Market Commentary

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Investment Managers

Richard Whitehead
richard.whitehead@dartcapital.com

Chris Bellchambers
chris.bellchambers@dartcapital.com

Andrew Savage
andrew.savage@dartcapital.com

Anna Whittle
anna.whittle@dartcapital.com

Research Team

Alexander George
alexander.george@dartcapital.com

Joe Healey
joe.healey@dartcapital.com

Daniel Patterson
daniel.patterson@dartcapital.com

Dart Capital
61 Queen Street, London EC4R 1EB
Tel: 020 7283 1117
Fax: 020 7283 0891

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Equity markets were challenging over October, with the sharp rise in US bond yields driving valuations down across most asset classes. However, early market moves so far in November have been far more positive, aided by less aggressive narrative from the US Federal Reserve and lower than anticipated projections for US government borrowing, with the strength of the rally bolstered by the fact that investors and traders alike have de-risked over recent months.

We have been leaning into share price weakness in high quality cyclicals and small & mid-cap companies, where generally positive company updates and strong balance sheets contrasts sharply with very weak market sentiment. In contrast, we trimmed back exposure to US technology and physical gold, which have again benefitted from investor inflows, which has pushed up valuations at a time when many other areas are looking increasingly cheap.

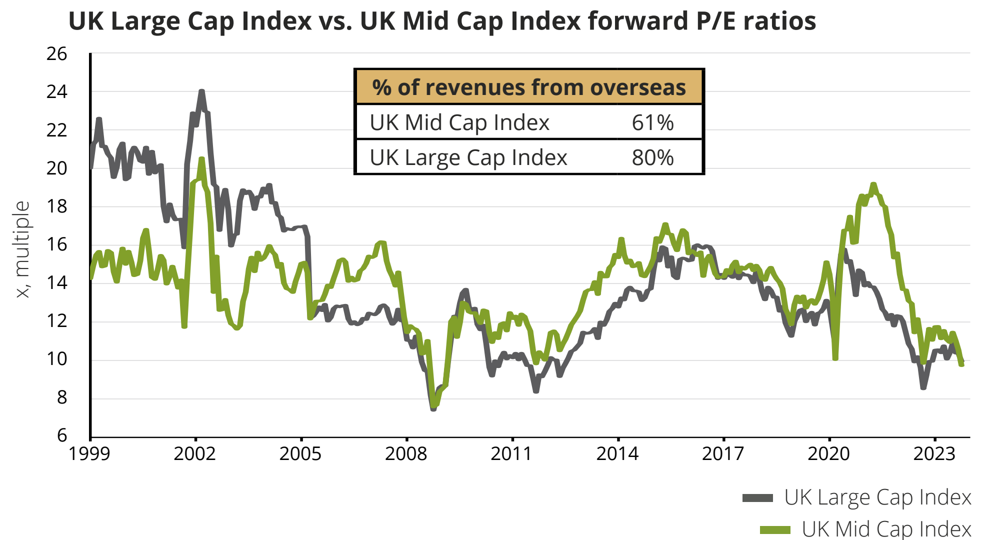
The opportunity in equities

Moves in equity markets are often indiscriminate, and this has certainly been the case over recent months, with the valuation of many stocks declining markedly regardless of their balance sheet strength, profitability, or future growth prospects.

Given that the interest rate on cash and short-dated government bonds has increased significantly over the last year, the return potential of equities has rightfully come under greater scrutiny. Importantly, the valuation on almost all areas of equity markets has declined significantly over the last two years, as valuations have re-calibrated to the higher interest rate environment. This de-rating has been most extreme in those areas deemed to be interest rate sensitive or cyclical.

One measure we use to assess the valuation of our underlying stocks is the forward price/earnings measure, which shows the amount paid for £1 of next year's forecasted profit. For instance, the forward P/E on the UK mid-cap index is c.10x[1], the lower bound of its historical range, where investors are paying c.£10 for every £1 of profit that the underlying companies are forecasted by analysts to generate over the next year. As shown below, two years ago this was around £19, indicative of the marked de-rating that this area of the market has experienced over the intervening period. Lower starting valuations inevitably boost future expected returns, particularly when the balance sheets of the underlying companies are in good shape, as we believe they are currently.

