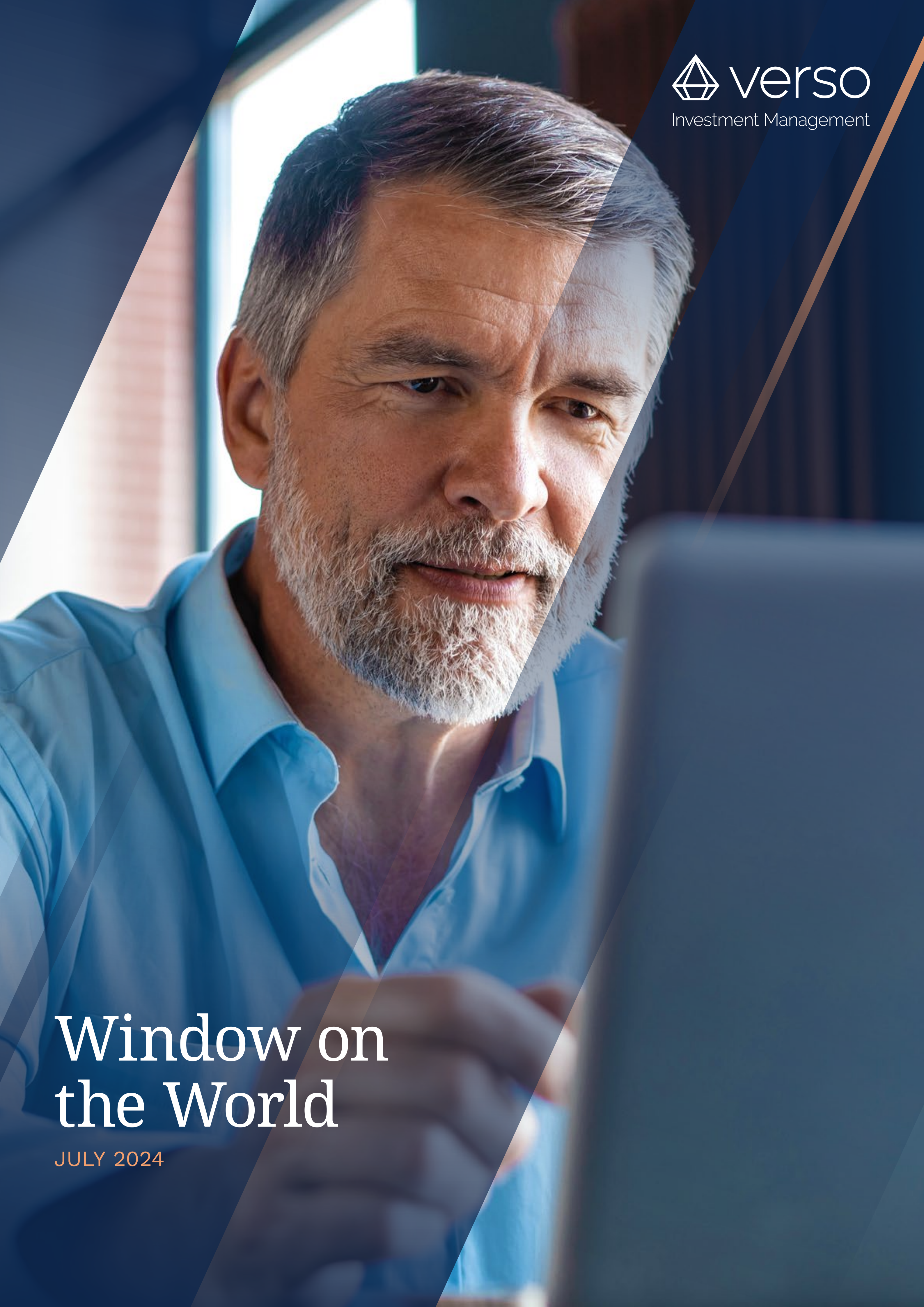

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Investment Management

Window on the World

JULY 2024

Introduction

Just as we pass the half-way mark for the year, whether you see that as the solstice or the exact halfway point, 02 July (182 days), our attention is focused on a whole number of things - holidays, the weather, the Euros, Wimbledon, and soon the Olympics! But it is worth squeezing in a review of where markets have been for the first half of the year and to get our crystal ball out and consider the second half.

