Capital Markets Update

Spring 2023

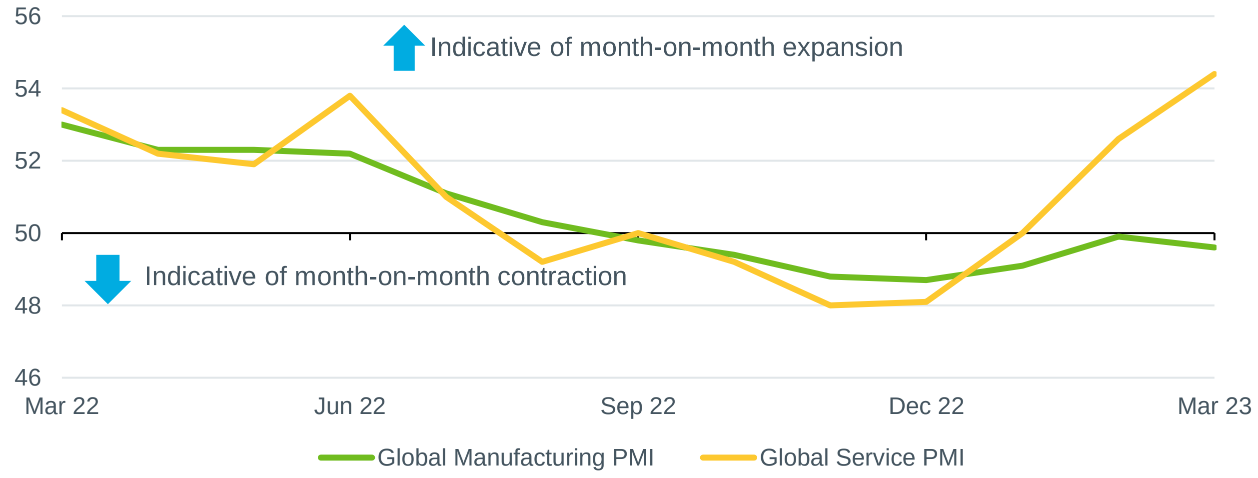
Global growth surprised to the upside in the first quarter of 2023 as falling energy prices, alongside a stronger-than-expected bounce in Chinese activity, led to an improvement in business sentiment.

Against this backdrop, global equities rose 6.0%. However, concerns about the financial sector, triggered by the collapse of Silicon Valley Bank in March, saw bank stocks and global government bond yields fall over the quarter.

Global themes

Economic data covering early 2023 was once again more resilient than expected, leading to further upwards revisions to global GDP growth forecasts for the year as a whole. Indeed, there are signs that global growth accelerated at the end of quarter one: the global composite PMI business survey rose to a 9-month high in March. However, a wide disparity remains between the performances of the service and manufacturing sectors (Chart 1). Perhaps driven by higher employment, service-sector surveys across the major advanced economies surprised to the upside, moving in aggregate to a level consistent with expansion. Meanwhile, the manufacturing sector looked weak in comparison, with the March survey highlighting still-modest demand, higher input costs and rising inventories.

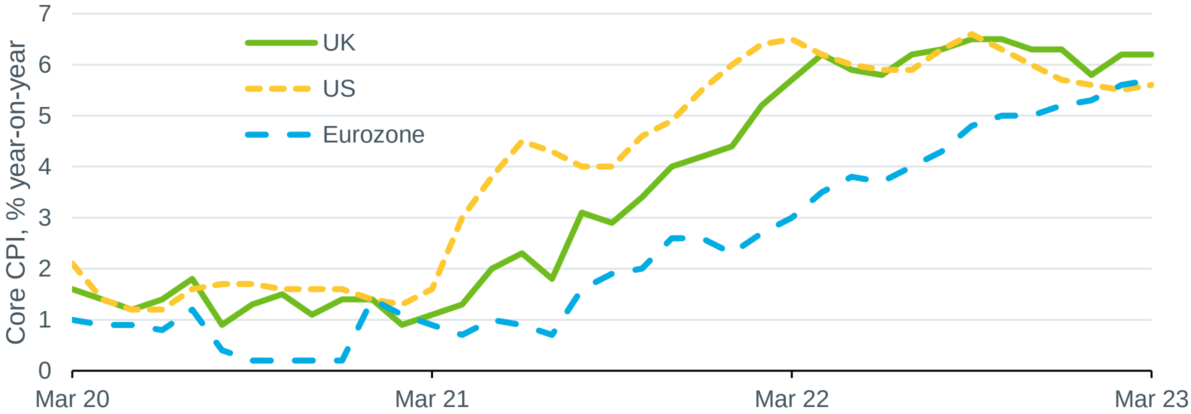
Chart 1: There's a wide disparity between the performances of the manufacturing and service sectors



The release of pent-up demand in China provided a one-off boost to global growth in quarter one. Although full-year forecasts have risen, the pace of growth is likely to ease. In developed economies, the lagged impact of monetary-policy tightening at the major central banks will weigh on growth over the remainder of 2023. Looking further ahead, forecasts for 2024 have been drifting lower in recent months. Markets expect to avoid a full-blown banking crisis, but recent developments in the sector are expected to prompt further tightening of banks' credit conditions, which could exacerbate the effects of previous policy tightening.

