Watson French
WEALTH MANAGEMENT

Asset Class Commentary
December 2023

To paraphrase a classic, do investors know it's Christmas? With the festive season fast approaching, investors are feeling optimistic for the year's end after a tumultuous 2023. Equities have risen, bond yields have fallen and investors are impatiently waiting for interest rates to be cut.

For investors, global central banks New Year's resolutions should be to cut interest rates at some point during the first half of 2024.

A continued stream of data indicating falling inflation is now putting pressure on central banks to lower interest rates as economies struggle to stay in positive territory and consumer savings shrink.

One of the main risks now present is a weak economy weighed down by tighter credit conditions.

Inflation, however, could be the grinch at Christmas. Although inflation has fallen, with consumers tending to spend more at this time of year we could see a pick-up in prices as businesses look to capitalise on this spending.

The probability of any further interest rate increases is unlikely (although we have heard this before!), with uncertainty now about how long rates will remain where they are. Last month the consensus was for rates to fall in the US in June 2024 – this has moved forward to March 2024 as inflation data has made investors more optimistic.

Falling bond yields have been a relief for longer dated bonds and equities with cashflows further into the future.

We continued to see the theme of AI dominate the equity space, namely the so-called "magnificent seven" technology companies. It is undoubtedly one of the driving forces of the future, but the big questions are who will be the winners of the AI boom, how much future value has already been priced in now, and is this the right amount?

We look forward to seeing if the Santa Claus rally will materialise or whether investors will be left with coal in their stockings (portfolios)!

Areas of focus

- Short-dated government bonds are still overweight as they offer an attractive yield, albeit one that has fallen in the last month.
- Long-dated government bonds are increasingly preferred as they stand to benefit from any rate cuts, while bonds in the middle of the maturity spectrum are most out of favour.
- High yield bonds remain underweight owing to the threat of recession. They will also miss out from capital appreciation from any rate cuts.

- US equities have powered ahead this month, but still face risks as we start the new year.
- Japanese equities have regained lost ground and present opportunities for a bottom-up investor.
- Thematic funds are appearing more in portfolios as investors look to take advantage of long-term opportunities, such as AI, aging populations and the energy transition.
- Inflation linked bonds time to shine may be now. With inflation and its volatility likely to stick at higher levels and the potential for rate cuts, these bonds look primed to deliver positive returns after two years of dreadful performance.

Selection of assets YTD returns and YTD range of returns as at 01.12.2023 (the two ends of the bars represent the range of YTD returns and the red dots represent the current YTD return). Indexes used: FTSE All-Share, Russell 3000, STOXX Europe 600, MSCI China, MSCI Japan, MSCI Emerging Markets, FTSE UK Conventional Up To 5 Years, FTSE UK Conventional Over 15 Years, ICE BOFA US Treasury, ICE BOFA Global High Yield, ICE BOFA Global Corporate, US Dollar Index, S&P GSCI Gold Spot, S&P GSCI Brent Crude Spot. Returns hedged back to GBP with exception of US Dollar which is in US Dollar terms. Data from FE Analytics and MarketWatch. Correct as of 01.12.2023.

