Watson French
WEALTH MANAGEMENT

Asset Class Commentary
February 2024

Following the optimism and hype at the end of 2023 expectations for any central bank interest rate cuts have been decisively pushed back, but US company earnings are keeping equity markets ticking along nicely.

While equities mostly reacted positively to recent economic news, bonds on the other hand did not. UK and US government bonds both fell as the prospect for rate cuts was pushed back and economic data highlighted strong labour markets, raising the concern that rates will stay higher for longer (yes, that old one again!).

In the US there is significant divergence between investors' expectations of five interest rate cuts this year, and the Fed's well-rehearsed hymn sheet of only three cuts this year.

We will continue to hear the phase the 'magnificent seven' often, as these huge technology companies have such a large effect on US market movements. In our view it is likely that their values will continue to be propped up, if nothing else than by investors' fear of missing out. There is no doubt that they all have the potential for large future growth, but whether it materialises and how much of it is already reflected in current share prices will be debated for much of the year.

UK equities fell in January as inflation ticked up slightly and the Bank of England held base rates at 5.25%. UK Gilts were one of the worst performing asset classes as the BoE maintained its stance on keeping interest rates where they are. Surprisingly, and somewhat concerningly, two members of the Bank of England's Monetary Policy Committee voted to increase interest rates by 0.25% (one member voted to cut rates and the other six voted to hold rates).

Slowing consumer spending and still high interest rates have led to the thinking that the UK economy will have entered a recession in the last quarter of 2023 (economic announcements are backwards looking, as it takes time to compile the data).

Lower energy prices have also meant that UK energy company profits have fallen relative to their 2022 and 2023 highs. This has weighed on the FTSE 100 index, highlighting the lack of innovative growth and technology companies in the UK and consequently its inability to benefit from the current trend. Not all is bleak though, with mortgage approval rates increasing and house prices ticking up, interest rate cuts later in the year could provide sweet relief for the unfavoured region.

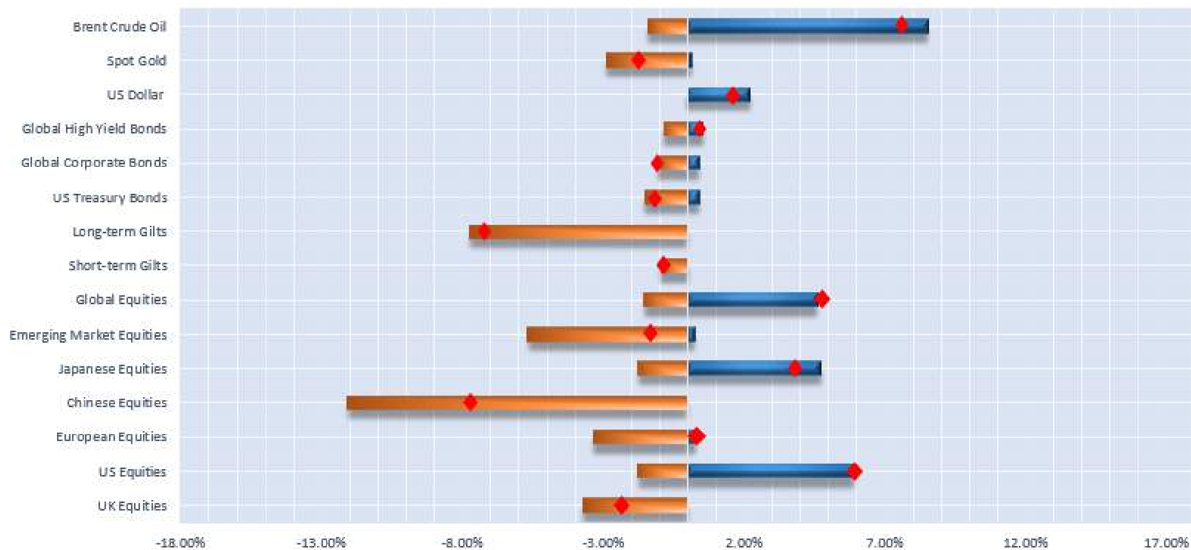
The Chinese economy continues to be plagued by deflation as consumer demand remains sluggish. The property sector also remains under pressure, and without buoyant consumer demand so will the economy this year. This has been reflected in equity markets, with the MSCI China down over 7% year to date, despite the relief offered by government intervention.

