A Month in the Markets

From the Multi Asset Solutions Team

September 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in August. Shares experienced their biggest drop in eight months[1] and developed nation bonds delivered negative returns[2] in August on worries that interest rates will stay higher for longer.[3]

Market Overview

A late comeback towards the end of the month wasn't enough to avoid losses, given that the mood soured during the first half of the month. Investors were concerned that a strong US economy[4], UK wage growth[5] and consumer inflation expectations above the European Central Bank's (ECB) target may stall progress in the fight against rising prices.[6]

Rising energy costs and a flagging Chinese economy added to the gloom.[7]

Given that bond prices and yields move in opposite directions, a drop in bond prices pushed 10-year UK government bonds yields to a 15-year high[9] in August. In the US, 10-year government bond yields[10] climbed to their highest level since 2007[11] before falling back. Yields on bonds of companies based in developed countries also rose despite staging declines in the last week of August.[12]

Gains in stock markets in the last few days marked the end of a rocky August as fears of inflation shocks[13] and interest rate rises weakened slightly.[14]

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.

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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UK and Europe

The Bank of England (BoE) raised interest rates to a 15-year high at the beginning of the month and warned businesses and households that rates will remain elevated for at least the next two years. The central bank also forecast that the economy will grow less than 1% over the next three years, although it won't shrink.[15]

A survey of business leaders painted a bleaker picture, showing that Britain's economy might be heading for a recession, defined as two successive quarters of negative growth. Business activity in August shrank by the biggest margin since January 2021, when there was a COVID-19 lockdown.[16]

The FTSE 100, which consists of the largest companies listed on the London Stock Exchange, and the FTSE 250, which comprises mid-sized firms, both recorded their worst month since May.[17]

In Europe, data released at the end of the month showed that Eurozone inflation remained steady in August. Core inflation, which excludes energy and food prices, fell. That prompted some traders to bet that the European Central Bank (ECB) will pause its interest-rate hiking cycle in September rather than increase rates once again.[18]

A survey of business leaders showed Eurozone business output reached its lowest point in August since November 2020, as the region's downturn spread from manufacturing to the services sector, which includes industries such as banking, education and nursing. Hiring reached a standstill as companies stopped expanding due to poor demand and prospects.[19]

US

Data released on the last day of the month showed that the Federal Reserve's (Fed) favoured way of measuring inflation met economists' estimates. This makes it more likely that the US central bank won't alter interest rates at their next meeting. The same report also revealed that people spent more money in July, indicating that the US economy is growing steadily.[20]

The jobs market is showing signs of slowing, which will also help the fight against inflation. Businesses posted fewer open positions in July, while the number of Americans quitting their jobs for better-paying work fell sharply, according to data released in August.[21]

At an annual meeting in Jackson Hole, Wyoming, from 24-26 August[22], Fed Chair Jerome Powell said, while progress has been made in bringing US inflation down, it is still above where policymakers feel comfortable.[23]

Asia Pacific

China risks missing its government's annual growth target of 5% as the world's second-largest economy struggles to deal with plunging property prices, weak consumer spending, falling demand for loans, and a shrinking manufacturing sector.[24]

While authorities have accelerated efforts to reverse the slump in China's real estate market, which threatens the nation's financial system and global financial markets, responses have been mixed with regard to their effectiveness.[25]

Chinese shares slid the most since February.[26] In contrast, yields on local bonds dropped[27], driving prices higher. Insurers are buying more Chinese bonds, and household deposits are growing quickly. Uncertainty about China's economy is causing local investors to buy bonds as a safer option than investments like shares.[28]

Japan's benchmark shares index, the Nikkei 225[29], had its biggest monthly decline since December, as concerns about higher interest rates and China affected the export-driven economy.[30]

The index reached a 33-year high earlier this year, in part helped by a push from the Tokyo Stock Exchange to get companies to disclose plans to improve how they handle their capital, boost their valuations, and, as a result, their dividends.[31]

In the third week of August, yields on 10-year Japanese government bonds reached their highest level since January 2014. This increase took place after foreign investors sold their bonds in response to a weaker yen, which would raise the cost of imports. Despite typically controlling bond yields, the government chose not to intervene and prevent yields from rising. Foreign investors also sold shares.[32]

Outlook

The market is still reacting strongly to changes in inflation expectations and how central banks might respond. As a result, we continue to treat shares with caution and bonds with greater optimism.

