Monthly market update

September 2023

Goldilocks or more bears?

Kevin Quinn,
Chief Investment Strategist,
Investment Markets

6 drivers of markets in August

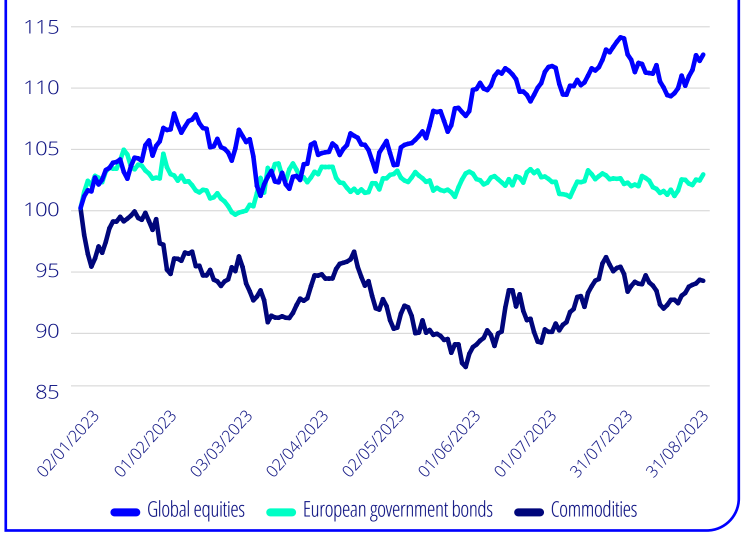
1. Evidence of US resilience remains
2. Europe and China are the weaker links
3. Earnings season still beats expectations
4. The Magnificent Seven, featuring Nvidia
5. Central bank remain inflation fighting
6. The bond market adjusts

Outlook

In August, equity markets suffered their first monthly loss since April as hopes of imminent interest rate cuts faded and policymakers continued to focus on inflation. The month saw quite a significant adjustment in the US bond market, reflecting in particular both the unexpected resilience of the US economy and a change in expectations about how long interest rates could be kept at higher levels. There was also more evidence in August that interest rate increases are slowing the European economy, with Germany in particular looking like it might be in recession.

- The US economy showed signs of resilience in the labour market, consumer confidence and industrial production throughout the summer and risks of a recession this year have faded. However data late in the month suggested a slight weakening cooling in consumer confidence and the labour market.
- The relative strength of the US economy and changing interest rate expectations are supporting the dollar, which has been strengthening against the euro.
- The European economy is weakening, with Purchasing Manager Indices (PMIs)[1] suggesting that Germany is already in recession.
- China's stuttering recovery continues with a string of recent reports showing a drop in exports, weak consumer spending and a worsening property crisis.
- In the US bond market, yields have risen across most maturities, with recent 2 and 5-year issuance showing the highest yields since 2008[2].
- Central banks on both sides of the Atlantic indicate that they remain very focused on inflation and doing what it takes to get back to the 2% target levels. US Federal Reserve (Fed) Governor Powell reiterated in his speech at the Jackson Hole Economic Symposium that they intend to keep interest rates at a restrictive level until they are confident that the job is done. European Central Bank (ECB) President Lagarde indicated the same message: that rates will be higher for as long as necessary.
- However, markets believe that a September rate hike by the Fed is unlikely, and even in Europe, the probability is dropping.
- The Q2 2023 earnings season shows that company earnings remain solid despite a downturn. Nvidia's much-awaited numbers came in well ahead of Wall Street expectations.

Figure 1: Asset class performance year to end August 2023



Asset class performances to 31st August	MTD	Q3	YTD
Global Equities	-1.3%	+1.3%	+12.7%
European government bonds	+0.3%	+0.2%	+2.8%
Commodities	-0.6%	+5.1%	-5.4%

Source: Bloomberg, 01.09.23.

[1] Purchasing Manager Indices measure the prevailing direction of economic trends in the manufacturing and service sectors. [2] Source: Bloomberg, 31.08.23.

Warning: Past performance is not a reliable guide to future performance.