This deflation could however help China's trading partners to bring their inflation rates down, as the price of Chinese exports has been falling as they have built too much capacity for the level of export demand. Further monetary policy loosening may help to prop up the economy, provided deflation does not become an entrenched problem. All in all, China still looks an uncomfortable place to invest right now and sentiment is far from positive.

Japanese equities remain in investors' good books, with year to date performance remaining positive. The biggest short-term risk for the region is monetary tightening; Japan has intentionally allowed inflation to grow, and at some point it will need to be reigned in again – the extent and timing of which will dictate price movements in the short-term. Longer-term, the corporate reforms we have discussed in previous commentaries continue to provide a tailwind for the asset class.

Areas of focus

- US equities have started the year strongly, with momentum likely to continue this trend. Tech companies have been beating their earnings targets, leading to strong growth.
- Japanese equities continue to be favoured by investors, although monetary tightening could prove a be a headwind in the short-term.
- UK equites started the year in negative territory amid a challenging economic backdrop and a lack of growth-orientated companies.
- Chinese equities continue to struggle. A looser monetary policy may not be able to prop up equites over the short-term, with investors mostly remaining tactically underweight.
- Short-term bonds are still yielding attractive returns while long-term bonds are now neutral in portfolios.
- Inflation-linked bonds remain in portfolios as inflation is likely to remain higher than many investors have been expecting.
- With recessionary risks lower than previously thought, high-yield bonds are starting to look more attractive. However, credit risk is still elevated with high financing costs.
- UK property prices have started to increase again, possibly highlighting a bottoming for an under-favoured sector. Interest rate cuts will only serve as a further tailwind for the property market.
- Emerging market economies are facing the prospect of slowing growth, leading to a preference for debt over equity in the regions.



Selection of assets 2024 YTD returns and range of returns (the two ends of the bars represent the range of YTD returns and the red dots represent the current YTD return). Indexes used: FTSE All-Share, Russell 3000, STOXX Europe 600, MSCI China, MSCI Japan, MSCI Emerging Markets, FTSE UK Conventional Up To 5 Years, FTSE UK Conventional Over 15 Years, ICE BOFA US Treasury, ICE BOFA Global High Yield, ICE BOFA Global Corporate, US Dollar Index, S&P GSCI Gold Spot, S&P GSCI Brent Crude Spot. Returns hedged back to GBP with exception of US Dollar which is in US Dollar terms. Data from FE Analytics and MarketWatch.

UK

With a December CPI reading of 4%, the Monetary Policy Committee (MPC) within the Bank of England voted by a majority 6-3 to keep rates at 5.25% in January, the fourth time in a row. Surprisingly, two members voted to raise rates by 0.25% to 5.5% while one voted to cut by the same amount.

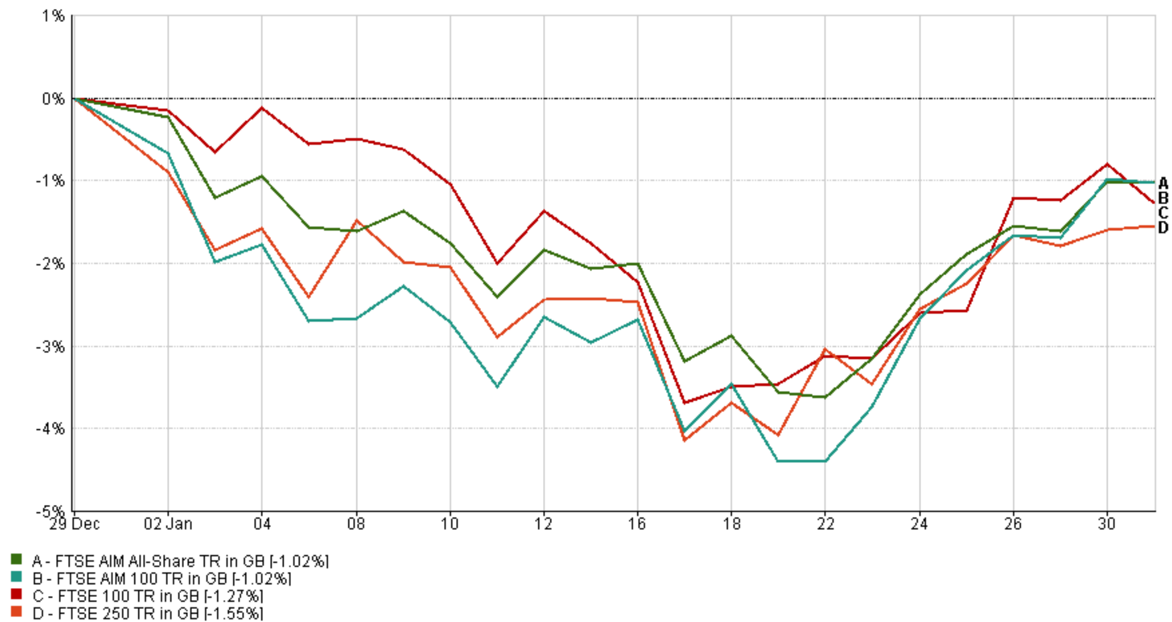
The BoE is hopeful that inflation will fall temporarily to the central bank's target of 2% in the second quarter of this year, before rising slightly towards the end of the year. Once inflation is back to target, it is likely that we will finally start to see interest rate cuts. Until then, we expect markets to remain volatile as they price in the probabilities of different macroeconomic scenarios playing out.

