Santander Asset Management

Where evolution meets tradition

Quarterly Perspectives

Q3 2023

This publication aims to provide an insight into the changing economic environment and importantly, how this has impacted financial markets and investments. Our Multi-Asset Solutions team at Santander Asset Management UK share their thoughts on the market outlook and how they have adapted investment portfolios to position our clients for the road ahead.

Summary of Quarterly Perspectives content:

- Review of the third quarter of 2023
- Investment performance of different asset classes year to date
- Our expert's opinion on the investment outlook
- How have our fund managers changed their portfolio positioning based on the outlook and our tactical asset allocation
- Summary of the quarterly perspectives

Outlook **at a glance**

Current view: ✓ Positive ■ Neutral ✗ Negative

Quarterly change since previous outlook: ▲ Upgrade ➤ Unchanged ▼ Downgrade

Asset classes	Current view	3 month change	At a glance
Shares	■	➤	Slowing economic growth following central bank increases in interest rates and high wage settlements provides numerous challenges for companies and the prospect of future earnings. While shares have performed strongly so far this year, driven by resilient earnings, current valuations face an increasingly competitive environment when compared to higher bond yields and cash rates.
Bonds	✓	➤	While interest rates may go higher depending on economic data, we believe they are either at or close to their peak. Bonds are therefore unlikely to become more attractively priced as bond values fall when interest rates rise. We believe that they are currently an appealing investment.
Cash	✗	➤	While cash has become attractive, we have used our cash holdings to invest more in bonds, given their lower prices and higher income.

Regions	Current view	3 month change	At a glance
US	■	➤	While our views on the US remain neutral, given the market is adjusting to the change in the stance of the Central Bank, meaning interest rates may stay higher for longer, we believe US shares may be volatile and will be selective in what we buy. We remain neutral on US shares as we prefer bonds.
UK	■	➤	After 14 consecutive rate rises, the Bank of England paused in September. Our view has marginally changed as we believe that the UK economy is susceptible to a recession and the outlook remains uncertain. Our preference is to hold UK bonds over UK shares.
Europe	■	➤	Europe's economy continues to show signs of a slowdowns as Germany's exports remain weak, offset in some respects by southern European countries benefiting from a strong summer of travel and tourism. Interest rates have reached record levels following the Central Bank's latest interest rate rise in September. We remain neutral on European shares as we prefer bonds.
Japan	■	➤	The Japanese stock market has performed strongly so far this year. However, some of this momentum has slowed, and we are unsure if it will continue, leading us to remain neutral. The Bank of Japan has chosen not to follow other policymakers in pursuing higher interest rates despite a recent relaxation of their monetary controls, leading to a sharp devaluation of the yen, especially against the US dollar.

Reviewing the third quarter of the year

During the quarter, global markets were largely influenced by inflation data and major central banks meetings, with investors trying to anticipate whether we are close to the peak in interest rate rises.

