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Market Update

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Macro Backdrop

The first quarter of 2024 unfolded with a striking contrast of economic resilience and global tension. The United States, for example, continued to display surprising strength, with GDP growth estimated at around 3%* and a still-robust labour market. Europe, as well as the United Kingdom, enjoyed a more positive - or less negative - economic picture compared to recent quarters. Consumer spending in the UK improved, with signs of inflation markedly ticking down and a possible resurgence in the property market. Additionally, the UK labour market showed signs of loosening, potentially providing some relief to wage pressures, a factor that has kept services inflation (e.g. hospitality and education) elevated.

However, this optimistic economic narrative was rivalled by a deteriorating global environment. Tensions between the West and China continued to escalate, fuelled by accusations of espionage and restrictions on trade, such as China's potential ban on Intel products. The ongoing invasion of Ukraine by Russia has cemented the end of the so-called peace dividend in Europe, and the war between Israel and Hamas has returned the Middle East to a hotbed of instability.

Despite these geopolitical headwinds, interest rates remained the focal point for markets in the first quarter of 2024. The Federal Reserve in the US surprised some by considering potential rate cuts despite a strong labour market and economic growth, although the matter of when to cut rates is increasingly becoming a political battleground, as November's election starts to loom. This shift in stance likely stems from an improved inflation situation, which is also apparent in the UK and Europe. It is an open debate as to which central bank will lower interest rates first, although most are agreed it will be this year for nearly all.

However, a notable outlier emerged in Japan. The Bank of Japan, after decades of deflationary pressures, surprisingly raised interest rates. Many commentators are increasingly positive on the Japanese economy, especially as wages have also been rising, after a lengthy period of languishing.

Bond Markets

The first quarter of 2024 painted a complex picture for bond markets. Early enthusiasm, stemming from an optimistic end to 2023 regarding imminent rate cuts, quickly met a dose of economic reality. As data throughout Q1 pointed to surprising resilience in major economies, a sharp correction ensued, particularly for longer-duration bonds. This stemmed from the simple fact that with the likelihood of imminent rate cuts diminishing, the appeal of these bonds, which are more sensitive to changes in interest rates, also waned. This phenomenon played out across various durations and regions, from the US and Europe to Japan.

Later in the quarter, inflation data published in several developed economies, including Australia, the UK, and Switzerland, threw another curveball, with numbers dropping off sharply, supporting the notion that enough action has been taken to slow inflation. Elsewhere, as reported by Jenna Barnard, manager of the Janus Henderson Strategic Bond fund, & in the US, although headline inflation showed a slight uptick year-over-year, the core Personal Consumption Expenditures (PCE) index, a key gauge of inflation, dropped to 2.8%. This data strengthened the case for potential rate cuts later in the year, reigniting investor interest in bonds as an asset class. Given the current environment where yields are significantly higher compared to the near-zero interest rate environment of the past decade, bonds offer a more attractive risk-reward proposition than they have in a very long time.

This sentiment is aptly captured by the managers of the Invesco Tactical Bond fund, who highlighted that "current market pricing suggests that we are likely at the peak for interest rates and we are comfortable with a more interest rate-sensitive portfolio."

However, the bond market is not without risk. Any moves upward in inflation could send bond prices on a downward trajectory, and if the economic backdrop weakens this may lead to an uptick in corporations defaulting on their debt repayments.

Equity Markets

The first quarter of 2024 presented an optimistic narrative across most equity markets. The US remained dominated by the "Magnificent 7" - a group of very large mostly Artificial Intelligence-associated companies like Apple and Microsoft that have enjoyed significant rallies. However, as the managers of the BNY Mellon Long Term Global Equity fund point out, "concentration has been a market topic over the last year, but the story has become more nuanced. This month saw ongoing performance disparity amongst the various members of the Magnificent Seven" referring to stocks like NVIDIA continuing to rocket, whilst Apple has taken a knock following antitrust lawsuits and drops in demand. This, coupled with the fact that the rest of the US market trades at a much lower valuation, suggests there is perhaps room for a broadening of market returns as the year progresses as investors seek better value and improved diversification.

