ESTATE CAPITAL INVESTMENT PORTFOLIOS

OUTLOOK

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UK interest rates are expected to start to fall from May.

The worst of China's property crisis is over.

ESTATE CAPITAL

The world is starting to make its first ever exit from Quantitative Easing.

The world has moved quite decisively from low inflation and declining interest rates to quite the opposite. This transition has brought greater economic volatility with the risk premium of holding equity assets haven risen. We are now potentially coming to the end period of high inflation and interest rates look as if they may have peaked. With this comes some investor optimism, that we have endured the pain and better times are ahead.

We must still be cautious because as the world economy slows, it will flirt with recession and endure the lag impact of high interest rates.

2024 will be a year influenced by elections both here in the UK and in the US. In the run up to these elections, there will be a political desire to maintain high budget deficits. Markets will start to price in this spending. The cost of capital as measured by gilt yields will be a theme of the year ahead.

Much of what has surprised central banks and financial markets through 2022 and 2023 comes from the lack of experience and past knowledge over the impact a pandemic would have upon the global economy. As we enter 2024, we should start to gain clarity over what a post pandemic world will look like and what the optimal rate of interest should be for this new environment.

Markets, analysts, and policy makers have been wrong about recession recently as the global economy has been quite resilient despite the circumstances. We now have forecasts of a 'soft landing' as far as the economy is concerned, where the recent rate hikes and tightening of fiscal policy has done enough to gradually return the economy and labour markets to close to a normal standing.

There are still areas of the economy that are of concern and that could have a greater negative

impact. One is the levels of free savings that have been drained and with-it consumer spending, raising unemployment, and that the cost of re-financing is now far higher. If there are signs of recession then central banks may seek to cut rates earlier to support the economy. These are the factors that emanate from the lag between rate rise and its effect on the real economy.

There are signs of recession in Europe and for this reason it is expected that the ECB may be first to cut rates in 2024. This is then likely to be followed by the Fed.

Markets are becoming more optimistic about a soft landing. The decision to keep rates high to reduce inflation seems to have worked. Once the Fed and other central banks are comfortable that the fight is won, they will respond by loosening policy and ease the costs to households and business.

Policy makers will continue to test the financial system as the world makes its first ever exit from Quantitative Easing. There is much about this process that we do not know as it has not been done before. The selling back into the market of US$ trillions of maturing or pre mature gilts and bonds by central banks will remove cash from the global economy and that impact and process is both unknown and undone.

Inflation is expected to progress towards 2% in both Europe and USA.

The governments of the developed world are being held back by the crushing responsibility of repaying huge debt piles at elevated interest rates. This debt has been accelerated in the past 15 years through the buying out of banks in the financial crisis of 2008/9 and the recovery cost of the Covid pandemic in 2020/21. The impact of this heavy investment is now returning as inflation.

The Institute of International Finance (IIF) has calculated that total world debt including government, corporate and household, stands at US$307tn.

Global growth is slowing, countries are less able to rely on growing their economy to reduce real debt levels. Countries are facing reduced GDP growth rates meaning that the world will see lower rates of expansion and less resilience to future shocks.

Countries are getting used to a growth model that is based upon borrowing to stimulate. Over the longer term this will have negative consequences if growth is not then forthcoming. Higher interest rates have sent the cost of servicing debt to a new high, with counties now borrowing to plug the gap between revenue and public spending.

Within the G20, Russia and Saudi Arabia have the lowest government debt to GDP at 17.2% and 30% respectively. Singapore has 168% debt to GDP while Japan is the highest at 264%. Those over 100% debt to GDP include Canada at 107%, France at 112%, Italy at 145%, Spain at 113%, UK at 101% and USA at 129%.

These rates of indebtedness are concerning bankers and economists alike. JP Morgan's Chief Executive Jamie Dimon has noted that 'the financial situation and fiscal spending is more than it ever has been in peace time with the highest government debt levels we have ever had.' Mr Dimon felt the situation can be managed but is concerned.

Allianz Chief Economist Mohammed El Erian feels that 'some countries are well placed to handle the heavier debt loads, especially if they have medium term growth potential, strong economies,

and respected currencies.' It is the debt burdened developing countries that will suffer most. In some African countries over 50% of total tax revenue is spent on interest payments. Some countries have defaulted on debt. In 2022, more sovereign debt defaults occurred than in the past 40 years.

A factor that influences sovereign defaults is that US$ denominated debt remains an issue for countries with weaker currencies as the combination of rising interest rates and the value of the US$ has an impact.

HSBC Chief Executive Noel Quinn, also joined the voices of the IIF, World Bank and IMF when he warned that 'the global economy is growing very slowly, too slowly to cope with the rate by which government debt is rising.' Global GDP is expected to hit 3% this year but many countries have inflation and interest rates above this figure.

Borrowing comes at a price and for advanced economies the price is weaker growth and less money for public services as tax payers service debt repayments.

We started the 2020's with a Covid inspired recession which we have recovered from, at the expense of massive borrowing. The Treasury issued gilts that the Bank of England bought. Both the UK and Europe are facing challenges from demographics, productivity, and sustainability.