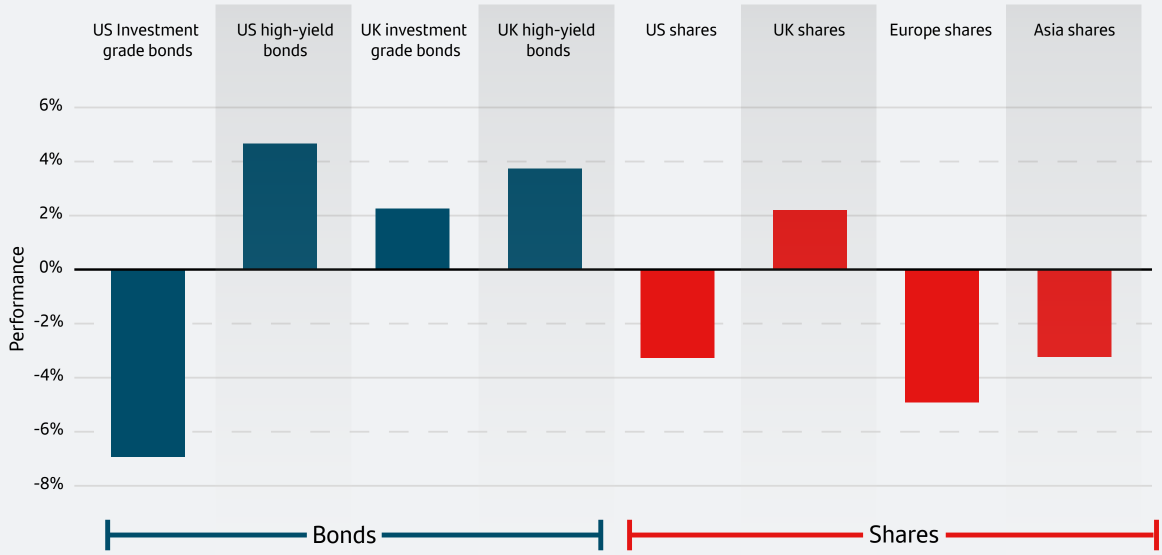
In July, stock markets rose amid expectations that US and European interest rate hikes are nearing an end and that the global economy will grow more than previous International Monetary Fund (IMF) forecasts suggested.[1] The US Federal Reserve (Fed) raised interest rates to a 22-year high in July, and the European Central Bank (ECB) followed suit by lifting rates to their joint highest level on record.[2] Measures by China to accelerate economic growth and better-than-expected UK inflation data added to investor optimism.[3] Towards the end of the month, the Bank of Japan (BoJ) surprised investors by signalling that it might raise interest rates in the future, marking a significant shift away from its current policy of ultra-low interest rates, which are designed to stimulate economic growth by encouraging consumers to spend rather than save.[4]

During August, shares experienced their biggest drop in eight months, and developed-nation bonds delivered negative returns on worries that interest rates would stay higher for longer.[5] 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. The Bank of England (BoE) raised interest rates to a 15-year high at the beginning of August and warned businesses and households that rates will remain elevated for at least the next two years.[6] The central bank also forecasts that the UK economy will grow less than 1% over the next three years, although it won't shrink.[6] This move by the BoE comes after it raised interest rates by more than expected in June in a bid to tackle inflation that has proved more stubborn than in many other major economies. Investors' concerns grew over a strong US economy, UK wage growth, and consumer inflation expectations above the Central Bank targets, which may stall progress in the fight against rising prices.[7] Fed Chair Jerome Powell stated that while progress has been made in bringing US inflation down, it is still above where policymakers feel comfortable.[8]

Share and bond prices fell in September as investors came to terms with the fact that interest rates are likely to stay higher for longer.[9] Yields on US government bonds surged to 16-year highs after the Federal Reserve (Fed) indicated that another interest rate hike would be implemented before the end of 2023.[10] The reduced appeal of shares contributed to global stock markets experiencing their biggest monthly decline – and first quarterly decline – in a year.[11] 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.[12] 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.[13] The Fed also held interest rates steady, giving consumers struggling to repay loans some breathing space.[14] 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.[15]

Overall, it was a tough quarter for markets when compared to the first half of 2023. Investors were closely watching major central bank policies and economic data releases for signs of future market movements. Interest rates may have reached their peak, so there may be some relief for investors and borrowers for the remainder of 2023.