6 drivers of markets in August

1 Evidence of US resilience remains

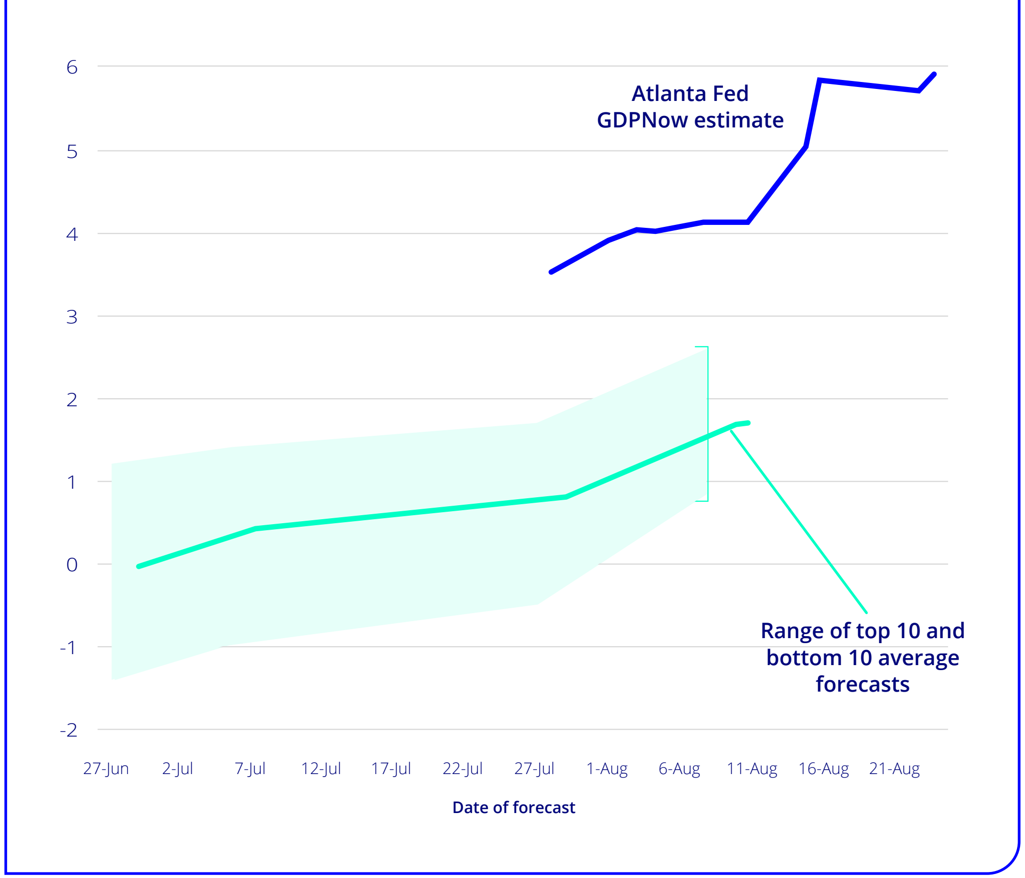
August began inauspiciously for the US, with credit rating agency Fitch downgrading the country's debt from its AAA status[3]. Markets appeared to take this in their stride, as it's not the first agency to do so. However, a series of data points about the US economy began to suggest that the slowdown that was supposed to bring inflation down further simply wasn't happening. A buoyant consumer, strong labour markets and industrial production all pointed to the opposite. Despite eleven interest rate rises since late 2022, the US economy is proving more resilient than anyone expected.

At the end of August, the Atlanta Federal Reserve's GDPNow indicator, a running estimate of economic growth based on the available data for the quarter, was pointing to a growth rate as high as 5.9%[4] per annum (p.a.). It's also well above most forecasters expectations, and while few believe that the outcome will be as high as this, it does show how robust the US economy is proving to be.

However, there are still signs that the US economy is slowing. Consumer confidence fell more than anticipated in August, while labour market growth slowed. There are some signs that the much-heralded slowdown may simply happen at a much slower pace, and it may be next year before we see anything approaching recessionary conditions.

Bottom line: The US economy is faring better than had been expected, and recession risks for 2023 are fading, although they may still surface by next year.

Figure 2: Evolution of GDPNow estimate for Q3 2023



Source: Federal Reserve Bank of Atlanta, 24.08.23.

[3] www.fitchratings.com, 01.08.23. [4] Source: Federal Reserve Bank of Atlanta, 24.08.23.