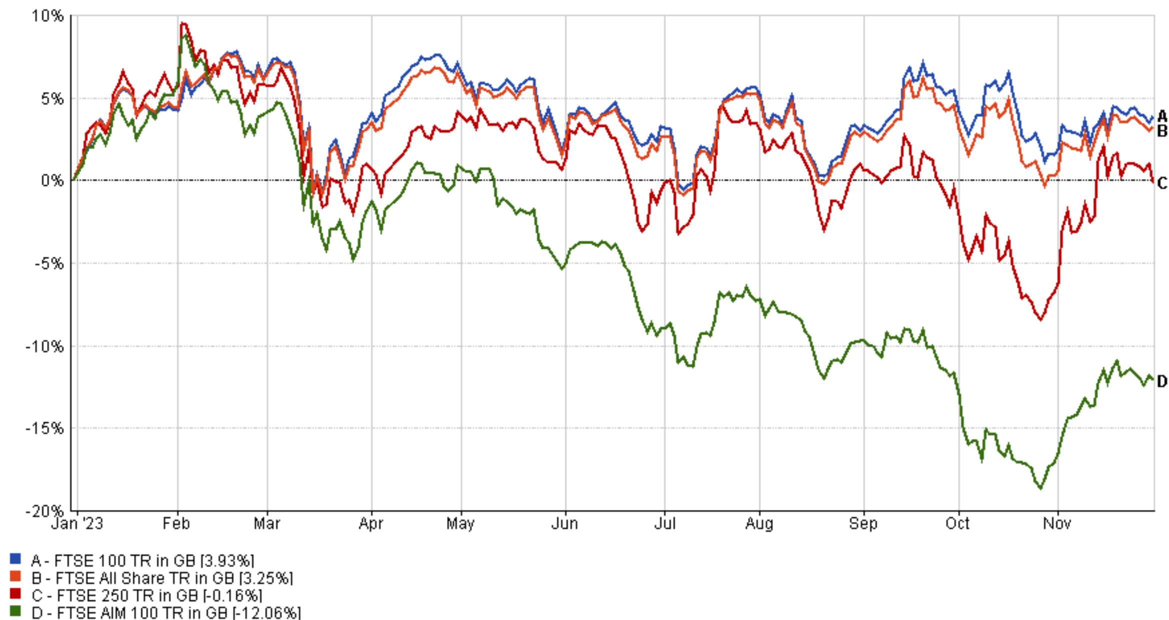
UK

The UK economy saw a larger-than-expected decrease in inflation over November. CPI came in at 4.6% – the lowest since 2021 – albeit core inflation currently sits slightly higher at 5.7%. Such promising figures gave investors further confidence that the Bank of England will leave interest rates unchanged at their next meeting and reassured many that rates may have indeed peaked.

In an unexpected turn of events, UK house prices increased in November – according to Mortgage provider Nationwide. Its house price index showed that house prices grew 0.2% over November, while economists had originally forecast a 0.4% decrease over the period.

This is likely in response to the view on base rates mentioned above having a positive effect on mortgage affordability – at the very start of the UK rate hike cycle, markets were expecting a peak

interest rate of 6.5%. Many now believe that we have reached the peak, at 5.25%, and this has led to easier borrowing costs.



YTD performance of major UK stock market indices

As shown above, UK equities witnessed positive gains across the board last month. The FTSE 100 was up 2.21% while the smaller cap FTSE 250 index climbed 7.53% over the same period.

Whilst there are many factors at play, the positive gains over the monthly can mostly be attributed to the promising inflation data, which has led to falling future interest rate expectations.

Despite an impressive performance from UK stock markets last month, the year-to-date performance of the FTSE All Share remains relatively flat at 3.25%. Looking forward to next month and the end of 2023, we could see a rally in UK stocks – over the past 50 years the FTSE 100 has produced positive gains 76% of the time during December, returning 1.7% on average.

	Yield (%) as of 01/12/2023	1 month change (%)	YTD change (%)
2Y Gilt	4.52	-5.91	26.61
10Y Gilt	4.20	-7.10	14.94

In fixed-income, UK gilts witnessed a significant reduction in yields. The 10-year gilt finished the month at 4.2%, while the yield on 2-year gilts finished slightly higher at 4.52%. These figures are both down around 50 basis points from their October highs.

Investor sentiment improved over the course of November and the rhetoric of "higher for longer" is slowly wearing off – much as central bankers might insist that controlling inflation remains their highest priority. The Bank of England wants to keep yields elevated, and the market knows this.

Over the past 18 months, we have witnessed government bond prices fall significantly. In some cases, they fell even more than equity prices – leaving cautious investors feeling somewhat let down

by the asset class. This has now created the potential for growth in the sector. Investors must keep a watchful eye on credit quality and duration of their bond exposure, however.

India

In a year featuring high inflation, high interest rates, and continued talks of many Western economies entering a recession, it might seem difficult to see where the next investment opportunity lies. The global economy will likely recover as it adapts to a new (or perhaps, reverts to the old) regime and we believe that India will significantly benefit from this over the longer term.

India has hardly lagged over the last ten years, with MSCI India outperforming MSCI World by an average of 2.00% a year over that time. With strong demographics, high investment in manufacturing infrastructure, and a focus on technology for a greener future, the trend of outperformance looks promising.

MSCI India and MSCI World ten-year performance.

During the last decade, India's economy grew faster than any other country, averaging 5.5% yearly GDP growth. This has led economists to predict that it will overtake Japan and Germany by 2027 to become the world's third-largest economy, having the third-largest stock market in 2030 as a result of this.