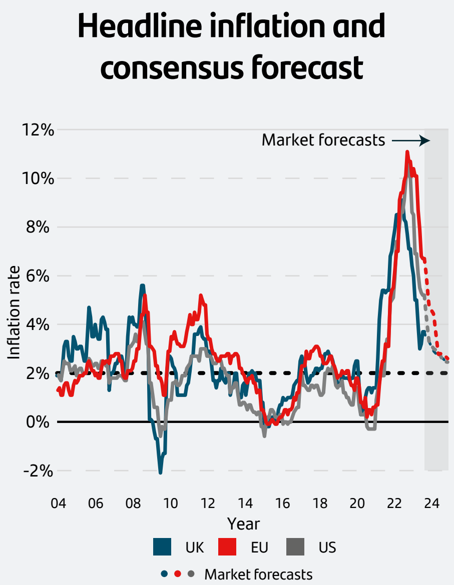
3rd quarter asset class performance

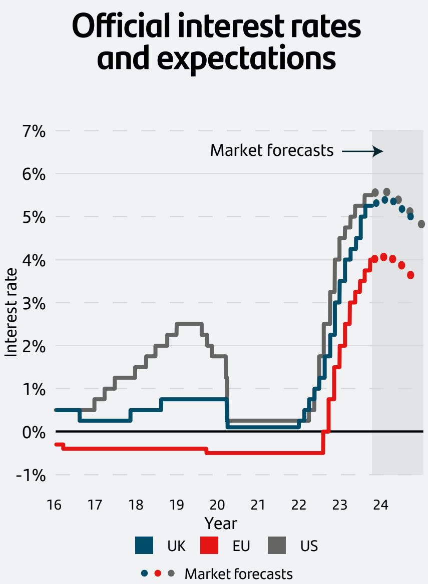


Source: Refinitiv Datastream, Eikon. Bond returns are in Pound Sterling, share returns are in their respective local currencies. US Investment grade bonds: Bloomberg USD Liquid Investment Grade Corporate USD. US high-yield bonds: Bloomberg U.S. Corporate High Yield USD. UK investment grade bonds: iboxx £ non-gilts. UK high-yield bonds: ICE BofA Sterling Developed Markets High Yield Index. US shares: S&P 500. UK shares: FTSE 100. Europe shares: MSCI Europe. Asia shares: MSCI ASIA EX JP. Data as at 30 September 2023.

Inflation and interest rates

Inflation and interest rates have been dominating the financial news lately, and for good reason. Understanding these measures is crucial to making informed investment decisions, as they can help explain why your portfolio may be behaving in a certain way. The two charts below provide a view of historic and current trends in these areas, helping you to better understand what's going on in the current economy.





Source: Refinitiv Datastream & Santander Asset Management.
Data as at 30 September 2023.

When interest rates go up, it becomes more expensive to borrow money, which can lead to a decrease in consumer spending and economic growth. This can cause shares and bonds to lose value and make it harder for companies to generate profits, which can ultimately hurt your investment returns. However, rising interest rates can be a powerful tool for tackling inflation. The slowdown in spending helps to reduce the upward pressure on prices that contributes to inflation. While rising interest rates may have a negative impact, it can play an important role in keeping inflation in balance.

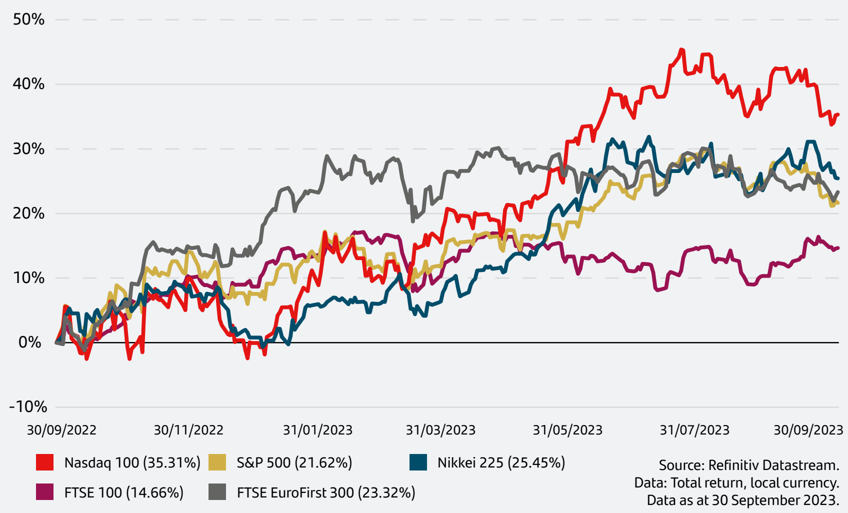
Inflation and interest rates outlook

We believe that investor focus has now shifted away from concerns about inflation and interest rate rises to future global economic growth. In the last round of major central banks meetings, both US and UK policymakers chose to pause on further interest rate rises. Although they warned that they would be prepared to go higher if necessary, given the expectations for inflation, this is increasingly unlikely. Even though the European Central Bank (ECB) increased interest rates in September's meeting to a joint record high, given that inflation is falling against an economic slowdown, this may indeed be their last rise. While it may appear that interest rates have peaked, policymakers warn that they will stay higher for a longer period of time because it will take time for inflation to decline to the desired 2% target. We therefore see greater risks in economic growth estimates than in those with inflation or interest rates.

