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Reflections on Recessions

What a different a year makes.

In preparation for this year's year end meeting I wanted to set a scene of contrast – by firstly painting a picture of how the world looked a mere 12 months ago. In late November 2022, the state of tumult in UK financial markets was central to any piece discussing the world economy. An already bruising year in both equity and bond markets had crested with a brutal Autumn as the Truss/Kwarteng mini-budget had sparked a sell-off in UK government bonds and a crisis of confidence that required Bank of England intervention.

In early November 2022, global markets were down around 20-30% for the year, with the FTSE a notable exception (-1.5%), more to do with the cheapening of Sterling than any inherent strength. Inflation remained top of mind, having touched 10.1% in September 2022 (a 40 year high) and bond markets were reeling as central banks remained mid-hiking cycle, at aggressive instalments of 75 bps. Geopolitical concerns had risen as Russia's invasion of Ukraine passed the 10-month mark and the approaching winter stoked anxiety around energy prices. The consolidation of power of China's leader undermined confidence in that area, leading to continued weakness. Finally, in stark contrast to today's dialogue, there was no widespread discussion of AI tools like Chat GPT.

This year things look somewhat different:

- Market performance is a mirror image. Markets are positive in the 10-30% range, with the notable exception of the FTSE 100 which remains stuck at more or less the same year to date number (flattish – +0.5%) as it sat at one year ago. The resilience in equity markets has confounded critics who have been forced to shelve their predictions of a recession in 2023.

- Inflation seems to have turned a corner. European inflation levels were recently their lowest in two years, and in the US and the UK latest numbers have been more subdued.
- Central banks seem to close to the end of their hiking cycle with a sustained pause/hold in the US for the past two cycles and a hold in both the Bank of England and the ECB.
- Geopolitical risk has amplified with the outbreak of war in Gaza, which erupted in the aftermath of the October 7 terrorist attacks on Israel, and this element of surprise initially shook markets, which had not anticipated this development. To date the oil price has stabilized despite some initial volatility.
- The sharp rise in interest rates (and fall in bond values) started to show collateral damage with the collapse or rescue of three regional banks in the US in the Spring, and while this development seems to have been stemmed – for now – there remain hints that financial institutions are bearing much of the brunt of the rise in rates.
- China concerns seem to have receded somewhat, although its market performance remains lack lustre. With eyes on other geopolitical flashpoints, even the Russia/Ukraine conflict is no longer making headlines.
- Chat GPT and other natural language processing AI tools have captured imaginations and driven the dominance of the Magnificent Seven Tech stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) which have lifted the entire US stock market year to date.

The contrast with last year's market environment underscores how quickly cycles now occur in markets – how quickly information is disseminated, digested and discounted into market activity. That perhaps should be a reminder of maintaining a long-term time horizon, and one's investment nerve!

Key Developments since the last quarterly update:

- **Inflation continues to recede** As of the end of October UK grocery inflation dropped (barely) into single digits (9.7%) but further drops were expected by the Bank of England. Overall inflation was lower at 6.7%.
- **The sudden end to the "higher for longer narrative"** The Bank of England has kept its policy rate unchanged now (at 5.25%) for two meetings in a row (its run of 14 straight rake hikes ended in September) and the US Federal reserve has also paused twice. While initially this pointed to a pause it now looks more like a "hold" and the consensus around "higher for longer" has ebbed significantly in recent weeks.
- **Recession, what recession?** Despite widespread forecasts of a recession in 2023, this has failed, so far, to materialize, although in Europe corporate earnings changes remain mired in

negative territory (as discussed below). Economic growth has been stubbornly resilient, and in the UK earnings revisions to the second quarter 2023 showed growth from pre-pandemic numbers (1.8% higher than in 4Q 2.19 v. 6.1% higher in the US).