There were clear signs of a growing UK economy last month. Consumer confidence increased to a two-year high in January, according to research company GfK. In addition, the Purchasing Managers' Index (PMI) increased by 0.4%, the largest increase in seven months, indicating that UK economic activity is strong.

While January's cut in National Insurance coupled with falling mortgage costs may have helped to boost consumer confidence in the short run, the cost-of-living crisis is still hurting lower income households, and this has had a negative impact on recent retail sales figures.

After an impressive end to 2023, UK equities suffered in January. This underperformance can be explained by two factors. First, considering the positive short-term returns witnessed in December, some investors will have seen the year-end rally as a chance to take profits. Additionally, investors

have started to reevaluate the timing and pace at which central banks will start to reduce interest rates. Investors were perhaps too optimistic towards the end of last year, and this realisation has caused UK equity prices to suffer.



YTD performance of major UK stock market indices

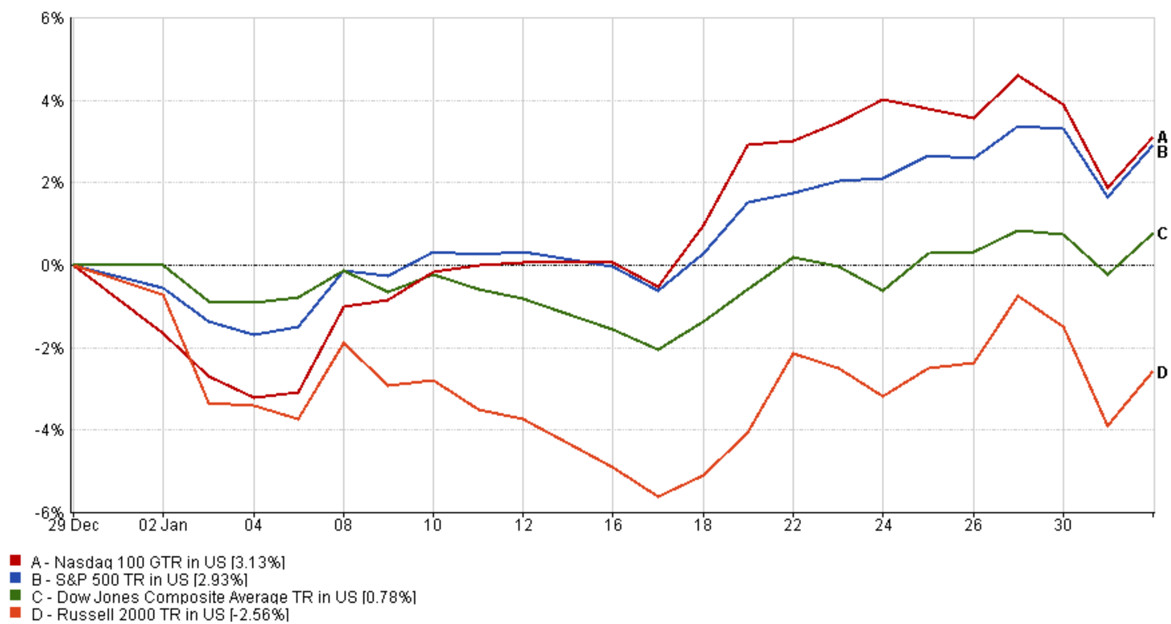
As shown above, the four major UK stock market indices remained negative throughout January. The headline FTSE 100 was down almost 4% by the middle of the month, before a slight rally in the final week.