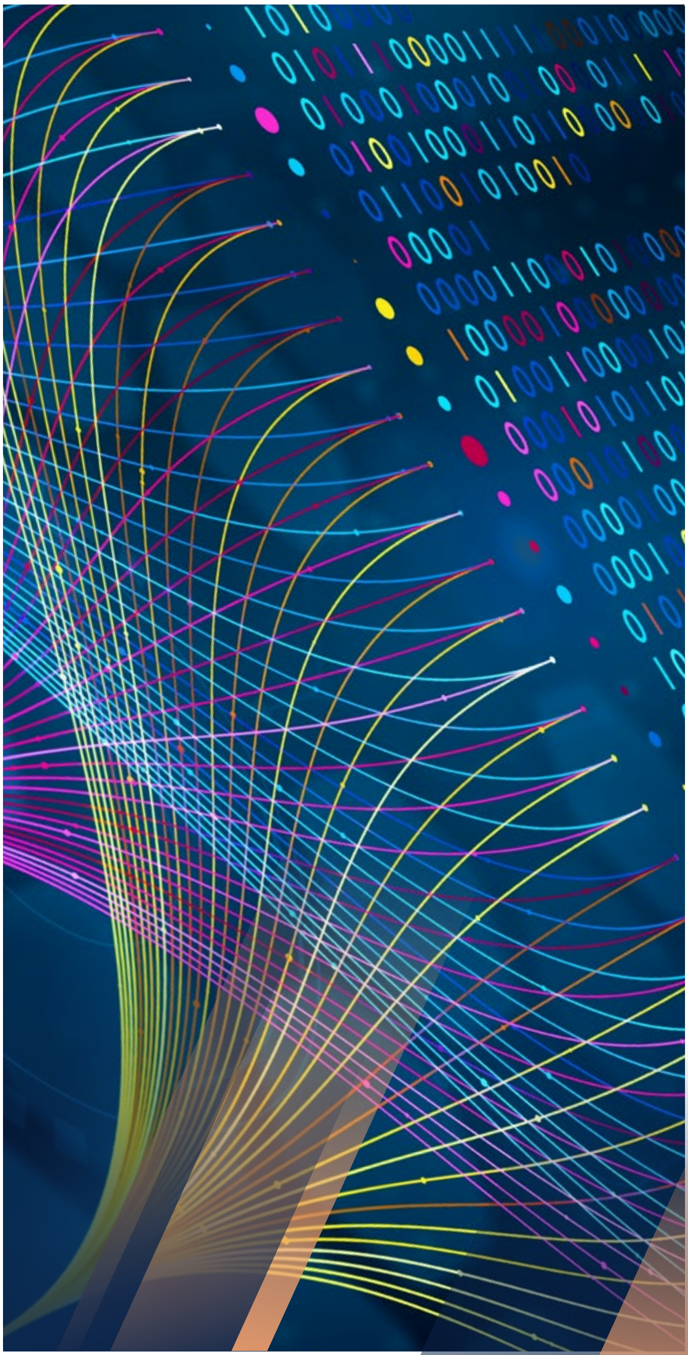
In the first half, there is no question that the path for inflation, and consequently the outlook for interest rates had been at the top of investors watch lists. The other big focus was Artificial Intelligence (AI) which has been and remains in the glare of the spotlight. The potential benefits that AI can bring us has been a massive attraction for investors because of the huge profits likely to be generated. More recently elections in the UK and France have been centre stage, and in Europe driven a degree of volatility in some capital markets - and there is likely more politically driven volatility to come! This month's edition of Window on the World assesses all of these alongside focal points for the rest of the year.

