrel for the first time since November 2022, with the price up by 32.7% since the low in June. This was a key driver behind the rise in commodities over the quarter, with the S&P GSCI up by 16.0% (19.5% in euros).

The US dollar rose against the euro as resilient activity in the US contrasted with weak data in the Eurozone, and the ECB suggested peak policy rates may have been reached. EUR/USD fell by 3.1% to 1.0573 over the period.

MARKET ROUND-UP

Equities

Global equities, as represented by the MSCI All Country World Index (ACWI) declined by 2.4% (-0.4% in euro terms).

The backdrop of sticky inflation and hawkish central banks pushed bond yields higher in Q3, a headwind for global equities as they began to price in higher rates for longer. The rate outlook pushed equities lower amid potentially slower growth and tighter credit conditions.

US-China tensions in the tech sector intensified. In September, there were reports that China was curbing state employees' use of Apple's iPhone. At the same time, the US government said it needs "more information about [the] precise character and composition" of Huawei's chip for its flagship H60 phone to determine whether US restrictions on semiconductor chip exports have been violated. The former led to concerns over Apple's sales in China, which is one of the company's largest markets by revenue. Apple's stock price declined by 10.8% in Q3.

In Q3, small-cap equities fell by 3.2% (-1.4% in euros), underperforming large caps as concerns around the impact of higher rates and resultant tighter financial conditions weighed on the asset class.

Emerging market (EM) equities were down by 1.3% (+0.2% in euros) in Q3, outperforming developed markets (-2.5% in local currency terms and -0.4% in euros). The asset class was supported by rallies in certain markets like India (+2.7%) and Brazil (+0.1%); favourable long-term growth prospects provided a boost in the former, and rising commodity prices benefited the latter.

Bonds

The ICE BofA 5+ Year Euro Government bond index fell by 4.4%. As markets priced in higher-for-longer rates, yields rose and so government bond prices fell.

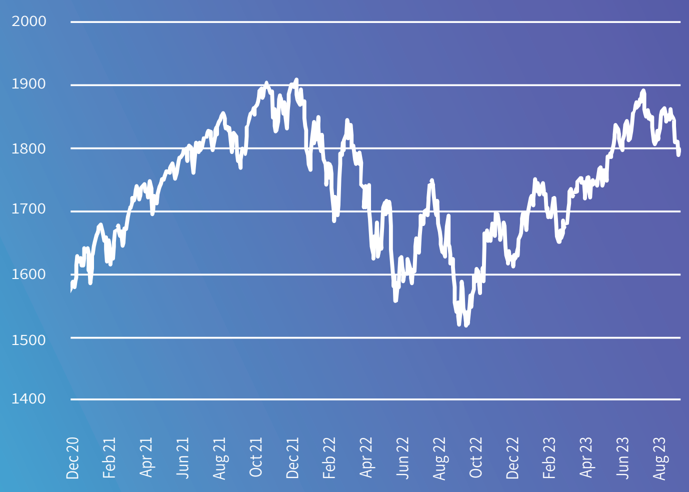
European investment-grade (IG) corporate bonds rose by 0.3% in Q3, supported by carry from high interest rates. IG yields rose by 11bps to 4.52%, and spreads narrowed by 9bps to 151bps over the period. Global high yield bonds rose by 0.7% in Q3, also aided by interest rate carry. Yields were up by 28bps to 8.07%, and spreads narrowed by 2bps to 356bps.

EM local debt fell by 0.6% in Q3 and yields rose by 46bps to 6.79%. EM hard debt declined by 3.2%, hampered by a stronger US dollar, and yields also increased by 83bps to 8.44%.

Meanwhile, peripheral Eurozone bond spreads widened. Italian 10-year spreads over the equivalent German bunds rose by 26bps to 194bps, while spreads for Spanish government bonds were up by 10bps to 109bps. Spreads in Italy widened more than those in Spain; concerns over the former's fiscal deficit rose amid increasing government spending aimed at supporting households without commensurate cuts in state spending or revenue raising.

CHARTS OF THE QUARTER

Global Equities



Source: ILIM, Bloomberg. Data is accurate as at 30 September 2023.

