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Investment Management

Window on the World

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Introduction

As summer draws to a close and autumn commences, it brings to an end an eventful third quarter for markets.

Christmas is not too far away as our attention now turns to the final months of 2024, where in the UK all eyes will be on the first Labour Budget at the end of October and the US Presidential election in November, set against a backdrop of the ongoing conflicts in the Middle East and Ukraine. The past three months have given investors plenty to digest, most importantly the long-awaited start of an interest rate cutting cycle in most developed markets, a serious bout of equity market volatility in August, and very recently a raft of measures in China aimed at stabilising its markets and economy.

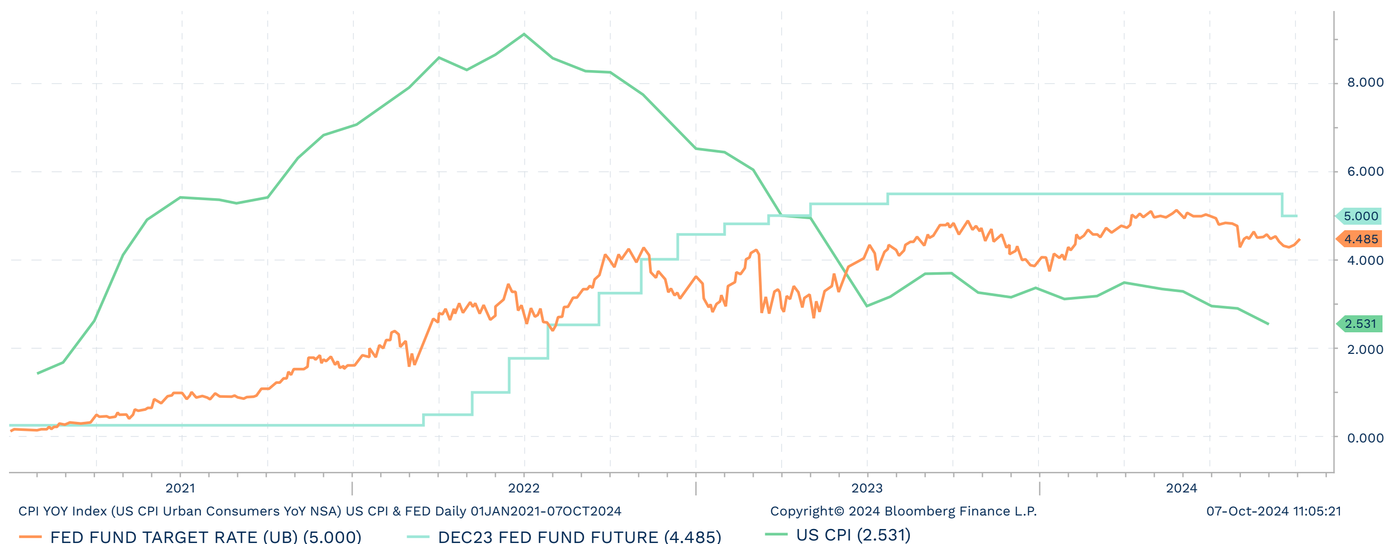
A new phase of the interest rate cycle?

For most people, the COVID-19 pandemic and lockdowns are history, a fading memory, and something we hope is never repeated.

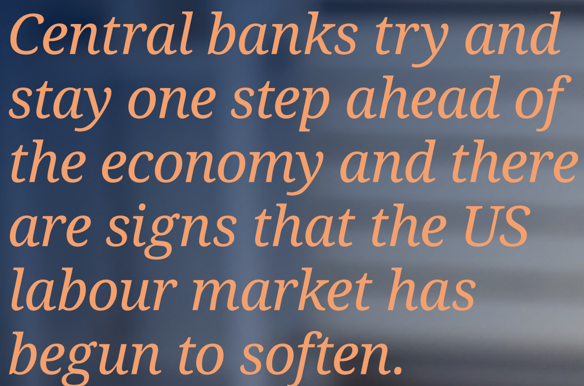
Life is very much back to normal, but for economies the impact takes far longer to wash through, most noticeably inflation and interest rates have taken longer to fade. Nevertheless, with most economies finally showing signs of normalising from the distortions that lockdowns and policy responses had, we are arguably entering a new phase of the business cycle – one where central banks can start to cut interest rates from their current high levels.

What has laid the foundations for this shift in policy essentially comes down to one factor – the taming of inflation. Global supply chains have rebalanced after the massive disruption caused by COVID-19, and pent-up demand for goods and services after lockdown have been satisfied. Additionally, the energy price spike resulting from Russia invading Ukraine has also faded as supplies have been rerouted - so inflation has declined and begun to return towards central bank targets. This allows central bankers to focus on the other aspects of their mandates, which in most cases is supporting the economy and labour markets.