Headline inflation is falling but remains well above most central bank targets. Of most concern to central bankers is that a tight labour market and strong nominal wage growth, particularly in the service sector, could prolong upwards pressure on core inflation (Chart 2). It's true that weakness in the financial sector could contribute to tightening financial conditions. But central banks have sufficient tools to provide liquidity to ensure financial stability while raising interest rates to rein in excess demand. Against this backdrop, the large downwards revisions to interest-rate expectations in the wake of the Silicon Valley Bank collapse look overdone, particularly in the US.

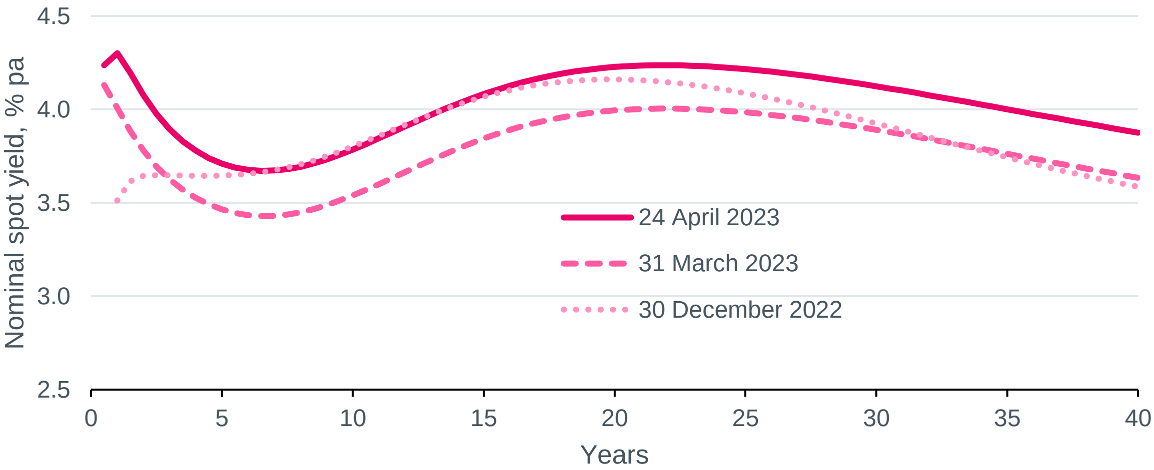
Chart 2: Core CPI is not falling as quickly as headline CPI – and is still rising in the eurozone



Government bonds

Yields edged higher again in April. While interest rates may not fall as quickly as bond markets expect in the near term, bond yields remain at attractive levels relative to longer-term real growth and inflation expectations, which inform our assessment of fair value (Chart 3). Although the UK economy has also shown unexpected resilience in recent months, the UK is forecast to see the weakest GDP growth of the major advanced economies this year and next. Along with an anticipated easing in headline inflation, this should lend support to government bonds.

Chart 3: Gilt yields remain at reasonable levels relative to longer-term fair value