Shares

The below chart demonstrates how various indexes have performed over the last year. An index is a collection of stocks that are grouped together to represent the overall performance of a particular market or sector. In this case, we're looking at major indices from different regions around the world, such as the S&P 500 in the United States, the Nikkei 225 in Japan, the FTSE EuroFirst 300 in Europe, the FTSE 100 in the United Kingdom and the NASDAQ 100 which includes 100 of the largest non-financial companies listed on the Nasdaq stock exchange. These indices are made up of the largest and most influential companies within a given market, and their performance can give us an idea of how well that particular economy is doing.

Share index performance over 1 year



Source: Refinitiv Datastream.
Data: Total return, local currency.
Data as at 30 September 2023.

Share outlook

Shares have performed strongly since the start of the year, especially shares situated within the NASDAQ 100 Index, pushing up share values and making some share valuations expensive. We believe the impact of rising interest rates combined with slowing economic growth provides an uncertain and challenging outlook in the short term, leading to our decision to maintain a neutral position on shares. Stock markets continued to perform well throughout much of the third quarter until a fall at the end of September. The negative impacts of higher interest rates and slowing consumer demand may not necessarily lead to a recession, especially in the US, but we believe these are significant obstacles that justify our neutral position. In contrast to the environment of recent years, where risk-free investment was penalised by low interest rates, the risk-versus-return trade-off now favours lower-risk investment options. Investors are no longer forced to increase risk and invest in shares to obtain positive returns.

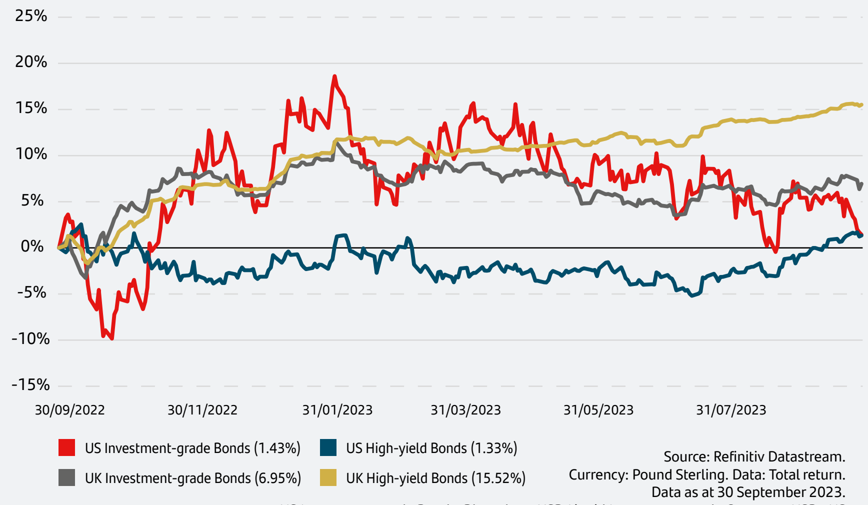
Bonds

The chart below demonstrates how global bond indexes have performed in the past year. Bond indexes track the performance of a group of bonds and are typically created by selecting a specific set of bonds that meet certain criteria, such as maturity dates, credit ratings, or other characteristics. There are many different types of bond indexes, including those that track government bonds, corporate bonds, municipal bonds, or bonds from a particular region or country. Just like equity indexes, bond indexes provide investors with a convenient way to track the performance of a particular segment of the market.

Bond index performance over 1 year

Investment-grade bonds: Issued by companies considered most financially secure and least likely to default on their loans.