Rise Of The Machines

Since coming onto investors radars excitement about the potential that AI offers has driven big inflows of money into the technology sector, amplifying the performance of the Magnificent Seven, a phrase coined to describe the seven US companies which now dominate the US equity market (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla). Of these seven the poster child for AI is Nvidia, which is the market leader in the design and manufacturer of the semiconductors that drive AI.

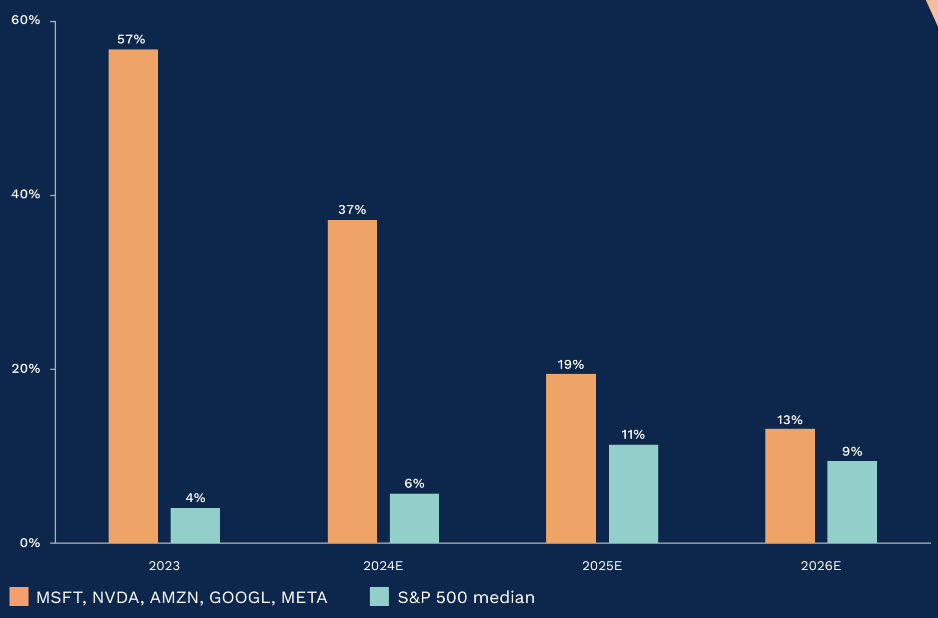
The explosive growth in demand for its products over the past 18 months as firms ramped-up their capital expenditure on AI development has seen its profits rise sixfold over three years. It reached $30billion at the end of their last financial year and is expected to grow to $90billion over the next three years. This phenomenal rise has fuelled an astonishing increase in the value of the company's shares, which now exceeds $3trillion. Putting this into context, this exceeds the value of the UK, French and German stock markets. It is worth reflecting on this because it is saying that Nvidia is worth more than the combined value of over 4000 European companies – hard to believe!

But is there an AI driven bubble? Investors are always on 'bubble watch' but can be prone to seeing them where they do not exist, however, there is no doubt valuations are stretched in the sector relative to the broader US equity market. Nevertheless, capital expenditure in AI continues to grow strongly, and earnings growth in the technology sector continues to exceed that of the broader market by a wide margin, which investors often see as justifying these higher valuations. But as the chart below shows the rate of growth will slow.



PROFIT GROWTH IN THE FIVE BIGGEST US COMPANIES CONTINUES TO EXPAND AT A MUCH FASTER RATE THAN OTHER INDUSTRIES BUT IS LIKELY TO SLOW!

Annual earnings growth.



Source: Goldman Sachs

We always remind ourselves that valuation is at the heart of investment, after all what you pay for something will determine your return in the long run, and it is clear that if the sector does suffer a correction, it will weigh on the broader US equity market. As such, we remain cautious on US equities generally, preferring to overweight markets where valuations are less demanding and economic momentum is improving, such as the UK, Europe, and Emerging Markets.

(As a side note - if the stock market narrative follows the narrative of the film 'The Magnificent Seven' not all of them survive!)

