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Market Update

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Macro Backdrop

Interest rates have dominated investor sentiment this quarter, driving pronounced volatility in bond, equity and currency markets. The long-anticipated chapter of monetary loosening began in earnest in the US and UK, with central banks reducing base rates by 0.5% and 0.25% respectively (source: Federal Reserve, Bank of England). This significant move has been highly anticipated, following the European Central Bank's early cut a number of months ago. Many prominent investors are increasingly confident of a potential "soft landing" for the US economy, where inflation returns to target levels without major disruption to the labour market or the broader economy (source: Reuters). This optimistic outlook has been reassuring for both equity and bond investors globally.

In the UK, the economy has shown unexpected resilience, with growth forecast at 1.2% for 2024 (source: OECD). This stronger than expected performance has sustained inflation expectations, with the current rate at around 2.2% (source: Office for National Statistics), and analysts from Goldman Sachs and Barclays predict the UK will therefore maintain elevated interest rates for longer than its peers. This has contributed to a strengthening of the pound, which has gained over 5% against USD and 4% against the Euro so far this year (source: Financial Times).

Adding to this momentum is the political stability brought by Labour's landslide election victory, which has included business-friendly overtures. However, uncertainty remains over whether the soothing language will translate into effective policy and whether anticipated changes to the tax regime could undermine the UK's business competitiveness and its otherwise impressive and growing inbound foreign direct investment.

Staying close to home, Europe presents a less optimistic picture. Key European nations are struggling with pronounced political unrest, economic malaise, ballooning deficits, declining foreign investment and waning global industrial competitiveness. In response, the former Italian Prime Minister, Mario Draghi, has published a landmark 400-page report, recommending between €750-800bn in investments to revitalise European capital markets, defence, and public spending (source: The Economist), an essential step, if adopted, to counter Europe's increasingly stagnant economic outlook.

Elsewhere in the world, markets in Asia have experienced a more optimistic quarter. The Japanese yen, which had fallen to multi-decade lows by July, saw a sharp rally after the Bank of Japan raised interest rates (source: Financial Times). This move, in part, caused turmoil in the Japanese stock markets, which plummeted by 20% in yen terms in a single day as investors unwound positions built on the assumption of continued low interest rates (source: Trading Economics).

The Japanese stock markets appeared to be finishing the quarter broadly flat on where they had begun, before falling on the final day of the quarter owing to the announcement of a general election - somewhat masking an otherwise very eventful three-month period. Nevertheless, the economic picture in Japan is rapidly normalising, bringing with it significant uplifts in investor confidence.

Meanwhile, China's government has introduced significant stimulus measures. The Communist Party recently unveiled extensive support for bank liquidity, the property market, as well as lower interest rates (source: Bloomberg). These interventions come after a period of pronounced economic difficulties, including deflation, and are seen by investors as encouraging steps towards stabilising China's economic deterioration.

Bond Markets

Rate cuts in the US and UK were welcomed by bond markets, leading to a significant drop in yields on government-issued bonds during Q3. For example, yields on 10-year US Treasuries fell from over 4.4% to under 3.8% in Q3 (source: Trading Economics), reflecting greater investor confidence as the prospect of lower future interest rates materialised. When interest rates fall, yields tend to fall, as existing bonds with higher yields become more in demand. This explains why we saw such a pronounced drop in yields this quarter.

UK government bonds saw a similarly sharp decline in yields mid-quarter, though they climbed towards the end, finishing marginally lower than where they began in July. This performance aligns with the earlier discussion of the UK's resilient economy and persistent inflation, which has led many investors to believe that UK interest rates may remain higher, or be reduced more slowly, than those in peer economies.

Bond fund managers in our portfolios are now adopting a slightly more cautious stance by marginally reducing their portfolios' exposure to interest rate movements. In recent months, many had been positioned to benefit from falling rates, as the consensus anticipated that rates across major economies would soon decline. However, with rate cuts already underway in the US, UK, and other major Western economies, managers are adjusting by trimming interest rate risk. This suggests that they are becoming more balanced in their outlook, having already benefited from the initial rate cuts, and are now positioning themselves slightly more cautiously as we enter a new phase of monetary policy adjustment.

This shift in strategy reflects an understanding that while rate cuts have begun, there may be uncertainties ahead. With inflation proving stickier in regions like the UK, and potential risks of further economic surprises, it's prudent for managers to take a more measured approach, especially with yields on longer-dated bonds coming down, lowering the compensation for the added risk. They recognise that bond markets may not enjoy the same strength tailwinds from falling rates going forward, and some volatility may persist as central banks navigate the path to normalising inflation without stifling growth.

