# When Will Markets Recover?

**We always welcome client feedback – we actively encourage it. Our recent valuation letter sparked a flurry of queries. A common theme emerged, when will markets recover? This is a fair question, especially given the turmoil experienced over the last two calendar years. I do want to provide a straight answer but, sadly, my response does not point to a specific date (no one would be happier than me if I could be that prescient). However, as mentioned, the question is valid, and I want to give you as much of an answer as possible.**

Pinning down market revivals to one event is implausible. In reality, it does not work this way, but I believe that a small number of interconnected events will be the catalyst for optimism to return. Open any good financial markets textbook and it will state that the market is a "discounting mechanism". In effect, it discounts what it believes to be future events to today. Or, in other words, if the market expects the environment to be better in a year it would reflect that price today. As with many investment issues, this is not an exact science and changes very quickly on fresh news flow. That is what makes market timing so imprecise and why we believe that portfolios should be fully invested as turns can be unexpected and/or quick.

So, what are the signs we are looking for that will herald the return of optimism or "animal spirits" as they are referred to colloquially. Perversely it will be a case of bad news is good news. Let me explain. Our core thesis remains that developed economies will enter recession (if not already there). The US may pull a rabbit out of a hat by achieving what is known as a "soft landing[1]"; these are difficult to achieve but are not impossible, just rare.

[1] Soft landing is when the central bank increases rates by enough to subdue inflation without pushing the economy into recession.

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For those of us in the UK, recession is inevitable due to policy mistakes made by the Bank of England's Monetary Policy Committee (MPC). Restrictive monetary policy (high interest rates) weighs heavily upon markets. This curbs growth as the cost of capital increases significantly. Interest rates are a blunt tool and have a lagging impact, but they are at the forefront of inflation busting. Current interest rates, although only relatively high, (speak to anyone with experience of the 1970s about high rates), are slowing the economy and having the desired impact of reducing inflation. The Bank of England has a mandate to keep inflation at 2%. It has thoroughly failed in this. They are conducting an internal review as to what went wrong. I believe it is valid to question whether, if the MPC got it so wrong on rates going up,  should they be any better on the way down. Nevertheless, the first two interconnected signs will be inflation falling faster than predicted as the economy enters recession and then the MPC backpedalling vigorously to lessen the recessionary impact. The market will discount this forward on the basis that monetary conditions are easing, making life easier. This will also be a trigger for our long duration assets, those that will benefit from a falling rate environment, to resurge. As a reminder, these are our alternative income investments, such as infrastructure and green energy and take the form of investment trusts. The performance of the underlying assets held within these trusts has been acceptable and they have continued to generate good dividends. However, the share prices within the investment trust sector have been hurt by sentiment, as the market has reflected a discount to their true worth.

OK, we know what to expect, but when will these events unfold? This is the more challenging aspect. As it stands, the market expects the first UK rate cuts in the second half of 2024. The Bank of England's last two MPC meetings left rates on hold at 5.25%, but with accompanying rhetoric which was harsh. The message was along the lines of 'we will hold for now but don't tempt us if inflation comes back and do not expect cuts any time soon'. In my view, rates have peaked and the MPC has to say harsh things to avoid the market getting ahead of itself. Huw Pill, the Chief Economist at the Bank of England, made a speech in Cape Town over the summer. Using the location to provide an analogy, he made the comment that UK rates will look like Table Mountain, as opposed to the Matterhorn. Historically, rapid rate rises are usually followed by falls. Huw Pill has since made comments that rates might come down a little quicker than the second half of next year, which had a positive impact on the bond markets and some of our long duration assets. When cuts do come, and they will, their effect will be cumulative.

Analysing all the information that is currently available to me, our base case is that rates will start to fall earlier than the MPC is stating and, possibly, a little sooner than the market expects. It is trite to say that we are closer to this point than we were, and I apologise for that. But I maintain confidence that pockets of investments within our portfolios are

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undervalued and to capitulate at this point would be wrong. Patience remains key and, rest assured, the investment team continues to challenge its views and outlook for the market and seek every opportunity to enhance performance for you.

If you have any questions or comments, please feel free to contact me directly.

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**James Calder, Chief Investment Officer, City Asset Management**

James joined City Asset Management in 2009 and is our Chief Investment Officer, where he is responsible for managing the investment process and chairing the asset allocation, portfolio construction and fund selection committees. He is also a member of our Executive Committee. He has 25 years' experience, including roles at Gartmore, BestInvest and Baring Asset Management, and specialises in multi-asset real return investing. Throughout his career he has been a key mentor for younger analysts and enjoys watching them progress on to their own successful careers.