Inflationary Pressures Are Becoming More Regional, Less Global

Inflation globally has come down a long way from when it topped 10% and has continued to decline this year. The two major impacts driving recent inflation, COVID-19 supply chain disruption and energy prices have largely returned to normal – consequently we are pretty much back in 'normal long run' inflationary territory, with regional differences starting to show – notably in the US where services inflation has been sticky.

The path back to normality has not been the one investors expected, and so the outlook for interest rates has been recalibrated – and although interest rate cuts are anticipated there is a sense that higher for longer will be the mantra. This of course knocks onto fixed income markets which are waiting for the rate cutting gun to be fired – and the big question is how many cuts will there be?

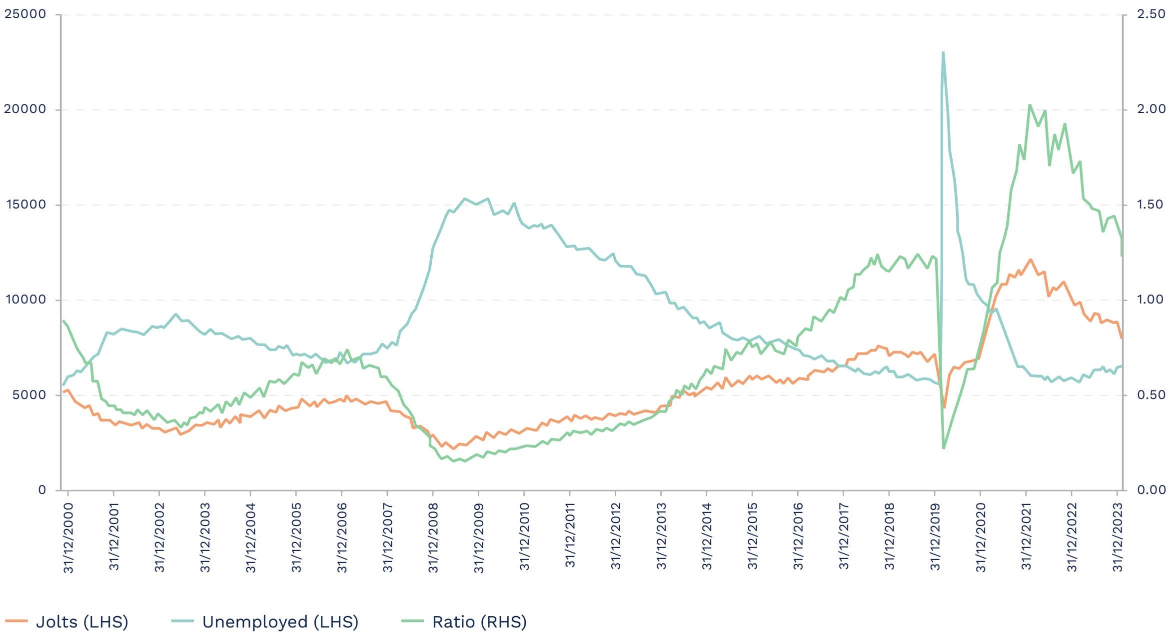
As suggested above, US inflation is proving particularly sticky because demand for services remains robust. The funny thing is that this is a function of a strong labour market and rising real income – i.e. good news. So, with inflation in the US remaining above 3%, the Federal Reserve (Fed) has yet to deliver any cut in interest rates. Roll back six months and investors had expected there to have been two or three cuts already this year – which shows just how hard forecasting is. Another factor driving the resistance to cutting rates has been the ongoing resilience in the US economy (good news), but it negates the need for a rate cut to stimulate economic activity. That said, we do expect inflation to continue to trend downward in the US and expect the Fed to cut rates later this year – but we said the same last year, so it will depend on the data.

Here in the UK, inflation has returned to 2% (we have a weaker economy), which will likely allow the Bank of England to cut interest rates at the meeting in August. Elsewhere, in Europe, Switzerland and Canada central banks have already started the process of cautiously cutting rates – again their economies are weaker than the US. The expectation remains that we will see a number of rate cuts, but central banks will not want to cut too aggressively to only have to raise them again – we may be in a new era of more thoughtful rate management.

