A Month in the Markets

From the Multi Asset Solutions Team

October 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in September. Share and bond prices declined across a wide range of markets in September as investors came to terms with the fact that interest rates are likely to stay higher for longer as rising oil prices make it more difficult to reduce inflation.[1]

Market Overview

Yields (the income an investor expects to receive each year for a bond) on US government bonds surged to 16-year highs after the Federal Reserve (Fed) indicated that another interest rate hike may be likely before the end of 2023.[2] As bond prices and yields move in opposite directions, bond prices tumbled. Yields on Eurozone[3], Japanese[4] and Chinese[5] bonds also climbed this month, while UK bond yields fell slightly.[6]

High interest rates and bond yields are influencing the broader economy. In currency markets, the pound and euro fell to six-month lows against the dollar as investors sought the higher yields offered by US bonds, compared to their UK and European counterparts.[7]

The fact that European banks are setting stricter lending conditions because of high interest rates means it's harder for businesses and consumers to obtain loans, which economists predict will contribute to Eurozone growth slowing in 2023 and 2024.[8] Persistent inflation and high interest rates are also contributing to US consumer spending – the main driver of Eurozone economic growth – weakening.[9]

Soaring bond yields affected stock markets, with bonds becoming more compelling as an alternative to shares. High bond yields meant that bonds and shares offered investors comparable returns, while bonds are generally considered less risky than shares because they only fail to provide a return if the company or government issuing them is unable to pay its debts. Even in the event of bankruptcy, bondholders are repaid before shareholders.

The reduced appeal of shares contributed to global stock markets experiencing their biggest monthly decline – and first quarterly decline – in a year.[10] The

PLEASE REMEMBER THAT ALL INVESTMENTS CARRY VARYING DEGREES OF RISK TO YOUR MONEY. THE VALUE OF INVESTMENTS AND ANY INCOME FROM THEM CAN GO DOWN AS WELL AS UP AND YOU MAY GET BACK LESS THAN THE FULL AMOUNT YOU INVESTED. PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

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FTSE 100 Index, which tracks the largest companies listed on the London Stock Exchange, bucked this trend by ending the month and quarter higher[11] as new economic data suggested the UK economy was performing better than had been predicted.[12]

Baffled by bonds?

It may be worth taking some time to learn the basics to help you better understand how they work. Visit our Basics on Bonds page for more information.

UK and Europe

Data released towards the end of September indicated that the UK economy had grown faster after the COVID-19 pandemic than economists had previously believed. However, optimism was tempered by the fact that the UK had still lagged behind the US, Canada, Japan and Italy over this period, with Germany and France being the only G7 nations it had outperformed.[13]

Data released earlier in the month revealed that the UK economy shrank by 0.5% in July, more than most economists had predicted, wiping out June's 0.5% growth.[14]

A widely followed survey of business leaders indicated that a recession – defined as two consecutive quarters of negative growth – may be approaching for the UK. The downturn measured by the Purchasing Managers' Index (PMI) survey is the steepest since the global financial crisis of 2008 and also signalled the sharpest fall in employment since 2009.[15]

The Bank of England (BoE) surprised investors by choosing to hold interest rates steady for the first time in almost two years, although they remain at a 15-year high. The central bank's decision to pause its rate hikes has raised hopes that interest rates have peaked, although its governor, Andrew Bailey, stressed that further hikes were possible.[16]

The European Central Bank (ECB) took a different approach, raising interest rates this month to their highest level since the launch of the euro. However, ECB President Christine Lagarde hinted that rates may have peaked.[17]

Preliminary data suggested that Eurozone inflation fell to its lowest level since October 2021 in September, reinforcing expectations that the ECB won't impose further interest rate hikes.[18]

However, a survey of business leaders indicated that the Eurozone economy stagnated in September, with output from the region's private sector falling for the fourth successive month. The rate of job creation is weakening and economic confidence in the region fell to its lowest level since November 2022.[19]

US

Data released at the end of the month showed that the Fed's preferred measure of inflation, which strips out volatile food and energy prices, rose at its weakest monthly pace since 2020. This raised hopes among investors that the central bank may decide against a further interest rate hike at its next meeting.[20]

On 20 September, the Fed announced that interest rates would be held steady, giving consumers struggling to repay loans some breathing space. This marked the second time this year that the central bank paused rate hikes. However, with two more meetings remaining before the end of 2023, Fed officials have indicated that they're willing to raise rates further unless they're confident inflation is falling sufficiently.[21]

The world's largest economy has maintained strong levels of growth. Data released at the end of the month revealed that a sharp fall in consumer spending during the second quarter was offset by an increase in investment into factories. However, an ongoing strike by auto workers is creating uncertainty about the US' economic prospects over the remainder of the year.[22]

