

Investor focus shifts from inflation to growth



Quarterly investment update

October - December 2023

What moved markets over the quarter?

The main theme in our investment thinking over the last quarter has been how to shield portfolios from losses in an environment of uncertainty. Geopolitical risk, inflation and policy decisions dominated investors' thinking over the last 12 months but, as we welcome 2024, we think economic growth will be the main focus.

The market narrative this year has been that any bad news for economic growth is actually good news for asset prices. Any weakness in consumer or wage data has received a positive reaction from markets. Why? Because investors are worried about inflation, and they know that when wages are higher, people feel richer and spend the money in their pockets. This can cause inflation to become more entrenched.

The full effects of the most rapid policy rate hike trajectory in 40 years have not yet fed through into the real economy. As more fixed-rate mortgage deals and corporate loans come to an end, consumers and businesses will begin to feel the full force of interest rate increases, and this could cause economic growth to slow.

In Q4, central banks looked again at their inflation forecasts. In the US, the Federal Reserve signalled an important shift in its views and lower interest rates for 2024. The Bank of England stuck with its 'higher for longer' message on interest rates in the face of mounting signs of economic weakness.

In China, policymakers are expected to target growth of around 5% in 2024 and have incrementally eased monetary and fiscal policy to achieve that goal.

We see a low probability of further rate hikes in most developed economies, but we also think bond market expectations of imminent rate cuts are overly optimistic.

How did this affect portfolios?

Developed market equities (stocks from industrialised nations including the UK, US and eurozone) posted record gains in the fourth quarter as inflation slowed across the globe and investors' hoped that interest rates had reached their peak.

MSCI World - 5 Year Performance

The MSCI World is a stock index made up of large- and medium-sized listed companies from 23 developed market countries.



Disclaimer: Past performance is not a reliable indicator of future returns. The value of investments, and the income from them, can go down as well as up and you could get back less than originally invested. The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries. All data from Morningstar.

There were positive returns from global government bonds and investment-grade bonds in the fourth quarter. Bond yields, which move in the opposite direction to bond prices, fell on the possibility of sooner-than-expected rate cuts.

For strategies that invest into bonds, we have used some types of US government bond to hedge against the risks of recession and we remain happy with our positioning.

Our view on the major asset classes

Below is a high-level outlook for each asset class. This is just an overview, and we may adapt our views as markets move.

Equities

Markets are still volatile because of the uncertain outlook for inflation, interest rates and economic growth. We think company earnings estimates look high over the next year. We're taking a neutral view in the medium term (which we define as the next five years) and a little more negative over the next six to 12 months because of some of the risks we see.

We expect Japanese stock markets to offer better value, supported by economic policies and improving corporate governance.

Bonds

We predict some volatility in government bonds. UK bonds look attractively priced given the significant interest rate rises seen in 2023 and a poor growth outlook. In the corporate bond space, markets are pricing in a slightly above-average level of credit losses.

High quality credit should outperform equivalent government bonds, but we are cautious on speculative-grade credit (meaning bonds issued by companies with lower credit quality) as the pricing of these bonds doesn't reflect the risk of defaults.

Real assets

Real estate underperformed wider equity markets in 2023, partly as a consequence of the crisis seen in the US banking sector in March. If we are correct about the prospect of an economic slowdown in major economies, this could make us cautious about the fundamentals of real assets such as property over the next year, but equally we may see some opportunities to buy at lower prices.

Overall

We expect to see economic growth overtake inflation as the key concern for policymakers and capital markets.



Haig Bathgate
Head of Investments

How do we view portfolio composition moving forward?

We favour some types of US government bond as a way to protect portfolios in a recessionary environment in which interest rates are rising. In the event of an economic slowdown, government bonds have historically risen in price as central banks cut interest rates to stimulate the economy. In general we prefer high quality government bonds such as US treasuries and UK gilts.

We continue to see a favourable outlook for Japanese equities which we think justifies higher stock valuations compared to other developed markets.

Alongside these stable building blocks in portfolios, we also find selected opportunities in active funds where we think the fund managers can deliver returns above their benchmark.

Our outlook for 2024

In 2024 and beyond, we expect to see economic growth overtake inflation as the key concern for policymakers and capital markets. Leading growth indicators are showing signs of weakness in various major economies, but markets are not pricing this in. Recession risk remains on the cards, with the threat of a hard landing (meaning a quick shift from economic growth towards recession, usually caused by a government trying to quell inflation) most significant in Europe. Germany, the UK and Canada would likely be the first major economies to enter recession.

This year is a big one for elections. Historically, S&P 500 reaction to a new US President has been limited and short-lived, but we will keep monitoring global policies for changes that could affect your investments.

It is likely that geopolitical risk will remain heightened this year. As well as 'known unknowns' such as the current conflicts in the Middle East and Ukraine, there could be 'unknown unknowns' which, by definition, are risks that are hard to forecast.

It remains our view that maintaining a diversified portfolio that uses downside risk protection and active management remains the best way to navigate these uncertain times and to maximise the chance of investment success.

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