US Economic Activity May Be Waning

Continuing to focus on the US there is no doubting that the economy has broadly remained in good shape so far this year, with a tight labour market and a strong consumer. Ideally management of the economy is a case of 'not too hot, not too cold' and although recent economic data has started to disappoint, coming in below consensus expectations, it can be viewed as a positive and has addressed some concerns that the US economy may be overheating, instead of heading for a soft landing.

IN THE US JOB OPENING (JOLTS) HAVE CONTINUED TO DECLINE, WHILST UNEMPLOYMENT HAS GRADUALLY RISEN, CONFIRMING A COOLING IN THE US LABOUR MARKET, AND THE RATIO HAS RETURNED TO PRE COVID-19 LEVELS.



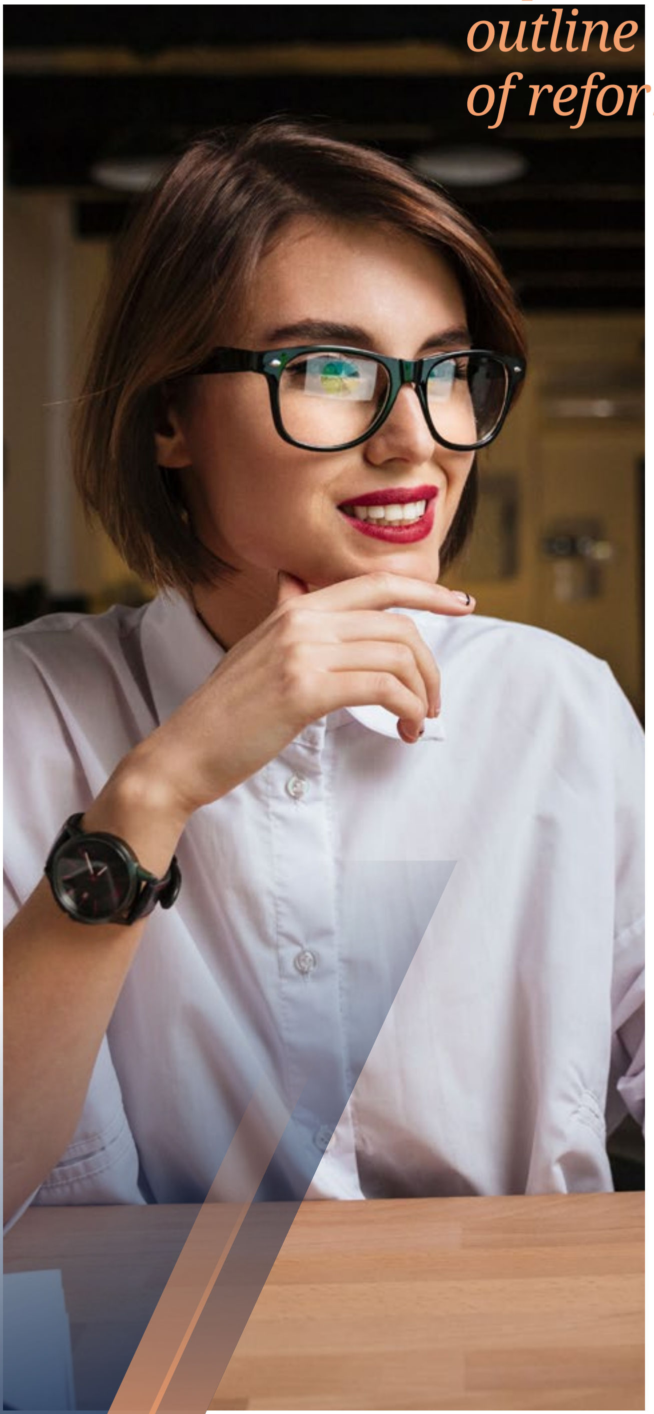
Source: Twenty Four Asset Management, Bloomberg

From here, a close eye needs to be kept on the softening in the US economic data. We expect it to be nothing more than that – a softening from a high growth rate to something lower, as opposed to any broader setback. The key indicator will be the US labour market, which is now back in balance, with the job-workers gap (the difference between job openings and unemployed workers) back to February 2020 levels. If there are fewer job opening, then wage growth tends to slow, which knocks onto consumer demand and might just allow the Fed to cut rates.