The US economy has done a remarkable thing. It has grown GDP by 4.6% and reduced inflation to 3.2%. Despite the scares over the collapse of Silicon Valley Bank, Signature Bank and First Republic Bank earlier this year, US banks now look to be in a more resilient position. The fact that the Federal Reserve held US interest rates at 5.5% in the November FOMC meeting has helped.

A major concern in world markets has been the state of the Chinese residential property market. This sector is so significant to the country and its people. Many large companies have been on the brink of bankruptcy this year including the two largest, Country Garden and Evergrande. The property market bubble in China is a major issue as almost three quarters of Chinese households have 70% of their overall wealth tied up in property. Fears of a Chinese property collapse have unnerved investors across the world. Policies have helped stem the concerns over a major Chinese property market collapse but analysts feel the worst of the crisis as now over. China has -0.2% inflation in its economy

and interest rates of 3.45% so there is plenty of room for interest rate cuts to stimulate the property market.

The other great investment bubble that is of concern is the heavily indebted countries of Europe. Italy is trying under new Prime Minister Giorgia Meloni to spend its way to growth with debt to GDP rising from 120% to 145%. Italian government 10-year bonds are now trading at 4.23% having peaked at 5% in mid-October. This is relevant, as Italy will need to refinance 24% of its GDP as bonds mature this year. If the ECB is called in to buy these new bonds a new buy out crisis could develop.

The UK is also not in a great position. In 2020, the Office for Budget Responsibility (OBR) forecasted that the UK debt interest spending was expected to be £23.5bn in 2023/24. Last March the OBR predicted a rise to £94bn. Britain is now likely to spend £110bn or 10.4% of GDP on debt interest in 2023. This has increased significantly due to the level of index linked gilts in circulation and the rate of inflation this year. This sum is greater than we spend each year on Education. Debt repayment now stands second only to the Health Service budget as a cost to the country. UK policy makers must focus on growth if they are to escape the burden of debt.

The UK is an oil importer and now has limited gas storage facilities. Britain is therefore exposed to a costly cold winter and spikes in oil and gas prices.

All markets have been nervous this year with geopolitical conflict, high inflation, and high interest rates, slowing growth and consumer confidence falling. Despite these challenges the global economy is proving to be far more resilient than many expected. This is particularly true in the USA, where high interest rates have not affected many consumers and corporations yet. Most US homeowners hold 25-year fixed mortgages so interest rate rises have not had the impact one may have expected. However, excess savings built up during lock down are now falling and student loan repayments are restarting so we could see a fall in disposable income.

The longer-term themes of low carbon energy, infrastructure and technology innovation including AI are attractive sectors and will be the drivers of growth in the decades ahead. The traditional sectors that have been hurt by high interest rates such as property, fixed interest and growth stocks are now looking more attractive as global interest rates look to have hit their peak.

We are now witnessing declining inflation in the US, Europe, and the UK, but inflation is still high compared to central banks 2% target. Rising bond yields have been doing some of the tightening work for the central banks. It is increasingly likely that yields will fall as interest rate cuts are expected next year. The consensus amongst economists is that inflation will make continuous and uninterrupted progress towards the 2% target in both Europe and USA.

The earliest date for a Fed rate cut is May and will prompt a change in asset returns.

GDP growth in the US continued to surprise on the upside while inflation maintained its steady decline. The resilience of consumers in both the US and UK has meant that the ECB, Fed, and BoE have been cautious about their rate outlook and reinforced the stance of 'higher for longer.' This outlook supressed markets in September and October but the holding of rates in early November has prompted a feeling we may have hit peak rates.

The pausing of interest rate rises by these three main central banks in the same week was a great boost to economic optimism, that rates are now at their likely highest level. Stock markets took comfort from this and rallied through most of November. Despite the optimism from stock markets, the real economy is not likely to start a recovery phase for another 12 months.

The global economy is decelerating and for this reason within the next six months the major central banks are expected to start cutting interest rates. The most influential forecast is that the Federal Reserve policy rates will be lower within the next 12 months. This is the same outlook for interest rates in Europe and the UK. Yield curves will steepen as short-term rates start to fall.

With this outlook it is right to maintain and even overweight the bond allocations in our portfolios. We have therefore focused upon UK and US government bonds and investment grade credit. In any rate cutting environment as bond yields fall prices will rise.

All our portfolios have been holding a significant allocation to cash as this has been the most reliable diversifier in 2023. We have however removed our exposure to natural resources as the global demand slows and to property due to high interest rates and falling office occupancy. We will review these holding in the future.

We expect to maintain our overweight in the US and to international markets and have further increased our exposure to emerging markets and Japan, but eased down our holdings in Europe, UK, and Asia.

The conflicts in Ukraine and Gaza are both near to major large energy exporting regions and the price of oil and gas could have been affected. Fortunately, the conflict in Israel looks to be contained to the Gaza area and oil prices have fallen over the period of the conflict. Brent oil now stands at US$79pb down from US$88pb on 7th October, the day Hamas initially attacked Israel. The revenues from the energy sector this year have been strong and despite a fall in oil prices, due to reduced demand, we are still happy to hold the Guiness Global Energy Fund in the portfolios.

The next year will see slowing economic growth but also the start of a recovery. This journey is not likely to be smooth as geopolitical events have proved. Markets are still sensitive and over react to events and comments.