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Asia Pacific

China's economy is showing signs of recovery, aided by a number of measures by the Chinese government and central bank designed to bolster consumer and business confidence amid an ongoing property crisis. Activity around malls has increased, and traffic congestion in the week through 27 September was the highest of any week in 2022 and 2023, suggesting an uptick in consumer spending.[23]

Additional data released at the end of September further supported the idea of an economic recovery. China's factory activity expanded for the first time in six months, although weakness in the property sector led the Asian Development Bank to trim its 2023 economic growth forecast for China from 5.0% to 4.9%.[24]

Japan's government upgraded its estimates for company profits for the first time in 18 months in a monthly report on the economy. In its assessment, the government maintained its forecast of a moderate recovery in economic growth due to improving wages. It is planning a new economic stimulus package to protect consumers from price increases and encourage sustainable income growth.[25]

Investors have been on high alert for possible intervention by the Bank of Japan (BoJ) to prevent the yen from continuing to fall, relative to the dollar. The currency weakened to an 11-month low in September as the BoJ remains committed to ultra-low interest rates, whereas US interest rates have risen significantly. Higher interest rates led to more attractive bond yields, and the US dollar consequently performing better than the Japanese yen as investors sought dollar-denominated bonds. However, the BoJ has stressed the need for patience before raising rates.[26]

Outlook

We anticipate slow economic growth and a gradual decrease in inflation.

However, if inflation stays high and doesn't decrease as expected, central banks might raise interest rates again. This could lead to instability in bond markets and shares falling in value.

While valuations of shares appear fair, high yields currently make bonds more attractive and we remain cautious regarding shares. For these reasons, the funds are overweight bonds, relative to the benchmark, meaning they hold more of these assets than the benchmark. In contrast, the funds are underweight shares and cash as we believe that bonds are currently likely to provide greater returns.

While we generally are positive towards bonds, we have a slight preference for government bonds over company, high yield and emerging market bonds.

We believe bond yields are unlikely to rise much further, and when yields fall, bond prices rise. This creates an opportunity to sell the bonds for a profit, improving the funds' returns.

Portfolio positioning

As at 30 September 2023

The fundamental approach

An update on positioning for the following ranges:

- Santander Atlas Portfolios
- Santander Multi Index
- Santander Portfolio Investments, Santander Max 100% Shares, Santander Max 30% Income Shares and Santander Max 60% Income Shares Portfolios)
- Santander Vista Model Portfolios

These portfolios follow a fundamental approach investment strategy, which is based on market and economic outlook and geopolitical considerations to determine which asset or sub-asset classes, geographies and sectors to invest in, both on a longer-term (strategic) and shorter-term (tactical) basis. They are positioned with a single set of tactical asset allocation views for all regions and countries. One TAA (Tactical Asset Allocation) is driven by internal research, which is reviewed and agreed by Santander Asset Management's Global Asset Allocation Committee.

They provide a template asset allocation, which is subsequently translated to each individual portfolio by the portfolio management team in the UK, selecting the most appropriate funds and instruments in which to invest in dependent on their objectives, benchmark and investment policy whilst monitoring risk.

Discretion is exercised by the portfolio manager and there will be times where our income funds do not reflect the One TAA view as it may impact the fund's ability to deliver its income objective.

Underpinning One TAA is a modelling of market outcomes under very different economic and market scenarios. One TAA provides the benefit of a more streamlined decision-making process and a collective view.

How did the fundamental investment process change the funds' and models positioning during September?

The funds were conservatively positioned, holding fewer shares than the benchmark and more bonds, which aided performance.

Throughout the month, shares were added to the funds as stock markets fell and share valuations became more attractive. The funds reduced their underweight position in shares, relative to the benchmark. This approach was consistently applied across all regions.

Cash was used to finance some of the share purchases.

Some of the funds' holdings of other European shares were sold in order to buy Swiss shares. The Swiss market is more defensively constructed (it has more companies that have stable earnings so are less sensitive to economic downturns) than Europe as a whole, which suits our cautious outlook. We therefore believe it has the opportunity to outperform the broader European index in the near term.

During the month, we also added more US government bonds to the funds by selling some UK government bonds and reducing the funds' holdings of cash as much as possible. US government bonds are offering a higher yield for a similar level of risk to UK government bonds, which makes them more appealing in our view. As previously mentioned, we believe bond yields are approaching their peak, and as prices rise when yields fall, this means that they can be sold for a profit.

The funds hold more bonds that take longer to mature than the benchmark. This means that they hold more bonds where the amount the issuer agrees to pay back to the investor upon the bond's maturity is due in 10 years time or more. This worked in their favour during September.

