

Investment Comment

01 August 2023

In July, the common theme among markets was an easing of headline inflationary pressures, with data showing greater falls than anticipated in many regions. Most central banks are still expected to push through rate increases at their next meetings, as core inflation data remains sticky and growth robust, however falling headline figures have prompted speculation that banks may bring interest rates to their peaks more quickly than previously forecast.

US inflation data led the way with a decline from 4% in May to 3% in June, its lowest level since March 2021. However, the Federal Reserve still took the decision to increase rates to their highest levels in 22 years at their July meeting, having 'paused' rate increases at the meeting a month prior. The unanimous decision was taken in light of an increase to the forecast for core inflation as some areas of the market, notably services, still demonstrated elevated levels of inflation; robust additions in the jobs market; and moderate economic growth. Markets have priced in a roughly 50% chance of another increase to 5.75% when the Fed next meets in September. Q2 earnings season also began in earnest with good results for the big financials and there was a continued rally among stocks tipped to be beneficiaries of Artificial Intelligence. The performance of the top handful of stocks has been so concentrated year-to-date that their aggregate weight in the index has triggered a 'special rebalance' of the Nasdaq index to bring the weight of these stocks down, this is the third time such a rebalance has occurred, after 1998 and 2011.

The UK economy posted a monthly contraction of 0.1% in May, having risen 0.2% in April. Continued strike action remains a hindrance to growth, while production was the biggest laggard due to a slump in electricity and gas supply. House price data showed a 2.6% annual decline against forecasts of a 1.7% fall, as higher interest rates have decreased mortgage affordability and accessibility for those renewing or getting their foot on the ladder. However, it is worth noting the data reflect historically high house prices last year caused by the temporary cut in Stamp Duty. Retail sales data remained robust, while unemployment figures rose marginally. Inflation fell more than expected in June to 7.9% year-on-year, down from 8.2% a month prior, the Monetary Policy Committee will meet on 3 August to decide whether to increase rates further.

Europe continued the trend for falling inflation, posting an annual reading of 5.5% for June, down from 6.1% in May. Despite facing calls from banks to signal an end to further interest rate rises, having experienced a notable decline in demand for financing from small business, the ECB pushed ahead with a ninth consecutive rate rise, bring the benchmark borrowing rate to 3.75%. The possibility of a pause at the next meeting in September was floated however, as Christine Lagarde ditched the recent trend of guiding markets as to the decision at the next meeting, rather stating that the decision was 'in the balance' and that the ECB's decision would depend on the economic data. Similarly to other economies, the core inflation rate in Europe remains near recent peaks while the labour market continues to be robust with unemployment near recent lows.

The main outlier to the inflationary trend seen in July was Japan, where inflation increased to 3.3% year-on-year, outpacing US inflation for the first time in eight years, indicative of the fact that Japan is no longer an outlier in avoiding the increased inflation levels that have affected the rest of the world in recent times. The Bank of Japan surprised markets by relaxing the yield curve control on 10-year Japanese government bonds, diluting its 'limit' of $\pm 0.5\%$ on the yield to a 'target' and stating that it would not intervene until a $\pm 1.0\%$ limit was breached. Xi Jinping's 24-man politburo had its quarterly meeting in China and called for strong 'countercyclical' measures to support the economy, however without much detail at this stage. There was a shift in stance towards the ailing property sector, with the politburo being more supportive through an expansion of government subsidised housing to meet resident's essential housing



demand. In face of high youth unemployment, the politburo said it was 'necessary to increase the protection of people's livelihood and raise the issue of stabilising employment to a strategic height'. The general market reaction to the outcome of the meeting was favourable.

July saw the continuation of macroeconomic factors that were at the forefront in Q2 across most geographies: falling headline inflation but sticky levels of core inflation, low levels of unemployment and related growth in wages causing demand and supply side pressures. All these factors create a difficult picture for policymakers. US equity markets, with the S&P500 index performance now as concentrated as it has been since the 1970s, continued to benefit from the excitement around AI. Such excitement has not spread to the rest of the index however, but there is reason to be positive that there are opportunities across global equities that will be brought about by the advancements from AI and these need not be limited to technology names.

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