The monetary tightening cycle is now expected to come to an end in both the US and Europe but high interest rates are expected to prevail for up to six months and in that period the economy will slow. High interest rates will stall the economy but falling job numbers and prices will prompt a welcome start to interest rate cuts in 2024.

The earliest date for the Fed to start cutting interest rates will be May 2024. That will prompt a change in asset returns. Past experiences of asset return around the first rate cut from the Fed is that equities, government bonds and investment grade bonds will do well and outperform other asset classes. Generally, it is government bonds that produce the best returns within twelve months of a rate cut.

One issue that may determine the level of return to be expected after a first Fed rate cut will be the speed and depth of any rate cut. This will be determined by the economic environment at the time. If inflation is sticky and economic growth strong, we can expect smaller cuts. However, if inflation falls from 3.2% to close to the Feds 2% target, we could expect a significant reduction especially if the jobs market has declined and economy weaker.

We are expecting the economic pressure on markets to ease as inflation and wage growth fall. While consumer spending is a concern, analysts expect that the bad news is already in the price and that falling inflation and falling interest rates will start a recovery in 2024.

The next year will see slowing economic growth but also the start of a recovery.

As interest rates start to fall, government bonds will provide attractive returns.

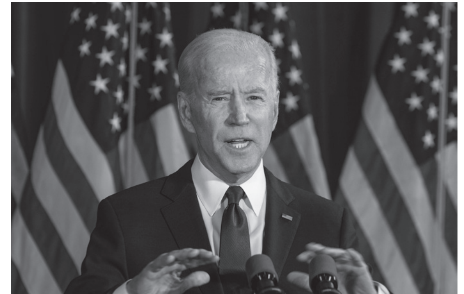
Over the past three years, we have witnessed significant volatility in bond prices as central banks flooded the global economy with cash to pay for a Covid recovery. The peak of the loose monetary policy saw US$11tn of sovereign debt trading at negative interest rates. As interest rates increased to counter the resulting inflation, yields rose and prices fell. Long dated government bonds loosing up to a quarter of their capital value.

With inflation having peaked and now falling, interest rates too are likely to have peaked. With the decline in both inflation and interest rates then the benchmark US 10-year treasury yields are likely to ease also. They peaked at a sixteen year high of 4.97% on 19th October and now stand at 4.47%. This decline in yield is a confidence measure. The fall in yields has also resulted in a rise in prices. Bonds values are now recovering the losses made when yields were higher. Many leading bond fund managers think that bond yields have risen to their peak.

High yields are the cost of borrowing. This has risen across the world with governments and corporations challenged by higher refinancing costs. Governments do not want high interest rates as borrowing costs and the servicing of debt hits public spending. The world could not handle bond yields over 5% very well. The Bank of International Settlements warn of the implications of such yields will have on margin calls for derivative contracts.

While inflation has been the focus for many months, the focus has now shifted to the slowing economy as a slowing economy with high interest rates is not ideal. PMI indicators are generally hovering around 50 points showing a weak outlook for economic activity.

The pausing of interest rates by three major central banks in the first week of November is a measure that policy makers are concerned. It feels that inflation has been restrained and it is all about keeping inflation under control while not hurting the economy.



This does seem to have happened in the US as GDP growth for Q3 was 4.9% up from 2.1% in Q2, indicating that the US has beaten inflation and grown their economy at the same time. Commentators put much of this growth down to the massive infrastructure spending and the Green Deal that pushed investment and raised the supply side of the US economy. It also pushed US government debt to 129% of GDP, an increase from 107% when Joe Biden took office.

We have been maintaining an overweight position in short dated credit including some floating rates. This is in addition to the hedged bond and target return bond funds we have held. As there is now a point of pivot in interest rates and yield, we are increasing our longer dated government bonds. There is an expectation that as interest rates start to fall then government bonds and investment grade bonds will provide attractive returns.

Markets have rallied on the signs that borrowing costs have peaked.

Despite Jerome Powell, the US Federal Reserve Chairman saying that 'price rises still need to be kept under control' the Federal Open Markets Committee held US interest rates at 5.25- 5.5% range in their November meeting.

The US economy has been growing faster than expected and the Fed has faced criticism that rising rates to what is now a 22 year high, could put the US economy at risk. Despite high interest rates the US economy grew by 4.9% in Q3. This was a significant boost, helped by a strong jobs market and improved consumer spending.

By holding rates, the Fed will pause to review the good economic data before making its next move. Mr Powell said that the Fed was very aware that rate rises were hurting households and businesses, but inflation at 3.7% stands above the Fed target of 2% and that the 'US has a long way to go in the battle to get inflation back to 2%.'

The Fed is clearly pleased that the economy has grown at the same time inflation has fallen. They do not need to retain high interest rates longer than is necessary but do want to ensure that inflation is controlled.

A useful indicator of the market perception of the strength of the US economy is the yield on long term bonds. 10-year bond yields have risen recently hitting a high of 5.0% on 19th October. These yield rises have also prompted the pause in rate rises which has in turn prompted a reduction in yields. Markets now expect rate cuts in 2024. US 10-year yields are now trading at 4.4%.

The Federal reserve followed the ECB who also kept their interest rates on hold at 4.5% on the back of inflation falling to 2.9%. There are concerns within the ECB that Eurozone growth is weak and that further interest rate rises would be counterproductive.