Warning: Past performance is not a reliable guide to future performance.
Warning: These figures are estimates only. They are not a reliable guide to the future performance of your investment.

6 drivers of markets in August (Cont'd.)

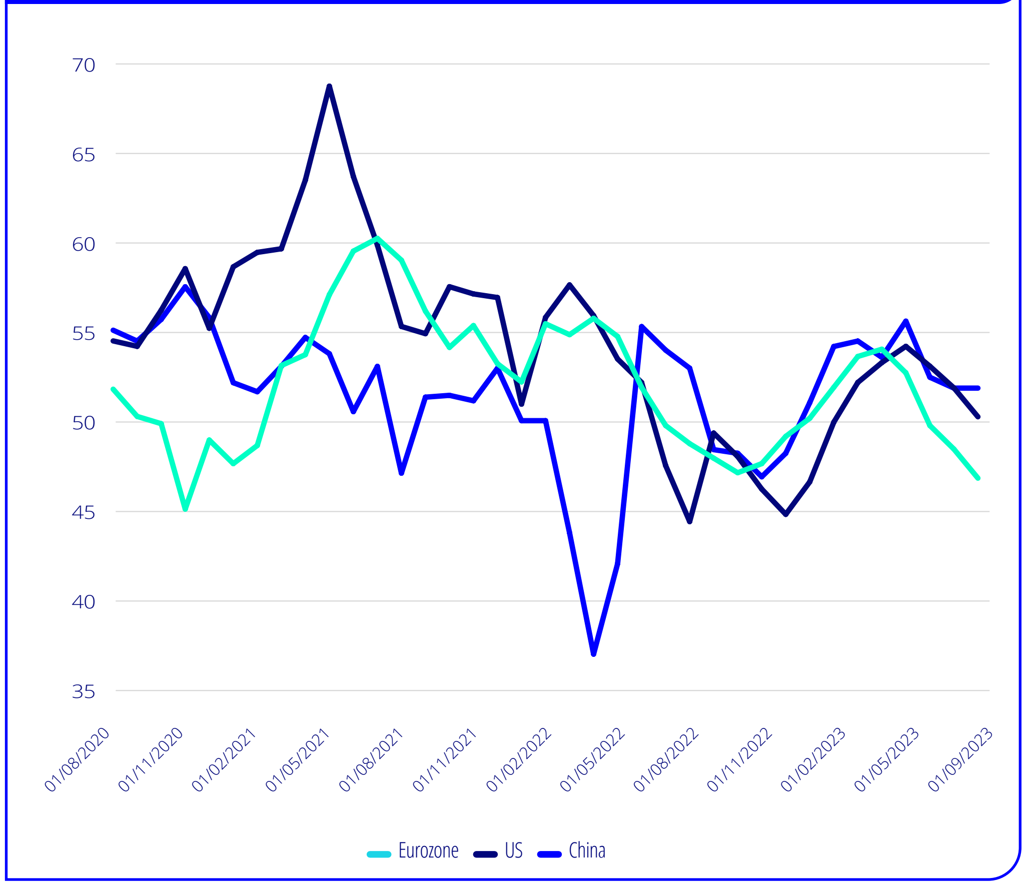
2 Europe and China are the weaker links

In contrast to the US, the European economy has slowed down after nine interest rate rises, and the data released in August showed evidence of this. European PMI's slipped during August[5], turning negative for the euro area as a whole. This time, both manufacturing and services registered recessionary levels in Germany and, to a lesser extent, in France. Consumer confidence in the euro area also fell in August, the first decline since September last year[6]. Euro area economic confidence slowed more than anticipated for the fourth month in a row, according to a sentiment gauge from the European Commission[7].

In the early part of the year, China's reopening was heralded as likely to generate almost half of global economic growth. While the economy is expanding and is widely expected to reach the government's 5% growth target, growth in the first half of this year has fallen short of expectations[8]. The major drivers of the economy – exports, foreign direct investment and land sales - have all been declining. China's outlook is increasingly dependent on the government's willingness to change its approach at a policy level, and the level of fiscal stimulus has been behind what was hoped for. Equally, the property market in China remains a source of risk for the economy.

