Monthly Markets Update

31 May 2023

SOUTHERN FINANCIAL SERVICES

- **Equity markets remain flat, tech rallies**
- **Bonds yields remain attractive**
- **Inflation is proving stickier**

Key points

1. Equity markets remain flat as inflation has proven stickier than expected. US tech stocks rallied as artificial intelligence (AI) frenzy invigorated positive sentiment in the sector.

2. Short duration bond yields remain attractive and long-term government bonds now provide a good risk-return trade-off while hedging against recession risk.

3. As inflation is proving stickier, we continue to expect Central Banks to keep interest rates higher for longer, and a pause in Fed hikes before any pivot.

Top Line

Equity market remain flat in May as investors expect interest rates to stay higher for longer based on the latest inflation numbers, which were ahead of expectations. US Equities benefited from the surge in tech stocks share prices. EM Equities were lifted by the Indian equities as the Reserve Bank of India (RBI) voted to hold interest rate unchanged. Short duration bond yields remain attractive and long duration bonds now provide a good risk vs. return trade-off.

Equities

Global Equities closed the month +0.29%, US Equities +2.08%, whilst UK Equities weakened by -4.83% in GBP terms, driven mainly by stickier inflation and potential further hikes from BoE. This takes YTD performance to +4.56%, +6.46% and +1.92% for Global, US and UK Equities respectively.

Bonds

Corporate Credit spreads continue to widen. Weaker GBP against USD meant better performance of unhedged Global bonds, relative to GBP-hedged this month. US 10 year yields closed the month higher at 3.67% (from 3.56% last month). UK 10 year yields ended higher at 4.18% (from 3.72% last month). US 5 year market-implied Break-Even Inflation Rate "BEIR" closed the month lower at 2.14% (from 2.25% last month), whilst the UK 5Y BEIR increased to 3.55% (from 3.47% last month).

Alternatives

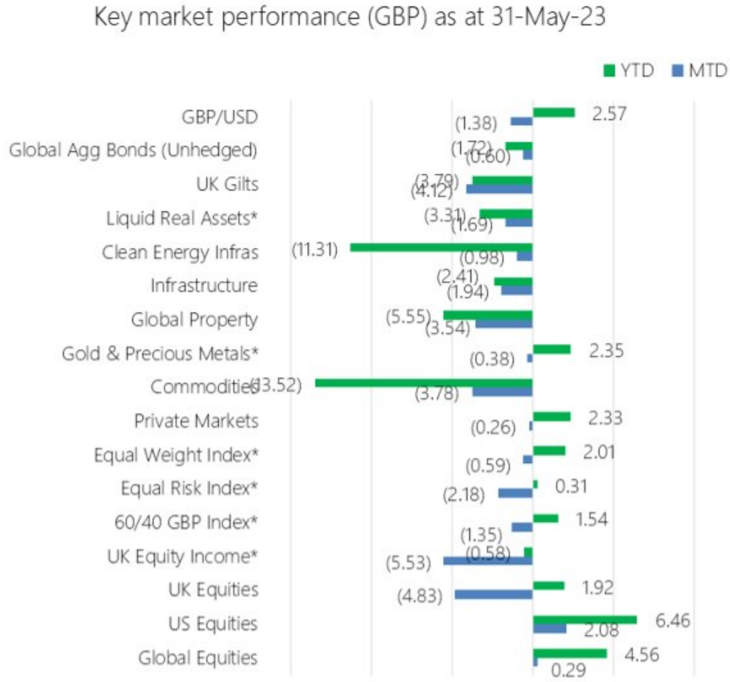
Alternative Assets: Alternative assets declined for the month. Commodities saw a monthly loss of -3.78%, followed by Property -3.54%. Liquid Real Assets were down -1.69%. Gold & Precious Metals were flat -0.38%.
Alternative Strategies: an Equal Weight strategy delivered -0.59% for the month and +2.01% on YTD basis.

Currency

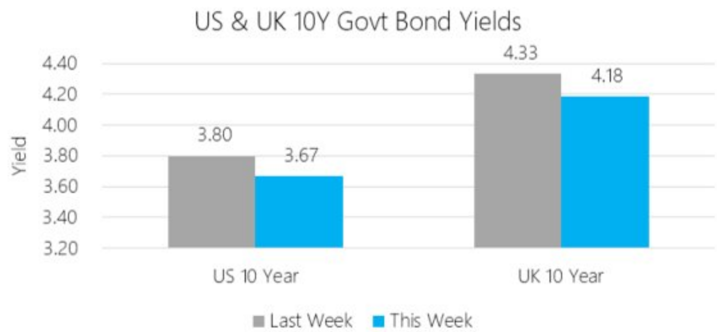
Sterling was down against the Dollar: £1 buys $1.2384, from $1.2567 last month (-1.46% change). Sterling was up against the Euro: £1 buys €1.1642, from €1.1404 last month (+2.09% change).

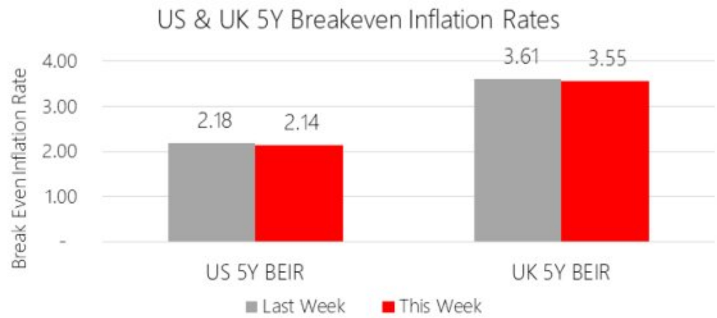
Markets

The month-end market snapshot is summarised in the charts below.