- **Middle East tensions strain.** The explosion of tensions in Israel and Gaza followed by a ground war has stirred tensions in the region, although, to date, there has been little explicit involvement of other nations, namely Iran. Were this to happen, this would be likely to provoke an oil price spike as well as a host of other unknown geopolitical consequences, so it remains a region to watch carefully.

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Current Macro Snapshot

An economy stirs to life?

Last quarter we asked if the UK economy was "stuck in the mud" as inflation remained high and an outlier within global markets and the stock market, too, failed to generate any gains for the year to date, in contrast to US and European markets. Ultimately, however, the economy has started to move more in sync. Inflation is starting to weaken, albeit at a slower pace than elsewhere – in September UK CPI was 6.7% and the highest among other advanced economies although the Bank of England suggested it would fall below 5% in October numbers. The sluggish – but perceptible – economic growth is another sign of life, and the fact that the Bank of England has now paused in its rate rise cycle is now driving speculation of rate cuts from mid 2024. The jobs picture is a little less positive as job openings rise, attrition – or the "great resignation" – grinds to a halt and job cuts continue to be announced.

Sterling actually lost some ground over the past 3 months – falling 3% against the dollar but remains slightly stronger year to date (+1.29%).

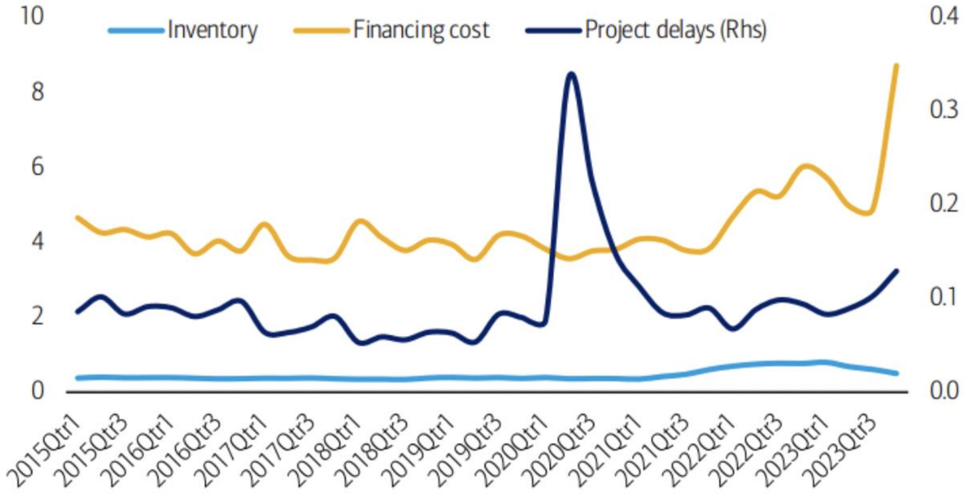
Time out for central banks

While last quarter central banks seemed to be "on the fence" about where to go next – to continue tightening or pause, doing one thing and often signaling the other, this time around it seems that conviction is a little stronger. The ECB signaled that rate hikes were "over" pending any shocks down the line, while the US Fed warned that it would remain data dependent but seemed content to pause two meetings in a row. This development removes some of the uncertainty regarding where rates go from here, and although mortgage rates remain high (close to 22 year highs in the case of the US) the suggestion that they are currently peaking will bring some relief. This also brings clarity to corporates, who can once more plan debt issuance, as well as banks.

Meanwhile, over in equity markets, AI is still on the table, but no longer a singular obsession, and investors have actually been fairly picky in response to earnings season. Tech stocks were punished for not showing growth in every area – and September and October were both negative months for global markets. Renewable energy stocks have had a disastrous year, with the recent casualty being the European stock market darling – Orsted – down almost 60% year to date, as woes mount in the area of offshore wind generation.

Last quarter we showed a word bubble showing the incidence of AI in corporate earnings, this time around we can see that it is financing concerns and the cost of capital which seem to have risen to the fore:

Exhibit 26: Mentions on 3Q S&P 500 earnings calls
Financing costs are a key risk, and a pickup in delayed projects could slow business investment



Source: BofA Global Research

Individual Asset Class Performance.