Bottom line: Europe is struggling, and its main economy, Germany, may already be in recession. China is in deflation, growing at a slower pace than expected, and needs more stimulus.

Figure 3: European and Chinese Purchasing manager (PMI) indices



Source: Bloomberg, 01.09.23.

[5] Source: Bloomberg, 31.08.23. [6] Source: Bloomberg, 30.08.23. [7] Source: Bloomberg, 30.08.23. [8] Source: Bloomberg, 30.08.23.

Warning: Past performance is not a reliable guide to future performance.

3 Earnings season still beats expectations

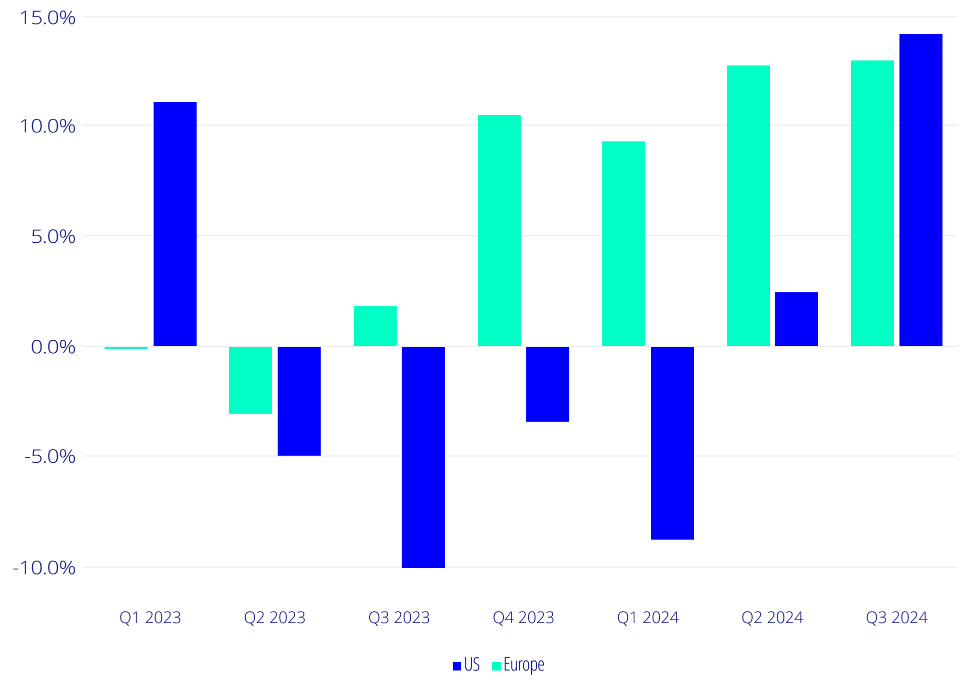
In the US, while Q2 2023 earnings fell overall by 3%, 79% of companies that have reported are ahead of analyst expectations. This is further evidence that the economy is proving stronger than feared. Excluding energy companies, which had a tough year by comparison to their bumper 2022, company earnings actually grew by 3.4%[9].

In Europe, company earnings are expected to have contracted by 5% in Q2 2023. However, when the energy sector is excluded, that turns into growth of 11.4%. With almost half of the companies in the Stoxx 600 having reported, about 53% are ahead of expectations, which is modestly behind the typical quarter[10].

So we have an earnings recession to deal with, albeit one driven more by the energy sector than elsewhere. When we look at the coming quarter, expectations are that US earnings will be back in positive territory, while the concern for Europe is that we will see an earnings recession until the middle of next year.

Bottom line: Q2 2023 earnings were better than expected, and there was evidence of resilience in the real economy. We may have an earnings recession, but it's not as bad as feared. The expectation is that the US may emerge out of this by next quarter, but Europe looks like it could take until the middle of next year.

Figure 4: Earnings estimates for the US and Europe



Source: I/B/E/S Refinitiv, 29.08.23.

[9] Source: I/B/E/S Refinitiv estimates, 25.08.23. [10] Source: I/B/E/S Refinitiv estimates, 25.08.23.

Warning: Past performance is not a reliable guide to future performance.
Warning: These figures are estimates only. They are not a reliable guide to the future performance of your investment.