/ US CONSUMER PRICE INFLATION HAS RETREATED TO 2.5%, AND THE GAP BETWEEN INFLATION AND INTEREST RATES STANDS AT 2.5%, INDICATING VERY TIGHT MONETARY POLICY.



Source: Bloomberg



Rate cuts are underway

The interlinked nature of economies does mean they move together to some extent, even if the timing is not exact. The European Central Bank was the first to move in the summer and cut rates again in September.

Having shown signs of an improvement in economic activity at the beginning of the year, manufacturing activity in Europe has since shown signs of stagnating this summer, particularly in Germany, where the economy appears to be flatlining. This, coupled with Europe wide progress on bringing down wage growth and domestic inflation has provided the Bank with the leeway needed to start cutting.

The Bank of England has also cut interest rates, the first time since it began raising them in December 2021. A symbolic cut of 0.25% in August however was not followed up by one in September as many people had hoped. Unlike Europe, economic data in the UK has broadly been improving, which is good news, but it delays further cuts – but with consumer confidence having weakened of late, perhaps reflecting concern about the impending October UK Budget, we still expect a further cut this year.

The key central bank in all of this is of course the US Federal Reserve, so with both Europe and the UK having cut rates all eyes were firmly on the US, who duly delivered a 0.5% cut in September in their headline interest rate. The US economy remains in resilient shape, and is currently growing at around 2.5%, based on the Atlanta Federal Reserve Gross Domestic Product forecast, so this cut could appear baffling. But central banks try and stay one step ahead of the economy and there are signs that the US labour market has begun to soften, as unemployment has crept up to 4.1%, from a low of 3.4% in January 2023. This, coupled with further declines in inflation and weaker consumer confidence, has provided the Federal Reserve with the evidence to begin loosening what remains very tight monetary policy.

But how much is priced in and what are the market implications

The question that has been puzzling investors for a long time now is how far central banks will cut rates by. This of course depends on a range of factors, mainly how the economy performs in coming months, what inflation does and whether employment is rising or falling.

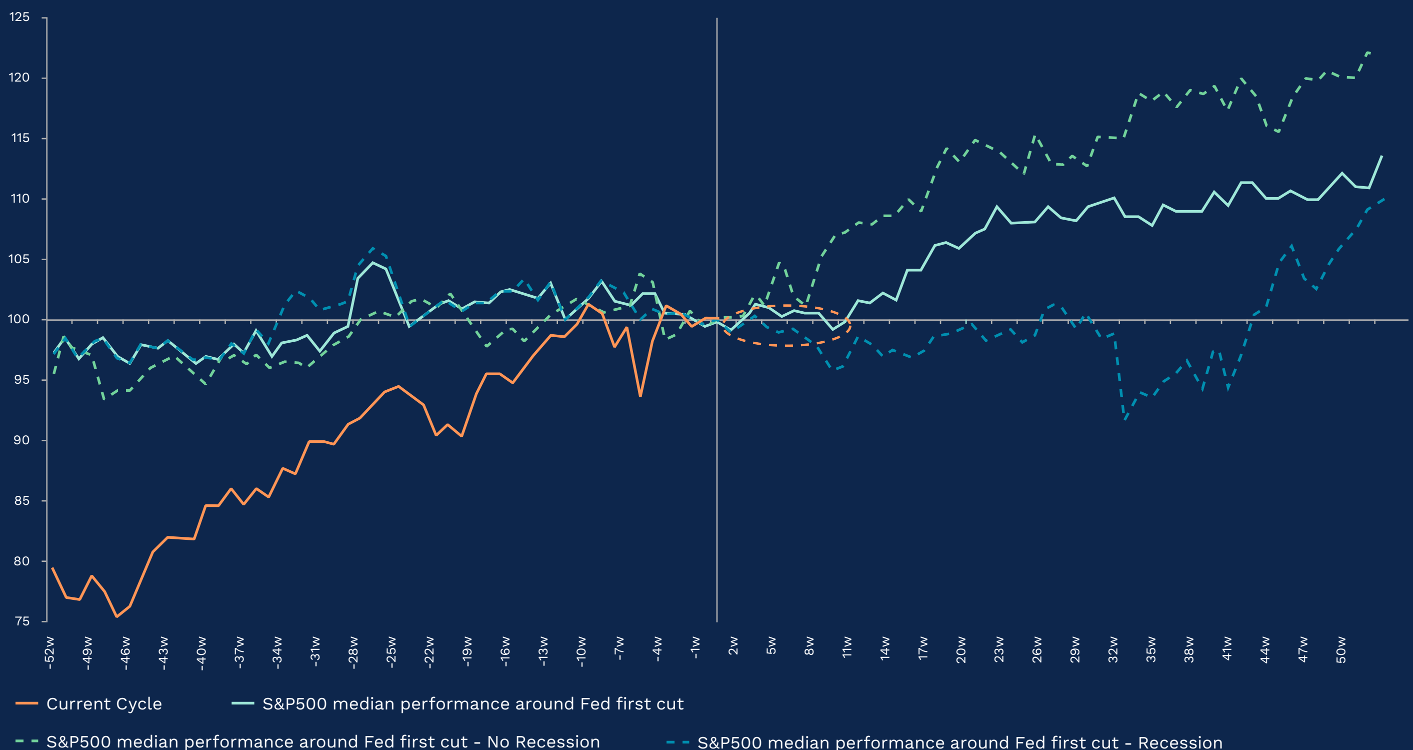
Markets anticipate the future, and price in the outlook for interest rates based on expectations for these factors and many more - currently markets are forecasting that the Federal Reserve will have reduced interest rates from the current 5% to 3% by the end of 2025. That is quite a big move and to us looks overly optimistic given the ongoing resilience of the US economy.

