

# Quarterly Investment Bulletin

January 2023

**Cedarwood Wealth Management Ltd**

85 West Regent Street, Glasgow, Lanarkshire, G2 2AW, United Kingdom

Tel: 0141 3540000 Email: [info@cedarwoodwm.co.uk](mailto:info@cedarwoodwm.co.uk)



### Headlines

- ❖ Inflation may have peaked with rate cuts moving earlier in 2024.
- ❖ UK inflation fell to 3.9% in November, surprising many observers.
- ❖ Equity market returns (excluding China) were very strong in quarter four of 2023.
- ❖ Equity market returns broadened in December having previously been focussed on technology stocks.
- ❖ UK interest rates remain at 5.25%.
- ❖ European inflation was down from 2.9% in October to 2.4% in November.
- ❖ European economic growth is likely to recover slowly in 2024 but should avoid recession.
- ❖ US interest rates are paused but the direction is for cuts in 2024.
- ❖ A soft landing for the US looks more likely.
- ❖ China continues to struggle with no stimulus measures in sight.



## General Economic Overview – Quarter 4 2023

At this time of year we look back at the final quarter of 2023 and the year overall, but we also look forward into 2024 to provide some guidance as to the likely path of the global economy and markets. Last year at this point we were focusing on inflation and whether central bank action was likely to be effective and over what timeframe. We were also worried that policy tightening would lead to a recession in the US and then across the rest of the world. Fast forward to December 2023 and we can start to see more clearly the effects of the policies and perhaps have a better vision of the path ahead for inflation and interest rates in 2024.

Throughout 2023 familiar themes dominated investor sentiment and market movements. Inflation and interest rate speculation, alongside geopolitical concerns, were at the centre of most of the volatility in asset prices. We have become so used to these factors as the catalyst for change that the belief in fundamentals has waned considerably in recent years with companies, even if performing well, unable to influence their market price. The one notable exception has been the strength of the US technology sector and the performance of a concentrated number of large cap stocks – the so termed magnificent seven are now 26% of all global equities (FT Dec 2023) – which have performed well throughout 2023. This has broadened out in the final quarter of the year with a US-led global equity market rally in November and December sending equity markets into the festive period close to all-time highs. Returns have not just been focused on equities; bond markets have seen good positive returns as yields have fallen in anticipation of lower interest rates coming earlier in 2024. Perhaps the most disappointing aspect of 2023 has been the economic performance of Asia (with the exception of India) which has struggled after a very positive start to the year when China reversed its strict post Covid conditions and opened up the economy. Since then, there has been little encouragement for investors with no real central support to drive the economy forward, particularly in the property sector.

Most predictions of the path for economic growth into 2024 have focussed on the outlook for inflation. It is widely believed that we have now seen peak inflation and that the next move for interest rates will be downwards. This was confirmed by the more dovish words of the US Federal Reserve (Fed) in its December 13<sup>th</sup> meeting, indicating a less aggressive stance on interest rates, with the dot plots (US Fed officials predictions for rates) also showing a larger number of rate cuts in 2024. This approach stoked the rally in both bonds and equities in the final quarter without much reference to the state of the global economy, where growth levels vary significantly between regions. The US is showing far stronger data than Europe and the UK, and emerging markets are equally as fragmented as the West but overshadowed by the conditions in China. The US economy is likely to have grown around 2.5% over 2023 which is in stark contrast to the latest Office for National Statistics (ONS) figures for the UK which shows stagnation or zero growth, with GDP shrinking by 0.3% in the third quarter. Another quarter of negative growth will signal a technical recession. Europe is in no better shape with Germany and France in technical recession and forecasts from Consensus Economics showing growth predictions from a range of economists for 2024 to be around 0.5%, half the rate indicated at the start of 2023.

We have probably now reached a point in the economic cycle when different regions separate in terms of growth. The US appears to be more stable and has an economic focus on technology and specifically AI which has been a significant theme in 2023. A soft landing in the US seems to be the more likely scenario at this point which, if it is the case, will mean the actions by the Fed to combat inflation have



been successful. The rest of the world looks to be in a more precarious position with greater geopolitical and economic threats to its growth pathway.

## Equity Markets

Despite predictions that some equity markets were fully priced, western markets have raced away in the final quarter of 2023. The reason stems from the more dovish statements of the Fed in November and December indicating that interest rates are more likely to fall in 2024 as inflation data has become more favourable. This, combined with an increasing belief that the US economy is heading for a soft rather than hard landing, has led to a global equity market rally. Growth stock valuations now look inflated as sectors such as technology and consumer discretionary have benefitted from this confidence. The question for 2024 is whether this latest rally is sustainable, and if certain assets are priced to perfection. The rally has at least broadened out to other sectors as the perceived cost of capital for weaker companies should reduce. The fact that the rally has also encompassed bond markets adds to the concerns for some investors as reducing yields point to a recession whilst rising equity prices indicate strong earnings progression, both of which are unlikely to be right at the same time. There are also geopolitical concerns for 2024 with several countries going to the polls, including the US and the UK, as well as Taiwan in January.