Our outlook on bonds remains positive because we believe interest rates are approaching their peak. This is expected to decrease the likelihood of bonds falling in value, given that yields are elevated and less likely to rise further.

We are positive on highly-rated high-yield bonds, which both contributed to the performance of some portfolios in August.

We expect interest rates to remain higher for longer, and holding highly-rated high-yield corporate bonds in the UK, US, and Europe is also less volatile than shares.

We anticipate that global economic growth will be slow and that inflation will continue to decline gradually. Sluggish growth in China should also dampen global demand.

We expect to remain underweight shares relative to the benchmark.

Portfolio positioning

As at 31 August 2023

Private Banking

The fundamental approach

An update on positioning for the following fund 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' positioning during August?

Across the majority of the funds, small amounts of cash were moved into US bonds, predominantly government bonds, and some into company bonds. An even smaller amount was shifted into shares.

The funds continue to hold fewer shares than the benchmark and are overweight bonds. The funds also have more bonds that take longer to reach maturity than the benchmark.

The decline in stock and bond markets resulted in a mixed month for the different funds.

When compared to the benchmark, the lower-risk portfolios, which were overweight in bonds with long maturity dates, had a challenging month. However, the higher-risk funds, which were also overweight long-dated bonds but underweight shares, performed better.

The funds have been building up their positions in company bonds over the past few months to benefit from their higher yields over government bonds due to their higher risks.

So far, government bonds have proven more volatile than company bonds, where investments have focused on firms that can easily repay their debt from their profits. There have not been significant corporate defaults.

Where funds are introducing high-yield bonds, this is being done cautiously with the help of managers with the experience of building portfolios able to withstand economic changes, and in issuers less likely to default.

Portfolio positioning

Private Banking

As at 31 August 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 August?

The positioning in the Max 30% Shares Portfolio and the Max 50% Shares Portfolio were little changed during August as their overall asset classes remained stable. Both funds remained overweight shares relative to the benchmark and underweight bonds.

In terms of shares, both funds favoured US shares over UK shares while maintaining an underweight position (meaning holding less than the fund's target benchmark) in highly-rated company bonds. The Max 50% Shares Portfolio marginally decreased its underweight position in UK and Europe (excluding the UK) shares, while slightly lowering its overweight position (meaning holding more than the target benchmark) in Japanese shares.

The Max 70% Shares Portfolio adapted to changing market conditions by progressively increasing shares when they fell and then taking quick profits by selling them when they recovered toward the end of the month. The model sold bonds, particularly highly-rated company bonds, to fund the moves.

In terms of performance, the Max 30% Shares Portfolio generated returns above that of the benchmark after the US dollar gained[33], boosting the value of high-yield bonds that make up about 15% of the fund.

The Max 50% Shares Portfolio performed in line with the benchmark. The Max 70% Shares Portfolio slightly underperformed as the fund could not fully recover losses earlier in the month.

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**.

All data as at 31 August 2023.

[1] S&P Global BMI, 31 August 2023
[2] S&P Global Developed Sovereign Bond Index, 31 August 2023
[3] Associated Press, 31 August 2023
[4] Associated Press, 30 August 2023
[5] The Guardian, 15 August 2023
[6] Bloomberg, 8 August 2023
[7] Reuters, 21 August 2023
[8] CNBC, UK 10-year Gilt, 31 August 2023
[9] Bloomberg, 17 August 2023
[10] CNBC, US 10-year Treasury, 31 August 2023
[11] Reuters, 23 August 2023
[12] S&P Global Developed Corporate Bond Index, 31 August 2023
[13] Reuters, 31 August 2023
[14] Reuters, 31 August 2023
[15] The Guardian, 3 August 2023
[16] Reuters, 23 August 2023
[17] Reuters, 31 August 2023
[18] Bloomberg, 31 August 2023
[19] HCOB Flash Eurozone PMI, 23 August 2023
[20] Associated Press, 31 August 2023
[21] Associated Press, 29 August 2023
[22] Federal Reserve Bank of Kansas City
[23] CNBC, 25 August 2023
[24] Reuters, 31 August 2023
[25] Bloomberg, 31 August 2023
[26] S&P China BMI, 31 August 2023
[27] S&P China Bond Index, 31 August 2023
[28] Bloomberg, 24 August 2023
[29] Google Finance, 31 August 2023
[30] Livemint, 18 August 2023
[31] Reuters, 31 August 2023
[32] Reuters, 31 August 2023
[33] Reuters, 14 August 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.

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