The ECB have been criticised for its past rate rises as Eurozone inflation is below 3% partly due to falling energy costs. Higher interest rates have led to a decline in growth as GDP fell by 0.1% in Q3. The demand for new bank loans has fallen sharply as has mortgage demand as lending criteria heightens and credit supply falls. Analysts are predicting a -0.5% fall in GDP in Q4 and that growth will not return until Q3 2024. Italy's UniCredit Bank feels that the ECB have tightened more than is needed as inflation was falling and growth turning negative.

Fidelity shares the view that ECB rates may be now higher than the economy can take particularly if they stay at this 4.5% level. If the ECB persists with higher for longer 'the implications could be a deep recession.' The criticism of the ECB is that the Bank is too willing to sacrifice growth as they are so focussed on inflation. Fidelity expects Christine Lagarde to have to cut rates in Q1 2024 much sooner than Ms Lagarda herself has indicated.

Some analysts have suggested that central Bankers at the ECB have not faced a cost-of-living crisis of this nature before and so have no experience of how far rates need to rise or how long it takes for borrowing costs to feed through to the real economy.

Oxford Economics feel that over the next year, developed economies will be impacted by higher rates and will need to cut early and rapidly.

The Bank of England (BoE) also left interest rates unchanged at the MPC meeting in November. Sluggish economic growth and signs that the UK job market is slowing down have led to calls for a halt on interest rate rises. UK unemployment is now 4.2%.

The BoE have been raising rates since December 2021 to bring down inflation. UK inflation peaked at 11.3% in October 22 and now stands at 4.6%. It is predicted to fall further but remains a long way off the BoE target of 2%. The BoE will have to balance the need to bring inflation down as this has such an impact on the cost of living by keeping rates high which will hurt household borrowers and business lending. UK inflation remains much higher than Europe at 2.9% and USA at 3.2%.

Andrew Bailey, the BoE Governor has said that there are ‘increasing signs that higher interest rates are starting to hurt the UK economy’

Fidelity is worried that if the BoE keep interest rates on hold, then the UK may also pay a price in terms of growth as well as the Eurozone. The Institute of Economic Affairs has called on the BoE to start cutting rates to avoid a recession.

The fact that the BoE, Fed, and ECB all put interest rates on hold in the same first week of November, has increased optimism that the global cycle of interest rate rises has come to an end. It shows that higher interest rates have driven inflation down and if held for a period longer should continue to reduce inflation.

While, the UK economy has slowed and unemployment risen in the face of these high interest rates, the US has been able to perform much better with significant economic growth and a strong jobs market. US unemployment is 3.9%.

Jerome Powell has stated that reducing US inflation is likely to require a period of lower growth and the softening of the labour market. Despite some softening in the labour market, the Fed feel that a recession in the US is not likely. Traders took the sign that borrowing costs had peaked and markets rallied throughout November on this outlook.

The S&P 500 started November at 4237 points and hit 4559 on Friday 24th November, a rise of 7.6%. All other major markets saw meaningful rises too.

UK interest rates are expected to start to fall from May next year.

The BoE Chief Economist Huw Pill has hinted that 'it is not unreasonable' to predict a rate cut next summer. This is the clearest signal yet that the BoE is at the peak of interest rate rises.

Financial markets are pricing in a rate cut next June and a cut from 5.25% to 5%. Inflation is currently 4.6% which is over double the target rate, however Mr Pill predicts a rapid fall in the coming months.

The comments of Mr Pill do however conflict with the public statements of BoE Governor Andrew Bailey who has said that 'it is much too early to consider rate cuts.' Mr Bailey is renowned for caution.

Despite the Governors view, markets now believe that the UK has finished its rate rising cycle and that UBS forecast that UK interest rates will be at 4.25% in December 2024 and 2.5% in December 2025. PWC have predicted that UK inflation will continue to fall throughout 2024.

The fact that the ECB, Fed, and BoE have all paused interest rate rises and that employment growth has softened suggests that 'higher for longer' interest rates may not be the case in 2024.

Bond yields have been rising and are now starting to fall so now is an opportune time to consider the allocation to fixed interest and the durations of gilts and treasuries.

Cash and short dated credit have been the assets of choice recently. The pivot in monetary policy can give bond investors an attractive yield and the potential of a capital gain as yields fall and prices rise. For this reason, we have increased our allocation to US treasuries and UK gilts.

The yields on UK 10-year gilts fell from 4.65% on 19th October to 4.28% on Friday 24th November based upon the expectations of the BoE cutting interest rates. This is a great boost to Chancellor Jeremy Hunt, as well as borrowers and mortgage holders.

Analysts are expecting UK interest rates to start to fall from May next year much earlier than previously

forecast. There is an expectation that UK interest rates will fall by as much as 1% throughout 2024.

There are some differences of opinion within the banking sector with Goldman Sachs suggesting a February first cut, while Morgan Stanley say May for the first interest rate reduction. The Nationwide Building Society believe rates will not fall untill 2025.

While bond yields have been falling on the expectation of lower interest rates, the BoE have also been selling off government bonds and in doing so reducing the size of the BoE balance sheet and taking cash out of the economy. The gilts issued by the government during the pandemic are now being sold at a loss rather than being kept to maturity. This means that the UK tax payers are picking up capital losses on these gilts. It is suggested that the premature sale of gilts will cost £15bn more than if kept to maturity. One must ask who is making these decisions?

