Santander Asset Management

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A Month in the Markets

AUGUST 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in July. Stock markets rose in July amid expectations that US and European interest rate hikes are nearing an end[1] and that the global economy will grow more than previous International Monetary Fund (IMF) forecasts suggested.[2]

Market Overview

Measures by China to accelerate economic growth[3] and better-than-expected UK inflation data added to investor optimism.[4]

Towards the end of the month, the Bank of Japan (BoJ) surprised investors by signalling that it might raise interest rates in the future. This would mark a significant shift away from its current policy of ultra-low interest rates, which are designed to stimulate economic growth by encouraging consumers to spend rather than save.[5]

In the latest moves in their battle against inflation, the US Federal Reserve (Fed) raised interest rates to a 22-year high in July[6] and the European Central Bank (ECB) followed suit by lifting rates to their joint highest level on record.[7]

Bonds issued by the governments of developed countries saw a slight decline in value in July[8], including US[9] and Eurozone bonds.[10] Japanese government bonds fell sharply after the BoJ signalled a willingness to increase interest rates[11] – as bond prices and yields move in opposite directions, the rise in yields that followed this decision was met by a corresponding fall in bond prices. UK government bonds bucked the trend, delivering a positive performance to bring three months of losses to an end.[12]

Baffled by bonds?

It may be worth taking some time to learn the basics to help you better understand how they work. Visit our <u>**Basics on Bonds page**</u> for more information.

UK and Europe

A survey of UK business leaders found that economic activity grew at its slowest pace in six months in July, as 13 consecutive interest rate hikes and increased living expenses cut into consumer spending.[13] Data released this month also showed that the economy shrank by an estimated 0.1% in May, likely because of productivity falling due to multiple bank holidays, including King Charles' coronation.

Defying gloomy predictions that it would have entered a recession by now – defined as two consecutive quarters of negative growth – a strong job market and lower energy prices kept the UK economy out of recessionary territory.[14] However, declining manufacturing sector activity and the fact that interest rate hikes have yet to take full effect mean that a 2023 recession remains a possibility.[15]

Data released in July showed that retail sales rose more than expected in June, after lower energy prices increased people's disposable income.[16] On the other hand, a separate survey revealed that consumer confidence fell in July for the first time since January. Persistent inflation and the interest rate rises implemented to combat it are eating into consumer confidence in the UK economy, despite figures released this month showing inflation fell more than expected in June.[17]

The Eurozone is facing similar issues. Business activity shrank sharply in July as demand in the European services industry – which spans sectors including finance, retail, healthcare and leisure – declined. In another worrying development, factory output fell at its fastest rate since the COVID-19 pandemic began.[18]

Data released on the last day of July revealed that Eurozone economic growth reached 0.3% in the second quarter, after zero growth in the first quarter.[19] However, like the UK, a recession remains a possibility. Headline inflation for the region fell in July, but core inflation, which excludes volatile energy and food prices and is closely monitored by the ECB, remained unchanged.[20] This may mean interest rates have to remain higher for longer, which risks slowing the economy to the point of recession.

In July, ECB policymakers predicted that core inflation would take longer to come down than they had previously expected when polled in May. This is mainly because a strong labour market is leading to high wage growth, which is stopping consumer demand from dropping further, making the fight against inflation more difficult.[21]

US

Data released in July showed that the world's largest economy grew faster than expected in the second quarter as businesses invested in factories and equipment, the government increased spending and the job market remained strong. This has fuelled optimism that the Fed will be able to bring inflation down to within its target without triggering a recession.[22]

Additional data released in July further supported the case for a so-called 'soft landing', in which inflation will ease without causing a downturn. The Fed's preferred measure of inflation continued to fall in June, while robust consumer spending is preventing the economy from sliding towards recession.[23]

The prospect of a soft landing for the economy drove the S&P 500 Index, which tracks the largest companies listed on the New York Stock Exchange, to its sixth monthly rise in the last seven months. Investors are increasingly swapping cash for shares, reflecting their growing willingness to take on risk in the confidence that the economy will continue growing.[24]

Asia Pacific

China's economy lost momentum in July as the manufacturing sector shrank and the services and construction industries weakened, while property prices slumped due to falling consumer demand. Extreme weather conditions, including heat waves and floods, further hampered manufacturing activity by damaging the energy grid and transport infrastructure.[25]

However, China's government has taken action to stimulate growth. It has outlined plans to make it easier for households to borrow money, encouraging consumers to refurbish their homes and buy goods. Steps are also being taken to increase the manufacturing of small consumer goods, which make up a quarter of China's exports. Additionally, the government softened its regulatory crackdown on technology firms, promising to make it easier for private companies to do business. These pro-growth measures helped drive gains in the Hang Seng China Enterprises Index, which tracks Chinese shares listed in Hong Kong.[26]

In Japan, the nation's benchmark Nikkei 225 Index fell in July, ending a six-months of positive returns.[27] However, earlier in the month, it had risen to a 33-year high as business sentiment improved.[28]

Data released at the end of July showed that factory production rebounded in June following a downturn in May, with increased production of cars and electronic devices leading the charge. This indicates that Japan's modest economic recovery continued into the second quarter. A weakened yen is also aiding the recovery by making trips to Japan cheaper for tourists, but rising inflation is eating into the disposable income of locals.[29]

Outlook

We continue to treat shares with caution and bonds with greater optimism.

Stock markets have seen rapid gains over the past few months, but our view is that this rally is likely to be unsustainable as companies are becoming overvalued and we are in an environment of low economic growth. As a result, we expect to see a fall in the value of shares.

We have a more positive view of bonds because we believe interest rates are approaching their peak. This should reduce the risk of bonds falling in value, as bond yields are higher and less likely to increase further.

We are therefore using excess cash to buy bonds so we can capitalise on higher yields. We favour most bonds, including UK and US government bonds, company and high-yield bonds.

We anticipate that inflation will continue to gradually fall, enabling central banks to hold interest rates steady for a sustained period without raising them further.

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All data as at 31 July 2023.

[1] Reuters, 28 July 2023
[2] IMF, 25 July 2023
[3] CNBC, 24 July 2023
[4] Reuters, F19 July 2023
[5] Reuters, 31 July 2023
[6] Euronews, 27 July 2023
[7] The Guardian, 27 July, 2023
[8] S&P Global Developed Sovereign Bond Index, 31 July 2023
[9] S&P US Treasury Bond Index, 31 July 2023
[10] S&P Eurozone Sovereign Bond Index, 31 July 2023
[11] S&P Japan Sovereign Bond Index, 31 July 2023
[12] S&P UK Gilt Index, 31 July 2023
[13] Reuters, 24 July 2024
[14] The Guardian, 13 July 2023
[15] Reuters, 24 July 2024
[16] Reuters, 21 July 2023
[17] Reuters, 21 July 2023
[18] Reuters, 24 July 2023
[19] Eurostat, 31 July 2023
[20] CNBC, 31 July 2023
[21] Reuters, 28 July 2023
[22] Associated Press, 27 July 2023
[23] CNN Business, 28 July 2023
[24] Bloomberg, 28 July 2023
[25] Bloomberg, 31 July 2023
[26] Bloomberg, 28 July 2023
[27] Statista, 31 July 2023
[28] Nikkei Asia, 4 July 2023
[29] Bloomberg, 31 July 2023