By 2031, Indian GDP is expected to double from £2.76 trillion to £5.92 trillion and a stock market capitalization of £7.90 trillion, according to Morgan Stanley.

In a post-pandemic environment, where remote working has become normalised, we have seen many countries adopt a “work from India” approach.

Unlike other developing nations, which may not have the infrastructure to provide online services to developed nations, India has long been a reliable place to offshore relatively low-skill services such as call centre work (and more latterly, higher-skill services such as bookkeeping).

This option for CEOs will only get more attractive as domestic workers demand higher wages and technological advances make the prospect more accessible. In terms of goods manufacturing, the Indian government is creating conditions to succeed with corporate tax cuts and large infrastructure spending.

India has long been a leader in digitalisation, partly due to favourable economic timing and partly down to entrepreneurial innovation. The hallmark of this is a national identification program called Aadhaar. This creates a biometric ID that is used for proof of residence, digitalising transactions, and a wide range of other benefits.

Recently becoming the world's most populated country with over 1.428 billion people, surpassing China's 1.425 billion, India now contains 17.76% of total world population. Unlike China, which is experiencing a negative yearly population growth, India's population is still growing at 0.81% a year.

Aside from the sheer size of India's population, its demographics are equally as exciting with the median age being 28.2 years, well below peak working age. In contrast, China's median age is 39.0 years.

Median age tends to rise as economies become more prosperous as a result of lower birth rates (generally owing to urbanisation and access to birth control). As median age rises, a country will have a smaller workforce which produces less output, all whilst supporting a larger group of retirees.

This will also bode well for consumption as median household income rises. As of 2021, 38% of Indian households earned under $5,000 a year with just 2% earning above $35,000. Bringing more and more of its population out of poverty will result in overall consumption rising from £1.58 trillion to £3.86 trillion by the end of the decade.

It is not only domestic consumption that will help the Indian economy, new foreign direct investment has also risen rapidly in recent years. Google established a "Google for India Digitization Fund" in 2020 that plans to invest $10 billion into India in the next seven years. Likewise, Meta (formerly known as Facebook) invested $5.7 billion in Jio Platforms which acts as a holding company for India's largest mobile network operator.

Finally with growing populations and consumption, one may ask where the energy is going to come from. The Indian government has pledged to invest around £3.39 billion in green energy technology such as wind, solar, hydrogen, and biomass. Currently the third biggest carbon emitter and home to 14 out of the 20 most polluted cities in the world, India has pledged to reach net zero by 2070.

Included in the government's plan are subsidies for private sector projects in battery energy storage, state-of-the-art electrical transmission lines, and large investments into research and development of green hydrogen energy. The plan also includes a promise to improve transportation systems with the use of electric vehicles and a more diversified public transportation system.

For all these reasons, in our opinion the prospect of investing in India looks relatively attractive. This is not to say that it will not come without potential risk and volatility in the event of a sustained global slowdown, geopolitical tensions, and the challenges of the green transition. Nonetheless, India has the opportunity to harness many of the same economic factors that helped China grow into what it is today, with some stark differences – perhaps growing in a way that is not only beneficial to India but also society globally.

US

The S&P 500 had one of its best months since 1950 in November, returning 8.90%. This ranks as the 18th-best performing month in the past 73 years and the second-best November since 1980. The Nasdaq 100 and Russell 2000 also performed extraordinarily well, returning 8.89% and 8.50% respectively. The Dow Jones lagged slightly but still managed to post a gain of 7.59%.