PWC have predicted that UK inflation will continue to fall throughout 2024.

UK business is hoping that the BoE will turn to support the economy.

The Office of National Statistics (ONS) confirmed in November that the UK economy grew by 0% in Q3. This news was a disappointment to the UK stock market with both FTSE 100 and 250 falling over 1% on the news. Analysts had predicted a -0.1% reduction in growth so that no fall in GDP was better than expected but still disappointing. These results mean that the UK has avoided recession in 2023.

The stagnant economy was put down to consumer demand. A sign that households are feeling the squeeze. House sales and mortgage approvals fell so hitting the housing market.

Chancellor Jeremy Hunt has been under pressure to offer a boost to UK voters ahead of next year's General Election. In last month's Autumn Statement, he did cut business taxes and National Insurance rates for both the self-employed and employed workers in a boost to employment. But with £6bn of head room on the UK £2.6tn debt pile there was little room to manoeuvre.

With interest rates at 5.25% and 10-year gilt yields at 4.28%, the debt repayments on the government debt pile will hinder any ambitions of Jeremy Hunt or whoever succeeds him at No 11 Downing St. For each 1% in interest rate the UK tax payer pays an additional £15bn in annual interest payments.

In March's Budget Statement, the Office of Budget Responsibility (OBR) thought that UK base rates would peak at 4.25% but we are 1% above that position and expect our current 5.25% rate to stay in place for several more months.

Last March there was a forecast for £89bn of debt interest spending but this is now likely to be £109bn. Hence the Treasury and BoE desire to see inflation fall. Any falls in interest rates would save the Government significant amounts in reduced borrowing costs as credit is refinanced. Falling interest will also reduce the losses from selling bonds that were bought as part of the quantitative easing programme.

When the OBR run the numbers for Chancellor Jeremy Hunt's Autumn statement, they will have done

so at the hight of interest rates and therefore bond repayments at their highest.

The signs that the UK job market is starting to slow helped the BoE to pause interest rate rises. UK unemployment now stands at 4.2% up from 3.7% twelve months ago. Businesses appear to be hiring less as the cost of living and high interest rates hit consumer spending. Output from British private companies have fallen in Q3.

The BoE are conscience that the full impact of past interest rate rises is yet to hit the economy and that younger and lower paid workers could be hit the hardest. The UK could be facing harder times over the winter and into the spring.

Capital Economics has suggested that ‘a mild recession is underway and that the BoE has finished hiking rates.’ This view is in line with other economists and business leaders are hoping that the BoE will turn to support the economy soon once inflation has fallen further.

Joe Bidens economy is booming?

In Q3, the US posted GDP growth figures of 4.9%. This was way above any other major developed country. This was a remarkable growth figure given the rates of inflation, interest rates and economic outlook.

The third quarter growth was driven by resilient consumer spending despite higher interest rates. Further study shows that much of this spending was on credit, so the pain of payment is yet to come.

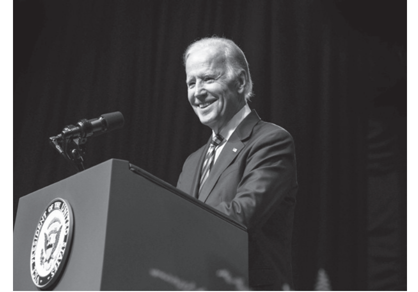
In October US unemployment increased to 3.9%, which is still relatively low but up from 3.4% earlier in the year. A rise of 0.5% could be seen as a warning that the economy is slowing and that the delayed impact of interest rate rises is starting to hit the economy.

President Biden established legislation to add US$1tn to the US economy via the Inflation Reduction Act at a time when there was a huge level of monetary stimulus already pumped into the US economy. Despite Biden splashing cash and creating an economic sugar rush, Americans are not impressed with price rises and a weakened economy. For this reason, he is trailing Donald Trump in the key swing states in the lead up to next November's US Presidential elections.

The US commercial property market is a concern. Office blocks bought when interest rates were low, now remain half empty 18 months after the end of Covid lockdowns. The return to work is not yet happening with data from entry systems showing occupancy levels are still 49% of pre pandemic levels.

If hybrid work is here to stay then business will off load leases and downsize. Commercial property is less in demand. Columbia University in New York calculated that US office space stock has lost 40% of its pre Covid value due to falling demand and falling rent revenue plus high borrowing costs. Office blocks are coming up for sale at 50% of their past value, just to get out of the mortgage.

US commercial property has US$5.5tn in borrowing against it and lenders are concerned about the refinancing of maturing loan deals. A 10-year loan in 2013 was charged at 3.5% and will now be 7.5% or more now. Lenders are being selective and if a mortgage holder cannot refinance then properties are being sold at discount values to clear the borrowing.



US regional banks are being squeezed from all sides. Interest rates for depositors have increased to stop deposit flight, their bond portfolios will be trading at a paper loss and revenue from loans is being used to fund depositors as well as loan default rates rising.