4 The Magnificent Seven, featuring Nvidia

The driver of returns in the equity markets for most of this year has been the narrative surrounding artificial intelligence (AI). One can see this from even a cursory glance at the performance of the US S&P 500 compared to the same index, but excluding the "Magnificent Seven" - the top 7 IT stocks that are seen to benefit from the commercialisation of AI including Google, Microsoft, Nvidia, Amazon, Apple, Tesla and Meta.

The highlight of the month among the Magnificent Seven was the much-awaited Nvidia Q2 earnings numbers. Their performance came in impressively ahead of analyst expectations, with revenue of $16.5 billion compared to the markets expectation of closer to $11 billion[11].

Bottom line: Nvidia's earnings were important evidence that demand for AI componentry is insatiable, which in turn is recognition that this innovation is transformational for many industries.

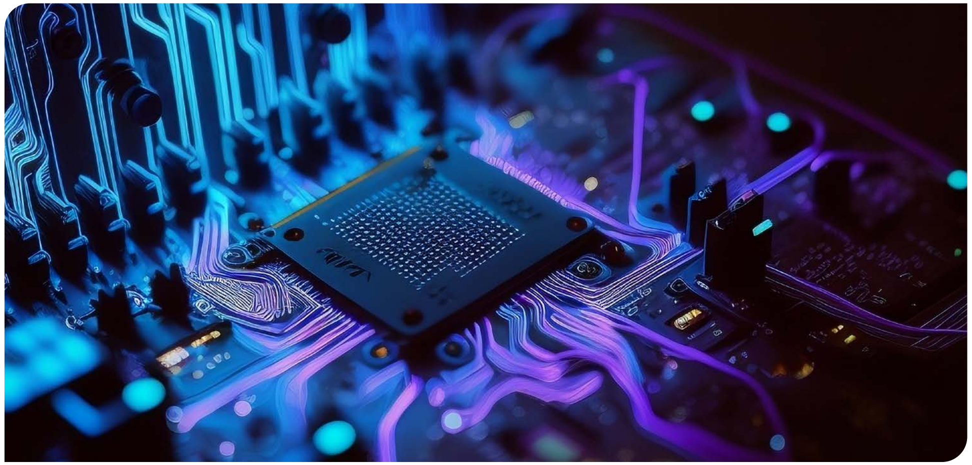
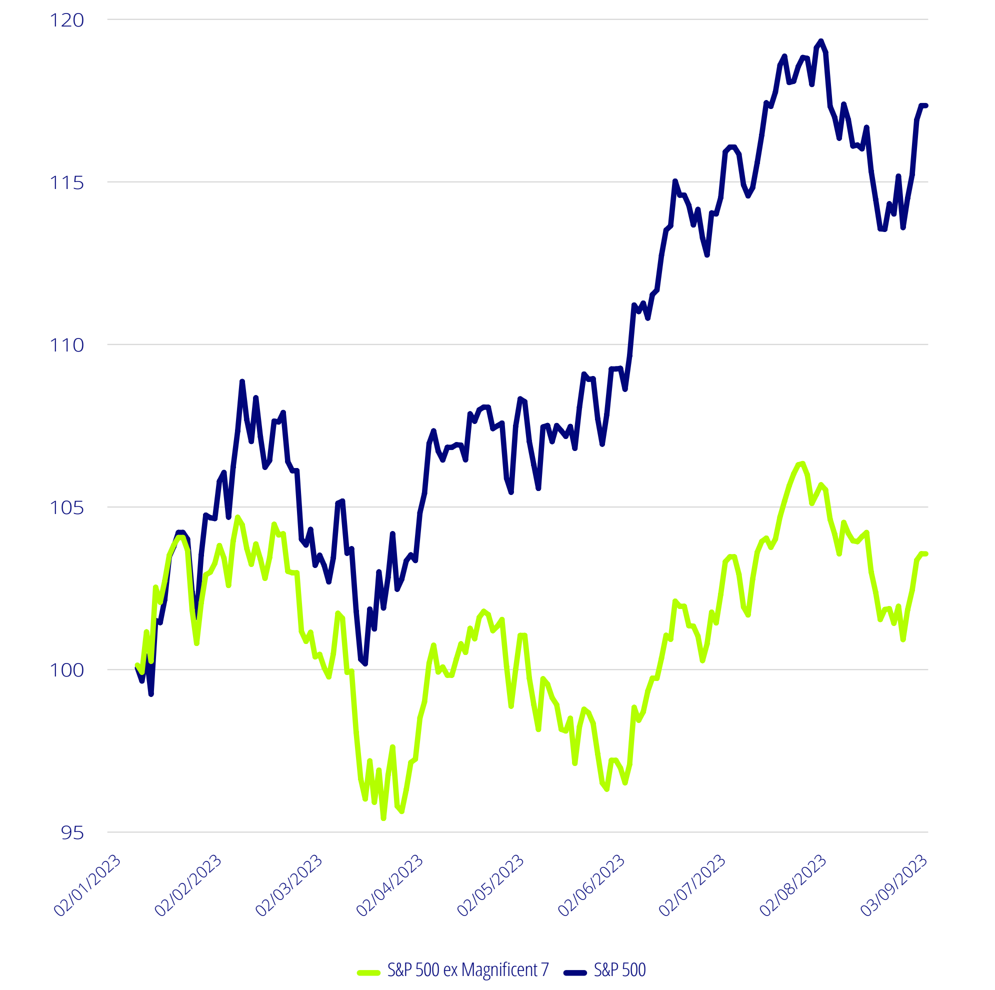


