Monthly market update

May 2023

April bucks its trend

Kevin Quinn,
Chief Investment Strategist,
Investment Markets

5 return drivers for April

1. Core inflation overtakes the headline
2. Company earnings expectations flatten out
3. Tech to the top again
4. Recession risks still persist
5. China takes to the stage

Outlook

Outlook

April is often celebrated as the best month for the stock market, with historical evidence often pointing to it as the strongest performing month of the year[1]. This has not proven to be true in 2023.

Markets began April on a positive footing, and remained positive until mid-month, as expectations persisted that interest rate cuts would follow quickly after challenges in the banking sector appeared to dissipate. However, as inflation data showed core inflation remaining sticky, optimism fell away. The failure of another mid-size US bank, First Republic, and its takeover by JP Morgan saw markets close largely flat for April.

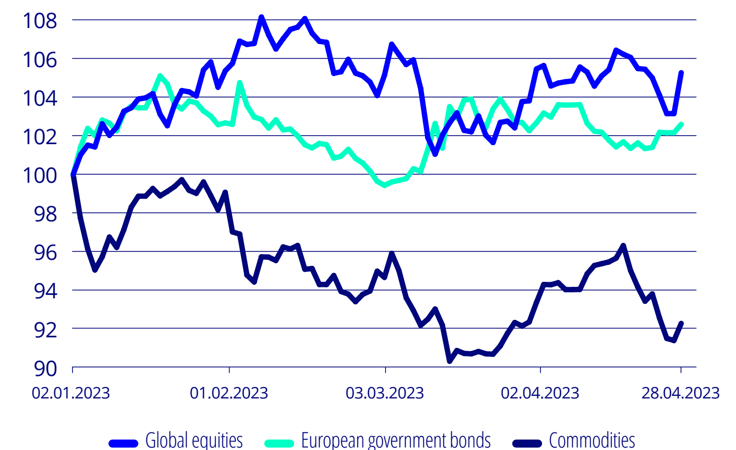
2023 performance so far

So far, 2023 has largely been a mirror image of its predecessor, with both equity and bond markets making, and holding on to, most of the gains made early in the year.

- Relatively benign disinflation figures and hopes that interest rate increases would turn to rate cuts, helped the year begin on an optimistic note.
- This was interrupted by fears that inflation was proving much stickier and that rate increases might persist for longer and at a higher level than previously thought.
- The mood changed again with banking issues that gave investors cause to believe we had moved much nearer to the end of the rate hiking cycle.

While the problems in the banking sector were rapidly firewalled, the failure of another Californian lender in April, First Republic, illustrates the impact that rising interest rates have had on the US financial system. For its real economy impact, it seems likely, as a result, that lending may be more constrained as a consequence in many parts of the developed world. In turn, this makes an economic downturn more probable, even if it has been pushed further out, perhaps into 2024.

Figure 1: Asset class performance April 2023



Asset class performances	April 2023	YTD 2023
Global equities	-0.2%	+5.2%
European government bonds	-0.1%	+2.5%
Global commodities	-2.6%	-10.2%

Source: Bloomberg 02.05.23

[1] Source: "Why April is considered the best month for stocks" M.Mitra for Money.com April 2022

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1 Core inflation overtakes the headline