The likes of Silicon Valley Bank, First Republic Bank and Signature Bank have all failed in the past year due to the pressure of high interest rates. They are unlikely to be alone. Columbia University predict that up to 200 more US small banks will need a bail out or take over. US$2.7tn of commercial real estate debt is held by US banks with 60% held by small to medium sized regional banks. Federal Reserve officials are worried about this situation and are sending supervisory teams to those banks most exposed.

Monetary tightening hits an economy with a long lag. Only time will tell if the Fed has over tightened and compromised the small US banks and commercial property sector. News for interest rate cuts in 2024 will be welcomed by many.

Europe

The Eurozone has not grown at all in 2023.

The Eurozone looks as if it has entered recession with slowdowns in the major economies shrinking GDP growth to -0.1% in Q3. Germany has a Q3 GDP growth rate of -0.4%, France was 0.7% and Italy 0.04%. These figures support the figures that indicate that the Eurozone has not grown at all in 2023.

This is not a surprise as the ECB has hiked interest rates all year and that these rate rises have weighed upon growth. The only benefit is that inflation has fallen from 4.3% in September to 2.9% in October. Analysts now feel that the ECB has finished rate rises and that rate cuts are likely in Q2 2024.

The Eurozone will still feel the impact of higher interest rates of 4.5% for a while even if inflation has fallen to 2.9% and that a period of economic stagnation can be expected. Stagnation is however better than recession.

India

India recorded year on year GDP growth of 7.8% in Q3.

India has been one of the fastest growing major economies this year. India recorded year on year

GDP growth of 7.8% in Q3. India's robust economy has high foreign exchange reserves, manageable debt to GDP levels and well contained fiscal deficits. This means that the country is in a strong and stable position and can absorb external shocks.

The latest PMI data shows a positive trend in both manufacturing and service sector activity. This is driven by the continued improvements in export demand.

India's equities are trading at high values with PE ratios that match the USA and not emerging markets. With valuations at developed world levels good stock selection within funds in vital.

The worst of China's property crisis is over.

HSBC Chief Executive Noel Quinn has suggested that the worst of China's property crisis is over and now expects the Chinese property market to stabilise. This outlook will be seen as a very important commentary on the situation within China. Mr Quinn stated that he thinks we are at the bottom of the market but it will take quite a while for markets to regain momentum.

HSBC has set aside US$500m to cover expected loan losses on commercial property in China. The recent property sector support measures announced by the Beijing authorities have yet to translate into a meaningful rebound in property values although they are expected to do so, to the relief of investors and home owners. Credit conditions in China are not yet good for the property market but this ongoing weakness should also improve.

Mr Quinn's assessment came at a time that the mega sized Chinese property developers Evergrande avoided liquidation. Evergrande has debts of US$300bn and is the poster boy of indebtedness in China's debt ladened property sector.

The Nikkei 225 has risen 31% this year, but currency movements have offset these gains.

With the Yen trading at a 12 month long low to the US$, Japan's Finance Ministry warned against speculative moves against the ¥. The authorities were not ruling out any option to deal with currency volatility.

The reforms in corporate governance led by the Tokyo stock exchange have improved the returns on Japanese stocks. While the reforms will take several years it is likely to see increased pressure on companies to unwind cross shareholdings and restructure of non-profitable businesses. These changes should foster a permanent change in corporate mentality and lift profitability, dividend levels and share prices in Japanese companies.

The Japanese economy has proved to be resilient. Inflation has long been absent from the Japanese economy now stands at 3.3% while interest rates remain at -0.1%. GDP annual growth is 1.6%.

Japanese stocks have had a good year. The Nikkei 225 has risen from 25736 points at the opening of trading in January and now stands at 33725. A rise of 31%. However, currency movements have offset these gains for foreign investors.

The market performance of the Nikkei 225 has been broad spread and balanced unlike for example the US S&P500 as the largest part of this year's returns have come from a small number of tech companies, while in Japan returns have been less concentrated.

An escalation in the conflict in Gaza could hit oil prices.

The energy sector has hit the headlines this year due to high prices, high profits, and supply. The geopolitical conflicts in Ukraine and Gaza have further disrupted the market.

While developed markets have moved to reduce their reliance upon fossil fuels, oil and gas remain central to economic activity and will be for at least another decade to come.

Brent crude hit US$92pb in mid-September but since then oil prices have fallen due to lowering of demand despite the potential of conflict in the Middle East. Brent Crude oil now stands at US$80pb.

The World Bank is concerned that any escalation in the conflict in Gaza will hit oil prices. So far it looks as if the Israeli retaliation to the Hamas attack has been more limited than initially expected. A full-blown Middle East conflict does not look likely but modelling from the World Bank based around the experience of the 1973 Arab Oil Embargo suggests just a small disruption could see oil prices hit US$100pb.

Fortunately, the world is far less reliant on oil now than in 1973. Oil made up 44% of all energy supply then but is now 30%. However, oil production in the region accounts for 30% of global supply and is critically important to the world economy.

A rise in oil prices would have an impact on other commodities such as natural gas and food, leading to another round of inflation in energy and food.

The uncertainty over the direction of the global economy is likely to prevent energy prices going much higher in the short term. A prolonged conflict in Gaza and Ukraine may keep oil prices elevated but no more at this stage. The World Bank is forecasting an oil price of around US$81pb in 2024

Natural Gas prices have also stabilised. EU Natural gas is trading at €46pmh down from the high prices of last December when prices were €150pmh. There are concerns that Europe will be hit with very cold weather this winter that will test reserves and supply costs.