- Equities
- Fixed income
- Real Estate and Real Assets

The chart below shows recent performance in main equity indices (at November 27, 2023)

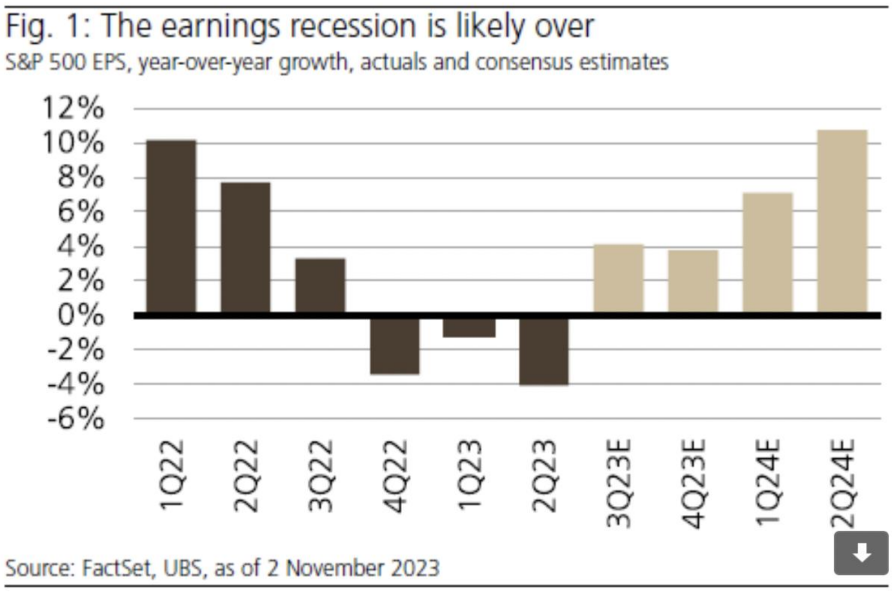
Equity Index	Last 3 months	Year to date (November 27, 2023)
FTSE 100	-2.14%	0.49%
S&P 500	4.18%	18.75%
Nasdaq	5.84%	36.16%
Dax (Europe)	2.54%	15.12%
Hang Seng	-2.21%	-11.23%

Shanghai Comp	-0.75%	-1.56%
Nikkei 225	4.15%	28.86%

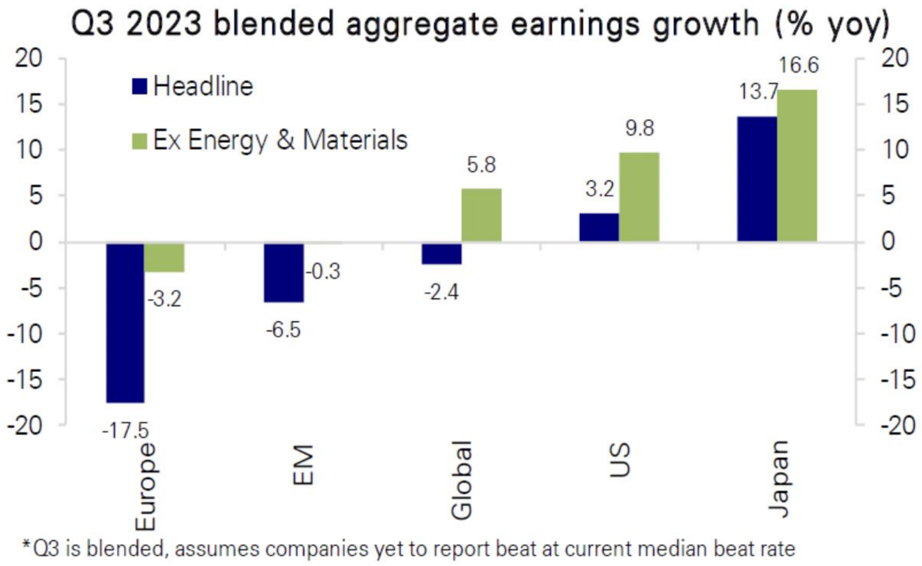
Equities: Zero Tolerance around Earnings