Most global government bonds were down over January, but UK gilts suffered the most. Sticky services inflation and continued wage growth delaying the prospect of imminent rate cuts by the BoE. This caused fixed income investors to rethink and the market repriced gilts accordingly.

	Yield (%) as of 01/02/2024	YTD change (%)
2Y Gilt	4.22	6.03%
10Y Gilt	3.75	5.93%

As shown above, the yield on 2- and 10-year gilts rose by around 6% in January. The yield curve remains inverted, hinting to short term issues in the UK economy.

US



YTD performance of major US stock market indices

US indies have continued their stellar performance from the end of last year into 2024 with the Nasdaq 100, S&P 500, and Dow Jones Composite Average all at or above all-time highs. This rally was mostly on the back of strong Q4 GDP growth and falling inflation. Markets are currently priced for perfection with the soft landing (or indeed, “no landing”) becoming many investors’ base case scenario. Positive recent earnings have also helped to reinforce this view. We remain cautiously optimistic, weighing these mega trends with lurking risks.

In the month of January, the Nasdaq and S&P indices increased by 3.13% and 2.93% respectively. The Dow Jones squeezed out a gain of 0.78% whilst the Russell lost 2.56%, as smaller companies continue to suffer.

As an aside, it is also worth keeping in mind that when the financial press celebrates markets reaching all-time highs, there is no adjustment for inflation. The high levels of inflation we have experienced over the last couple of years will feed into higher nominal earnings, and therefore higher share prices. Adjusted for inflation the S&P is actually still 4.39% off its November 2021 high.

All of the “Magnificent Seven” technology companies, except Nvidia, have recently reported their Q4 earnings and investors have reacted differently to each announcement. To start, investors didn’t take kindly to Tesla’s announcement that it will likely enter a period of lower growth in 2024, with its share price dropping 12% as a result (wiping $80 billion off the company’s total value).

On the other hand, Meta’s revenue was up 25% from last year and they also announced their first ever dividend. This caused shares to surge 17%, to a new all-time high and the largest single day market capitalisation gain in Wall Street history of $196 billion.

Highlighting the often-fickle nature of investment markets in the short term, these recent moves can mostly be attributed to sentiment rather than actual future earnings. Big tech company earnings are extremely difficult to value, largely because future earnings potential is unknown and because of the

uncertainty around how much of their huge investments into research and development (especially in Artificial Intelligence) will actually translate into profits.

The late Benjamin Graham, the founder of value investing and mentor of Warren Buffet, put it most succinctly when he said: “In the short run, the market is a voting machine but in the long run, it is a weighing machine.”

US fixed income

	Yield as of 01/02/2024 (%)	January change (%)
2Y Yield	4.21	-0.12
10Y Yield	3.88	-0.06

	Yield as of 05/02/2024 (%)	Change post Fed (%)
2Y Yield	4.47	0.26
10Y Yield	4.16	0.28

The US yield curve remains inverted with the 2- and 10-year treasuries currently yielding 4.21% and 3.99% respectively. The 2-year yield decreased by more than the 10-year yield in January, pointing to the so-called “bull steepening” and indicating that the yield curve may soon ‘un-invert’ due to rate cuts pulling down the short end (as opposed to the long end rising).

However, both the 2- and 10-year yields increased sharply after the Fed’s January Meeting, rising 26 and 28 basis points respectively.

Markets had to walk back their expectations of a March rate cute after the Fed’s January meeting, where Jerome Powell took them sharply off the table by commenting that the Fed is not comfortable cutting rates with inflation still above the 2% target.

Economists expect inflation to come in at around 3% in January, down from December’s 3.3% reading. Investors are now pricing in an 84.5% probability of no change to rates in March and a 60.4% probability of cuts in May. These probabilities are subject to change based on future economic data.