It is against this background we make our recommendations.

30th November 2023

The most profitable point to invest in duration is when the Fed stops raising rates.

The USA continues to drive the global economy and across leading economic indicators, the US shows the clearest signs of expansion and current levels of growth above trend. This expansion has been led by improvements in consumer sentiment, rising new orders and a robust labour market despite a recent dip in new job openings. GDP growth in Q3 was 4.9% and as the US economy moves further into an expansion phase growth will continue above trend. We have therefore further our allocation to US equity as markets are expecting an economic recovery and the US is especially well placed. We have holdings in US large cap corporations, the S&P 500 index, and US tech stocks.

With inflation now falling significantly, central banks are likely to have hit the peak of their policy tightening. This is particularly true of the UK and Europe as these economies could do with an easing of interest rates.

In the UK there are also signs of improving consumer confidence and manufacturing activity. Attractive equity valuations, earnings improvements and the unloved nature of UK stocks should see improvements in UK markets in 2024. UK inflation has reduced to 4.6% and expected to surprise on the downside. Interest rates are likely to have peaked and rates expected to fall from Q2 2024 so mortgage rates and borrowing cost will reduce. The FTSE 100 index is well placed to benefit from global growth and the FTSE 250 benefit from internal UK improvements.

The Eurozone has continued to decelerate with weakness in consumer sentiment, housing surveys and under performance in manufacturing. Likewise, the underperformance of China is wide spread, with the housing and manufacturing sectors having been impacted the most. The easing of monetary and fiscal conditions is expected to result in improvements in the property and credit markets.

We have in the past raised our allocation to Japanese equities. The Japan funds have done well even after the ¥ to GB£ currency conversion. We will continue to support the Japanese stock market; however, it is possible that the Bank of Japan (BoJ) could raise interest rates from its current -0.1% as Japanese inflation is now at 3.3%. If this happens the ¥ will strengthen. Japanese equities have shown a strong performance this year but this has been driven by a weaken ¥.

We have raised our exposure to select emerging markets particularly India and have also invested in emerging market bonds as returns are attractive.

Markets that are expected to grow above trend are US, UK, Japan, and Emerging Markets. We have therefore either maintained or improved our allocation to these regions while Asia Pacific, China and Europe have been reduced.

As far as credit markets are concerned, over the next year we can expect interest rates and bond yields to fall, so that bond prices will recover and offer attractive returns. We are at a point where fixed income yields are offering good value compared to other asset classes. If UK inflation now surprises on the downside, falling rates and yields will drive a price recovery.

We have moved from inflation linked bonds to conventional bonds as inflation is on the decline. We have increasing duration over our fixed interest holdings. Government bonds and investment grade credit should do well in the year ahead. Historically, the most profitable point to invest in duration is when the Fed stops raising rates. US treasury yields are strong but expected to decline providing capital returns that are enhanced on duration.

The outlook on property is mixed. The falling demand for office space and therefore yield is a headwind but the fact we have likely to have now reached peak interest rates, despite tightening credit conditions, should aid the sector. Property funds have endured significant falls over the past 18 months but there is an expectation that real estate equities can start to recover. We have maintained our investments in infrastructure but reduced our property holdings due to reduced occupancy hitting demand.

Cash deposit rates are currently attractive so we have retained a full allocation. Government gilts and investment grade credit should benefit from falling interest rates. Gold and commodities are expensive and we have not included these assets in our portfolios. US, International, UK, emerging markets and Japanese equities are either maintained or improved while Europe, Asia Pacific and China are underweighted.

One reason to expect a slowdown in economic activity is that of a reduction in money supply. This will be the result of high interest rates and quantitative tightening that central banks have actioned over the past 18 months. Inflation remains a key indicator and central banks will continue to assess whether they have done enough to bring down and keep down inflation.

With a halt in rate rises from the Fed, ECB, and BoE there is a collective belief that rates have peaked and that the first-rate cut will occur in Q2 2024. Given the expected fall in interest rates then lending and money supply should improve. Stock markets have already looked beyond any slowdown to a falling inflation and falling interest rate environment.

The recent improvements in equity and bond prices are typical at the start of an economic upswing. Financial markets are anticipating a recovery that is yet to occur and so could lead to disappointment.

We believe that the global economy is decelerating which brings risk. However, over the next 6-12 months, we expect some central banks most notably the ECB and Fed to start easing which will help markets recover.

We have balanced our style risk between both value and growth and blended active and passive funds to access markets. Overall, the expected returns on gold and commodities are negative while cash, corporate bonds, government bonds, equities and real estate are positive.

As far as the 40th Edition is concerned, across all five portfolios, 7 new funds have entered the selection of which some are re-joining while 8 existing holdings have been dropped or substitutes for performance, ratings, or cost reasons.

