Three big surprises and three big questions

Trevor Greetham
Head of Multi Asset

When thinking about the outlook for financial markets over the coming year it pays to start with a little humility. This time last year, economists had pencilled in recessions for 2023 on the back of swingeing rate hikes and extremely high energy prices. And yet, as is so often the case, things didn't turn out the way they were meant to.

A resilient world economy...

The first big surprise for 2023 was that the world economy was much more resilient to higher interest rates than anyone expected. The previous year had seen the most dramatic tightening in monetary policy in generations after inflation turned out not to be as 'transitory' as central banks had hoped. And yet the US economy trundled on as if nothing special was happening with growth more or less in line with its long run average. US home buyers are on 30-year fixed rate mortgages so, as long as they don't move house and refinance their loan, their payments don't increase. Most corporates are also benefitting from fixed rate borrowing. The Federal Reserve's underpinning of ultra-low rates in 2020/1 gave indebted companies something of a Get out of Jail Free card, allowing them to term out their debt at lower rates. Elsewhere in the world, a sharp decline in energy prices kept Europe and the UK bumping along the zero growth line and China's economy continued to expand, if not in spectacular fashion.

> "Inflation turned out not to be as 'transitory' as central banks had hoped."

It's often said that central banks keep raising rates until something in the financial system breaks. So far signs of stress are not obvious. Silicon Valley Bank's problems early in 2023 were linked to losses on their holdings of government bonds rather than their loan book.

… with rising real yields…

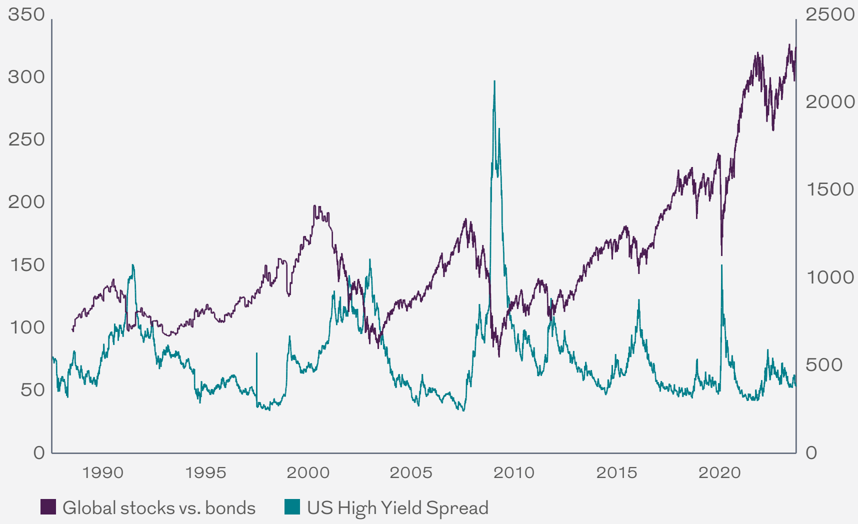
The second big surprise of 2023 has been the fact that government bond yields have continued to move higher despite a more-than-halving in the rate of inflation in major economies. Investors in US treasury bonds have suffered the largest peak-to-trough losses on record, with holders of 20-year bonds losing half of their money. Inflation expectations remained fairly steady at around 2.5% over this period, so the bulk of the move was in real yields, reflecting a belief in higher interest rates over the long run. Yields on 10-year US inflation-linked treasuries rose from -1.0% in late 2021 to more than 2.0% in 2023, a massive turnaround.

… and rich stock market valuations

This itself presents a puzzle and the third big surprise of the year. US real interest rates are the risk-free rate all other asset classes are priced off, and yet we haven't seen a blanket collapse in valuations. Property markets have seen yields rise, it is true, but stock market multiples remain rich. In our view, a major de-rating of stocks is most likely during a recession when earnings are also collapsing but earnings, like the world economy, have held up: in levels terms, S&P 500 earnings per share are 60% higher than in 2020. Much excitement for the future surrounds the prospects for artificial intelligence, with the tech sector outperforming once again in 2023 despite the additional rise in bond yields.

In sum, the world didn't plunge into recession and bond yields continued to rise. In financial markets, global stock performance remains at its cycle highs when compared to government bonds and credit spreads are tight (Figure 1).