Equity Markets

On the surface, Q3 appeared to be a robust quarter for the US equity market. The total value of the largest American companies reached yet another record high (source: CNBC), driven by a combination of factors: expectations of a soft landing for the economy, cooling inflation, particularly in the jobs market and decreasing interest rates. However, this apparent tranquillity doesn't tell us the whole story.

For instance, between mid-July and early August, the market experienced a drawdown of over 8% (source: Trading Economics). This decline was triggered by sudden panic surrounding mixed US jobs data, which heightened fears of a potential recession. A similar, albeit smaller, drawdown occurred in early September. On both occasions, the market swiftly rebounded, but these fluctuations highlight the significant intra-quarter volatility that characterised the market – and all other markets, given the USA's dominance - for the quarter.

Across the Atlantic, the UK continued its positive performance streak in 2024, with its largest companies posting returns of around 1.8% for the quarter (source: Trading Economics). In contrast to the US, where companies are considered very expensive, UK companies are considered relatively cheap, meaning they are trading at lower valuations in relation to their earnings. This is despite the fact that, by and large, UK-listed companies tend to have low levels of debt, are reporting record earnings, and have a strong international presence. It is no surprise therefore that they are currently attracting considerable buyout interest. Coupled with some degree of renewed enthusiasm from institutional investors and active share buyback programmes, this has led to robust performance for the value-oriented funds in our portfolio.

Interestingly, growth-focused funds, particularly those in the lower market capitalisation range, lagged in this quarter, a trend mirrored in Europe.

In Asia, particularly in Japan and China, stock markets have seen a flurry of activity. In the final days of Q3, the Chinese stock market surged by over 20% (source: Trading Economics), reversing a prolonged period of negative returns that had persisted since early 2023. This downturn was largely due to extremely poor sentiment surrounding the country's economy, particularly concerns about its high levels of corporate debt, the property sector crisis, and deflationary pressures. Consequently, India overtook China in terms of market size within Asia (source: Financial Times). However, recent stimulus measures announced by the Chinese government, such as lowering interest rates, bolstering the stock market, increasing bank liquidity and assisting mortgage payers, have rekindled investor confidence in China.

In the past, to stabilise the value of the renminbi, China had increased interest rates, even though it was not grappling with the same inflationary pressures as other major economies. With rates now declining across the wider world, China is able to reduce its interest rates again, injecting much-needed vitality into its economy.

Notably, Chinese companies are currently trading at 50-60% below their peak valuations (source: Man Group), and some of our managers believe there are substantial opportunities for investment as earnings for these companies begin to improve in a more supportive macro-environment.

Turning to Japan, early August saw a dip in confidence regarding the US economy, combined with rising interest rates in Japan, resulting in a dramatic “flash crash” in the Japanese stock market. During this event, the main market plummeted by around 20% in yen terms (source: Trading Economics) in a single day, only to recover those losses within the week. With a second, smaller shock falling on the final day of the quarter with the announcement of a general election in Japan, the overarching narrative for the quarter was one of pronounced volatility.

However, with a new Prime Minister taking office at the end of Q3, coupled with an economy returning to a standard model of inflation rather than deflation, investors are feeling optimistic about this major global economy and market, an attitude that has shifted after decades of neglect.

Outlook

As we look back at Q3, the dominant theme has undoubtedly been volatility. Interest rates, inflation, shifts in economic sentiment, and currency fluctuations have all caused moments of panic amongst investors, only for markets to stabilise after a few tense days. Adding to the uncertainty are ongoing conflicts in the Middle East, which have now spilled over into Lebanon and Iran, falling commodity prices, and political pressures, particularly with the US election looming on the horizon.

In times like these, a well-structured investment approach is crucial. Diversifying across asset classes, regions, and investment styles allows us to navigate market turbulence without taking on excessive risk or becoming overly conservative. Our goal is to provide smoother, more consistent growth for our investors by focusing on high-quality investments and carefully curated diversification. Through a selection of best-in-class funds, handpicked by our award-winning research team, we aim to deliver resilience in a challenging and unpredictable landscape.

All data has been sourced from FEFundinfo, Square Mile, Lipper, a Refinitiv Company (all rights reserved), Federal Reserve, Bank of England, Reuters, OECD, Office for National Statistics, Financial Times, The Economist, Trading Economics, Bloomberg, Man Group and CNBC.

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