Portfolio positioning

As at 30 September 2023

The systematic approach

An update on positioning for the following funds within the Portfolio Investments range:

- Santander Max 30% Shares Portfolio
- Santander Max 50% Shares Portfolio
- Santander Max 70% Shares Portfolio

These funds use a different investment approach to the rest of our fund range, known as 'quantitative' investing. This approach is rules based, using data with the aim of benefitting from investor bias and market inefficiencies.

The strategy uses models to interpret large amounts of data. This is then used by the investment experts to make investment decisions. This method avoids the emotion of the markets and builds a portfolio based on desired exposures. The managers rely on this 'process' and 'science' to help generate returns by applying consistent metrics.

At times, these portfolios may appear to act in an opposite way to how markets are behaving as it aims to capture opportunities. As with most styles of investing, at certain times during your investment journey, one approach may provide better outcomes than the other.

How did the systematic investment process change the funds' positions during September?

The overall positioning of the Max 30% Shares Portfolio and the Max 50% Shares Portfolio remained relatively stable in September. The funds maintained their postions, holding fewer bonds and more shares compared to the benchmark.

Both funds held fewer highly rated company bonds than the benchmark throughout the month. While the Max 30%'s underweight position in government bonds barely changed, the Max 50% shifted from a slight overweight position to a small underweight position during the month, compared to the benchmark, in keeping with its risk profile.

In terms of shares, financial contracts were purchased to allow the fund to make a profit should the S&P 500 Index, which tracks the biggest shares on the New York Stock Exchange, fall below a certain level. This decision proved successful, adding to returns during the month. The decision was taken to protect the Max 30% and Max 50%.

During the month, the funds overweight holdings of US shares were reduced, particularly those of the Max 30%, but they are still overweight when compared to the benchmark.

The models further reduced their positions in UK shares relative to their benchmarks, while increasing the Max 50%'s overweight holdings of Japanese shares. The Max 30%'s overweight position in Europe, excluding the UK, was little changed, while the Max 50% moved from slightly underweight to overweight during the month.

The Max 30% is the only fund that includes global high-yield bonds in its portfolio, where it is overweight, relative to the benchmark. It was the only fund to have benefited from an appreciation in the dollar's value during the month.

The Max 70% Shares Portfolios maintained its underweight position in bonds and shares, relative to the benchmark. However, towards the third week of the month, when stock markets began declining sharply, the systemic model progressively added more shares to take advantage of the lower prices.

The funds delivered positive absolute performances and generated positive excess returns, compared to their respective benchmarks.

For more information on the systematic rules-based investment process, please refer to the Fund's Prospectus, which can be found within our **Fund Centre**.

Private Banking

All data as at 30 September 2023.

[1] Reuters, 29 September 2023
[2] CNBC, 20 September 2023
[3] S&P Eurozone Sovereign Bond Index 29 September 2023
[4] S&P Japan Sovereign Bond Index, 29 September 2023
[5] S&P China Bond Index, 29 September 2023
[6] S&P UK Gilt Index, 29 September 2023
[7] Yahoo! Finance, 27 September 2023
[8] Politico, 11 September 2023
[9] CNN Business, 28 September 2023
[10] Reuters, 29 September 2023
[11] London Stock Exchange, 29 September 2023
[12] Reuters, 29 September 2023
[13] BBC, 29 September 2023
[14] Reuters, 13 September 2023
[15] S&P Global Market Intelligence, 22 September 2023
[16] The Guardian, 21 September 2023
[17] The Guardian, 14 September 2023
[18] Euronews, 29 September 2023
[19] HCOB Flash Eurozone PMI, 22 September 2023
[20] Bloomberg, 29 September 2023
[21] Fox Business, 20 September 2023
[22] Reuters, 28 September 2023
[23] Bloomberg, 28 September 2023
[24] Reuters, 30 September 2023
[25] Reuters, 26 September 2023
[26] Reuters, 29 September 2023

Note: The Portfolio Investments and Atlas Portfolios are Multi-asset, globally diversified portfolios. Although the portfolios may share similar underlying investments in terms of asset and fund selection, they will differ in terms of the way the funds are managed and the proposition in which they are held. Please refer to the Key Investor Information Document (KIID) for details on the objectives of the individual funds. If you have any questions relating to specific differences of the Portfolio Investments or Atlas Portfolios fund ranges, please contact your Private Banker.

The views expressed in this document are of the Multi Asset Solutions Team at Santander Asset Management UK Limited or where appropriate the Sub-Investment Manager, are subject to change and do not necessarily reflect the views of Santander Asset Management UK Limited or Santander UK plc (as a whole or any part thereof).