### UK

The UK stock market has recovered from a negative 2022 although returns have been lower than other western markets. It is perhaps not that surprising that the UK economy has fared worse than the stock market. The FTSE 100 is more global in its earnings footprint and whilst it is a small weighting in global market terms, foreign investors hold more than half of the market capitalisation. The UK economy has largely stagnated over the year with third quarter GDP barely above the levels at the end of 2022. The latest ONS figures for GDP indicated that the economy shrank in the third quarter by 0.1% after zero growth in the previous three-month period. Households cut real expenditure by 0.5% and business investment fell by 3.2%. Households still face higher levels of food inflation (10.1% in October) than the current overall inflation rate of 3.9%. It is unlikely that we will see rising productivity levels in this environment which will be a drag on performance. A further fall in GDP in the final quarter of the year will result in a technical recession.

Despite these dark clouds there are some reasons to be more optimistic as we move into 2024. The lowering of inflation has helped households as wage rises are now ahead of inflation and further cuts in National Insurance rates in January will also boost expenditure and confidence levels. If the Bank of England start to cut rates in 2024 this will also help borrowers and businesses as the year progresses.

The UK stock market has had a reasonable year with a rally at the end of year, but this was mainly in large cap stocks and mid and small cap stocks have struggled for most of the year, reflecting pressure on the domestic economy.

Perhaps the most optimistic conclusion that can be drawn is that despite all the headwinds, the economy has yet to fall into recession, which shows how robust it has been. A softer landing in the US and Europe would help the UK to recover faster in 2024.



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### US

Since the end of third quarter of 2023, markets have moved forward quite rapidly with the S&P 500 leading the way for western equity markets, rising over 20% in 2023. Much of the focus of the growth in market prices has been in the technology sector and a concentrated number of stocks have led the way with the Nasdaq up over 40% this year. The US has been the strongest western economy since the pandemic and has shown robust growth and employment data throughout 2023. The labour market has been slightly softer with the three-month average of non-farm payroll gains averaging just over 200,000. Unemployment is likely to end the year at around 3.7% and strong job creation has been accompanied by an increase in the supply of workers as the labour force participation rate has moved up, particularly for individuals in the 25-54 year age bracket. The Fed only expect the unemployment rate to rise to 4.1% by the end of 2024 which would be a soft landing if it occurred. Inflation has eased from its highs, and this has occurred without a significant increase in unemployment. In fact, for the unemployment rate to stay virtually constant when interest rates have been raised 525bp is unprecedented, but the Fed still believe inflation remains too high, despite ongoing progress. After very strong GDP growth in the third quarter, economic activity has slowed which should not be surprising given higher interest rates and the run down in post pandemic savings. Fulcrum estimates GDP in the fourth quarter was showing signs of coming in at around 1.5% - a sharp slowdown from the previous quarter. Economic growth for 2023 is likely to be around 2.5% (Fulcrum) which is well in excess of expectations at the start of the year and Fed committee participants expect growth to fall to around this level or slightly below in 2024 as a whole.

The US is still an engine of growth for the global economy, but it is increasingly focused on its own protection as it wrestles with global issues such as Ukraine and the Israeli Hamas conflict. The Fed needs to tread carefully to ensure a soft landing for the economy, but it seems that so far it has achieved its key goals of lowering inflation whilst maintaining a robust economy.

### Europe

Europe has been in a similar position to the UK in 2023 with the pressure of inflation hitting households hard, particularly on the energy front as higher prices have hit most regions. European economists do not expect a rapid recovery in the euro area with consensus suggesting they may avoid an outright recession but with weak economic growth at around 0.6% in 2024 (FT survey of 48 economists Dec 23). Risks include a prolonged war in Ukraine and a US presidential victory for Trump who might pursue a US - EU trade war.