Figure 1: Stocks versus bonds at cycle highs, credit spreads tight



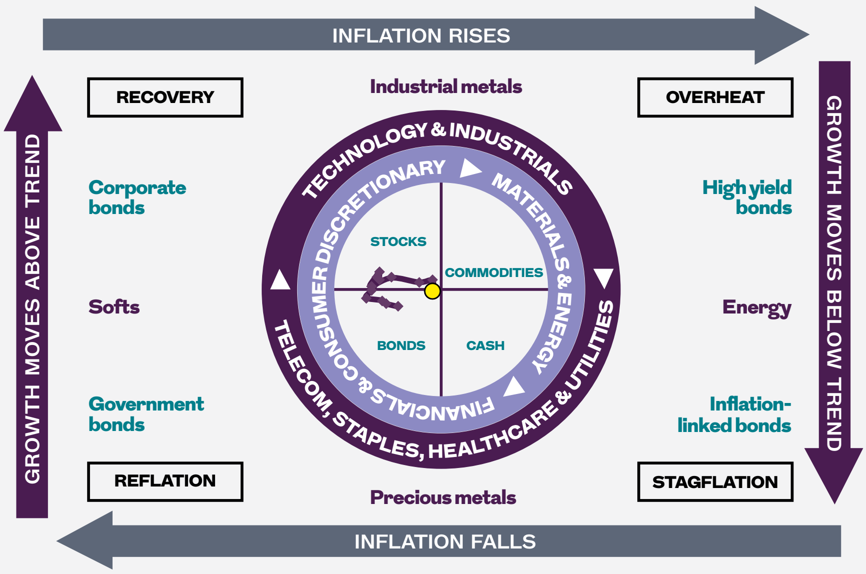
Past performance is not a reliable indicator of future results

We have three big questions for 2024 and beyond.

1) Where is the business cycle headed?

The first is where is the business cycle going? Is there even a global cycle anymore? We use an Investment Clock to relate the current stage of the cycle to asset allocation, telling the time using indicators for growth and inflation. As 2023 comes to an end our indicators are mixed, with the reading on our diagram close to the crosshairs (Figure 2). Global growth is holding up quite well, but business confidence has been declining. The surge in inflation has mostly reversed, but further progress depends on commodity price trends and the evolution of labour market slack.

Figure 2: Investment Clock in the crosshairs



Our base case sees economies continuing to weaken as consumers and businesses gradually refinance their debt at higher rates. Rising unemployment eventually bears down on wage inflation and bond yields drop. Stock and credit markets soften in the face of earnings downgrades and corporate defaults. This is a move into Investment Clock Reflation, with central banks beginning to cut interest rates. It sounds convincing enough, but we'd have said the same a year ago, before developments led us to take a more positive short-term view.

> "Our base case sees economies continuing to weaken."

So where are the risks to this base case? We might move back into equity-friendly recovery if the US can deliver a soft landing. With inflation coming back under control, it's plausible the Fed cuts rates before the full pain has been felt, turning what today looks like a looming wall of refinancing into a garden hedge the economy can simply step over. We suspect the same trick won't work as easily in the UK and Europe with wage inflation sticky and earnings prospects less rosy. If a US soft landing means the dollar stays strong, we could see another year of strong equity market performance in Japan though, with exporters benefiting from a weaker yen.

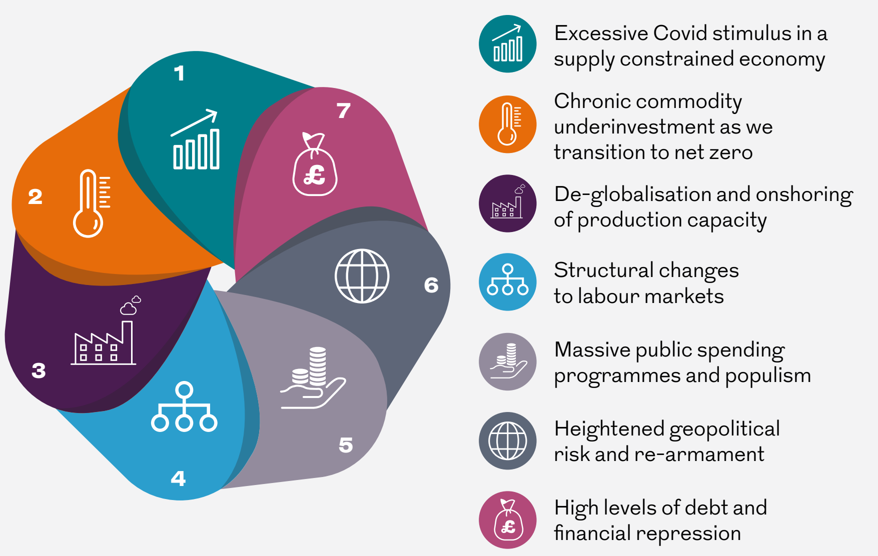
Downside scenarios come back to inflation and the lagged impact of interest rate rises. If core inflation stays high, or a deteriorating geopolitical situation leads to another surge in commodity prices, central banks could end up hiking rates still further, drawing obvious parallels with the stock and bond weakness of 2022. The sort of interest rates hikes we have seen over the last two years have almost always ended in recession after what monetarist economist Milton Friedman first called "long and variable lags".

2) Will inflation spike again?

Our second big question is longer term. Was the inflation surge of 2021-2 a one-off, related to excessive Covid stimulus left too long in a supply constrained world economy or is it a taste of things to come? In our view, we think it's likely that we have entered a new era of what we are calling 'Spikeflation'. This is a regime characterised by periodic upward shifts in prices on the back of structural drivers including the transition to net zero – which means reduced investment in fossil fuels, offset by a surge in the demand for metals that support renewable energy infrastructure – heightened geopolitical risk, demographics and deglobalisation (Figure 3) all against the backdrop of high debt levels which create the temptation to debase the value of money.

> "We think it's likely that we have entered a new era of what we are calling 'Spikeflation'."