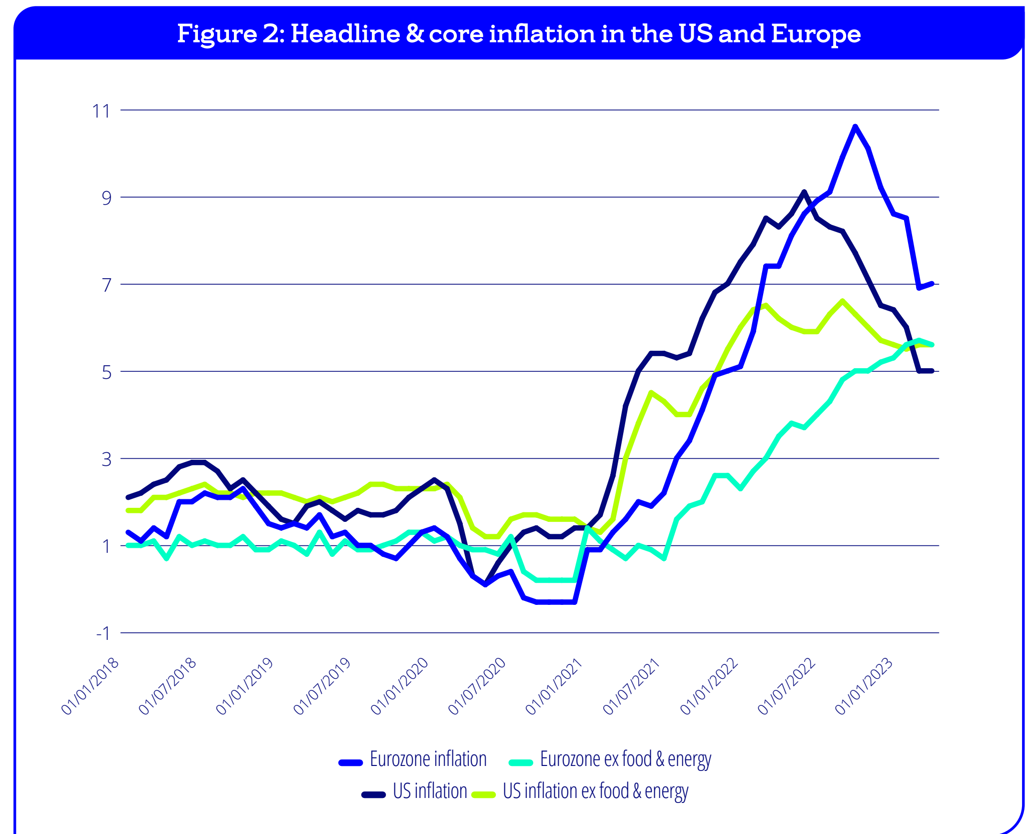
Whether the glass is half full or half empty is being heavily debated when it comes to inflation.

- On the one hand, data in April confirmed that we are seeing "disinflation" or a slowdown in the rate of inflation. Both US and European headline consumer inflation, which accounts for changes in the prices of goods and services in every sector, fell meaningfully.
- For Europe, the most recent headline inflation stands at 7% and for the US, 5%. So far so good[2].
- However, core inflation, which excludes the more volatile energy and food prices, actually went up. In the US, core inflation is now higher than the headline inflation number at 5.6%, in the eurozone it also stands at 5.6%.

This has given central banks cause to be more circumspect about if and when interest rates might fall. For the US, it has meant that expectations of where interest rates will land have hardened. At the end of March, there was an anticipation that rate cuts might begin in mid-summer. That has now moved back out to the end of the year.

While the tussle between market optimism and central banks pragmatism has continued, markets have been responding well to what is relatively benign disinflation, at least so far. However achieving the target of 2% appears to be some distance away.

Figure 2: Headline & core inflation in the US and Europe



Source: Bloomberg 02.05.23

[2] Sources: Eurostat 19.04.23, US Bureau of labor statistics 27.04.23

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5 return drivers for April (Cont'd.)

2 Company earnings expectations flatten out

As the size of interest rate rises are set to moderate, company earnings are going to play an increasingly central role in the direction markets take.

- Today, equity valuations aren't cheap. What you pay for an average euro of company earnings is currently marginally higher than historical average[3] and that's before we see the full effect of a downturn.
- On the other hand, plenty of individual markets and sectors are cheap by historical standards.

Early into the Q1 2023 reporting season, we've seen a slight contraction in company profit margins for the US market. If this holds, it would be the seventh quarter of contractions in a row.

- Five sectors are reporting above-average growth in margins compared to Q1 2022, led by energy. At the same time, six sectors are showing slower profit growth compared to 5-year averages, led by communications[4].
- There have been some positives that helped the market mood towards the end of the month – for example, Deutsche Bank, whose top line results were the best since 2016. This was along with better-than-expected sales numbers for a number of the largest technology names[5].
- Future earnings expectations are flat to marginally negative for the year ahead, although some sectors continue to show strong sales growth. The US stock market for example, is showing an expectation for flat to mild contraction in company earnings for the coming 12 months, while the European stock market is essentially flat. In both instances, expectations are for a recovery in earnings growth in 2024[6].

This presents a near-term headwind for markets as equity prices typically follow earnings. Whether this comes to pass will rest largely on the extent of any slowdown that is driven by 1) higher interest rates and 2) tighter lending in some regions. This does look like a market where there'll be quite a dispersion of outcomes.

