Q3 2023 MARKET REVIEW AND OUTLOOK

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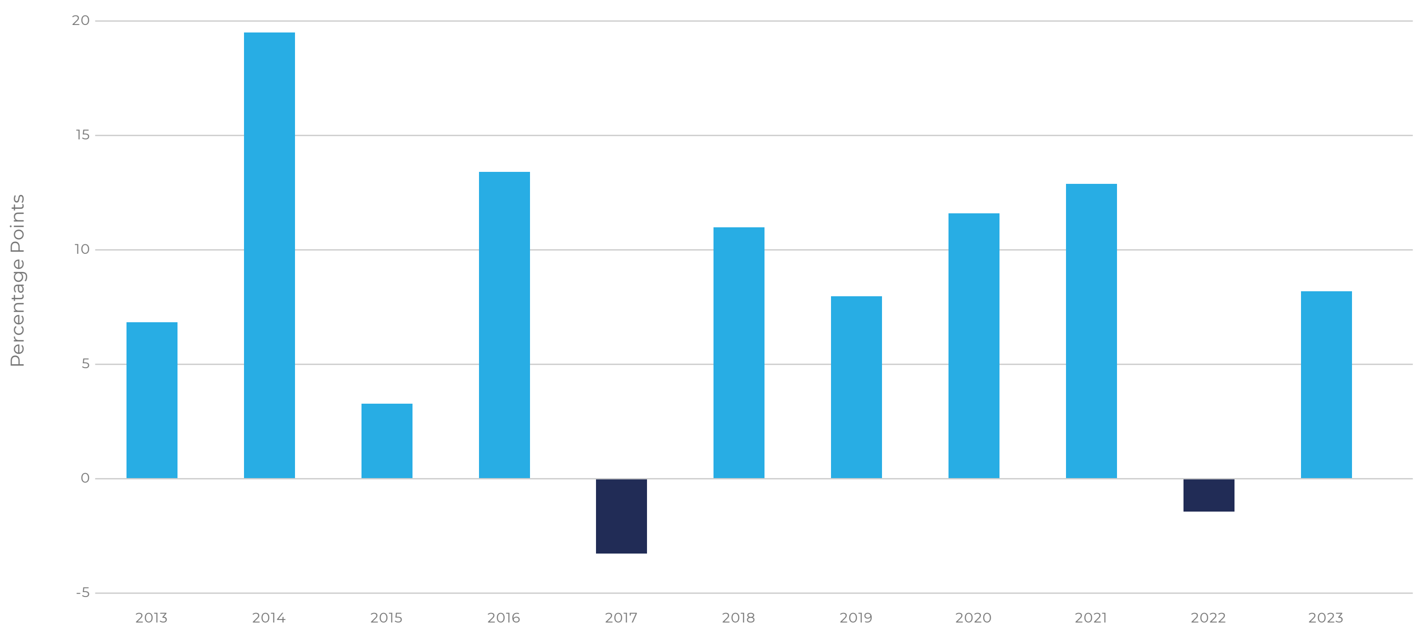
After a strong start to the year, equity markets faced some consolidation in the third quarter of 2023. The MSCI World Index (USD) finished the quarter down 3.36% but is still up 11.55% year to date. The quarter saw the return of the 'good news is bad news' mindset as positive economic data surprises spurred equity market drawdowns and spiking bond yields as investors feared a stronger economy would result in a reacceleration of inflation and higher for longer interest rates.

In the US, GDP's 2.1% growth rate exceeded virtually all start of year expectations and unemployment has stayed historically low. Hiring remains solid, albeit slowing amid signs the labour market is cooling, and US consumers boosted spending during the summer. The surprising resilience of the US economy has also attracted investors fleeing European stocks, for 25 consecutive weeks, as the S&P 500 looks set to outperform the Stoxx Europe 600 for the 8th time in the last 10 years as shown in Chart 1.

