Climbing the "wall of worry" - a review of markets in 2023

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Investors climbed a proverbial "wall of worry" in 2023 as forecasts of challenging economic times ahead gave way to more optimistic assessments and global equities rose 15.88% in sterling over the year.

The US economy, in particular, proved stronger than many forecasters feared, with some having predicted recession in response to well-established leading indicators. These included an inverted yield curve as 10-year US government bond yields fell below two-year yields and tighter lending conditions revealed by Federal Reserve surveys of commercial loan officers.

In December 2022, the forecasts of Fed Reserve Board members and Fed Reserve Bank presidents suggested the economy would at best grow 1% and at worst contract 0.5%, unemployment would be between 4% and 5.3% and core inflation excluding food and energy costs would, according to the Fed's preferred measure, range between 3% and 3.8%. By contrast, their forecasts last month suggested 2023 growth would emerge between 2.5% and 2.7%, year-end unemployment would be between 3.7% and 4% and year-end core inflation would be between 3.2% and 3.7%.

US stocks outperformed, rising 19.16% in sterling, with leadership narrowly focussed on technology stocks, which rose 55.76%. Economic growth benefited the technology sector and other growth sectors. These sectors also benefited from rising expectations that peak interest rates were at hand because growth company valuations typically benefit from falling interest rates as their future cash flows are discounted less aggressively. Technology shares had fallen 26.29% in sterling in 2022 as rising interest rates led investors to favour value stocks. Nvidia, a semiconductor maker serving the artificial intelligence sector, was a standout performer, rising 222.14%.

European Central Bank (ECB) forecasts for gross domestic product (GDP) growth were cut from 0.9% to 0.5% in December 2022 and may prove broadly accurate, with last month's forecast being 0.6%. By contrast, Andrew Bailey, the Bank of England governor, said in November 2022 the UK faced a recession of record-breaking length lasting throughout 2023 and into 2024. In the event, UK GDP is likely to have risen 0.5% in 2023 according to the BoE's November forecast.

Though already lower than its 2022 peak, inflation started 2023 far above central banks' 2% targets, then declined significantly. US headline inflation fell from 6.5% in December 2022 to 3.1% last November; eurozone inflation fell from 9.2% to 2.4% and UK inflation fell from 10.5% to 3.9%. Energy costs were a significant factor, with oil prices falling 9.22% in sterling over the year.

Interest rate rises slowed in early 2023 after the rapid rises of 2022. The US Fed Funds Rate began 2023 at 4.25-4.5% and increased by a quarter percentage point on four occasions to 5.25-5.5% in July.

The BoE increased Bank Rate on five occasions, taking it from 3.5% at the start of the year to 5.25% in August, while the ECB raised its key policy rate from 2% in December 2022 to 4% in September. Rates have been on hold since then but monetary policy has tightened through other means as these leading central banks withdraw liquidity by reducing the bonds in their balance sheets.

Rapid rate rises undermined the balance sheets of five small and medium-sized US banks including Silicon Valley Bank, which all failed as customers withdrew deposits. The largest insolvency was, however, in Switzerland, where Credit Suisse, the country's second largest bank, was forced by the government into the arms of its larger rival, UBS.

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In the US, Switzerland and elsewhere, regulators and policy makers acted decisively to avoid contagion and protect customers. Fears of a repeat of the 2007-09 global financial crisis proved unfounded, partly because post-crisis regulatory changes have improved bank balance sheets and increased management accountability.

Bond prices also benefited from signs of a peak in the interest-rate cycle. Global bonds rose 5.71% in dollars but fell 0.25% in sterling during 2023 as a result of the pound's rise. In the UK, high-yield bonds did best, returning 15.77%, while investment-grade corporate bonds and government bonds rose 9.70% and 3.62% respectively. The pound gained 13.23% against the yen and rose 5.98% and 2.39% respectively against the dollar and the euro.

Equities in Asia excluding Japan and emerging markets lagged in 2023, rising 0.34% and 4.05% respectively in sterling. The International Monetary Fund forecast for Chinese GDP growth in 2023 is 5.4%. Chinese stocks fell 16.05% in sterling, however, as a first-quarter rebound after zero-Covid restrictions ended gave way to fears that an over-indebted commercial property sector would hurt the economy after two large property developers, Evergrande and Country Garden, defaulted on their debts, the first in 2021 and the second in 2023. Elsewhere, Indian stocks outperformed, gaining 14.45% in sterling in response to rapid economic growth and the government's pro-business policies.

Prospects

Lower interest rates may prove a tailwind for equities and bonds in 2024. According to the Fed, many US market participants believe rates have peaked for this tightening cycle and the Fed Funds Rate may be cut as soon as June. Economic growth is slowing in the US and stalling in the eurozone and UK but confidence is growing that central bankers have engineered that most difficult of monetary policy feats, "a soft-landing". Technology stocks led the charge in 2023 and may perform well in 2024 given a favourable economic backdrop for growth companies and the significant advances in the sector, in particular in artificial intelligence.

Out-of-favour emerging market assets may also benefit if the Fed reduces interest rates because that is likely to weaken the dollar. Political risk will, however, be a significant factor in markets this year, with general elections due in the US, India, Taiwan, Indonesia, Pakistan, South Africa and Mexico and, probably, the UK.

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