The funds that have been removed are;

	TER
Royal London Global Equity Select	0.95%
Aegon Short Dated High Yield Global Bond	0.77%
Threadneedle US Equity Income	0.79%
iShares Environment Real Estate Index	0.31%
Royal London Sustainable Leaders Trust	0.98%
Guinness Sustainable Energy	0.77%
Stewart Asia Pacific Sustainability	1.03%
FSSA Greater China Growth	1.16%

The funds that we have added are;

	TER
BNY Mellon US Equity Income	1.09%
JP Morgan UK Equity Values	0.90%
Guiness Global Energy	1.11%
Jupiter Asian Income	1.10%
Liontrust European Dynamic	1.32%
M&G Emerging Markets Bond	0.78%
M&G Short Dated Corporate Bond	0.38%

PORTFOLIO PERFORMANCE

The Estate Capital Investment Portfolios

The Estate Capital Investment Portfolios now offer five risk related investment strategies designed for medium to long-term investors seeking capital growth and income from a portfolio of leading investment funds. The individual funds that make up our diversified portfolios are selected on the quality of the fund manager and both the quality and consistency of past performance.

There is a wide range of asset classes across global markets available to investors. Our portfolios bring together a diversity of global equities, fixed interest securities, cash deposits, commodities, precious metals, infrastructure, and property. The global balance of investments across differing asset classes is the primary driver of portfolio returns.

Our asset allocation is built using a fully modelled asset allocation tool. This system is powered by research from actuaries Willis Towers Watson and investment data from Financial Express.
This modelling system offers us great accuracy to build and test the most efficient blend of assets for our five model portfolios. Each new edition of our portfolios is published on our website with fact sheets, performance figures, risk ratings and range of returns.

We benchmark and publish our portfolio performance against the most relevant national averages.

Our sister company Crossing Point Investment Management offer a new range of portfolios that replicate the Estate Capital portfolios. The Passive Portfolios and Growth Portfolios were launched this summer and mirror the asset allocation and fund selection of the Estate Capital advisory range. These portfolios are competitively priced within the greater UK market and are run on a discretionary basis. The investment managers of the Crossing Point Portfolios are Chris Davies, Tomiko Evans, and Mike Buckle.

The balance of investments across different asset classes is the primary driver of portfolio returns.

1.65% 3.78% -3.09% 1.46%12.63%

Cumulative Portfolio Performance from 8th November 2023.

Below are the past five year's gross investment returns for each of our portfolios from 8th November 2023.

Portfolio	*6 months*	*1 year*	*2 years*	*3 years*	*5 years*
Cautious	1.65%	3.78%	-3.09%	1.46%	12.63%
Conservative	1.94%	3.59%	-3.85%	2.49%	17.64%
Balanced	1.35%	3.15%	-5.52%	6.84%	26.56%
Strategic	1.28%	2.95%	-2.03%	12.77%	27.19%
Speculative	1.30%	2.84%	-6.47%	4.57%	26.69%

Discrete Portfolio Performance from 8th November 2023.

Below are the gross investment returns for each of our portfolios for each 12-month period over the last five years from 8th November 2023.

Portfolio	*2023*	*2022*	*2021*	*2020*	*2019*
Cautious	3.78%	-6.62%	4.70%	4.12%	6.62%
Conservative	3.59%	-7.19%	6.60%	6.56%	7.72%
Balanced	3.15%	-8.40%	13.08%	9.36%	8.32%
Strategic	2.95%	-4.84%	15.11%	2.81%	9.71%
Speculative	2.84%	-9.05%	11.80%	10.62%	9.52%

The above performance tables are produced by data from Financial Express Analytics. The tables are a proxy to our actual portfolio performance as they do not include adviser, manager and platform charges nor accurately reflect the actual dates that individual investor portfolios are rebalanced from one edition to another. The rebalance lag could amount to 8 weeks per rebalance. The proxy portfolio performance reflects the fund selection in each consecutive edition of our portfolios.

The value of investments can fall as well as rise. Past performance is not a guide to future performance. Cumulative and discrete performance charts show % growth from 8th November 2023 calculated using bid prices with income reinvested into the fund net of tax.

Asset Allocation January 2024 - Edition 40

Portfolio	*Risk*	*Money Markets*	*Fixed Interest*	*Property*	*UK Equity*	*US Equity*	*Europe Equity*	*Asian Equity*	*Japan Equity*	*Global Equity*	*Other Assets*
Cautious	3	30%	34%	0%	4%	14%	3%	4%	3%	6%	2%
Conservative	4	26%	32%	0%	6%	18%	4%	5%	4%	3%	2%
Balanced	6	17%	28%	0%	7%	24%	5%	4%	5%	2%	8%
Strategic	7	14%	21%	0%	8%	26%	8%	3%	6%	11%	3%
Speculative	8	12%	11%	0%	9%	31%	8%	4%	7%	15%	3%

Perspective Range of Return & Volatility

Portfolio	*Risk*	*High*	*Low*
Cautious	3	17.09%	-6.60%
Conservative	4	21.63%	-9.82%
Balanced	6	30.90%	-16.40%
Strategic	7	35.36%	-19.63%
Speculative	8	39.82%	-22.92%

Investment Ratios

Portfolio	*Risk*	*Beta*	*Alpha*	*Info R*	*MDD*
Cautious	3	0.80	0.16	0.92	-7.30
Conservative	4	0.74	0.01	-0.05	-8.03
Balanced	6	0.83	0.02	-0.10	-9.21
Strategic	7	0.88	0.16	0.70	-9.64
Speculative	8	0.94	-0.05	-0.25	-10.16

Maximise your returns with a level of risk you're entirely comfortable with.

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