Here in the UK, expectations appear more credible, with interest rates expected to stand at around 4% by mid-2025, versus the current level of 5%. Nevertheless, the key conclusion for investors to take from this is that a rate easing cycle has begun.

Naturally, there will be some concern that central banks are cutting interest rates in order to stimulate a weakening economy, and historically many rate cutting cycles have coincided with recessions. In these situations, fixed income markets perform well (investors buy fixed income securities) as the decline in interest rates makes them more attractive and lower yields drive up the value of fixed income investments. For equities, much depends on how economic conditions evolve. If a recession is avoided, then evidence shows that equities deliver positive returns in the 12 months following the first rate cut; but an actual recession can result in negative returns – that said we are not expecting a recession but need to be alert for any signs of one.

/ ABSENT A RECESSION US EQUITIES PERFORM WELL FOLLOWING THE FIRST RATE CUT, BUT CAN DECLINE UNDER A RECESSION SCENARIO

S&P500 median performance around fed first rate cut



Source: JP Morgan, Bloomberg

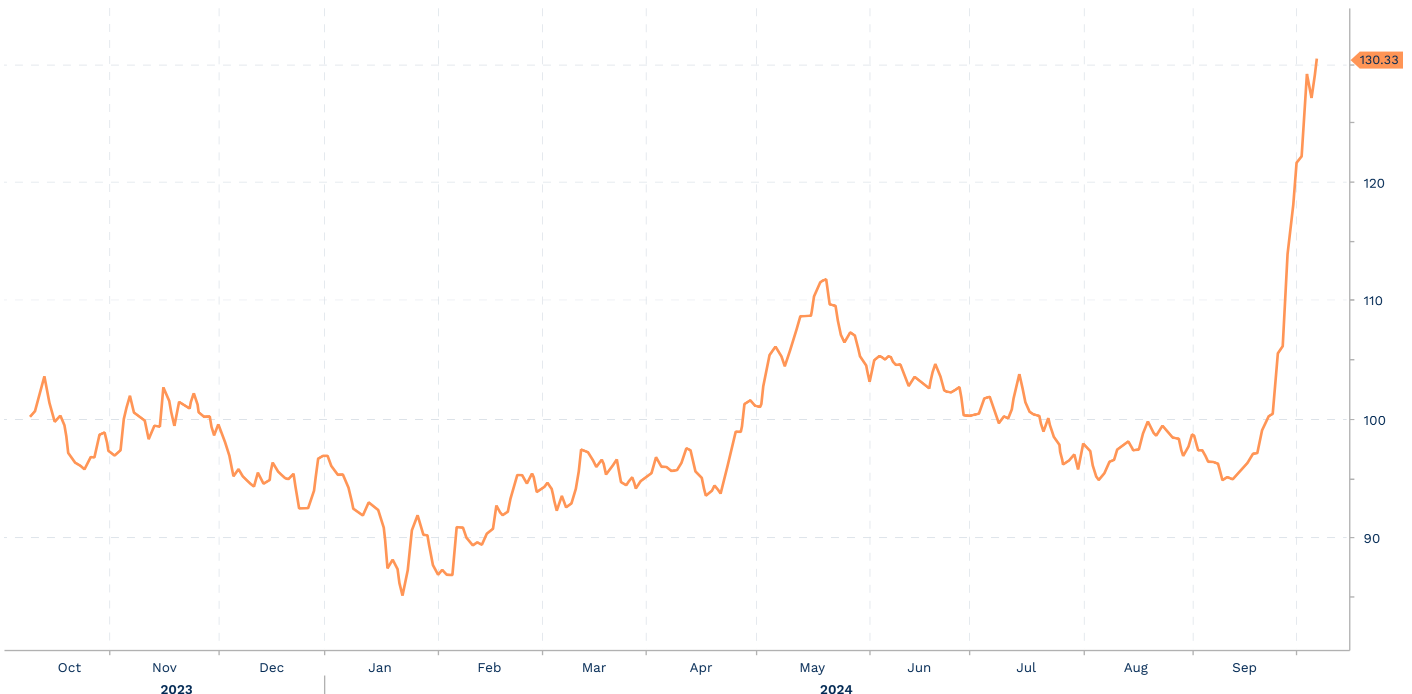
Japan is the exception whilst China goes a step further

There is always an exception to the rule as not all central banks are currently easing monetary policy. Japan raised interest rates in July to what is still a very low rate of just 0.25%.