Key economies such as Germany are the main cause for concern as they fight to reignite growth. In December, business activity worsened in Germany for the seventh month in a row, according to PMI data, and in October, merchandise exports and industrial production contracted. In addition from October to November the unemployment rate rose, and economic sentiment remained pessimistic. Historically high energy prices, elevated interest rates and soft foreign demand are all continuing to hit economic activity. In mid-December, the government coalition parties agreed to introduce austerity measures in 2024 worth some 0.4% of GDP to plug a multi-billion euro hole in the budget. Budget restraint is likely across the wider bloc as EU finance ministers agreed stricter constraints which make it more difficult for the bloc to boost economic activity as monetary policy tightens. Eurozone inflation has been reducing in recent months (2.4% in November) and is on target to hit the 2% goal set by the



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ECB but there are not yet any signs of lowering rates. Wages should therefore outstrip inflation, offering some encouragement moving through 2024.

### Asia & Emerging Markets

In contrast to the United States where growth this year has surprised on the upside, China has been the major economic disappointment of 2023. After the initial euphoria over the unexpected post Covid reopening, China initially saw a pickup in the service sector, but this was focused on smaller ticket spending such as dining out and entertainment. The manufacturing sector in China suffered from what Jay Powell referred to in his recent press conference as people having too much 'stuff' so they could not store any more goods and therefore manufacturing exporters across the world saw sluggishness in demand as spending switched to services. Chinese consumers left the pandemic in a vastly different position to those in the West. China did very little to support consumers during Covid – for example, Hong Kong gave its residents spending vouchers, whereas Chinese consumers received nothing. With many periods of lockdown people were forced to draw into their savings and so, in contrast to the developed world, Chinese consumers did not build up a buffer of excess savings during the pandemic. Furthermore, in the West the stock markets had been buoyant so when lockdown measures eased there was a positive wealth effect and property values rose.

In China around 80-90% of savings are held in property, although this is different to the West as many of these are unfinished apartments with a focus on 'buy not-to-let' rather than 'buy to-let'. Historically in China values of second-hand homes are lower than new builds as they are considered to be 'dirty' once people have lived in them. Chinese investors had bought these properties in the hope of capital gains, but with prices declining gains are less likely. The worst overcapacity issues are in lower tier cities and it seems in China, as in the developed world, excess inventory occurs in the places people least want to live. In China this is mainly due to fewer employment opportunities in lower tier cities. This has had a negative wealth effect, and the service sector has not seen a strong rebound especially in terms of employment.

In contrast, India has gone from strength to strength in 2023 and the country's macro and corporate fundamentals remain positive. Amidst sluggish global growth the Indian economy has grown in the range of 7-8% with softening crude oil prices a positive for the economy. Overall corporate results have been positive in India, although the banks have had some concerns that net interest margins may be peaking in the short term as the global interest rate cycle tops out. The private sector banks continue to gain market share and the under penetration of the banking sector, mortgages, and consumer credit at an overall country level suggest they remain a strong long-term investment story. India has also continued to benefit from the shift in manufacturing away from China with government policies attracting inward investment to this sector. Whilst the valuation of some stocks looks stretched in the short-term, there are still pockets of opportunity within the Indian market. The higher quality of companies listed and political stability, with Modi widely expected to be re-elected for a third term in 2024, means India is likely to trade at a premium rating to the rest of Asia.

Amongst the ASEAN economies, Indonesia has benefitted from the policies of President Jokowi and the election in 2024 is expected to hand power to his preferred successor. Indonesia has benefitted from the move from being a low added-value exporter of commodities, such as pure ore based products, to carrying out some of the added value extraction within the country, and it has a young low-cost labour force which should result in an increasing share of global manufacturing. Other ASEAN countries have



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had sluggish growth and in Thailand tourism has been slow to return to previous levels with an absence of Chinese visitors.

In Latin America, whilst leftist President Lula sparked some concern amongst investors, his lack of control of Congress has meant policies to date have not been extreme. The Brazilian central bank has tightened rates and early inflation appears under control with the prospect of rate cuts in 2024, which would be supportive of the stock market. Brazil is likely to see GDP growth in 2023 of around 2.5-3.0%. Mexico is benefitting from the reshoring or nearshoring of global supply chains away from China and also the expansion of activity by Chinese manufacturing companies.

### Japan

One of the surprises of 2023 has been the performance of the Japanese stock market which in local currency terms has been up over 25%. The currency depreciation has offset some of this for foreign investors but nevertheless the confidence and positivity this has created has offset some of the structural headwinds the economy has faced in previous years. In contrast to other economies, inflation has helped this. Since the 1990s Japan has struggled to create inflation with negative interest rates the norm for many periods, but in 2023 inflation was consistently around or above the targets set by the Bank of Japan (BOJ). The BOJ has maintained their ultra-low interest rate policy and has the world's only negative interest rates but concluded that they could not yet see that inflation was under control or stable. The short-term rate is at minus 0.1% with the ten-year rate slightly higher at 0.72%. The yield curve control policy remains in place, but it was tweaked in July when Governor Ueda raised the cap on the ten year bond yield to 1% from 0.5% without normalising policy.