CHART 1
US STOCKS HAVE OUTPERFORMED EUROPEAN STOCKS AGAIN SO FAR THIS YEAR

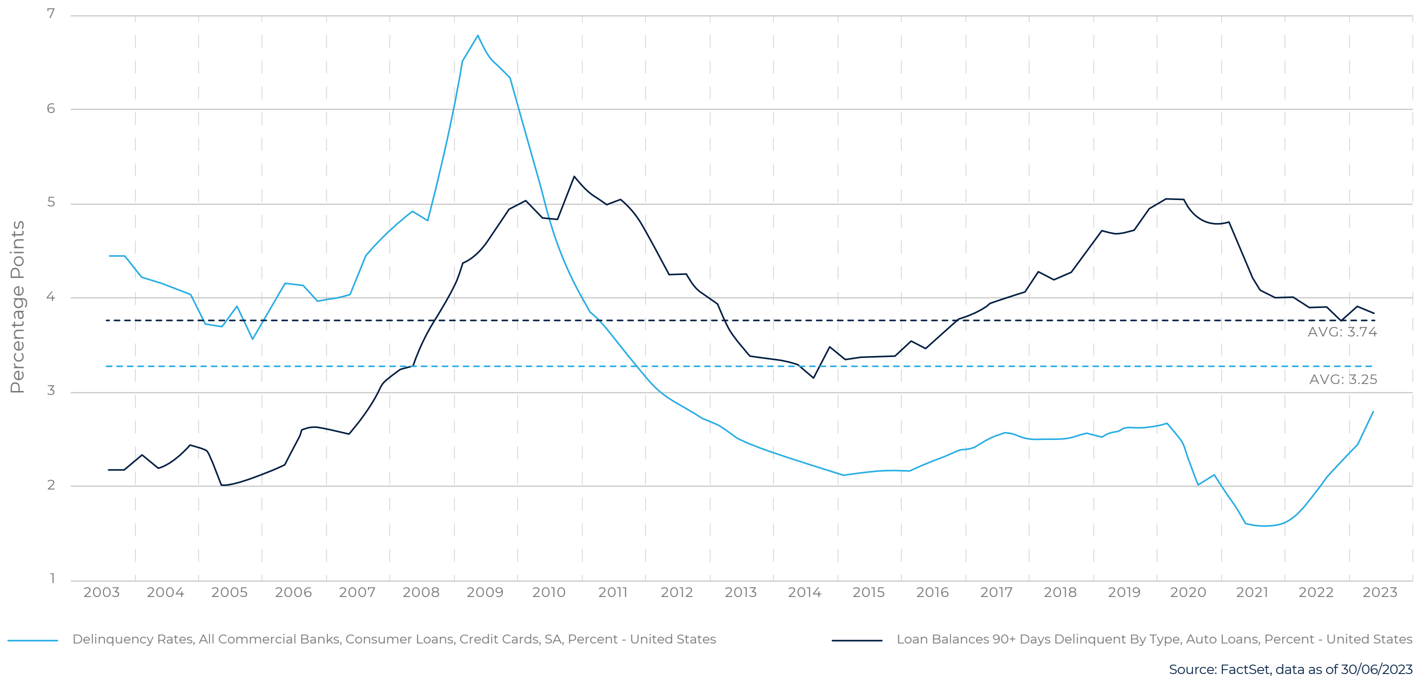


However, bullish sentiment faded over the quarter as equity markets retraced some of their year-to-date gains in August and September, signs this young bull market may be entering a new phase. With the strong initial V-shaped recovery seemingly behind us, investors may need to be prepared for potential bouts of volatility, and maybe even a correction or two, as sceptical investors fail to come to terms with this new bull market and any signs of risk quickly bringing back past negativity. A good case in point; investors were quick to bemoan a reacceleration in US Headline CPI from 3% in June to a higher than expected 3.7% in August. However, US Core CPI registered its lowest reading since September '21 (a rise of 4.3% y/y in August), solidifying the Federal Reserve's decision to keep interest rates unchanged at the September FOMC meeting.

Other widely discussed fears include question marks around the resilience of the US consumer, with outstanding credit card balances surpassing $1 trillion in August, and a potential US government shutdown in the fall. The rising consumer debt burden warrants some concern, especially with the recent pickup in delinquencies and the resumption of student loan repayments in October, however a closer look at delinquency rates in Chart 2 show they are currently still running slightly below or in line with longer term averages. As for the mounting government shutdown woes, history suggests such episodes can knock sentiment and markets initially as uncertainty flares, but they tend to have limited impact beyond that.

