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MULTI-ASSET PROCESS

Now is the time for investors to position their portfolios for the long term

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Equities and bonds have generally delivered positive returns in 2023, with a few exceptions such as UK gilts. The underlying tone in markets has improved after the relentless flow of bad news in 2022, but the downgrading of the US sovereign debt's credit rating by Fitch, together with wider worries such as economic recovery in Europe, have caused the worst jitters in markets since the mini banking crisis in March.

Monetary policy continues to tighten, with the Federal Reserve, the Bank of England and the European Central Bank all instigating yet another round of 25 basis point hikes over the last few weeks. But what does this mean for the markets and investors?

The nervousness that continues to be seen in global financial markets is unsurprising, given the pain that investors have been through in the last three years or so. First Covid, then the inflation and high interest rates catalysed by Russia's war on Ukraine, have driven sell-offs in both equities and bonds – a phenomenon that has only happened about five times in the last 100 years.

As much as investors' sentiment stabilised in Q2 this year after the financial sector issues in March, helped by data pointing to economic resilience in developed economies, some of the optimism seen at the start of this year after a bruising 2022 has dissipated. The mini banking crisis has largely disappeared off their radars and the US debt ceiling crisis dissipated as it usually does. But investors have become fickle, creating excessive volatility by being over-reliant on whatever the latest data or news angle dictates.

Inflation drivers are ebbing

Market sentiment is on a tightrope, thanks to inflation remaining stubbornly high, but the general situation is not so dire either. The key issue drawing investors' attention is how far central banks will raise interest rates to tackle inflation.

Nobody can say with any real certainty what will happen next for inflation and interest rates. The scale of the rises in them over the last couple of years has surprised investors and we have hit inflation levels unseen in around 40 years.

However, we believe the broad consensus is that we are through the worst of the inflationary increases. The inflation seen in 2022 can be blamed on supply chain issues, Russia's invasion of Ukraine, or even poor harvests in mainland Europe last year. But these drivers seem to be receding, reflected in the falls seen in headline inflation this year. Core inflation, which central banks worry about, is falling too but more slowly than hoped. Unfortunately, this is stoking fears that rates will remain higher for longer.

What has been avoided so far, despite much media expectations to the contrary, is a recession. Fears of a recession persist, but they remain stable. Our own view – that the chances of a recession are much lower than you might read in the papers – has proved to be correct so far this year. We continue to believe that a mild downturn is more likely in 2023 than a deep recession because central banks will strive to avoid it, and the global economy remains on a solid footing.

Equities offer best counter to inflation

In our most recent tactical review, we retained our overall positive outlook on markets, including for equities. This was raised earlier in the year when we sensed a positive switch in the underlying tone of markets, in contrast to the deeply negative one seen in 2022.

And corporates continue to make good money. Non-runaway inflation does not crash economies, although it can make it more difficult for companies to operate. After the sell-off in equities in 2022, we are gradually increasing our exposure to equities as we see opportunities to buy them at better value in certain areas. Investors should also remember that equities have proved time and again to be the best asset class to beat inflation over the long term.

We are still most positive on UK, Asian and emerging market equities. The UK still offers relatively good value despite its outperformance in 2022, while EM and Asian economies are recovering well post-pandemic and they have long-term potential supported by strong underlying fundamentals.

We also recently raised our outlook on European smaller companies to neutral, in line with our view on European equities generally. The continent is looking more settled now after being the region most severely affected by the war in Ukraine and arguably, the region’s equities have been impacted disproportionately.

Fixed income still offers diversification benefits

Regarding fixed income, we are more neutral. We struggle to get excited about government bonds, even when yields have risen to 400 basis points-plus. This does mean they offer more diversification potential than in the ultra-low yields seen previously. We are, however, positive on EM debt, both government and corporate, given prices are favourable versus what is available in more developed markets.

From an asset allocation perspective, we are not excited about the prospect of absolute returns and gains from bonds, but from a diversification perspective they are more valuable than they have been for over a decade.

Bonds’ role as a diversifier has been questioned, but we suggest that the opposite is true. Bonds and equities have so rarely sold off at the same time that to build an investment strategy around that would seem strange to us.

Invest for the long-term

The worries are not over for investors. The bigger risk today seems to be that interest rates will surprise on the upside. But central banks have already implemented aggressive hikes for an extended period and the chances are that we are close to terminal rates. There is certainly more optimism that this was the last US rate hike in the current cycle because of the latest data pointing to falling inflation.

We agree with the short-term diagnosis that inflation will be stickier than expected, but we disagree with any prognosis of severe damage being caused in the long run. Inflation is trending down, and we believe now is an opportune time to identify the positive potential in markets and put in place investments for the long term that are both diversified - to address volatility - and driven by a disciplined investment process.

Key Risks & Disclaimer:

Key Risks

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