Figure 5: S&P 500 v S&P 500 less the Magnificent Seven



Source: BOI Investment Markets/Bloomberg, 30.08.23.

[11] Source: Bloomberg, 23.08.23.

Warning: Past performance is not a reliable guide to future performance.

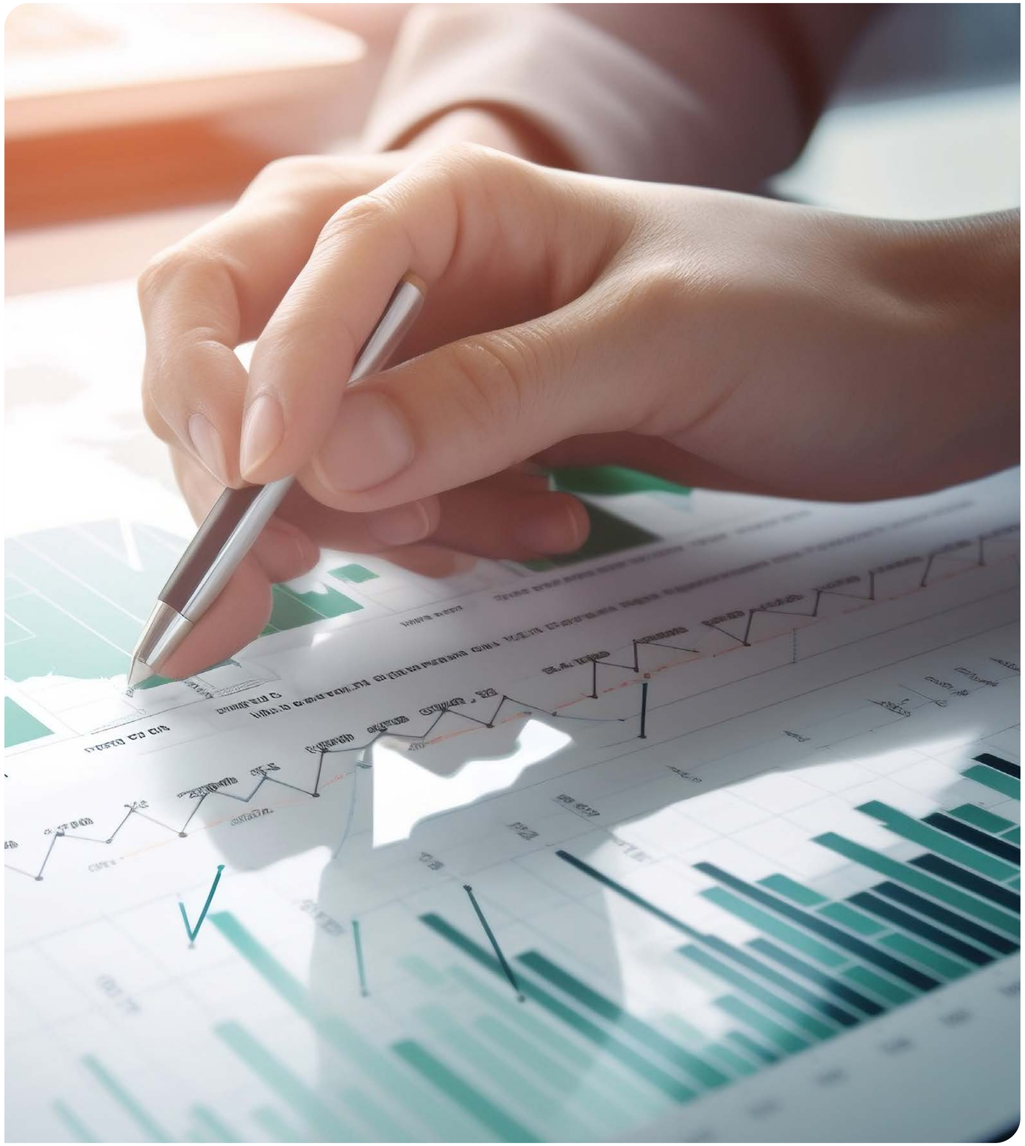
5 Central bank remain inflation fighting