Figure 3: Structural drivers of Spikeflation



Source: RLAM, for illustrative purposes

A period of spiky inflation would be very consistent with the historical record. Inflationary eras around the two World Wars and in the 1970s did not see high, stable inflation. They saw a series of individual price level shocks which in aggregate resulted in a twofold to more than fourfold rise in the cost of living. The measured annual rate of inflation over these periods fluctuated wildly, from close to zero to more than 20% (Figure 1).

Figure 1: Periods of high inflation since 1900

Inflation shock	Dates		Price level increase	Year-on-year RPI		
	Start	End		Low	Average	High
World War I	Jan 1915	July 1921	2.6x	0.0%	14.9%	25.4%
World War II	Oct 1939	Jan 1952	2.3x	0.0%	6.6%	20.2%
1970s	July 1967	Apr 1980	4.2x	1.4%	11.2%	26.9%
Post Covid*	Apr 2020	?	1.3x	0.5%	7.1%	14.2%

Source: ONS Retail Prices Index, long run series; * post Covid period to date as of October 2023

3) What does this mean for multi asset investing?

Our third and final question relates to investment strategy. What sort of approach does a highly uncertain economic outlook with the risk of further inflation shocks argue for? For us it means being as flexible as possible.

We believe investors should consider diversifying broadly, moving beyond stocks and bonds to include inflation-hedging assets like commodities or commercial property in their portfolios. They should also consider adopting a more active tactical approach to asset allocation suited to a period with more frequent recessions, as central banks repeatedly step in to bring inflation back under control. And they should look for strategies that can help them to manage downside risk.

The low inflation world from the 1980s onwards saw extremely long business cycles. We may be back to the five-year average that prevailed historically. More frequent recessions mean more frequent bear markets in equities. This matters especially to those drawing their retirement income from an investment portfolio. People are living longer but market cycles are getting shorter.

Sequencing risk is a growing issue for advisers to consider as more people use income drawdown - with market drawdowns potentially hurting future income potential. This was a factor in 2023, with many people forced to take large withdrawals after suffering large investment losses. With higher interest rates making annuities more attractive, decumulation investors will have to up their game.

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Changes in currency exchange rates may affect the value of these investments.

Important information

For professional clients/qualified investors only, not suitable for retail investors. This is a marketing communication.

This is a financial promotion and is not investment advice. Telephone calls may be recorded. For further information please see our Privacy policy at www.rlam.com

The views expressed are those of the authors at the date of publication unless otherwise indicated, which are subject to change, and is not investment advice.

The services being offered hereby are being offered on a private basis to investors who are institutional investors. This document is not subject to and has not received approval from either the Bermuda Monetary Authority or the Registrar of Companies in Bermuda and no statement to the contrary, explicit or implicit, is authorized to be made in this regard. The services being offered may be offered or sold in Bermuda only in compliance with the provisions of the Investment Business Act 2003 of Bermuda. Additionally, non-Bermudian persons may not carry on or engage in any trade or business in Bermuda unless such persons are authorized to do so under applicable Bermuda legislation. Engaging in the activity of offering or marketing the services being offered in Bermuda to persons in Bermuda may be deemed to be carrying on business in Bermuda.

This document is private and confidential and only for use by "permitted clients" in Canada. This document is for information purposes only and is not intended as an offer or solicitation to invest. This document does not constitute investment advice and should not be relied upon as such. Royal London Asset Management Limited is authorized to provide investment services in Canada under the International Adviser Exemption.

Royal London Asset Management's principal place for business is in the United Kingdom, and it is not registered as a manager in the provinces of Alberta, British Columbia, Ontario, and Québec.

Issued in December 2023 within Europe (ex-Switzerland) by FundRock Distribution S.A. ("FRD") the EU distributor for Royal London Asset Management Limited. FRD is a public limited company, incorporated under the laws of the Grand Duchy of Luxembourg, registered office at 9A, rue Gabriel Lippmann, L-5365 Munsbach, Luxembourg, and registered with the Luxembourg trade and companies register under number B253257. Page 23, FRD is authorized as distributor of shares/units of UCIs without making or accepting payments (within the meaning of Article 24-7 of the 1993 Law), as updated from time to time. FRD is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Portfolio management activities and services are undertaken by Royal London Asset Management Limited, 80 Fenchurch Street, London, EC3M 4BY, UK. Authorised and regulated by the Financial Conduct Authority in the UK, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Ref: BR RLAM PD 0161

Contact us

For more information about our range of products and services, please contact us. Royal London Asset Management has partnered with FundRock Distribution S.A, who will distribute its products and services in the EEA. This follows the United Kingdom's withdrawal from the European Union and ending of the subsequent transition period, as UK Financial Services firms, including Royal London Asset Management, can no longer passport their business into the EEA.

Royal London Asset Management
80 Fenchurch Street
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

For any queries or questions coming from EEA potential investors, please contact:

Arnaud Gérard
FundRock Distribution S.A.
9A rue Gabriel Lippman
Luxembourg-L-5365, Munsbach
+352 691 992088
arnuad.gerarda@fundrock.com

www.rlam.com

We are happy to provide this document in Braille, large print and audio.