CHART 2

US DELINQUENCY RATES HAVE PICKED UP BUT REMAIN AT OR NEAR LONG-TERM AVERAGES



Source: FactSet, data as of 30/06/2023

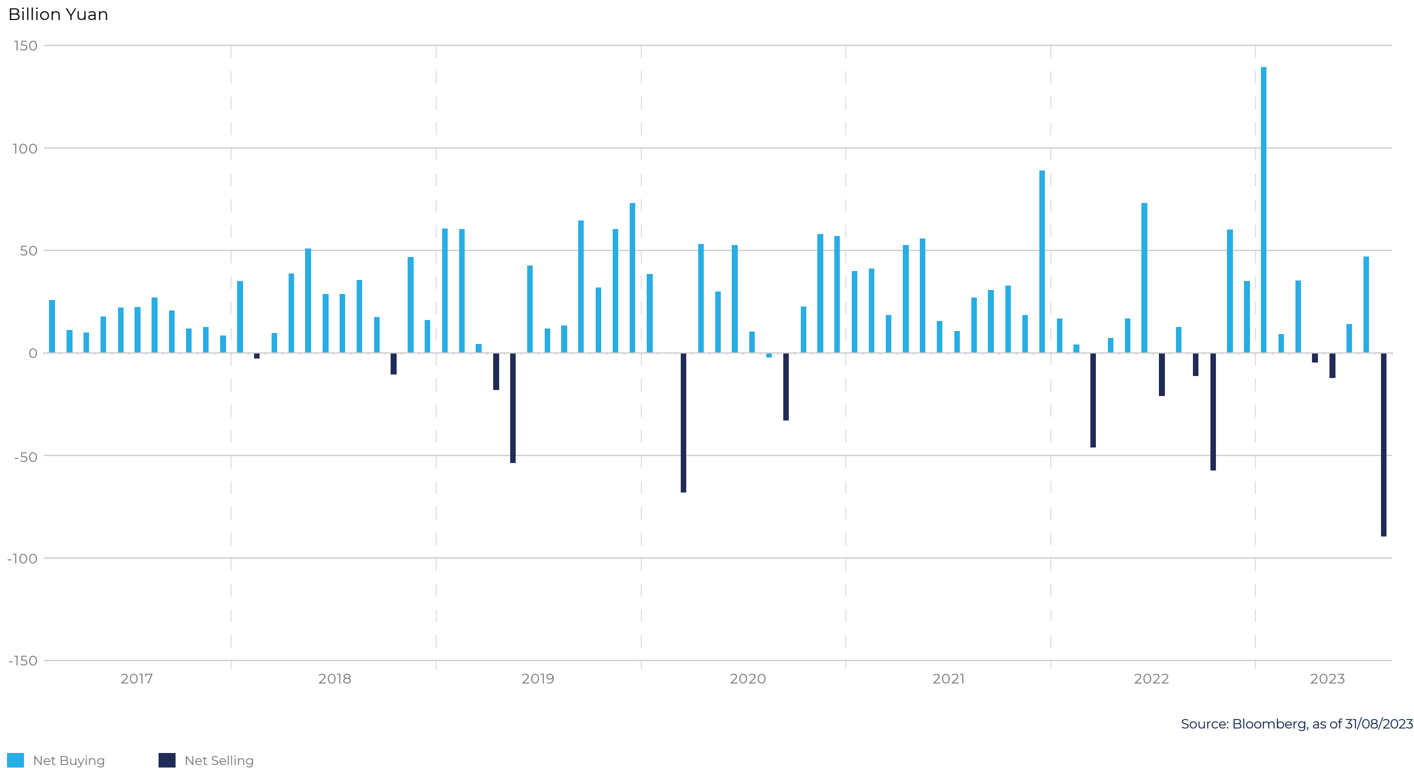
A combination of better-than-expected growth and greater uncertainty seems to have been behind the push higher in bond yields with the 10-year US Treasury yield closing the quarter at a new post Global Financial Crisis high of 4.59%. Notably, the longer end of the curve has been most affected by increased Treasury supply, Fitch's downgrade of US debt from AAA to AA+ two months after the debt ceiling suspension, and news Japan would loosen their yield curve control (YCC). While bonds may have struggled in the current market with the Bloomberg Global Aggregate Bond Index USD down 2.21% year to date, they remain a key component in client portfolios; they serve to dampen equity market volatility, and even with investment grade credit, there's still an opportunity for income. However, the potential for more meaningful capital appreciation may be contingent on global central banks concluding their rate hiking cycles and leaning towards rate cuts in the foreseeable future.