Equity markets blinked a little in the last quarter, perhaps surprised at their own strength for the year, but saw a strong rally over the month of November. The September effect is the term given for the fact that September tends on average to be the worst month of the year for the stock market and that played out in classic fashion, followed by another tough month in October. There were no obvious triggers for this, although the October 7 events in Israel did send a chill through markets briefly and investors weren't particularly cheerful about corporate earnings. US markets continued to perform strongly on a global scale, although, in Asia, Japan was a rare bright spot, while Hong Kong flailed.

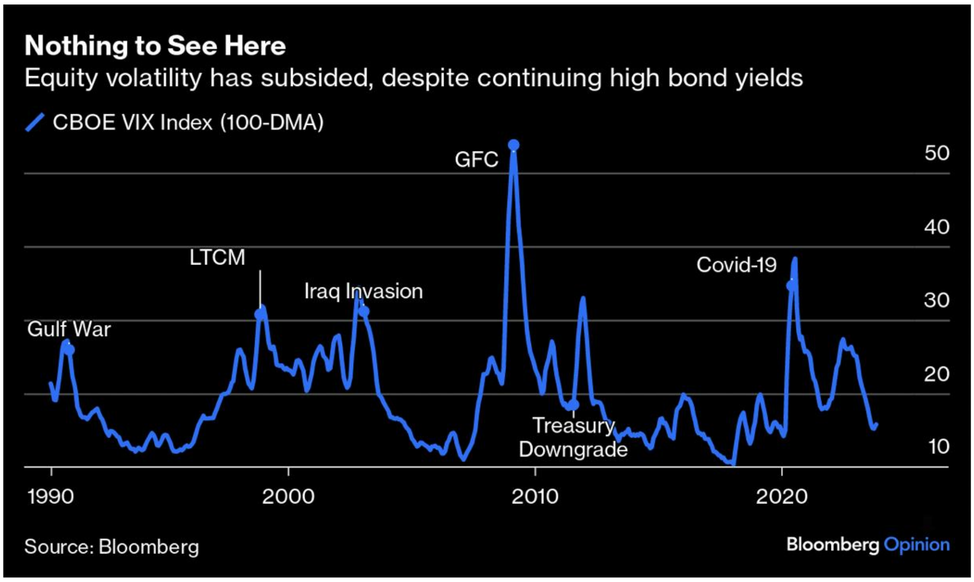
As the chart below shows, the earnings "recession" or more accurately recession fears in the US were actually very mild, and expectations have now come back around resilient earnings – led by expanding margins and supported customer demand.



The picture in Europe diverges quite sharply from the rest of the world though as can be seen from this chart, and energy and materials earnings growth continue to be a positive backstop.