YTD performance of US stock indices

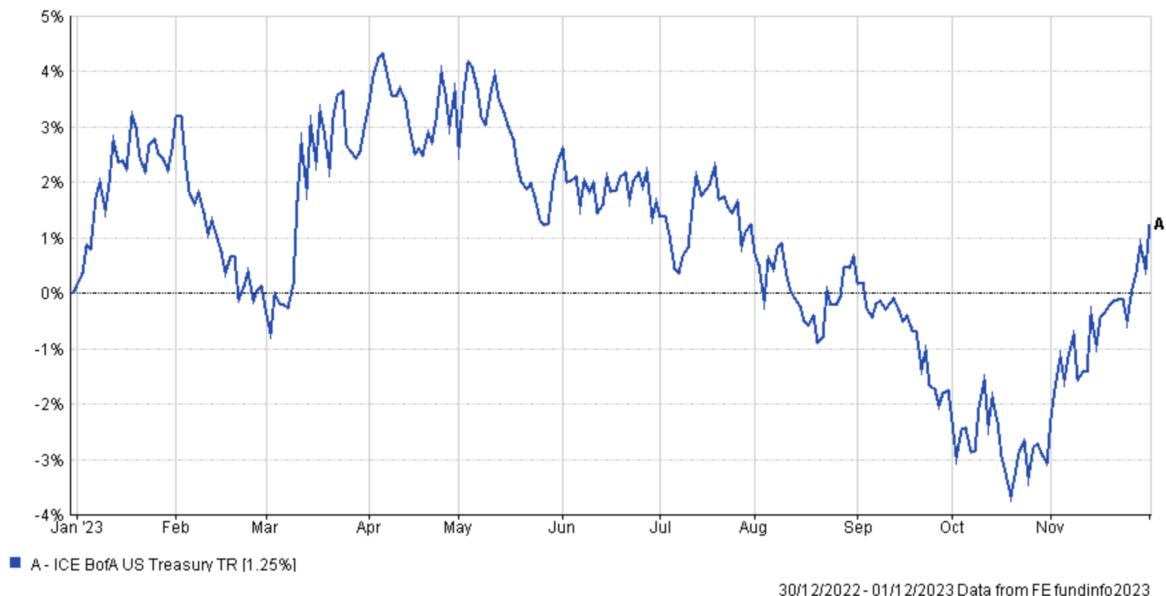
This resurgence of investor optimism has mostly been fuelled by the growing consensus that the Federal Reserve is done hiking rates, with rate cuts potentially now on the horizon. Markets are currently pricing in a 98.8% chance of Jerome Powell leaving rates unchanged in the next Federal Open Market Committee (FOMC) meeting scheduled for 13th December. In addition, the probability of a rate cut in March 2024 now stands at 63.4% and 89.3% for May 2024.

Equity markets tend to perform better with lower interest rates, as a lower discount rate makes the present value of future cash flows more attractive, meaning higher share prices can be justified now. Other reasons include the lower cost of borrowing for businesses, higher consumer spending, and the relative attractiveness as alternative investments such as bonds offer lower returns.

That said, equity markets are forward-looking – meaning that the multiple expansion we have seen since the start of the year could be investors already pricing in this information. When considering lower future rates, one must think about the potential reasons for this. Aside from the Fed claiming an immaculate “soft” landing, another likely reason could be lower-than-expected growth, which would not bode well for equity markets.

Meanwhile, the Treasury market seems to be singing from the same hymn sheet with the 2-year and 10-year yields both dropping significantly to 4.55% and 4.20% respectively. This also represents the best monthly performance for US bond market investors in nearly four decades. This revived

optimism for the traditional 80:20 investor has led some investors to believe that Christmas has come early with the arrival of the so-called "Santa Claus rally" still to come.



YTD performance of US Treasuries

The Santa Claus rally is a phenomenon in investment markets that is believed to create a sustained increase in stock markets around the festive period. Some theorists point the finger at end-of-year tax considerations and an overall cheerfulness on Wall Street due to the holiday season.

Some say that the Santa Claus rally happens in the final five trading days of the year along with the first two of the new year, whilst some will expand this timeframe to cover the whole of December. Yale Hirsch coined the term in 1972 (with the former definition), citing that between 1950 and 1971 the S&P 500 index gained an average of 1.5% during the festive period. Between 1950 and 2020 stock prices have been higher 57 times during that period with an average gain of 1.3%.

As far as December goes – sadly, there is no real evidence that the phenomenon exists. Over the last 20 years, the week leading to Christmas has been positive 13 times, negative five, and flat twice with a range of +5.4% to -10.7%. This being said, the "January Effect" also commonly gets floated around investment discussions as investors come into the new year with newfound bullish sentiment to start the year off well, increased buying because of tax-loss harvesting, and the use of year-end cash bonuses to invest into markets.

All in all, humans are prone to attempting to identify patterns, even when they may not exist. This may be a coping mechanism to deal with the unpredictability that stock markets often possess. Couple this with the fact that it is market commentators' job to dramatize markets, exaggerating the significance of relatively insignificant events. For long-term investors it proves prudent to expand your time horizon, disregard short-term fluctuations and instead concentrate on the fundamental growth prospects.