As for Europe, the ECB delivered a 10th consecutive interest rate hike at their September meeting, taking the deposit rate to a record high of 4.00%, and hinted at an end to their hiking cycle. In the UK, a better-than-expected August inflation report defied expectations for a reacceleration and allowed the Bank of England to deliver a surprise pause, choosing to keep the benchmark rate unchanged. Although inflation remains well above target, disinflationary forces are at work and Central Banks are at or nearing the end of their hiking cycles. Tighter policy is clearly starting to have ripple effects across the European economy, with manufacturing in a downturn and services activity waning, but continued support from strong labour markets and consumers could keep anything more than a mild recession at bay.

Following years of underperformance, Japanese equities staged a revival returning 22.09% year to date, as the Nikkei 225 soared to a three-decade high. The Tokyo Stock Exchange's call for corporates to enhance value through increasing dividends and share buybacks has investors excited that the long awaited structural and corporate governance reforms will finally start bearing some fruit. Pair this with a return of inflation and an economic growth rate running hot has sparked optimism decades of economic stagnation and chronic deflation are ending. However, we remain slightly less enthusiastic as much of the recent growth comes from a Covid reopening related boost which eventually normalises, and the effectiveness of structural reforms is yet to be seen.

While Japan basks in some re-found glory, China arguably faces its own threats of "Japanification". Hopes for a booming Chinese reopening have disappointed as economic data underwhelms and renewed fears of property sector defaults dragged the Hang Seng Index down -9.97% year to date. Furthermore, in August alone, foreign investors dumped a record 90bn yuan ($12.3bn) worth of mainland Chinese shares, according to data compiled by Bloomberg.

CHART 3
OVERSEAS INVESTORS SELL RECORD AMOUNT OF CHINESE STOCKS



The term "Japanification" refers to a prolonged period of economic stagnation and deflation, often following a debt crisis, as seen in Japan's "Lost Decades". China's similarities include a dramatic housing boom, with the real estate sector accounting for circa 30% of GDP in recent years, whilst aging demographics have resulted in population declines and a rapid debt buildup. However, China seems to have greater scope for urbanisation, fewer financial imbalances, like the large FX and equity market overvaluations that plagued Japan in the late '80s, and policymakers have moved more quickly on deleveraging; all signs the Chinese authorities may have learnt a lesson or two from Japan's past experiences.

Nonetheless, one must avoid extrapolating China's recent weakness to a doomed future. As the economy undergoes a process of post Covid normalisation and transitions from a manufacturing led economy to a consumption led one, a slowdown in economic growth is widely expected. But more telling for the future will be the Chinese authorities' ability to stimulate the economy through monetary and fiscal policy while successfully deleveraging the system and creating a regulatory framework that provides oversight without stifling technological and societal advancements.

One thing is clear, macroeconomic uncertainties will always exist and naturally they weigh more heavily on markets when sentiment sours. But the reality is, economic fundamentals aren't as bad as fearful headlines may suggest and the global economy continues to grow even with interest rates above 5%.

As we look ahead, the resilience and adaptability of global markets and corporates should not be underestimated. Despite bouts of volatility, equity markets should continue to climb the wall of worry higher in this young bull market as corporate earnings growth gets underway. Earnings expectations for the future are rising, which matters a lot more in the long run than mere perceptions on what a stock is worth; over the last three decades, the S&P 500 grew by 1,700%, with almost all of it from earnings and dividends, and just a fraction from changes in valuations.