Bonds – German 10-year yield

Source: ILIM, Bloomberg. Data is accurate as at 30 September 2023.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2022 Return (%)
MSCI Ireland	-4.7	18.4	-21.1
MSCI United Kingdom	1.5	7.6	1.4
MSCI Europe ex UK	-3.0	10.0	-11.9
MSCI North America	-0.2	14.0	-13.8
MSCI Japan	1.6	12.5	-10.8
MSCI EM (Emerging Markets)	0.2	3.0	-14.5
MSCI AC World	-0.4	11.4	-12.6

10-Year Yields	Yield Last Month (%)	2022 Yield (%)	2021 Yield (%)
US	4.57	3.87	1.51
Germany	2.84	2.57	-0.18
UK	4.44	3.67	0.97
Japan	0.77	0.42	0.07
Ireland	3.24	3.13	0.24
Italy	4.78	4.70	1.17
Greece	4.36	4.62	1.34
Portugal	3.60	3.59	0.47
Spain	3.93	3.66	0.57

FX Rates	End last month	2022 Rates	2021 Rates
U.S. Dollar per Euro	1.06	1.07	1.14
British Pounds per Euro	0.87	0.89	0.84
U.S. Dollar per British Pounds	1.22	1.21	1.35

Commodities (USD)	QTD Return (%)	YTD Return (%)	2022 Return (%)
Oil (Brent)	27.2	10.9	10.5
Gold (Oz)	-3.7	1.3	-0.3
S&P Goldman Sachs Commodity Index	16.0	7.2	26.0

Source: ILIM, Bloomberg. Data is accurate as at 30 September 2023.

THE ILIM VIEW – LOOKING AHEAD

With inflation having clearly peaked and central banks now suggesting that the end of the tightening cycle is very close, we expect bond yields to decline over the next 12 months. On a 12-month view, our base case is that German 10-year government bond yields fall from the current level of 2.84% at end-September to around 1.75% and that the equivalent for the US fall from 4.57% to somewhere in the region of 3.50%. We believe fixed income offers a strong risk-reward profile at this stage in the cycle and is attractive from a wealth preservation perspective. The relatively high bond yields and central bank commitments to bring inflation down mean bonds should remain attractive on a multi-year basis, with high single-digit returns possible over the next 12 months in riskier segments of fixed income.

Global equities have proved resilient in 2023 as recession fears have receded and a peak in central bank policy rates has come into view. While global earnings are forecast to be only modestly higher this year – by approximately 0.5% – they have held up better than feared at the start of the year, as sales have surprised to the upside and the margin squeeze for corporates has been less than anticipated. Global equity valuations are below long-term averages, trading on a 12-month forward price-to-earnings (P/E) multiple of 15.6x against a long-term average of 16.0x. Equities outside the US offer better value. However, equities remain expensive against both bonds and cash given the high yields currently available on these assets.

Despite equities appearing close to fully valued, the outlook for the asset class on a 12-month view is positive. Central banks are likely to pivot towards looser policy in 2024 as inflation continues to fall. An increasing probability of a soft landing with a rebound in both growth and earnings in 2024 should also provide support. Over the medium term, the rollout of AI should boost efficiencies and earnings across the whole market and allow equities to trade at higher valuation levels. The ongoing green-related capex cycle could also boost earnings over the medium term.

THE MONTH AHEAD

OCTOBER

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
				6 US Non Farm Payrolls US Unemployment Rate
		11 US PPI US FOMC Minutes	12 US Inflation Rate YoY (Sep) GB GDP MoM	13 CN Inflation rate YoY (Sep)
	17 GB Unemployment Rate (Aug) US Retail Sales MoM (Sep)	18 GB Inflation Rate YoY (Sep) CN GDP Growth rate YoY (Q3)		20 JP Inflation Rate YoY (Sep) GB Retail Sales MoM (Sep)
	24 DE HCOB Manufacturing PMI Flash (Oct)	25 EA ECB Interest Rate Decision US GDP Growth Rate QoQ Adv (Q3) DE GfK Consumer Confidence		27 FR Inflation Rate YoY Prel (Oct) FR GDP Growth Rate QoQ Prel (Q3)
30 DE Inflation Rate YoY Prel (Oct)	31 EA Inflation Rate YoY Flash (Oct) EA GDP Growth Rate YoY Flash (Q3) JP BoJ Interest Rate Decision			

Source: tradingeconomics.com

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Figures referenced herein have been sourced from ILIM and Bloomberg. Forecast figures have been prepared by ILIM based on reasonable assumptions, internal data and data sourced from Bloomberg.

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