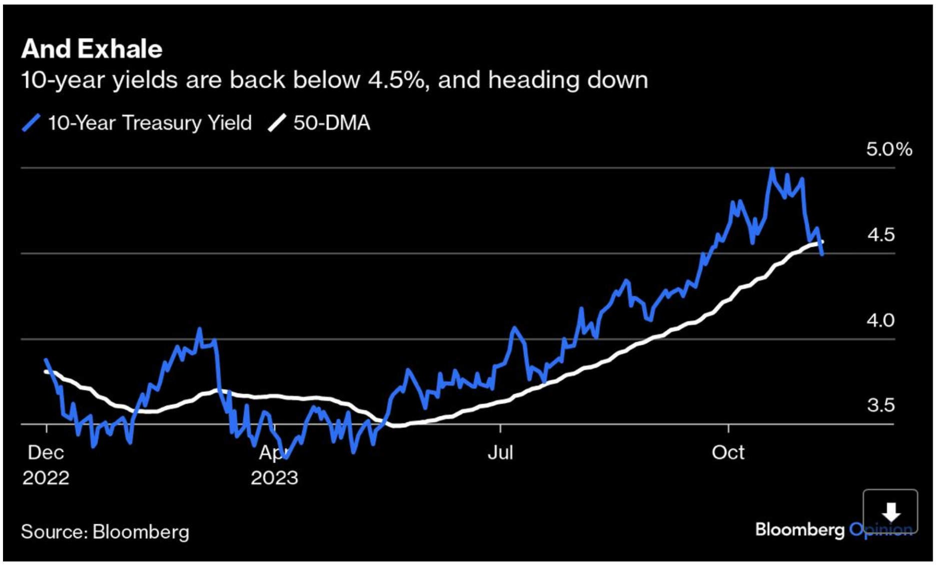


Volatility is now more modest than in recent months:



Fixed Income: Volatility Rules

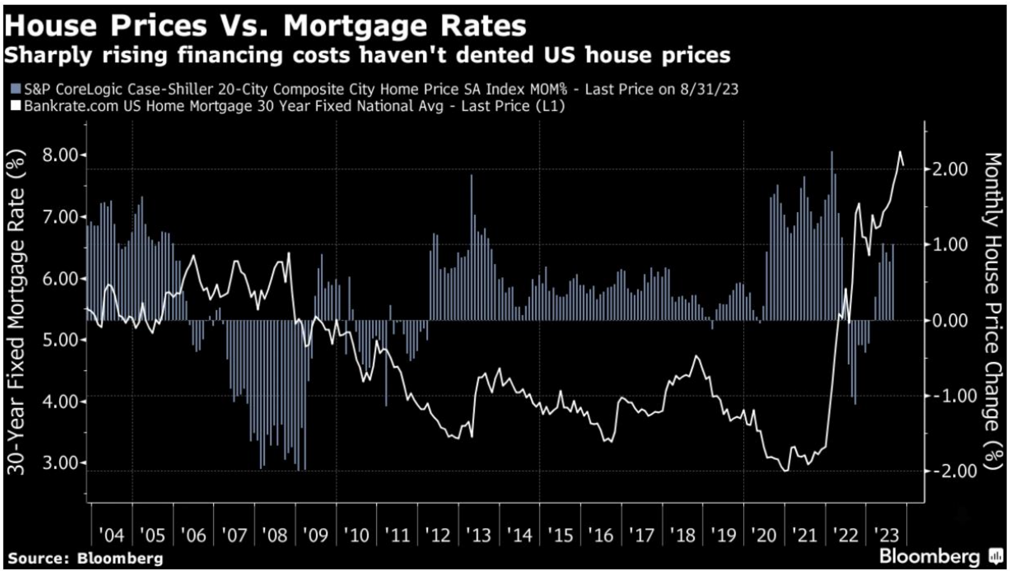
Not so in the bond market. Volatility now seems par for the course in bond markets as yields moved around vigorously both in the UK and the US. Some of this was in response to a perceived course correction by central banks, but mounting fears of budget shortfalls and incoming large bond issuance in the US also drove a sell-off. As can be seen below, the trajectory on longer dated debt is now firmly downwards once more.



While fixed income now presents compelling yields – even in shorter dated money market funds – vacillating bond prices have been problematic and returns haven't always matched the promise of the "yield" set on the tin. The increase in return on cash does change asset allocation considerations though. We continue to be supportive of using more fixed income – particularly cash generative strategies – in the portfolio at current levels.

Real Estate and Real Assets:

As an illiquid asset, most property prices/values are slower to respond than those of liquid assets. Only listed real estate trusts are a daily traded proxy. The poor performance of REITs year to date (-6.54% average performance in the US) even as equity markets have been in the black is a sure sign of the uncertainty around and lack of appetite for real estate at this juncture. This sits against a backdrop of some property price anomalies. In the US, despite record high interest rates and mortgage approvals being down (a natural relationship) the CASE Schiller home price index shows prices remain high.