Across the pond, the UK Spring Budget offered little in the way of major changes. Alongside negligible tax cuts, the chief announcement was the introduction of the British ISA, a new investment account allowing additional tax-free savings and investments. This policy is seen as a deliberate, though perhaps unambitious, government attempt to boost domestic investment. Perhaps more measurably fuelling optimism was Governor of the Bank of England Andrew Bailey's comments suggesting rate cuts are firmly on the cards for the near future. This was supported by recent revisions to GDP confirming a recession, alongside more optimistic voting activity (for rate cuts) within the Monetary Policy Committee, who decide where rates lie.

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This triggered a rally in the FTSE 100, pushing it to an all-time high, indicating perhaps the beginnings of a renewal of confidence - or at the very least a slowing of the rate of dissatisfaction - for the UK market. Given the extremely cheap valuations of UK companies, small changes to the economic picture could have outsized outcomes. As the managers of the Amati UK Smaller Companies fund stated, "it should not take much for confidence to improve and we have recently seen takeover bids for businesses such as Wincanton, Virgin Money and Spirent as well as significant numbers of quoted companies doing share buybacks. This supports our belief that there is compelling value on offer in UK public markets right now."

In another interesting development, exposure to China and Korea through Asia ex-Japan and Emerging Markets funds was the cause of some headwinds. Weakening Chinese consumer confidence due to lacklustre economic data and an increasingly authoritarian government stance dampened investor sentiment. As T. Rowe Price Global Focused Growth Equity's manager highlights, "China has continued to disappoint as the nation's macro environment has meaningfully deteriorated and policy uncertainty has led many investors to largely avoid direct exposure to the country. We think there are valuable franchises in China that we want to own, but we have to manage the positions for risk because of the heightened uncertainty around policy." The Korean market, heavily linked to the health of the Chinese consumer, suffered similar declines. However, both markets showed signs of life towards the end of the quarter, with rallies attributed partly to potential policy support from China and signs that deflationary pressures may be easing. Given the idiosyncratic nature of these markets, we believe it's best to leave the selection of companies within these regions to expert global, Asia and emerging market fund managers.

Finally, Japan's stock market continued its remarkable rally, reaching its highest level since 1989 this quarter. This revival can be attributed to several factors, including corporate reforms, persistently loose monetary policy and a renewed focus on shareholder value through increased dividends.

Outlook

As we journey through 2024, the global landscape appears increasingly uncertain. With numerous upcoming elections, shifting economic dynamics, and escalating tensions with key nations like China and Russia, investors may feel uneasy about the future. However, amidst these challenges lie opportunities.

The anticipated shift in global monetary policy towards rate cuts later into 2024 justifies our decision, and that of some of our underlying managers, to increase the duration (interest rate sensitivity) of our portfolios. The optimism surrounding potential rate cuts also aligns with the rally witnessed in equity markets recently. Therefore, maintaining a healthy exposure to equities still makes sense, especially considering the improved economic outlook in the US and UK, where we have our highest portfolio concentrations.

Whilst clear pathways exist towards a positive year for both fixed income and equities, any number of unforeseen economic or geopolitical developments could swiftly alter the trajectory. This is precisely why we maintain a diversified approach, avoiding concentrated bets in any single asset class. Our positioning allows us to navigate these volatile times with agility, while a healthy exposure to alternative investments, in those portfolios where it is appropriate, serves as a valuable hedge against potential market swings.

All data has been sourced from FE fundinfo, Square Mile, Lipper, a Refinitiv Company (all rights reserved), Janus Henderson, Invesco, BNY Mellon, Amati & T.Rowe Price.

***Forecast by the Federal Reserve Bank of Atlanta for Q1**

Important Information

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