Investment commentary

February 2023

Market overview

Continued falls in inflation and expectations that the cycle of rate tightening might soon come to an end drove markets higher in January. During February, however, this dynamic partially reversed as stronger than expected economic data served to lower expectations of recession but also raised concerns that inflationary pressures may persist for longer than had been hoped, potentially leading to a 'higher for longer' interest rate backdrop.

Counterintuitive as it may seem, February was therefore a month where economic news was generally positive, with labour markets strong, indicators such as purchasing Manager Indices ('PMIs') improving and energy costs falling, but markets were weak given their focus on the imminent outlook for interest rates. Developed market equities fell c2.5% while emerging market equities fell by over 6%, further pulled down by US dollar strength and the weakness in the Chinese market as geopolitical concerns escalated.

As was expected the Federal Reserve raised rates in the US by 25bps, a slowdown from a succession of 50bp rises, however Chairman Jerome Powell warned that further rate increases may be required if employment and economic data remained strong. Also, as expected, the Bank of England raised rates by 50 bps. Economic news in the UK was mixed with GDP numbers weak but sentiment indicators improving and labour markets strong with wage growth reported at nearly 7% over the last year. The Bank of England announced that it still expects the UK to fall into recession later this year, but that this recession is now likely to be shallower than had been anticipated, driven in part by the fall in energy prices. UK equities in fact held up relatively well over the month as dollar strength provided some support to companies and sectors with significant dollar exposure within their earnings streams.

Eurozone inflation has fallen to 8.8%, largely due to falling energy prices – European gas prices have fallen over 80% from their peak last year. As is the case for the UK, however, concerns remain around persistent core inflationary pressures. The European Central Bank raised rates by 50bps to 3% and flagged a further increase in March as it attempts to navigate a very difficult policy path – evidence suggests for example that inflation is picking up again in countries such as Spain and France.

Given the more hawkish tone bond yields rose (and values fell) with 10-year Treasury yields rising from 3.5% to 3.9% and UK 10-year Gilt yields rising from 3.3% to 3.7%. Credit markets fell further although European issues (where our current exposure is largely focused) proved more resilient than their US counterparts.

Most areas of the commodity markets were weak with industrial and precious metals, energy and agriculture all falling.

The US dollar strengthened against most global currencies, rising nearly 2% against sterling, and our exposure in strategies provided a degree of protection in a weak month for asset prices.

Strategy positioning

The heightened uncertainty around the path of inflation and central bank policy may continue to cause some shorter-term volatility however we are maintaining a full exposure to equities across our strategies and equities remain our favoured asset class for real returns looking ahead. The likelihood of severe recession appears to be falling, the outlook for corporate earnings looks more positive than many feared last year and valuations in many sectors look attractive. Our base case remains for inflation to fall to more comfortable levels for central banks over the course of this year, potentially allowing them to loosen policy into 2024.

We have high conviction in terms of our equity positioning to target relative economic and corporate strength. In terms of regions this points us towards the US and Asia while we have also identified attractive opportunities within infrastructure and sustainable energy.

Attractive opportunities have appeared in both government and corporate bonds, and we expect a more 'normal' return profile from fixed income assets going forward. We have adding further targeted exposure to corporate credit given our belief that current yields offer value to investors without significant default risk.

Whilst we currently see attractive investment opportunities we remain very mindful of downside risks, both in the equity and fixed income space, and are retaining some exposure to low risk, uncorrelated strategies in the alternatives space where appropriate for the investment mandate.

Risk warnings

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