Monthly Market Review

Review of markets over October 2023

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Risk premiums come in different shapes and sizes

In brief

- Investors are demanding higher compensation for the increased risks and uncertainties across Treasury markets and geopolitics, among others.
- Developed market central banks are likely at the end of their rate hiking cycles, less certain for the Fed than the BoE and ECB. The BoJ, on the other hand, continued to adjust the YCC policy.
- Further escalation of the Israel-Hamas conflict continues to be a looming risk, especially on energy prices. However, there are starting to be early signs of easing in U.S.-China tensions.

Risk premiums from different sources worked in different ways in October. Term premiums lifted long-dated U.S. Treasury (UST) yields further, due to the resilience of the U.S. economy. A number of central banks, both in developed markets and emerging economies, remain on the hawkish side for now. Meanwhile, the military conflict between Hamas and Israel has yet to influence geopolitical risk premiums in a material way. China has announced more fiscal support amid stabilizing economic data. There were also some initial signs that the U.S.-China relationship could be stabilizing as we approach the APEC meeting in San Francisco, where U.S. President Joe Biden and Chinese President Xi Jinping are scheduled to meet again.

Central banks are becoming less synchronized

UST yields continue to rise as investors are more willing to accept that the Federal Reserve (Fed) could keep high rates for an extended period of time. We saw the UST yield curve bearish steepened with the longer end (5-year and beyond) leading the rise, and the short end largely unchanged. This reflects that investors are demanding more return to invest in the long end of the yield curve, or requiring a higher-term premium. The current round of economic data out of the U.S. also supports the notion that recession is not imminent and the economy is still showing considerable resilience towards high rates. The 3Q GDP number was very strong (+4.9% quarter-over-quarter annualized), mainly on the back of personal spending. The November Federal Open Market Committee meeting saw the Fed keeping policy rates unchanged, but leaving the door open for one more hike. We still think that inflation and economic data should be on a cooling path for the Fed to stay put. That said, investors may need to be patient in waiting for rate cuts to come. The central bank seems determined to maintain a high rate environment for as long as it can.

While recent economic data can justify the Fed's optimism, there are risks lurking around the corner. High interest rates are already pressuring the housing market. President Biden's CHIPS Act and Inflation Reduction Act have helped to boost corporate investment, but rising funding cost could still persuade businesses to be more conservative in making investment decisions.

There are also risk events that could undermine growth momentum. The UAW strike could dampen car manufacturing in the near term. Congress managed to avoid a government shutdown at the very last minute, but the threat could return in mid-November once the current compromise deal expires. The Fed's firm stance on keeping rates high to put inflation to rest could exacerbate downside risk to the economy if such risk events take place.

Beyond the Fed, the European Central Bank (ECB) and the Bank of England (BoE) have strongly hinted that the end of their hiking cycles is upon us. Overall, despite the recent spike in government bond yields, we expect softening economic data and lower inflation should help to drive bond yields lower in the next 6-12 months.

Patience is a virtue in China and Japan

Meanwhile, the ECB kept its policy rate unchanged in its September meeting. This decision looked particularly sensible as the October inflation estimate dropped to 2.9% from September's 4.3% and core inflation is also coming off. Weak growth data is also likely to persuade the ECB to approach monetary policy with more caution. The Fed may want to take note of this even as the U.S. economy continues to be in solid shape.

The Bank of Japan (BoJ) continued to adjust its yield curve control (YCC) policy. It has removed the trading band for 10-year Japanese government bond (JGB) yield and established 1% as a reference point. By keeping its yield target vague, the BoJ is probably hoping to reduce the need for bond purchases and hence reduce the distortions in the market. Given the downward pressure on the Japanese yen after the announcement, it seems investors are hoping for more concrete direction from the central bank to normalize its monetary policy. This is not limited to YCC, but also the need to raise policy rates. Yet, given the risk of a global slowdown in 2024, the BoJ may worry that it is hiking into weaker export demand, even as inflation pressure is taking hold domestically.

The Middle East tension and U.S.-China relationship

The military conflict between Hamas and Israel has had limited impact on oil prices so far, but a more profound impact on natural gas prices. There was also an absence of safe haven flows into UST or similar assets. This is partly because the current bout of conflict has yet to impact on oil supply, and hence the economic impact globally remains limited at this point. However, if Iran becomes more directly involved in the confrontation, or oil export logistics in the Persian Gulf are affected, then oil prices could rise significantly from the current level. This could raise the risk of stagflation as higher energy costs, and subsequently food prices, would damage growth, especially for emerging market economies.

Meanwhile, China and the U.S. have stepped up dialogue at the senior level. President Biden and President Xi are scheduled to meet in person in San Francisco during the APEC summit in November. This is following a series of senior interaction between the two sides in recent months. This should help to limit the risk of friction triggered by errors or mistakes, especially ahead of the Taiwan presidential election in January. That said, the U.S. is still implementing export restrictions on tech products that would be used to develop artificial intelligence, and there are still heated exchanges over the South China sea. Hence, the geopolitical risk premium imposed by investors on Chinese financial assets may not decline anytime soon.

That said, we have seen some modest improvement in economic data in China. 3Q GDP came in better than expected, at 4.9% year-over-year (y/y). September economic data also showed that consumption is holding up even if investment and real estate data were still weak. Moreover, the government has approved an additional CNY 1trillion of central government bond issuance to support infrastructure. The economic boost could come in late 2023 and 1H of 2024. Overall, Beijing's economic stimulus may not allow for an acceleration in growth in the near term, but it will help to contain the downside risk to growth.