The fact that inflation is now considerably higher than savings rates in Japan has started to factor into the minds of the domestic investor. Previously, low interest rates weren't eroding the value of capital for the retail investor as inflation was also very low, but this is no longer the case and rising prices have begun to coax domestic investors back into riskier assets. The Japanese government has also seized on this situation and in January 2024 will offer an unprecedented inducement. The Nippon Investment Savings Account (NISA) will offer a lifetime tax exemption for individuals equity investments whilst also trebling the contribution limits. Historically Japanese households only hold around 24% in equities (source FT Dec 2023) which is far lower than in the UK (54%) and US (75%). A 2% reallocation of wealth could produce a \$150bn shift into equities. There is still a distrust of the Japanese economy for domestic investors which has developed since the late 1980s and 90s which needs to be overcome with previous incentives not fully taken up – perhaps economic conditions will mean it is different this time.

### Fixed Interest

After the significant rise in rates in 2022, and the belief that they were close to peaking, 2023 was expected to be the year of the bond, with yields forecast to fall into 2024. This did not transpire for most of the year with yields remaining stubbornly high – as an example, the US 10-year treasury note rose above 5% in Q3. Interest rates have now been stable for a number of months with the peak in interest rates called by many observers in the final quarter of the year. The mantra of central banks for most of 2023 was that inflation has not been conquered and in October markets finally seemed to absorb that message, with both equities and bonds delivering negative returns. Since then, the language from central banks has changed – specifically, the Fed- has driven a rally in both bonds, as yields have fallen





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(the ten year US treasury is below 4%), and equities as the likelihood of rate cuts earlier in 2024 has increased.

It is generally accepted that interest rates have peaked and even if there were an uptick in inflation in the coming months, a further increase in interest rates is unlikely. If there were an interest rate rise, it would probably only be temporary, and would be more likely in Europe or the UK. That said, the 'higher-for-longer' narrative that has emerged could continue to cause issues. Central banks look in no mood to start lowering rates at present but there will be considerable difficulty in getting inflation back to central bank targets of 2%. Moving from 10 or 11% to 4-5% was arguably the easier task but getting it to 2% will take more time. It is not impossible for us to return to a regime of lower interest rates, but it is important to recognise the economic forces that took us to that point previously (rapid globalisation of the macro-economy, tight fiscal policy, and high levels of debt) are not all still in place. 2024 is an important year with many general elections around the world, there are few politicians campaigning on a policy programme of 2010s-style fiscal austerity so inflation may return.

Bond markets have priced in interest rate cuts, but the question for investors is when they will happen. With five-year gilt yields about 100 basis points below base rates at the end of 2023, there is no surer sign that markets predict rate cuts in the next few years – it is just about deciphering how quickly they will come. The danger for the market is that the Fed keeps rates higher for longer and that this causes a deeper recession than expected. In the high yield market this could result in an increase in defaults which could widen spreads and increase uncertainty. At the moment there is an inverted yield curve with shorter rates higher than longer rates. This has meant investors have tended to favour shorter duration assets, protecting against the rising rate environment we have seen in the last two years. With rate cuts typically being front-end led, we therefore expect to see curves steepen. If rates start to fall in 2024 then bonds will become more attractive in terms of capital appreciation, and several managers are predicting this may be a rare opportunity to capitalise on a falling rate environment. Emerging market debt may also offer some opportunities as several countries have started to lower rates already.

Lastly, we see a lot of volatility ahead, caused by investors looking to move assets out of cash and into other vehicles in an attempt to maintain yields. There are also several macro factors to consider – geopolitics in the Middle East, elections in the US and UK, a continued heightened focus on monthly economic indicators, and increased supply as central banks seek to offload assets built up in the pandemic.

## Alternatives

As we move into a new phase of interest rate expectations the mood around investing in alternatives is improving in certain sectors, particularly property which has had difficulties in the last 18 months as it has caught up with the rapid interest rate increases in 2022/23. This, combined with changing structural trends such as hybrid working and the online economy, has put further pressure on office and retail space. For a number of years, the sweet spot for investors has been distribution hubs, supermarkets and data centres but this also waned in 2023. Values have fallen, but could still fall further in the near term, especially if a recession takes hold and occupier stress prompts an overshooting of the correction beyond just the reset driven by higher interest rates. While there are differences across sectors and markets so far, few parts of the market are escaping the effects entirely, irrespective of occupier performance, with Europe seeing a faster process of adjustment in yields than most other areas.





