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Investment review – End Q3 2024

September 2024

The third quarter has concluded on an upbeat note, with virtually all asset classes making headway in the past few months and contributing in some way to a positive quarterly outcome for investors.

The general backdrop has been one which has seen inflation retreat to within a whisker of central bank targets, some easing of labour market and wage conditions in key economies and, at last, all major central banks coming off the fence to take action on reducing interest rates for the first time in several years. Corporate earnings and profit margins have generally also held up well, whilst the secular growth drivers and productivity gains expected to emanate from further technological progress, including from artificial intelligence ('AI'), have helped keep investor interest in stockmarkets alive.

All's well that ends well

Overall, the global economy, which showed more resilience than expected in the first half of this year, is still working its way through the effects of previous high interest rates and has lost a bit of momentum over the summer months. Recent weakness has been particularly noticeable in Europe's manufacturing sector, for example. Perhaps not surprisingly, therefore, the past quarter has not been without a few scares that have kept overall investment gains in check. We have previously written about the early August market hiatus, when simultaneous, yet very different, events in the US and Japan caused a sudden, sharp reversal in sentiment. We said at the time it would be prudent to sit tight and ride out the period of heightened volatility pending a fuller assessment of the facts. That has proven to be the correct course of action given the subsequent market recoveries.

The summer's market volatility shows that we are rarely far away from sudden setbacks, and that is why, as a huge body of collective investors that represent 'the market', we seek higher returns from assets such as equities to compensate for the additional risk and volatility that is attached to them. It is not always the case, but adverse knee-jerk reactions to isolated information can also be followed by rapid recoveries, particularly if the information upon which the setback was based ultimately turns out to be somewhat flaky. We see this all the time in markets, but the coincidental events in the US and Japanese markets over the summer are good examples of over-reactions to one-off datapoints and poorly interpreted economic events at a time when many market participants' eyes were away from the trading screens enjoying a break. It is pleasing to have seen quick snap-backs after the mid-summer market chaos, with investor confidence returning and key market indices recovering all of their lost ground and, in the case of the US market, reattaining all-time highs again.

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Inflation risks remain

As noted, inflation has continued to moderate in major economies, allowing the eurozone, UK and now US central banks to reduce interest rates for the first time since the start of the global pandemic. In the UK and US in particular, elevated services inflation, including high wage growth, has caused some hesitancy on policymakers' action, but there are encouraging signs that this is now getting more firmly under control. Meanwhile, oil prices have fallen, aided by Saudi Arabia's readiness to abandon its loose $100 per barrel crude oil target and increase production, measures designed to retake some market share. This has helped petrol prices in the UK fall recently to a three-year low. The impact of Red Sea disruptions to shipping, where transport costs had risen and re-routing was causing some supply-chain and inflation worries, have also subsided, aided by lower cargo rates on outbound routes from Asia. All this said, upside risks to inflation still remain: the threat of strikes impacting major ports on America's eastern and southern seaboards is sending freight rates higher, whilst the escalating tensions in the Middle East are prompting fears of further disruptions to oil supply and maritime routes. The risk of policy error by central banks is therefore still possible.

First cut is the deepest

The principal focus for financial markets for much of the year, and notably in the past few months, has been the state of the US economy and whether it can engineer a soft economic landing – a scenario where inflation is brought back to target without a serious economic downturn. Alongside this there has been a well-worn debate over the timing and scale of the US Federal Reserve's ('Fed's') first cut in interest rates since 2020. What have subsequently turned out to be summer 'blips' on both the unemployment and inflation front have been followed by more reassuring data that suggest the US economy is still on track to achieve the desired soft landing and can tolerate a reduction in interest rates. Indeed, in unveiling a half a percentage point cut in interest rates recently, the Fed has acknowledged that the US economy continues to expand at a solid pace, that the unemployment rate is rising but at a low level and that it has confidence in inflation moving towards its 2% target. Rather than spooking markets with this over-sized first move on rate reductions, the market reaction to the Fed's policy shift has been quite positive so far, with a growing belief that the Fed is neither behind nor ahead of the curve with its actions and that a hard economic landing will be averted. Further, probably smaller, cuts to US interest rates are expected by the year-end, with this pattern continuing into 2025, with maybe another one and a half percentage points total reduction between now and then as projected by the Fed's official 'dot plot'. This should be supportive for risk assets.

US dollar and election

A near-term consequence of the Fed's super-sized rate cut has been weakness in the US dollar which, for sterling and euro-based investors, has taken the shine off international investment returns of late. At present, currency markets seem more preoccupied with the short-term relative changes in interest rates among key central banks rather than their economic credentials, which would typically have greater influence on currency trends.