The combination of what's happening with inflation and economic growth has led to a very different picture for interest rate expectations. We started the year expecting US interest rates to drop towards the low-to-mid 4% range by the start of next year, but now 5.5% is a probability[12], and the pace at which they are dropping is far shallower.

That's what the market thinks, but there's been a tussle between it and the Fed all year, and so far the Fed has had the upper hand. The minutes from the July Fed Meeting gave a clear message that they don't believe the job is over when it comes to fixing inflation. It seems unlikely that Governor Powell will ignore the risk that inflation could flare-up, especially with a still robust consumer base keeping the recession at bay. At the annual Jackson Hole Economic Symposium, he was predictably ambivalent, saying they'd raise rates if necessary, but indicating they'd hold them until they're convinced that inflation was gone. At the time of writing, markets believed an interest rate rise in September was unlikely, but a November hike was more probable.

For Europe, that's a little bit different. Yes, we have also seen a shift upward in rate expectations. Early this year, we were expecting rates to be just over 3% by the end of the year, but this is now closer to 3.75%[13] and likely to go higher. Despite the recent economic weakness in Europe, another 0.25% rise probably lies ahead, in either September or, more likely, October, although this obviously depends on the next set of inflation data. That said, there are reasons to believe European inflation will come down quite quickly from here, given the weakness now apparent in the wider economy.

Bottom line: The central banks are nearing the end of interest rate rises, but they are not there yet and will keep at this until the evidence is undisputable.



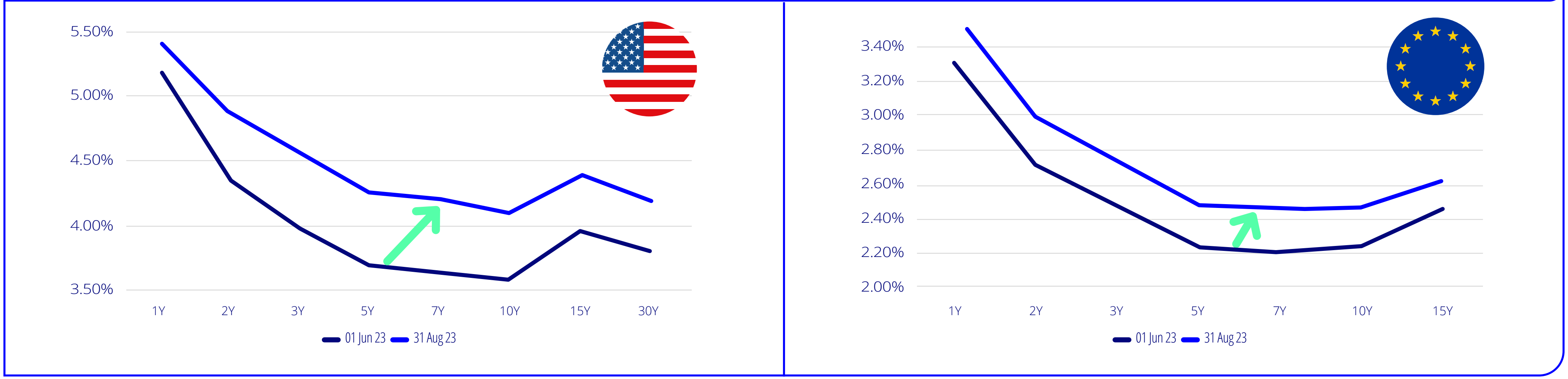
[12] Source: Bloomberg, 31.08.23. [13] Source: Bloomberg, 31.08.23.