Research certainly validates this view. From January 2003 to December 2022, $10,000 invested in the S&P 500 would have left you with $64,844. However, if you had missed the ten best trading days, your gains would have reduced by $35,136 to just $29,708. Missing the next ten best trading days would have reduced your return by a further $11,882. Indeed, you would have lost $1,952 (in

nominal terms) if you missed the 40 best trading days, which is not to mention the substantial loss in real terms.

This is encapsulated in the well-known statement by investment guru Ken Fisher, that "time in the market beats timing the market."

Value investing vs. growth investing

And finally, a note on two terms we use frequently in our asset class commentaries – growth and value investing.

These are two very different fundamental investment approaches. The former identifies shares that have the potential for earnings growth in the future, while the latter targets shares that are perceived to be currently trading below their intrinsic or real value.

The likes of the Magnificent Seven mentioned earlier – Apple, Microsoft, Google, Amazon, Nvidia, Tesla and Meta would be described as large-cap growth companies. Other examples of growth companies would be small- to mid-cap companies in areas such as technology/AI, renewable energy, and space exploration- which are expected to generate profits in the years or even decades to come.

Many growth companies focus on technological innovation and sales expansion, reinvesting their profits into these areas. Traditionally, because they reinvest profits to drive future growth rather than paying immediate dividends, growth companies tend to be more sensitive to interest rate expectations and are typically much more volatile than “value” companies.

Value companies, on the other hand, are often seen as the more traditional or “boring” companies. Examples of such companies are often found in sectors such as oil and gas, real estate or banking and finance. Investors looking to purchase value companies can often expect reliable dividends and somewhat consistent revenue growth.

The Price-to-earnings (P/E) ratio is one of the key indicators of whether a company is a value company or a growth company. The ratio essentially compares how much an investor can expect to pay for each “unit” of earnings (essentially, company profits).

A low P/E ratio means that investors do not have to pay much for the shares relative to the expected earnings. While indicative of a value company, this does not necessarily mean that a stock is undervalued – investors must be aware that sometimes a company is trading at a low multiple for a reason.

It is therefore important to look at some other measures – sometimes more qualitative features – to avoid the so-called “value trap”.

2022 performance of MSCI World Value against MSCI World Growth

The battle between value and growth investment styles is longstanding and the victor is yet to be decided. The year 2022 did, however, mark a significant victory for value investors. The chart above shows that the MSCI World Value index gained 6.05% over 2022 while the MSCI World Value Growth fell 20.11% over the same period.

This outperformance can be explained by traditional financial theory, which suggests that value stocks will fare better when interest rates are increasing. Interest rates directly affect the valuations of all companies by changing the net present value of their future earnings and cash flows.

Given that growth companies have higher future earnings expectations, rising interest rates will, in theory, affect growth companies more negatively than value-focused companies.

YTD performance of MSCI World Value and MSCI World Growth

In 2023, however, there has been a complete reversal – and this goes entirely against financial theory. As shown above, the MSCI World Growth, up 24.48% this year, has vastly outperformed a relatively flat MSCI World Value index.

In recent months, large-cap growth stocks have had a significant boost from the hype around AI and the potential growth that this might bring in the future. In response, we have witnessed the Magnificent Seven reach new highs, at a time when US interest rates are above 5%.

Performance of MSCI World Value and MSCI World Growth since 2008

If we look to the extremes, value stocks have outperformed growth stocks over the past 90 years. However, since the financial crisis, growth has significantly outperformed. This is shown above, with the MSCI World Growth Index returning 460.81% since 2008. This compares favourably against the MSCI World Value index, which has only returned 239.18% over the same period.

The COVID-19 pandemic exacerbated the relative underperformance of value stocks. As people were forced to stay inside, we saw a boom in growth sectors such as tech while more traditional value companies suffered (not to mention the fact that interest rates fell to virtually zero).

It is important for investors to think carefully about the world that we now find ourselves in. Technology has become a huge part of all of our lives, and it is hard to see a future in which this is not the case.

In our view, both value and growth investment styles have a place in a portfolio, complementing each other and acting as another useful form of diversification, with each coming to the fore in different economic environments.

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December 2023

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