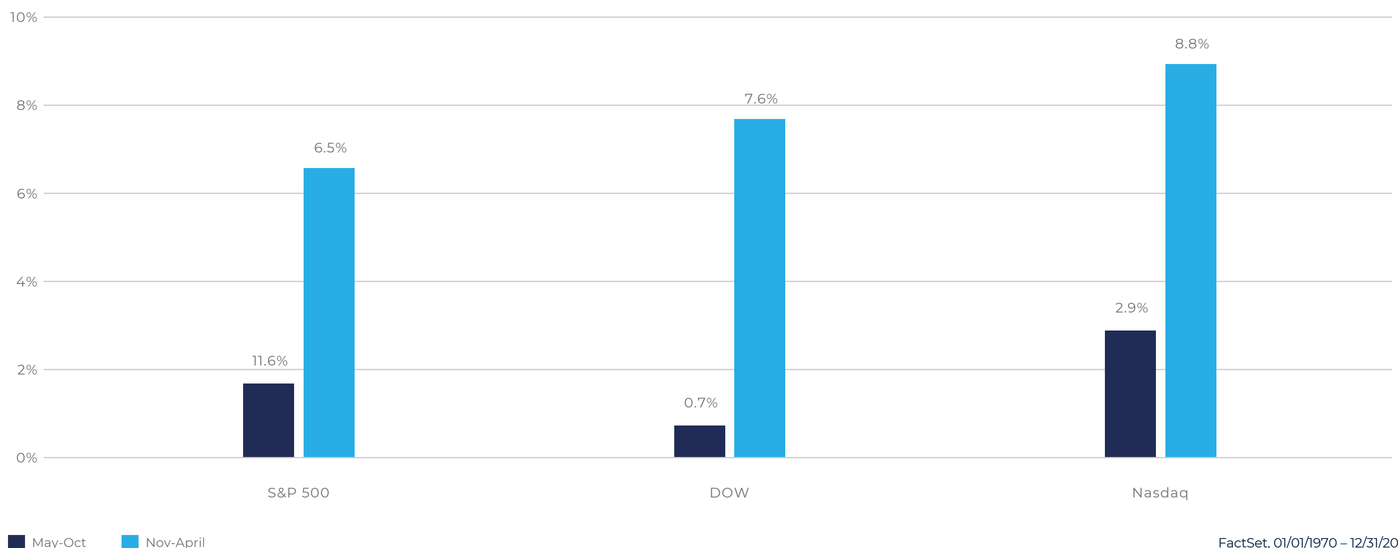
BEHAVIOURAL BIASES IN INVESTING: A DISCIPLINED APPROACH AMID MARKET VOLATILITY AND ECONOMIC UNCERTAINTY

Many investors tend to approach the stock market with the assumption of rationality; however, the reality is often quite different. Our decisions are frequently and sometimes unknowingly influenced by behavioural biases that affect our investment choices, which studies show is often to our detriment. Over the last quarter we have seen volatility resurface and investors typically become increasingly susceptible to psychological biases, that could potentially dictate investment outcomes, in more uncertain market environments.

"Sell in May and Go Away" and the "September Effect" are prime examples of myths that can induce emotional investing and perpetuate behavioural biases such as recency bias, extrapolating current trends into the future, and loss aversion (the tendency to prefer avoiding losses rather than obtaining equivalent gains). While these sayings have some empirical standing, see Chart 4, on average the S&P 500 has lost 1.1% in September, its worst month, dating back to 1928, they are not rules one should abide by. They may offer seemingly protective strategies, but adherence to them is counterproductive and often undermines carefully crafted investment strategies as investors miss the compounding growth benefits of long-term investing.

CHART 4
"SELL IN MAY AND GO AWAY"

Historically one would have still missed out on a positive contribution to returns



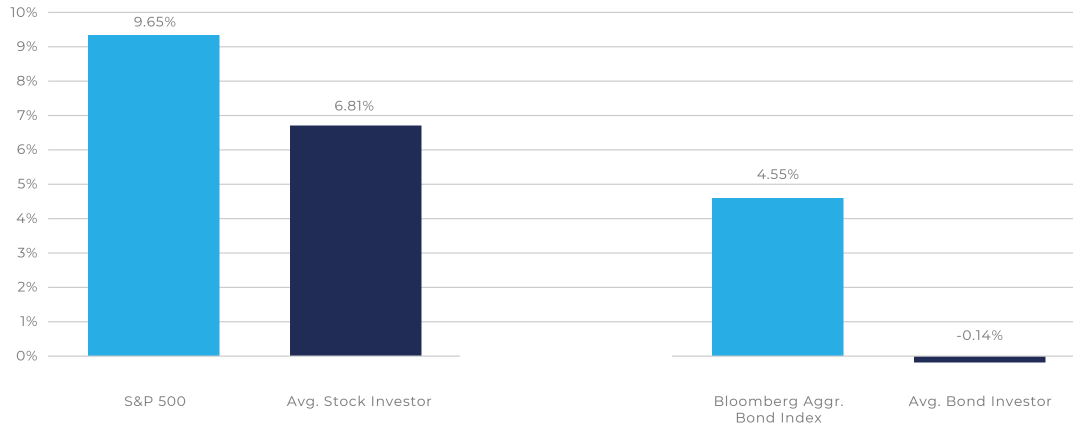
Other common behavioural biases include "overconfidence", which can lead to excessive trading, higher levels of risk taking, and neglect of potential warning signs. Studies show that overconfident investors tend to trade more frequently, but often achieve lower returns than their less-confident peers. Another trait of overconfident investors is confirmation bias, the tendency to seek out and prioritise information that confirms one's existing beliefs while ignoring contradictory evidence. This can lead to overconcentration in investments one believes will perform well while overlooking signs or data that suggest otherwise.