> "...company earnings are going to play an increasingly central role in the direction markets take."

[3] Source: MSCI World ACWI comparing forward price/earnings since 2006
[4] Source: Factset Earnings Insight 21.04.23
[5] Source: Bloomberg 27.04.23
[6] Source: Bloomberg earnings estimates 27.04.23. The US stock market estimate is for -1.6% in 2023 and +9.7% in 2024. The European stock market estimate is for +0.1% for 2023 and +6.2% for 2024.

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3 Tech to the top again

One of the impacts of the banking problems seen in the US and Switzerland in March was a drop in expectations of how high interest rates might rise. Coupled with slower growth expectations, these combined to bring expectations of longer term rates in the US market down considerably. The crucially important 10-year US Treasury bond yield (a measure of return) began March as high as 4.05%, but by late April was hovering near 3.4%, indicating this shift.

The sectors that tend to be most sensitive to long-term interest rates are technology and communications services. This is largely because so much of the company's value is seen to be coming many years into the future. Consider the view that artificial intelligence (AI) is going to transform the world economy over the coming decade. If the long-term interest rate used to value (or discount) these long distant earnings is lower, then the value of that company goes up.

Technology has had one of its biggest periods of relative outperformance.

- In Q1 2023, the MSCI technology sector was 13.3% ahead of the global equity market and almost 22% ahead of financials - its biggest outperformance in 14 years.
- In fact, the top technology firms, the so-called FAANGs (Meta (previously Facebook), Amazon, Netflix, Google and Apple) have grown in value by 25% in the year to end April[7].

Yet, most of this performance has come from investors being prepared to pay more for less earnings.

- Investors are paying a third more for earnings from the technology sector than from elsewhere. That's just under three times more of a premium than the average since 2006[8].
- The price-earnings (a way of measuring value) of global technology stocks expanded by 16% in just 4 months in 2023.
- At the same time, estimates for tech earnings have fallen back by 4% over the same period.
- The rationale for this is that, by 2024, earnings will be expanding rapidly again and there's been a lot of market focus on the transformational impact that AI may have.

The response of tech companies to changes in interest rate expectations has been one of the features, indeed drivers, of the up-down nature of equity markets in the past year or more - this looks likely to persist for a while yet. Abrupt reversals are the feature to watch and be prepared for.

[7] Source: Investment Markets/Bloomberg 25.04.23. Estimate based on combined market capitalisation as of 25.04.23 compared to end 2022.
[8] Source: Investment Markets. The estimates compared 12 month forward price/earnings estimates for the MSCI ACWI World and MSCI ACWI Financials indices.

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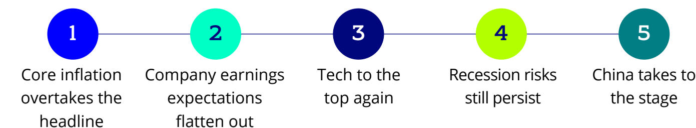

4 Recession risks still persist

One of the impressive features of the past quarter has been just how robust the world economy has shown itself to be, despite fears to the contrary. Yet, while the much talked about recession hasn't arrived, growth is weakening.

- US economic growth grew by less than expected in Q1 at just 1.1% per annum (buoyed by strong consumer spending) and growth estimates for the eurozone are at 1.3% per annum[9].
- Labour markets have remained very tight and indeed, in many parts of the developed world, labour shortages have been a feature.
- With high levels of savings still somewhat intact from the pandemic period, consumers who had been spending on goods, are increasingly spending on services despite a falloff in confidence.
- Supply lines that had been damaged in the Covid-19 period are largely restored and the reopening of China has given the world another source of demand.
- What's more, April saw a bounce in Purchasing Manager Indices (PMIs) across most regions - PMI's give an indication of what companies are intending to do, and when they expand it's a strong indicator the economy will follow. That the bounce came from the services part of the survey, while the manufacturing component contracted, also shows where the growth is likely to come from in the months ahead.

While the risk of a widespread banking crisis faded during April, the end of the month saw the failure of First Republic, another mid-size California based lender. At the end of April, it was taken over by JP Morgan, the largest US bank. The initial response was a sign of relief but at the start of May, there were other smaller lenders under pressure so concerns about the US regional banks may persist for some time yet.