In the UK home prices were said to be in a “slow puncture” phase, yet had apparently ended a six month declining streak in October, as property supply remained tight. Average prices remain lower than a year ago, although higher than pre-Covid levels. New home construction has also fallen, although forecasters were not expecting high rates to have an ongoing effect on prices.

Sustainable energy stocks and some infrastructure and real asset returns continued to be battered. Offshore wind projects suffered a blow both in the UK, Eurozone and the US as rising costs and supply chain issues shifted the economic models. Orsted, the Danish wind developer – and stock market favourite – announced that two projects off the coast of the US were being cancelled after its demand for higher subsidies was rejected and the firm took $4 billion in impairment losses. This comes after a surprise lack of bidders in a UK offshore wind auction in September again because minimum price support commitments were not deemed high enough. It turns out high energy prices (and windfall profits) had a very short runway indeed in the current high energy environment.

Utilities stocks – a proxy for mainstream infrastructure - are down close to 11% year to date (US), while ICLEAN – a global clean energy ETF is down almost 30%. This negative sentiment may reflect some of the push back we discussed to ESG in last quarter’s letter and a fear of weaker demand, but it does so far appear to be overblown. Oil has also been somewhat weaker in recent weeks and is now back to the same levels $80 + that it hovered at one year ago.

Spotlight on Natural Capital:

Many pools and local authorities now have committed to net zero goals and at a conference this week aimed at LGPS investors and their advisors the topic of natural capital received a large amount of attention and coverage. Increasing natural capital, which can be captured by a range of terms including “nature based solutions” or “nature positive” investing, is targeted as a portfolio ingredient both to increase a portfolio’s investment in nature and the benefits that flow from that as well as to accomplish a net zero (carbon emissions) outcome. Investing in nature includes forestry investments, including afforestation and reforestation, which can act as a source of return (through sales of timber) as well as carbon sequestration. New forests – afforestation – can generate carbon credits – which can be sold to enhance return of the forestry investment or can be used by an investing institution to offset other carbon emissions across the rest of the portfolio.

Natural capital is also defined as the stock of renewable and non-renewable natural resources on earth (planet's air, land, water, animals, and minerals) which are responsible for ecosystem services that drive the global economy and human wellbeing. It is currently estimated that $44 trillion of economic value generation – *more than half of the world's total GDP* – is moderately or highly dependent on nature and its services, so damage to nature has material financial consequences. As this area continues to attract more attention and investment products mature, we expect impact metrics to improve and the return profile to be supported.

Outlook

As we near the end of 2023, it is likely to be seen as the "comeback year" or the year of resilience. Maybe time will tell as to why. Whether it is lingering Covid-era largesse such as savings, the lower employment participation rate driving a stronger jobs picture or simply inherent strength, time will tell. In coming months we will be watching in particular:

- **Fixing the transmission.** Last quarter we noted that we were still watching the experiment of significantly higher rates. While "higher for longer" is no longer as prevalent a concern, there is still the matter that higher rates typically take 12-24 months to be felt throughout the economy – they don't have an instant effect. Consumers on fixed mortgages or companies with longer dated borrowing won't – yet – have felt their effect. The long-term effect (the "transmission") of these higher rates is key to observe.
- **The stamina of the Magnificent Seven**. The concentration and lack of breadth in the US equity market continues to be unusual and as the year comes to an end it will be interesting to watch if the popular support for the seven mega-tech stocks starts to bleed over into other sectors such as healthcare, industrials and consumer stocks.
- **Geopolitics at the forefront.** Although the relationship between geopolitical tensions and market performance is hard to draw at times, it has taken on heightened importance in media coverage and political life. We will continue to watch developments carefully as markets seem to remain fragile with little mood for volatility and surprise.

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November 27, 2023