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The lowering of interest rates, should it happen in 2024, will be a boost for the property and infrastructure sectors and could lead to a decent recovery but the focus may change – the capital value cycle is finely poised as at the moment. While there are plenty of areas where caution should be exercised, such as secondary stock in the office and industrials sectors, we are in the early stages of positive growth in new sectors that could generate very attractive long-term returns. Economic, regulatory, and societal changes are shifting trends in real estate that is reflected in greater investment. Three areas that property investors could benefit from are life sciences, Build to-Rent (BTR) and care homes.

For many multi asset investors the use of alternatives has been encouraged in recent years to diversify away from the core assets of equities and bonds and to offset some of the correlation that has occurred in these assets. In reality this has not been as effective as investors hoped as markets were driven more by macro influences and sentiment than fundamentals. The market in commodities struggled in 2023 especially as the price of oil retreated, which in turn helped inflation numbers fall more rapidly than expected. Oil may well be a barometer for commodity growth in 2024 as will weaker GDP data from China, which generally acts as a lead indicator to industrial metal prices such as copper, aluminium and nickel. One encouraging long-term factor for commodities outside of oil is the transition to net zero that has to take place to meet climate change goals. Renewable energy infrastructure will need huge amounts of these commodities to create enough alternative energy supply to reach these goals. The risks to the wider global economy from the commodity sectors are that they can be a source of increased inflation, if demand grows, as we saw in the recent movements in the oil price when supply was constrained. The renewable energy sector is the most likely source of inflation as we move through 2024.

The recent change in central bank language has helped stoke more interest in alternatives as a lowering of rates will be beneficial to a number of sectors, should it happen in 2024. Arguably some of the pricing of assets in the last few months has reflected this, but if we see a deeper recession than expected then this may well be reversed in the short term. A boost to Chinese growth or a settlement in Ukraine would also have a positive effect on some of these assets.

## Summary

As we enter 2024, investor optimism is very different to what it was at the beginning of 2023. For most of 2023 the uncertainty created by the highest interest rates in 40 years acted as a break on investors' willingness to put money into risk assets. A significant two month rally at the end of the year however left global stock markets with strong annual gains as investors bet that major central banks have finished raising interest rates. At the same time we have seen a bond market rally as yields have also fallen on the back of a dramatic shift in interest rate expectations following data showing that inflation is falling faster than expected in western economies. The Federal Reserve boosted this trend by moving its policy projections, also signalling a larger number of rate cuts in 2024. The shift in bonds has been more dramatic as the Bloomberg global aggregate index of government and corporate debt was up 6% this year after being down around 4% in October. Whilst debt market movements have generally been broad based, the equity market has been very focused on certain areas and regions. The US S&P 500 has moved up over 20% in 2023 led by the technology sector and within that a narrow range of stocks,



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although this has also broadened towards the end of the year. By comparison the FTSE 100 is up around 4% over the same period.

The bond and equity markets seem to be in lockstep at the moment, but not everyone believes this to be the long-term outcome. Falling bond yields generally forewarn against a slowing economy and is therefore negative for earnings and equity markets. Currently the easing of financial conditions is also acting as a boost for equities as wage growth now outstrips inflation, suggesting a stronger consumer and therefore stronger corporate profits. It is generally accepted that the strength of the US economy is supported by high levels of employment but also by the loose monetary conditions that followed the pandemic. Increased savings and government support allowed consumers to save and then spend. As these conditions tightened (across the West) it was anticipated that unemployment would rise and spending fall but this has not been the pattern so far. Rate rises usually have a lag before taking effect, which may yet lead to a recession in the West, although most observers now feel there will be a soft landing in the US even if other economies, such as the UK, have a harder landing.

There are still risks that we need to navigate. The main ones are that economies continue to weaken as consumers and businesses gradually refinance their debt at higher rates, rising unemployment eventually bears down on wage inflation and bond yields drop, and stock and credit markets soften in the face of earnings downgrades and corporate defaults. If interest rates do come down then the refinancing issue will fall away, but nothing is certain and there is always the possibility of geopolitical issues becoming significant once again. There are a number of elections due in 2024 the main one being in the US when a change of party at the helm may well deliver a different agenda.

As always when we enter a new year, we try to predict the more likely path for the economy and markets for the year ahead. This year we start on a high, as confidence that inflation and therefore interest rates have peaked has led to the surge in returns in the final quarter. This may already be priced into certain stocks and sectors with the potential for other less supported regions and sectors to catch up in 2024. This should present a more favourable backdrop for investors as we enter the new year with the headwinds of recent years dissipating.

**Ken Rayner, CEO, RSMR**  
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