*Elston Indices





Source: Elston research, Bloomberg data

Month in review

We summarise key drivers and data points in the last month for markets, the economy and inflation.

Markets

US tech stocks continued an AI (Artificial Intelligence) frenzy led by Nvidia, a chipmaker that specializes in making chips that enable heavy AI computations. Nvidia stock has posted a 150% gain since the start of 2023 and is one of handful of companies that have made it to $1 Trillion in market capitalisation. US market gains have mainly been driven by handful of "Big Tech" (Apple, Microsoft, Amazon, Facebook, Google, Netflix and Nvidia), while the rest of corporate America faces a slowdown in profits as cost pressures squeeze margins. Selectivity therefore remains key.

One positive is that the regional banking crisis seems to have been dealt with successfully for now and the Fed can continue its focus on fighting inflation. We continue to expect the Fed to follow a "pause before pivot" interest rate policy as outlined in our Quarterly Investment Outlook.

Bond yields remain attractive - particularly for shorter maturities, which carry lower duration risk. Moderating inflation expectations provides
further support to real (inflation-adjusted) yields. With interest rate peak in sight, long duration bonds now provide a good risk-return trade-off. Recovery in Sterling from its lows suggest a balanced approach between unhedged and GBP-hedged Global Bonds.

Economy

The US Fed, ECB and BoE all raised rates in May as telegraphed previously with no major shock announcements. Bank of Japan disappointed traders as it stuck to its yield curve control and kept rates unchanged. Traders were expected the new Governor Ueda to be less accommodative than his predecessor, but he reiterated that after decades Japan has seen inflation and BoJ would happily live with above target inflation for the time being.

The month was also filled with news about the US Debt ceiling and the risk of unprecedented default consequences if it was not raised in time. Eventually a deal was agreed but it is yet to be put to vote in both the Senate and the Congress. Developed market economies continue to point to a tight labour market, sustained economic expansion and in turn persistent inflation. So far rate hikes by Central Banks seem to be having a marginal effect in slowing down the economy.

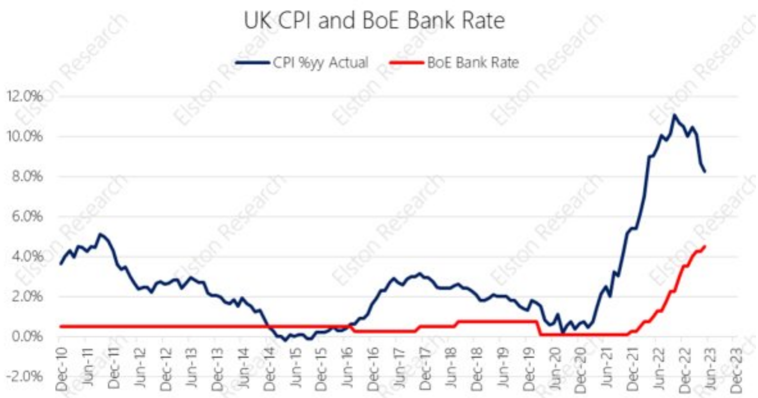
Inflation

Inflation in the UK finally dropped from double digits to 8.7% but it was higher than the expected 8.2%. Services and Core components saw their biggest increases for more than three decades, ramping up pressure on the Bank of England to increase interest rates further. A stickier inflation and a bumpy ride down, makes us believe that Central Banks are not near cutting interest rates anytime soon, contrary to traders pricing in rate cuts in coming months. The 10-year UK Gilt yields touched 4.4%, highs last seen during the Truss budget fiasco.

As China's re-opening boost fades, commodity markets remained subdued. Commodity traders are pricing in a rapidly slowing global economy and expect demand to falter, contrary to the positive macro-economic data points seen so far in May. Lower commodity prices are a welcome relief and are expected to be disinflationary in nature. However, Crude Oil prices remain incredibly sensitive to any supply changes as Saudi Arabia remain committed to keeping the oil price afloat by cutting production.

Inflation & Bank Rates

The latest UK inflation data is +8.7%yy, and Bank of England Bank Rate is at 4.50%. Their longer history is summarised below.



Source: Elston research, Bloomberg data

Bottom Line

The sentiment-driven growth in US large cap tech share prices should not be seen a sign of a growing economy. In fact, the growing performance divergence in FANG stocks and the rest of the equity market indicates the rising recession risk for majority of the US businesses. The expensive tech stocks valuations would be vulnerable in case of a hard landing. Likewise, the service sector expansion in contrast to the manufacturing sector contraction is rather reflecting a tight and expensive labour market. We still see inflation and recession as the key risks while managing portfolios.

What does this mean for portfolios?

Whilst portfolios we recommend have clear long-run strategic allocations, adjusting portfolios to align to changing market and economic conditions can help mitigate near- to medium-term risks and help navigate the markets.

Getting in touch

If you would like to find out more or discuss any of the above, please contact your financial adviser.

Contact us

For more information, please contact your financial adviser.

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