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This November's US election is also playing a role: Donald Trump's likely protectionist policies are viewed as being broadly positive for the US dollar, mainly because the imposition of tariffs on goods from China and elsewhere could see an uptick in inflation and therefore cause the Fed to act with more restraint on reducing interest rates. Now that the election polls are tipped slightly in favour of a Kamala Harris win, some of that election positivity for the dollar has disappeared. In our view it is dangerous to speculate on how political events might shape future currency movements – indeed, whoever wins the election, the impact on the greenback from their different policy positions is likely to be quite glacial rather than immediate. Of more relevance, we believe, is the relative strength of the US economy versus those, say, in Europe – from this perspective it does seem that the recent downward shift in the US dollar is a little overdone.

China joining in

Concerns over China's economic growth prospects and the country's influence on the global economy have also been in focus this year. China's stockmarket has struggled against a deteriorating backdrop of Chinese consumer confidence, pressured household finances and a challenged property market. Successive months of soft macroeconomic datapoints have put China's full-year growth target of around 5% at risk. However, in its boldest move for some time the Chinese central bank and regulators have also now joined the developed world in lending a supporting hand in a quest to keep their economic momentum (and in China's case, a heady growth rate) on track. As well as cutting official policy rates, help for Chinese households has come in the form of an immediate cut in mortgage interest payments and reduced downpayments for property purchases, whilst funding schemes designed to encourage banks to lend to businesses, including for share buy-backs, are being viewed as stockmarket-friendly initiatives. The success of this substantial stimulus package on the real economy will take time to evaluate, and more may be needed, but it does seem that the authorities are determined to turn China's fortunes around by taking a more accommodative and flexible stance. In the closing days of the quarter there have been sharp rallies in Chinese and Hong Kong-listed shares and we are hopeful that this renewed optimism can spill over into the wider Asian markets, many of which remain cheaply valued on a global basis. Furthermore, having greater confidence in China's economic fortunes should help breed wider market confidence too.

Eurozone struggling again

The eurozone economic backdrop appears to be flagging on a number of fronts after a more positive first half of the year. France may have had a summer boost from staging the Olympics, but recent snap elections and the resultant political mess are likely to hamper economic progress going forward: the tasks of agreeing an effective fiscal framework and a debt reduction plan with Brussels look particularly hard. Meanwhile, the eurozone's largest economy, Germany, is especially stuck in the doldrums, facing weak domestic and foreign demand in its heavily manufacturing-skewed economy. The two recent cuts to interest rates by the European Central Bank will help, but the transmission mechanism to the real economy will be slow and it is possible that the wider eurozone economy will now only deliver very modest growth this year and a low rate compared to other developed economies next year too. Ever since its formation, we have been more inclined to focus on company specifics in the eurozone rather than allocating investment capital based on geography or country-specific economic credentials.

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Our principal exposures to European (ex-UK) markets are via fund managers who are unconstrained by benchmarks – there are still plenty of cheap, quality, domestic and international growth companies (many with attractive dividend growth attributes too) listed on European exchanges and we are confident that our chosen managers can take advantage of such opportunities even if the general European economic outlook remains challenged.

Labour dressed for Budget action

As far as the UK is concerned, and with the honeymoon period for Sir Keir Starmer now over, the main short-term focus is on the end-October Budget. Whatever changes are made by the government, in conjunction with additional steps taken by the Bank of England to further reduce monetary policy, the tools to reinvigorate the UK economy – and for Labour's ambitious 'pro-growth' agenda to be successful – still look quite limited.

With a month to go to the Budget, there is a growing sense that the new government may be spending too much time focused on fiscal measures (and perhaps its wardrobe) rather than on growing the economy: a whiff of 'buyer's remorse' is now in the air, with the public seemingly becoming less willing to wear some of the suggested austerity measures that have been touted around or drip-fed into the media. According to one recent poll, Starmer's personal approval rating is now below that of Rishi Sunak; another poll suggests half of the population is disappointed with what Labour have done in government so far – this includes over a quarter of those who voted for the party at the recent election. Whilst what might be over the horizon is rightly causing some anxiety amongst investors, particularly vis-à-vis potential changes to the capital and inheritance tax frameworks, the old adage of 'not letting the tax tail wag the investment dog' is as important as ever. The Budget is expected to contain changes that will hit most people's pockets in some way, and it will undoubtedly mean extra things to consider from a personal wealth planning perspective. But none of this is likely to need any immediate adjustment to our current, relatively low, allocation to the UK stockmarket. Of greater relevance is perhaps the possibility that the government may rejig its borrowing rules, as has been mooted, in order to release more money for longer-term investment, including important infrastructure projects, that can grow the economy – any trickle-down effect to the stockmarket is likely to be slow, but it could revitalise certain sectors and lead to some gradual re-rating of what is still a cheap market, particularly lower down the market capitalisation scale. This is where our existing exposure still has some emphasis.