Evidence continues that a slowdown is happening. Consensus estimates of growth are continuously being revised downwards, interest rate increases are feeding through to the real economy, credit standards are tightening in many parts of the developed world, and inflation has taken its toll on consumer confidence.

Manufacturing continues to contract and the impact of the problems in banking have added to the probability that a recession will happen and will be somewhat more challenging than might have been expected only a matter of months ago.

> "Evidence continues that a slowdown is happening."

[9] Source: Bloomberg 27.04.23

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5 China takes to the stage

March saw China's National People's Congress open with an economic growth rate of "around 5%" as its target. This objective came on foot of a disappointing 3% growth in 2022, after widespread extensions of lockdowns created a stop-start year for China's economy[10].

Reopening came this year but recovery looks very much dependent on the state's policies to deal with its property sector and on restrictions that its technology sector faces.

The People's Bank of China has been active in supporting the reopening:

- firstly, injecting liquidity to support the property sector and
- secondly, cutting the Reserve requirement for banks by 0.25%, which has the effect of enabling banks to increase lending.

The Chinese authorities have also indicated they will increase government spending support and cut taxes for small business.

So far the effect seems to be working, with March seeing the Chinese services activity expand at its fastest rate in a decade[11] and retail sales looking strong. Economic growth estimates for Q1 2023 suggest growth of 4.5% per annum[12].

> " ...recovery looks very much dependent on the state's policies..."

[10] Source: Bloomberg, 27.04.23
[11] Source: Financial Times 31.03.23
[12] Source: Bloomberg 25.04.23

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Outlook

The events of recent years - Covid-19, the consequent high levels of inflation and interest rate responses - are beginning to wane in their influence, however slowly. These events have already left, or will leave the stage in the coming year. They will leave a changed investment landscape where inflation may remain at a manageable, but, structurally higher level than the previous decade. With that, interest rates are likely to remain more elevated.

During this transition, economic growth, recession, and company earnings will feature more prominently in market thinking. While bond markets have adjusted and resumed their more stable role in a portfolio, the volatile up-down pattern that we have been witnessing in the equity market is likely to persist for some time, as the market tests what might happen as the economy softens.

For the long-term investor transitions such as this should hold no fear, and may indeed present moments of opportunity, for they hold within them the seeds of what the future economy will be shaped into.

> "...the volatile up-down pattern that we have been witnessing in the equity market is likely to persist for some time..."

As always, we encourage you to talk to an Advisor before making any change to your investment portfolio.

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Performance table

Table 1: 5 year historic performances

Market	2018	2019	2020	2021	2022
Global equities	-4.9%	28.9%	6.6%	27.5%	-13.0%
US equities	-0.5%	33.9%	8.6%	39.3%	-13.0%
European equities	-12.0%	29.8%	-2.3%	23.8%	-9.9%
Emerging market equities	-10.0%	21.8%	8.7%	4.2%	-14.9%
Global bonds	-1.1%	5.3%	4.9%	-2.6%	-15.1%
US Government bonds	-10.6%	5.9%	8.8%	-2.2%	-12.5%
European government bonds	0.9%	6.8%	5.0%	-3.5%	-18.5%
Emerging market debt	-3.7%	0.6%	17.1%	-3.2%	-13.0%
Broad commodities	-6.8%	9.8%	-11.0%	1.0%	20.9%
US corporate bonds	2.5%	16.5%	1.3%	6.3%	-15.8%
European corporate bonds	-0.9%	6.2%	5.3%	29.2%	-14.1%
MSCI ACWI Technology	-0.8%	50.4%	34.3%	37.0%	-26.5%
Deutsche Bank	-55.6%	1.0%	29.4%	23.1%	-1.9%
First Republic	7.5%	37.2%	13.3%	55.8%	-37.3%
Amazon	34.8%	25.5%	61.9%	9.9%	-39.7%
Netflix	46.4%	23.3%	53.5%	19.6%	-35.5%
Apple	-0.7%	92.7%	67.5%	44.6%	16.2%
Alphabet	4.1%	30.7%	20.2%	77.5%	16.9%
Meta	-22.0%	59.7%	22.2%	32.2%	-48.9%

Source: Bloomberg 01.05.23

For more information: boi.com/marketwatchupdates

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