Political Dynamics Are Having Some Influence On Markets

2024 is a year in which a large proportion of the world's population go to the polls. India, South Africa, and Taiwan have held elections already, and of course closer to home we have had both the UK and French general elections, both concluding with quite different outcomes.

In coming weeks, we should expect the new government to outline and implement a series of reforms.



The Labour Party secured a sizeable majority, securing 411 seats and achieving a majority of 172. This majority gives the party the power to stick to its central plan of stability, encouraging private sector investment, and lifting longer-term growth. In coming weeks, we should expect the new government to outline and implement a series of reforms relating to these aims, although more details on the fiscal side are not expected until their Autumn Budget.

In the very near-term, any economic implications are likely to be modest in nature, but looking further ahead we would expect their policies to have increasing impact - fiscal constraints will be reviewed, there could be more government borrowing, and other sources of revenue will be sought, and targeted tax rises cannot be ruled out.

President Macron's surprise election call, triggered by the success of the far-right parties in the EU election, threw French politics into a spin – but the left wing and centrist parties regrouped quickly, and pushed Marine Le Pen's far right party National Rally into third place – but it will leave the country facing a hung parliament. The economic impact of the election result is likely to be limited in nature, and we remain optimistic that economic activity in the region continues to improve.

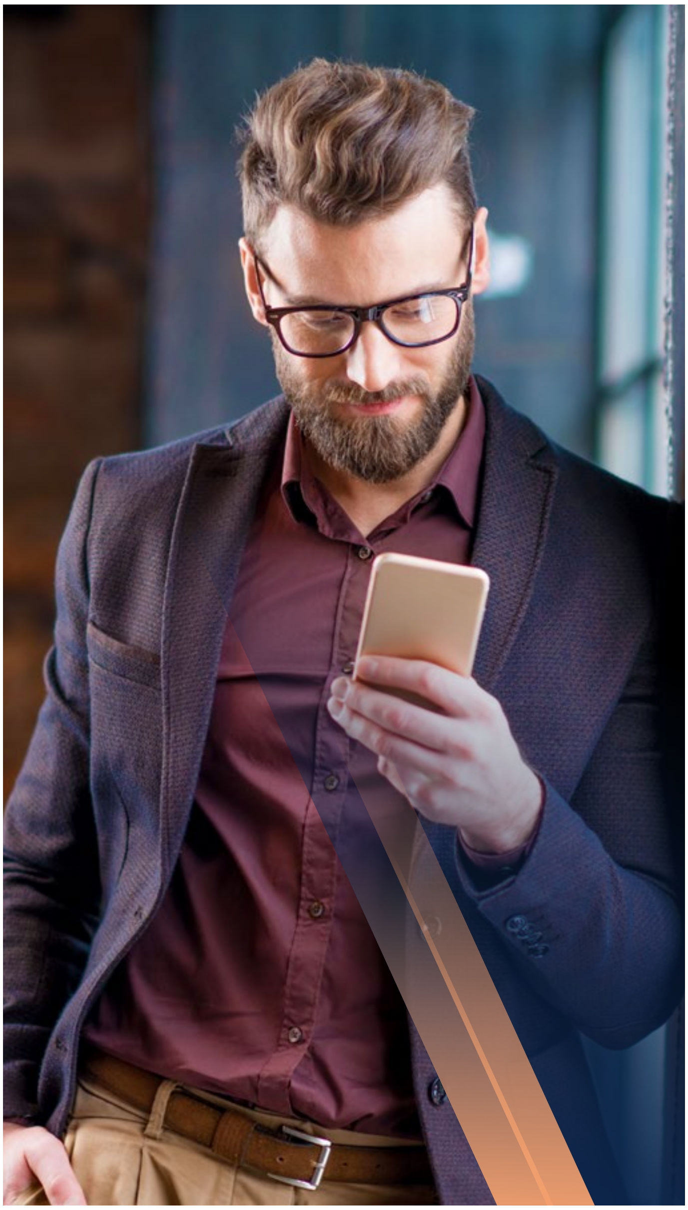
Attention now turns to 'arguably' the biggest election of them all, the US Presidential Election in November. President Biden's poor performance at the first Presidential debate in June has raised questions about his age and fitness for office as he handed Donald Trump a clear advantage. There is much speculation as to whether President Biden will stand for re-election or stand aside and if he does who would be the new candidate. In the meantime, Donald Trump continues to extend a slender lead in the opinion polls, and with the Supreme Court ruling that he is likely immune from prosecution for a lot of his alleged misdemeanours, he received a double boost. As we head towards November there is the potential that rash comments from either candidate could trigger volatility, but that all still seems a long way off.