Indeed, it was this move which caused the sudden wobble in markets in the summer, with the Japanese Yen strengthening significantly, causing an unwind of the Japanese Yen 'carry trade' and weakness across capital markets. It was all a bit technical and with hindsight a storm in a teacup, even if it was a little unnerving at the time.

In China, persistent weakness in the property market has continued to weigh on investor confidence, and in September the authorities announced a series of measures to boost the economy, including additional interest rate cuts, lower downpayment requirements for property purchases and additional liquidity support for stocks. The market reacted positively but it provides the clearest signal yet that the authorities remain concerned about the economy and stand ready to provide support.

CHINESE EQUITIES HAVE UNDERGONE A STRONG RALLY AFTER STIMULUS MEASURES WERE UNVEILED IN SEPTEMBER



Source: Bloomberg

A strong quarter for most assets

The third quarter was generally a positive one for markets despite a significant bout of volatility in August, although a sharp appreciation in the pound (which moved from $1.2650 to $1.3375 against the US Dollar) did take the shine off some of the returns from overseas markets when converted back.

Chinese equities led the way in the last five trading days of September rising by more than 20%, a big move spurred by the policy steps to stabilise markets and confidence. This was the key contributor to a strong return from emerging market equities, which rose by nearly 9% over three months. Japan had a more torrid time, suffering a sharp sell-off in July and August, before regaining lost ground to finish the quarter 5% lower in local currency terms.

US equities were higher, amidst signs of a long-awaited broadening out of returns, with Value as an investment style outperforming growth. In Europe equities also generated positive returns, despite some weakness from French equities following political stalemate in the July elections. The UK equity market was also in positive territory over this period, with upbeat economic data continuing to provide support.

The direction of travel for interest rates pushed bond yields lower and generated positive returns from fixed income assets in the three months to the end of September. As is often the pattern in these periods credit and high yield outperformed government bonds, with credit spreads continuing to tighten. At the end of September, the yield on the UK 10 Year Government Bond stood at 4.0%, down from a peak of 4.4% in May, at one point during the quarter it had fallen below 3.8%.

	Total Return (%)			
	1 Month	3 Month	12 Month	YTD
UK Equities	-1.5	1.8	12.3	9.8
US Equities	2.1	5.9	36.3	22.1
European Equities	0.9	2.5	23.7	13.9
Japanese Equities	-1.6	-5.0	16.4	14.1
Emerging Market Equities	6.7	8.8	26.4	17.1
UK Gilts	0.0	2.5	8.1	-0.5
UK Corporate Bonds	0.3	2.6	11.2	2.5
UK High Yield Bonds	1.5	4.1	16.2	8.8
US Corporate Bonds	1.6	5.6	13.6	5.6
US High Yield Bonds	1.6	5.3	15.7	8.0

Source: Bloomberg, total market returns in local currency for the month ending 30 September 2024.

Recent activity and current positioning

Portfolio's enjoyed good participation in the rally in both fixed income and equities over the course of the third quarter.

In particular, an overweight stance to emerging markets bore fruit with the strong rebound in Chinese equities. In addition, the broadening out in equity markets was most welcome, and we added to Japanese equities at the low point in August and benefited from the subsequent recovery.

Within bonds, we added to duration (sensitivity to interest rates) earlier in the year across our bond and multi-asset strategies, and our fixed income components therefore benefited from the move lower in bond yields. Duration was subsequently reduced in the summer into this strength, and reallocated to US inflation-linked Treasuries, where we believe the market is under-pricing the risk of a move higher in inflation.

Looking forward, we remain focused on the risks to a slowdown in economic activity in the US, and possible recession, but believe the probability is low, and our base case remains for a soft landing. Chinese stimulus measures are welcomed and a step in the right direction, and we anticipate further fiscal policy support, consequently we retain our overweight to emerging market equities.

In the UK, the forthcoming Budget is unlikely to have any meaningful impact on the UK economy, and remains a market we favour, given attractive valuations and ongoing economic recovery. Within fixed income, we would likely use any further move down in bond yields to rotate further away from longer duration fixed income assets, into inflation protected securities. With interest rate cut expectations elevated, additional volatility in fixed income markets cannot be ruled out.

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