Don't stand in front of the Fed… yet

With the Fed still maintaining a hawkish tone and economic data from the U.S. still strong, short duration, high-quality fixed income is probably a better option. It provides high income with a smaller exposure towards duration risk if rates rise further from the current level. Yet, we think investors should gradually extend duration as we expect economic data to moderate into 1H 2024, even though a recession is not imminent.

For equities, the prospects for lower UST yields should also benefit growth and tech stocks in the U.S. We will also pay more attention to Asian equities given the turnaround in export performance in Taiwan and South Korea in the past month. This should point towards an earnings up-cycle, with undemanding valuation for Asian equities. There is still a lot of skepticism towards Chinese equities, especially from U.S. and European investors. However, a combination of light positioning by international investors, consistent earnings performance and attractive valuation could offer an interesting opportunity to long-term investors. We expect Chinese tech companies to enjoy better earnings on the back of more disciplined cost management and an uptick in revenue with consumer spending improving. We also have industries with policy support, such as renewable energy, electric vehicles and advanced manufacturing. Company selection is key with these industries given the competitive landscape. Yet, the emerging winners could capture international markets as well as domestic markets.

Global economy:

- 3Q23 U.S. GDP showed the economy expanded 4.9% y/y, higher than expectations. U.S. lawmakers avoided a government shutdown. September U.S. labor market data showed a 170k increase in nonfarm payrolls, and the unemployment rate dipped to 3.7%, while average hourly earnings gained 0.3% month-over-month (m/m). September core consumer price index (CPI) was in line with expectations, but headline was hotter than expected. (GTMA P. 24, 29)
- China 3Q GDP expanded 4.9%, above consensus, driven by strong industrial production and consumption. China's Golden Week showed tourism revenue jumping to pre-COVID levels, up 130% y/y, but fell short of official estimates, while housing sales were still tepid and were down compared to the same point last year. Car sales improved in September. Exports and imports declined by 6.2% y/y but was better than expected. Headline CPI and core CPI rose 0.1% m/m and 0.8% m/m respectively. Beijing considers raising the budget deficit and issuing new bonds to stimulate the economy. (GTMA P. 5, 6, 7, 8)
- Japan core inflation rose 2.8% y/y. The BoJ tweaked YCC, with the 1% ceiling on 10-year JGB yields now being regarded as a reference rate and not a hard cap, while it will no longer offer fixed-rate bond purchase operations every day. Japan's largest labor union is set to demand at least a 5% wage hike next year. (GTMA P. 14, 15)
- The Israeli government declared war after Hamas launched a surprise attack, contributing to the volatility in oil markets.

Equities:

- October was a challenging month for equities overall with rising UST and rising geopolitical risk. The S&P 500 was down 2.1%, its third consecutive month of decline. MSCI Europe was down 3.7%, while MSCI Asia Pacific ex-Japan was down 4.1%. MSCI South Korea underperformed, declining 7.0%. Despite encouraging economic data, Chinese equities continued to decline, with MSCI China falling 4.3% in October. (GTMA P. 32)
- Most equity sectors, except utilities, returned negatively in October. MSCI ACWI utilities returned 0.2%. MSCI ACWI consumer discretionary, industrials and energy underperformed, declining 4.8%, 4.4% and 4.2%, respectively. Energy returned negatively, following three months of positive returns.

Fixed Income:

- The 10-year UST yield flirted with the 5% mark multiple times in October, before ending the month at 4.9% The rise was not only driven by continued resilience in the U.S. economy, but also by a positive term premia, representing the compensation required from investors for uncertainties in inflation and rates. With the UST supply expanding and the fiscal deficit widening, the 10-year UST might still have room to climb. In October, the yield curve bear steepened, with the 2s10s spread narrowing from -0.42% to -0.18%. (GTMA P. 23)
- In Asia, most central banks are likely to stay on hold, although inflation has come down to a reasonable range. With the U.S. dollar's strength and rate differentials quite negative, Asian central banks are unlikely to front run cuts ahead of the U.S., keeping real rates elevated. (GTMA P. 22)
- With the rise in yields, the Global Agg Index fell 1.2%. U.S. investment grade bonds fell 1.87%, while U.S. high yield bonds were slightly more resilient, falling -1.16% only. (GTMA P. 49)

Other assets:

- After the run-up since July 2023, the USD index (DXY) maintained its strength and was mainly flat in October, returning 0.4%, upon expectations of the Fed going on hold. The Chinese yuan, euro and the British pound were flat as well, marginally down around 0.2-0.3%. The Japanese yen continued to weaken, despite the Bank of Japan's decision to continue loosening YCC, ending the month at 151. (GTMA P. 66)
- Gold gathered strength in October, rising 6.8% to USD 1,997, driven by expectations of a less hawkish Fed but also a flight to safety caused by the Israel-Hamas conflict. Back in September, crude oil (WTI) reached a brief high of USD 93 on concerns of tight supply, before retreating in early October. After the outbreak of the Israel-Hamas conflict, however, prices climbed again to hit close to USD 90, but came down on signs of slowing global demand and slight relief that the conflict has not escalated to a broader regional conflict, eventually ending the month down by 10.8%. On the contrary, European natural gas prices soared 14.7% in October, hitting the highest level since February this year, driven by production and supply shortage fears. (GTMA P. 67)