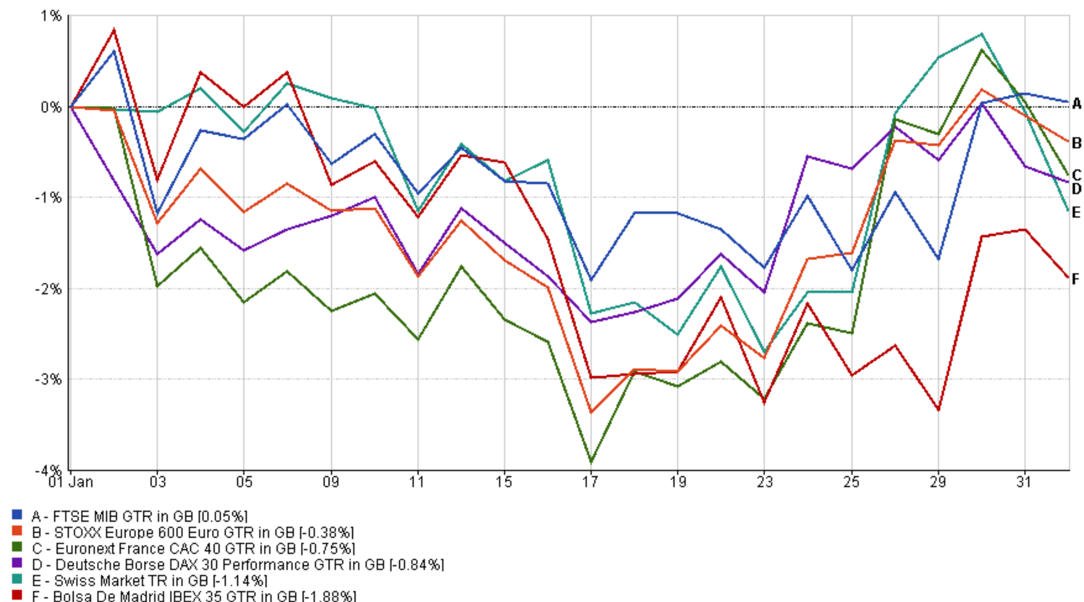
US markets have been in a state of limbo for well over a year now. While optimistic investors believe that we have secured the “no landing” scenario and look for markets to rally higher, more pessimistic investors await the (in their view) inevitable recession to bring equity markets down to more attractive valuations.

This provides a useful reminder that timing is always notoriously difficult when in investing, and a long term “by-and-hold” approach almost always prevails.

Europe

In Europe, the ECB followed suit with other major economies and decided to keep interest rates steady at the record-high level of 4%, reiterating its commitment to keeping inflation low and relying on the latest inflation data.

The region's PMI beat expectations last month and rose 0.3 points to 47.9, its highest level since July – a good (albeit not guaranteed) indication that the manufacturing sector has in fact bottomed out and that sentiment is now improving. This is an important indicator for the likes of Germany, which relies heavily on its automotive manufacturing industry.



YTD performance of major European stock market indices

European ex-UK equities followed a similar pattern to their UK counterparts, falling sharply until mid-January, before rising towards the end of the month. The Spanish Bolsa De Madrid IBEX 35 fared the worst in January, down by 1.88% over the month.

The world's largest luxury goods group, LVMH, climbed by over 13% in late January after reporting better than expected Q4 sales – contributing largely to the Euronext CAC 40's performance last month.

LVMH, given its size, is often used as a proxy for the wider luxury goods market. With concerns growing around the Chinese economy, companies such as LMVH (which depends to a significant extent on demand from China) may start to struggle in the short term. However, this recent outperformance is a good sign for the wider luxury goods market and could indicate that demand will stay strong over 2024 despite a tricky economic backdrop.

Like the UK, it seems fixed income investors were too optimistic about the timing of rate cuts in December and the most recent comments by the ECB caused European bond yields to rise again. Despite some concerns about rising levels of government debt in Europe, demand for new bond issuance remains high. Indebted countries such as Spain, Belgium, and Italy have all seen their new

government bond issues oversubscribed as investors attempt to lock in higher rates, before they (almost inevitably) fall later this year.

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This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.