A Positive Backdrop For Risk Assets

Equities have had a good year so far, continuing their positive momentum in the second quarter and are firmly in positive territory for the year.

It has very much been US equities leading the way, thanks to the aforementioned strong performance of technology stocks, particularly Nvidia. In the UK, optimism around the economy and the lifting of political instability has led to equities performing well and valuations remain attractive. French political woes have weighed to an extent on European equity markets, which fell by over 2% in the three months ending June 2024, but with those woes fading European equities should pick up. We have also seen a better performance from Chinese equities, which has supported emerging markets more broadly; but Japan has weakened recently amidst concerns on the outlook for monetary policy and the ongoing weakness in the Japanese yen, which is the cheapest it has been in over 20 years.

In fixed income markets, the recalibration in the outlook for interest rates that we discussed above has weighed on bonds, albeit this eased somewhat in the second quarter. UK Government Bonds are lower by nearly 3% this year, with the yield on the UK 10 Year Government Bond rising from 3.55% to 4.18%. This move higher in nominal yields also weighed on corporate bonds, but to a lesser extent, as spreads versus government bonds continued to narrow further.



	Total Return (%)			
	1 Month	3 Month	12 Month	YTD
UK Equities	-1.0	3.7	12.6	7.9
US Equities	4.3	4.1	25.3	16.4
European Equities	-2.2	-2.4	13.5	8.7
Japanese Equities	-0.2	-4.6	13.4	6.2
Emerging Market Equities	4.7	4.8	13.5	8.6
UK Gilts	1.3	-1.1	4.7	-2.9
UK Corporate Bonds	0.8	-0.2	10.8	-0.1
UK High Yield Bonds	0.9	1.6	15.7	4.5
US Corporate Bonds	0.7	0.2	4.8	0.0
US High Yield Bonds	1.0	1.1	10.4	2.6

Source: Bloomberg

Summary

As we enter the second half of the year, we expect some of the features which shaped investment markets in the first half of the year to change – the Magnificent Seven may continue to perform well but we think the market will broaden out and that we will see other sectors starting to perform better.

The disinflationary trend prevalent in Europe and the UK is likely to continue, allowing the Bank of England and European Central Bank to cut interest rates. In the US if we see a continuation of slowing economic activity it should pave the way for the Fed to start cutting rates before the end of the year and the Presidential Election in November will of course loom ever larger as the year progresses and come to dominate new flows and market commentary.

There are always uncertainties, but the pick-up in growth in the UK, Europe and China and a soft landing in sight for the US presents a broadly constructive backdrop for equity markets, although investors should be cognisant of valuations in parts of the US equity market - a pullback in US equities wouldn't come as a surprise, and is likely to present a buying opportunity if we see excess valuations reduced meaningfully. In the meantime, we retain a preference for UK, European and emerging market equities on both valuation grounds and improving fundamentals. In the fixed income space, the prospect of long-awaited interest rate cuts will act as a positive for the sector and notably UK Government Bonds and short dated corporate bonds, with valuations in both remaining at their most attractive levels in 16 years.

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