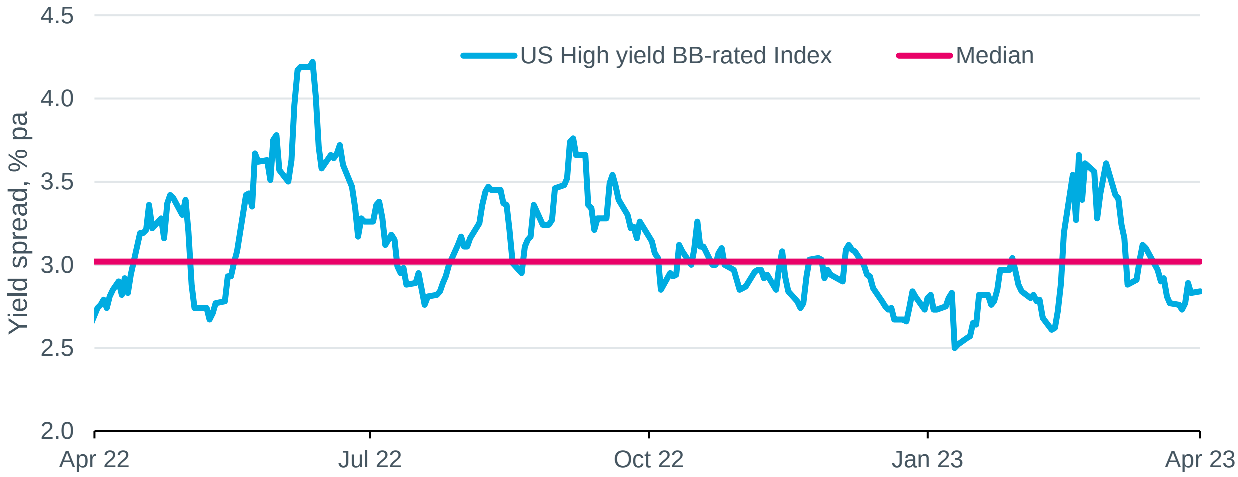


However, upside inflation risks and a high degree of uncertainty about where inflation will settle increase the relative attraction of index-linked gilts. Additionally, index-linked gilts are less susceptible to the technical pressures faced by nominal gilts: the Bank of England's selling from its Asset Purchase Facility does not include index-linked gilts; new supply, relative to nominal gilts, has declined in recent years; and institutional demand remains strong. However, the relative attraction of index-linked over nominal gilts is not constant by term, with nominals looking cheaper at longer terms.

Credit

There were more defaults in March than in any month since December 2020, taking the global speculative-grade default rate to 2.9%. While there were company- and sector-specific reasons behind the default of three US financial institutions in March, these do serve as a reminder of dormant risks that can be awakened by higher interest rates. The non-financial corporate default rate is also rising, with higher interest rates and slowing economic growth expected to weigh further on debt affordability for many borrowers this year and next. Against this backdrop, Moody's Investor Service expects the global speculative-grade default rate to rise to 4.6% by the end of 2023, before rising to 4.9% by the end of March 2024. If realised, this would be higher than the long-term average rate of 4.1%.

Chart 4: US high yield spreads make little allowance for an expected increase in defaults

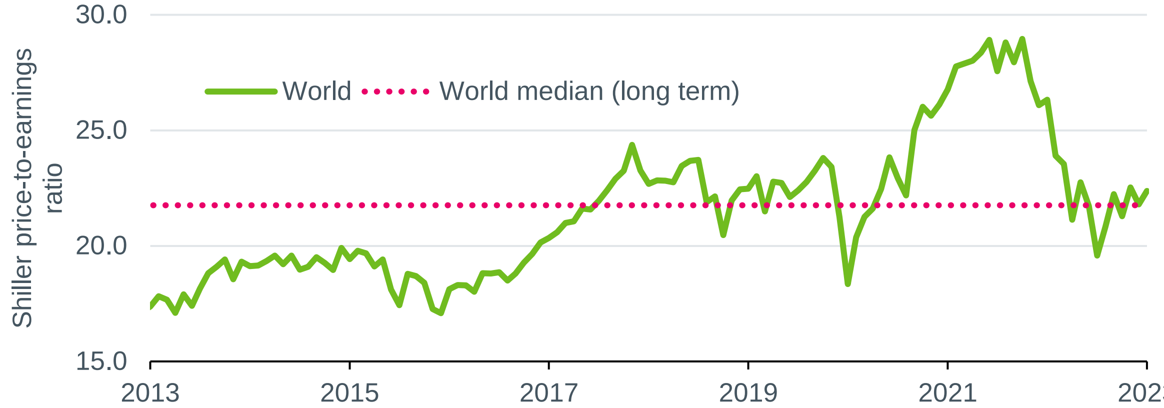


Despite the challenging fundamental outlook, US high yield credit spreads are not at levels that imply heightened risk of default or an impending economic downturn (Chart 4). As a result, we think that high yield spreads, particularly in the US market, look vulnerable to widening in the downturn expected in the second half of 2023. We think the investment-grade market, which is better insulated from challenging fundamentals, represents better value, both in terms of yield pick-up and spread over government bonds.

Equities

Global equities, particularly in the US, were boosted by lower interest-rate expectations in quarter one. However, the current US profit-reporting season may re-focus attention on weak fundamentals. Consensus earnings expectations for the first quarter have fallen sharply in recent months, and the reports so far have been a little ahead of these reduced forecasts. S&P 500 aggregate earnings are still expected to fall almost 7% compared to the first quarter of 2022, but forecasts for the rest of the year become increasingly optimistic, with year-on-year growth of over 8% expected in the final quarter. This rebound looks questionable, given that the lagged impact on economic activity of the US Federal Reserve's aggressive tightening cycle will be felt increasingly over the next few quarters.