Warning: Past performance is not a reliable guide to future performance.
Warning: These figures are estimates only. They are not a reliable guide to the future performance of your investment.

6 The bond market adjusts

In 1994, James Carville, a political adviser to President Clinton, famously remarked that if there were such a thing as reincarnation, he "would like to be reincarnated as the bond market". By this, he meant that he would like to wield the bond market's immense power over both policymakers and other markets.

Figure 6: US and Eurozone bond yield shifts over the summer



Source: Bloomberg, 31.08.23.

This bond market, especially in the US, had a lot to say this summer as it adjusted to the robustness of the US economy, sticky inflation and the prospect of another interest rate rise(s) on the horizon. The sell-off in US Treasuries at one point raised the all-important 10-year yield to 4.34%[14], its highest level since 2007. The adjustment can be seen in Figure 6 above, which shows how the various bond yields have changed since the start of the summer. In addition to the drop in bond values, this also had a knock-on effect on the equity market, especially the most interest rate-sensitive sectors, including IT and communications, and was a dominant driver of the downturn in equities during August.

Bottom line: The bond market has adjusted to the likelihood that interest rates might be at a higher level for longer, making the yields available even more competitive and valuable as a part of a well-diversified portfolio.

[14] Source: Bloomberg, 31.08.23.

Warning: Past performance is not a reliable guide to future performance.

Outlook

As we look out towards the rest of the year, it's useful to consider a "balance sheet of arguments" – what is making markets optimistic and what might drive returns the other way.

Positives

- Inflation is ending
- Interest rate peak is in sight
- US economic growth is more robust than expected & recession risk receding
- We can expect to see rate cuts in the year ahead
- Company earnings remain healthy despite a slowdown
- AI offers a big productivity gain and potential earnings boost

Negatives

- Shift up in bond yields
- Slower Chinese recovery
- Inflation remains stuck above policy targets
- Risk of over-tightening and further rate hikes to come
- Sluggish European economy & UK near stagflation
- Lofty valuations in US and in AI-related sector

Faced with these competing drivers, it seems likely that markets will continue to be in a period of adjustment as to what the new inflation and interest rate environment will be. For both bonds and equities, therefore, all roads will lead to the doors of the major central banks in the near term, at least for the next few months. A soft landing seems to be the most likely outcome for the global economy, although there may be pockets of recession, as might be the case with Europe in the short term and in the US in the medium term. Despite the very solid gains so far this year, a cautious approach may be warranted. In the longer term, however, investors should be encouraged by the many structural shifts happening in the world economy, as illustrated by the gains made by companies engaged in the "AI revolution".

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

Warning: Past performance is not a reliable guide to future performance.

Performance table

Table 1: 5 year historic performances

	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%
Japanese equities	-10.0%	22.2%	3.3%	9.8%	9.4%
Nvidia	-27.4%	80.5%	104.2%	142.1%	-47.1%
NASDAQ	2.0%	40.4%	33.2%	31.2%	-28.3%
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%
Microsoft	26.8%	60.7%	30.9%	63.7%	-23.5%
Netflix	46.4%	23.3%	53.5%	19.6%	-35.5%
Tesla	12.2%	28.2%	674.4%	60.8%	-62.8%

Source: Bank of Ireland Investment Markets/Bloomberg, 01.09.23.

For more information: Fund Centre boi.com/marketwatchupdates

Warning: Past performance is not a reliable guide to future performance.

Warning: Past performance is not a reliable guide to future performance.
Warning: The value of your investment may go down as well as up.
Warning: If you invest in these funds you may lose some or all of your investment.
Warning: These funds may be affected by changes in currency exchange rates.
Warning: These figures are estimates only. They are not a reliable guide to the future performance of your investment.

September 2023

Bank of Ireland