High-yield bonds: Issued by less stable organisations, with a higher rate of interest to compensate for the higher chance of defaulting.



Source: Refinitiv Datastream. Currency: Pound Sterling. Data: Total return. Data as at 30 September 2023.
US Investment-grade Bonds: Bloomberg USD Liquid Investment-grade Corporate USD ; US High-yield Bonds: Bloomberg U.S. Corporate High-yield USD; UK Investment-grade Bonds: iBoxx Non-Gilts; UK High-yield Bonds: ICE BofA Sterling Developed Markets High-yield Index.

Bond outlook

Bonds have become a much more attractive investment over the last couple of years. Rising interest rates in response to inflation have seen bond yields rise in line with higher rates, and as a result, bond values have fallen significantly, meaning that bonds are now priced at attractive prices with high yields. During the third quarter, yields initially fell until central banks warned of higher rates for longer, which saw yields once again rise and values fall. We have continued to move more of the cash held in portfolios into bonds to take advantage of lower valuations and higher yields. While inflation has been slower to fall than initially forecast, meaning interest rates are likely to stay higher for longer, our conviction remains that we are probably at the peak of interest rates. Our view is that it may be some time before central banks begin to consider cutting rates in the future, even in the event of a significant economic slowdown. However, investment markets tend to anticipate the future path of interest rates, which is then reflected in the change in both yields and values. The funds are holding smaller positions in cash as we have been using some of their previous cash position to buy more bonds.

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.

Our tactical asset allocation

Our tactical asset allocation represents our views on the financial markets based on the current market conditions and our own market outlook over the coming months. The below chart demonstrates how our current positioning is either underweight, overweight or neutral when compared to a funds benchmark. Generally, an underweight position means that we think a sector will perform worse than others, so we hold less of it. Holding an overweight position means that we think a sector will perform better, so we hold more of it. A Neutral position means that we think a sector will perform similarly to others, so we will hold a similar amount as the benchmark.

	July	August	September
Shares			
UK	Neutral	Neutral	Neutral
US	Underweight	Neutral	Neutral
Europe	Underweight	Underweight	Neutral
Emerging Markets	Underweight	Underweight	Neutral
Japan	Underweight	Underweight	Neutral
Pacific Region (Excluding Japan)	Underweight	Underweight	Underweight
Bonds			
Government Bonds	Overweight	Overweight	Overweight
Investment Grade Credit	Overweight	Overweight	Overweight
High Yield Bonds	Overweight	Overweight	Overweight
Emgering Markets Bonds	Overweight	Overweight	Overweight
Money Market			
Cash	Very Underweight	Very Underweight	Very Underweight

Very Overweight · Overweight · Neutral · Underweight · Very Underweight

Summary

- During the third quarter, central banks continued to raise interest rates, changing market expectations to a higher for longer outlook.
- Inflation continues to moderate, albeit slower than policymakers would prefer, and may take much longer to reach the desired 2% target of most developed markets.
- Shares have performed well so far this year but face a challenging and uncertain short-term outlook as slowing economic growth and both cash and bonds now offer an attractive alternative.
- Bond yields have risen throughout this year and have reached an attractive

level, given that we believe interest rates have probably now peaked.

- We are neutral on shares given the uncertain outlook and the raised valuations.
- We prefer bonds given their attractive yields.

Find out more

Learn more, visit our website here for more insights into financial markets.

Note: Data as at 30 September 2023.

[1] Reuters, 28 July 2023
[2] Euronews, 27 July 2023
[3] CNBC, 24 July 2023
[4] S&P Japan Sovereign Bond Index, 31 July 2023
[5] Associated Press, 31 August 2023
[6] The Guardian, 3 August 2023
[7] Bloomberg, 8 August 2023
[8] CNBC, 25 August 2023
[9] Reuters, 29 September 2023
[10] CNBC, 20 September 2023
[11] Reuters, 29 September 2023
[12] The Guardian, 21 September 2023
[13] The Guardian, 14 September 2023
[14] Bloomberg, 29 September 2023
[15] Fox Business, 20 September 2023