Policymakers on the front foot – positive for a range of assets

It is worth emphasising that the monetary easing cycle, which has only just begun, is quite different to previous phases when the Fed and other central banks were somewhat on the back foot responding to sudden and significant weakness in economic activity. Now, policymakers are moving decisively to forestall potential weakness in their respective economies. One could even argue that they are easing against a more stable, if not generally expanding, economic backdrop. This is slightly unusual, but not without precedent: there are some parallels, for example, with the mid- to late-1990s, when the US economy was faring better than the rest of the world, the internet boom was in full swing, inflation was subsiding and labour productivity was expanding.

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In that period the US stockmarket continued to rally, similar to the AI-enhanced boost markets have enjoyed this year. We should not necessarily expect an exact repeat of this 1990s experience, but there are clues from history that give us some confidence that pre-emptive moves by policymakers, as we are seeing, can be positive for both equity and bond markets.

Stockmarket exposure maintained, with skews to cheaper small caps

We therefore continue to see a favourable backdrop for a range of assets right across the risk spectrum into both the year-end and during 2025. Our stockmarket allocations remain at the upper end of strategic ranges, with skews in allocations continuing to reflect a combination of stronger longer-term growth (US and Asia), recovery and structural change potential (Japan) and value (Europe, including the UK), with a continued preference for ensuring good exposure to those parts of the market that should benefit most from looser monetary conditions and more relaxed lending standards, namely the less expensive medium- and smaller-sized companies in each region. We also expect the lower interest rate scene to be supportive for more capital-intensive businesses, including those with infrastructure projects and those focused on renewable energy initiatives contained within our global thematic fund allocation.

More recovery to come for bonds

We are pleased to have captured the recovery in bond markets this year and feel there is more ground to make up if, as we expect, central banks make further rate cuts before the year-end and also into next year. We are therefore maintaining our current exposure, the allocation and maturity profile of which was raised in 2023 and early 2024 in anticipation of the stimulus to come. This said, and with bond markets already a little ahead of the game in terms of where interest rates are likely to settle, we see an opportunity to modify some exposure.

With inflation having fallen we see less need for (principally sovereign) inflation-linked bond exposure – bonds in this category typically have a naturally higher maturity profile and tend to exhibit greater volatility, being more sensitive to both inflation and interest rate changes. Even though prices have moved higher and income yield differentials with government bonds have tightened, we believe we can achieve improved income returns and further recovery potential, whilst at the same time reducing risk, by adding to shorter-dated corporate bonds (i.e. credit) categorised in the crossover space between investment grade debt and high yield. Rather than ringing alarm bells in credit markets, businesses carrying or issuing debt in this area of the bond market seem to have generally come through the period of high interest rates without pushing themselves to the brink of default on their debt, as has occurred in some previous rate-hiking cycles. Instead, prudent management of cashflow and greater balance sheet discipline, probably aided by some forced corporate prudence during the pandemic, has seen only a moderate rise in corporate defaults, with the trend now easing. We believe this part of fixed interest markets offers good risk/reward characteristics and we therefore intend to raise our exposures accordingly.

Our counterbalance to bond market exposure within the non-stockmarket element of portfolio allocations has, and continues to be, our range of 'absolute return' investment funds.

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These continue to deliver on their promise of providing positive (absolute) returns regardless of market conditions, with extremely low levels of volatility. We make no apology for them being quite dull relative to the excitement of conventional stock and bond market investments, but they are doing the job we are asking of them and their place, particularly for lower- and medium-risk investment mandates, is still as relevant in today's world of uncertainties as it has ever been.

Cash has also been a safe and rewarding home for low-risk savings whilst interest rates have remained high and inflation has been falling. But as interest rates soften, we are starting to see the huge tide of money previously committed to money market funds and the like begin to ebb, reverting to longer-term assets such as bonds and equities. This shift from cash is likely to provide another important pillar of support for market strength and confidence.

The future is still bright

Looking further ahead, the general global macroeconomic backdrop still looks quite encouraging, with forecasts for gross domestic product ('GDP') growth mainly higher now than they were at the start of the year and broadly in line with the pre-pandemic average of around 3%. The spread of economic activity is, however, not expected to be uniform. Emerging Asian economies, for example, which are now collectively as large a group as advanced economies in terms of their contribution to global GDP growth, are expected to grow at a very healthy annual rate close to 5%. In contrast, economic growth in advanced economies is likely to be restricted to under 2% in the coming year, pegged back in particular by lacklustre growth in the eurozone. In the near term we may see a softer patch of economic activity, mainly emanating from manufacturing corners of the globe, but overall the reductions in inflation and interest rates should become increasingly supportive to business and to consumers as real incomes begin to rise again.

As we enter the final quarter, conditions seem set fair for an encouraging return result for the year as a whole, despite some bumps and inflight turbulence that we have encountered along the way this year. As things currently stand, an economic soft landing seems to have been engineered which will hopefully allow a variety of asset classes to remain airborne, not just for the remainder of this year but also into 2025.

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