Equity valuation multiples have declined sharply, boosting projected returns



Source: JP Morgan Asset Management. Data as at 31 October 2023.

US

US inflation remained flat in the 12 months to the end of September from the month prior, with the Consumer Price Index persisting at 3.7%, with an increase in energy costs continuing to contribute meaningfully[2]. The labour market remained relatively buoyant, with non-farm payrolls and JOLTS job openings well ahead of economist expectations, although the unemployment rate remained flat at 3.8%[2] in September due to the increase in labour market participation.

US Treasury yields continued to rise over the month, with the yield on the 10-year Treasury ending the month 30 bps higher at 4.87%[3], driven in part by resilient economic data, itself aided by continued government fiscal expansion, and the ramp-up in debt issuance by the US Treasury at a time when the Federal Reserve have reduced their government bond purchases. Notably for markets, the move higher in yields was driven by a rise in the real (inflation-adjusted) yield component, i.e. inflation expectations were broadly unchanged, which has a greater tightening impact on global financial conditions.

We trimmed exposure to US technology stocks mid-month, taking some profit from a successful addition to portfolios last year. We note that this is an area in which many investors and traders have crowded back into this year, amidst concern over the mixed outlook for the global economy. This has pushed valuations back up to levels which, in our view, don't reflect the level of interest rates, or the myriad of opportunities available elsewhere in equity markets. The S&P 500 ended the month down 2.2% in US Dollar terms.[4]

UK

Survey figures from the services sector indicated that it has slowed sharply over the last six months, with management sentiment impacted by rising interest rates and slowing consumer spending. The labour market has also become more mixed, with strong wage growth – which in part reflects the high level of headline inflation of the last two years – set against jobless claims which have edged higher and the unemployment rate rising to 4.2%[5]. Inflation was unchanged at 6.7% in the 12 months to September[5]. Against this backdrop, the Bank of England held the base rate at 5.25% in their meeting at the start of November. UK stocks performed broadly in line with other markets, with MSCI UK All-Cap declining 4.1% in capital return terms.[4]

Europe

The European Central Bank held their main base rate at 4.5% in their meeting late in the month, citing weaker global growth and its knock-on impact on the currency bloc, which has already seen a sharp deceleration in growth over recent months, led by the manufacturing sector which has seen weaker than expected demand from Asia. European stocks fell in line with other markets, with MSCI Europe ex-UK ending down 3.4% in local currency terms.[4]

Asia

The Bank of Japan's decision to further loosen their yield curve control policy and consider allowing the 10-year yield rise above 1% perhaps wasn't a surprise to most, given how out of step the policy is with that of other major Central Banks which have long-ended their bond buying programmes. From here, we note that the Yen is exceptionally cheap, and the direction of travel on monetary policy is more supportive for a rally over coming months. MSCI Japan fell 3.1% in Yen terms.[4]

China's stock market has continued to flatter to deceive, despite positive signs that consumer spending is starting to return. MSCI China H ended the month down 4.6% in local currency terms.[4]

Commodities

The events in Israel briefly pushed the oil price up mid-month, before falling back by month-end, with the price (as represented by Brent Crude) ending the month 8% lower at $87 per barrel.[3]

We trimmed exposure to physical gold over the month, on the back of the rally which drove the gold price to just under $2000 per oz[3], and a year-to-date gain of c.8% in sterling terms. Whilst we believe in the long-term investment case for gold, most notably its role as a store of value in an environment where the major western governments are highly indebted and likely to continue to resort to monetary devaluation and we retain the Jupiter Gold & Silver fund as our primary play on this long-term theme. However, we were concerned that the short-term rally was largely due to the conflict in the Middle East, which caused traders to close out short positions in the, traditionally safe haven, monetary metal. Furthermore, the rally had come at a time when the real (inflation-adjusted) yield on inflation-linked government bonds – which for many western investors are a viable alternative to gold exposure - had moved even higher, with the real yield on the 10-year US inflation-protected Treasury reaching 2.5%.[3]

1 JP Morgan Asset Management
2 US Bureau of Labor Statistics
3 LSEG Datastream
4 FE fundinfo 2023
5 Office of National Statistics (ONS)

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