Chart 5: Cyclically adjusted global equity valuations remain slightly above long-term averages



Cyclically adjusted valuations continue to hover a little above long-term averages (Chart 5), leaving limited scope for revaluation to drive equities higher against a challenging fundamental background. A decline in US real government bond yields has seen the equity risk premium rise from extremely low levels, but equities still look expensive relative to risk-free assets.

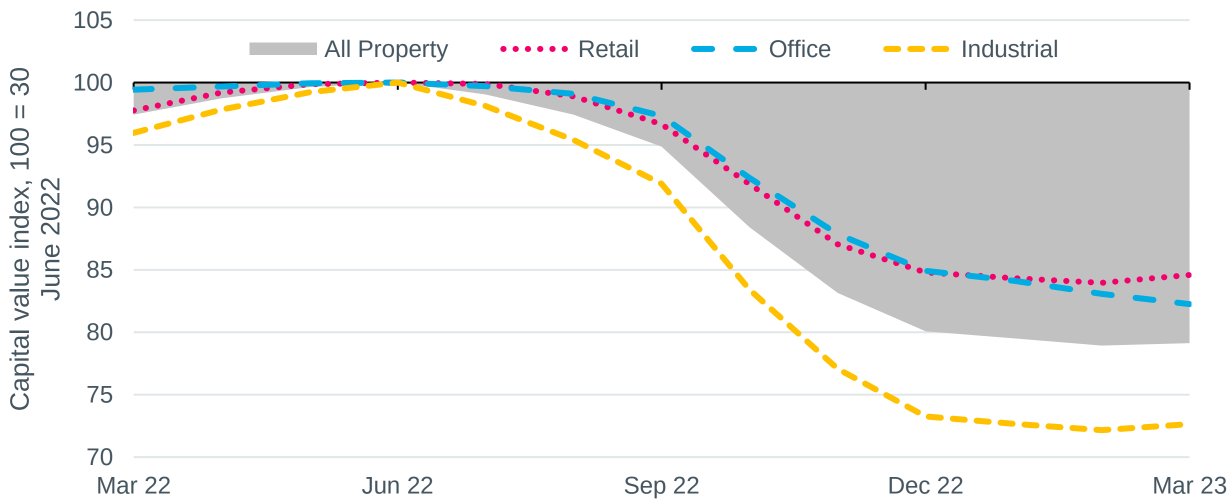
From a regional perspective, we retain the greatest degree of caution on US equities. More recently, we've trimmed the extent of our overweight to Europe ex UK. Regional indices have rallied a long way in the last six months, and valuations relative to global benchmarks no longer look cheap by historical comparisons.

Property

Capital values continued to decline in quarter one, but the rate of decline is starting to ease, and valuations saw their first monthly increase since June 2022 in March. Retail and industrial values rose, while office capital values continued to fall (Chart 6). However, the outlook is tough. While nominal rental growth is still positive, high inflation means it's deeply negative in real terms. Given the decline in capital values and rising rents, net initial yields have risen sharply over the past six months but are still unattractive versus longer-term history.

Furthermore, the latest UK Commercial Property Market Survey by the Royal Institute of Chartered Surveyors points to continuing short-term pressure: an increase in inducements offered to tenants by owners, lower occupational demand and a further decline in rent expectations. Additionally, tighter bank-lending standards following the recent turmoil in the US banking sector, on top of higher interest rates, may weigh on investment demand by deterring leveraged buyers.

Chart 6: UK commercial property capital values may be stabilising after a sharp fall



Conclusion

Resilient economic data has raised global growth forecasts for 2023, but quarter-on-quarter GDP growth is expected to ease beyond the first quarter as the lagged effects of ongoing monetary-policy tightening by major central banks weigh on economic activity. Against a backdrop of high headline CPI inflation and stubborn core inflation pressures, we think further rate hikes by the major central banks are likely and hopes that rates may start to fall in 2023 look overdone. While we don't anticipate banking-sector struggles will deteriorate into a financial crisis – policymakers have more tools than lowering interest rates to ease liquidity problems – the impact on US banks is likely to exacerbate the tightening in financial conditions.

Given our expectation that growth will ease over the next few quarters, we remain underweight risk assets such as equities, property and speculative-grade credit. Valuations are not sufficiently attractive to compensate. Commercial property values look particularly exposed to tightening in bank lending standards. Our corresponding overweight positions are in government bonds, investment-grade credit and cash. While we think near-term expectations of a pivot to rate cuts look optimistic, bond yields, in general, look reasonable versus our assessment of fair value.

Chris Arcari
Head of Capital Markets
chris.arcari@hymans.co.uk
0141 566 7986