While investors cannot control global trends or the monetary policies of central banks, they can manage their reactions to them. The key lies in self-awareness and discipline. By recognising and controlling behavioural biases, investors can protect their portfolios against impulsive decisions that often result in long-term setbacks.

Dalbar's QAIB reports have become a cornerstone for understanding the impact of investor behaviour on performance. For almost four decades, these reports have consistently shown that investors often impair their long-term returns by giving in to short-term strategies such as market timing, herd mentality and chasing heat, illustrated in Chart 5.

CHART 5
THE AVERAGE US STOCK AND BOND INVESTOR HAS SIGNIFICANTLY UNDERPERFORMED THE MARKET

Annualised Return (%)

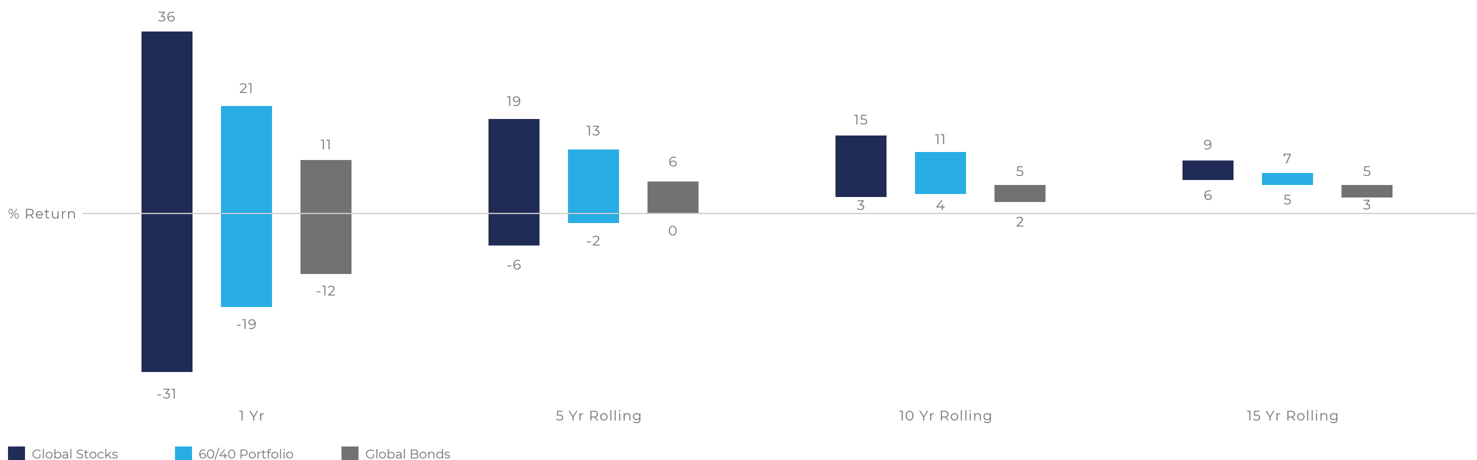


Source: Dalbar, 12/31/1992 – 12/31/22

Volatility is an intrinsic part of investing but history attests to the fact markets trend upward over the long term. Moreover, Chart 6 shows that for the best and worst 10 and 15-year rolling periods from 2003 to the end of 2022, there wasn't a single negative period for global stocks, bonds or a 60/40 portfolio. As such, the key to minimising anxiety and maximizing returns lies in knowing that a well-diversified portfolio, aligned with your risk tolerance and long-term goals, provides the optimum strategy for riding out market volatility. Ultimately, recognising our behavioural biases, maintaining a well-diversified portfolio, and staying invested for the long term offers the most promising path to financial success.

CHART 6
LONGER INVESTMENT PERIODS MEANS SMOOTHER RETURNS

Best & worst rolling returns from January 2003 to December 2022



Global stocks: MSCI World Index; Global bonds: Bloomberg Global Aggregate Bond Index, C$ hedged; 60/40 Portfolio: 60% global stocks (MSCI World Index), 40% global bonds (Bloomberg Global Aggregate Bond Index, C$ hedged).

Source: FactSet, 01/01/2003 – 31/12/2022

Thank you for taking time to read our Market Review.

Sigma Investment Committee

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