Watson French
WEALTH MANAGEMENT

Asset Class Commentary
March 2024

With the US election preparations in full swing ready for the vote in November, it is looking more likely than not to be the heavyweight rematch of Trump vs Biden (and yes, Mr Biden is medically fit for this fight!). Although perhaps a controversial figure, the last time Mr Trump was elected in 2016 equity markets reacted positively, driving the S&P 500 60% higher over his term of office.

While elections are also due to take place in the UK later this year, the results typically do not have a noticeable effect on either UK or global markets.

Away from politics, the US Federal Reserve has certainly not won over investors with its rhetoric of later interest rate cuts. This is evident in bond markets where bond yields have risen so far this year, a reversal of the large falls in yields that we saw towards the end of 2023.

The Fed has been adamant that although inflation is cooling, the unemployment rate is still low, wage growth is strong and the US economy is still booming, and therefore the risk of a resurgence in inflation is a present risk. Not only would this be damaging for financial markets, but serious questions would be posed to the Fed, having already wrongly called inflation “transitory” in nature when prices began to rise.

Despite this investors remain puzzled by the US economy’s resilience, as interest rate increases should have pulled growth down by now.

One risk for the US economy is the level of borrowing in the economy, which has been slowly increasing, particularly so for non-mortgage debt. The default rates have also picked up, particularly so for those on lower incomes and for younger generations.

Looking at the probability of US interest rate cuts, presently the chances of rates being reduced to 4.75% to 5.00% (a cut of 0.50%) is 13%. At the start of February this probability was 51%.

US equity markets have continued their drive upwards, fuelled by the resurgence in investors’ appetite for risk.

Japanese equities have also benefited from regained optimism for the country, topping developed market equity performance so far this year. Again, a near term risk for the region is the potential for interest rate increases. Japanese equities have only just regained their all-time high (which was previously as far back as 1989!).

UK equity growth remains stagnant as investors continue to prefer other regions. Active stock pickers have outperformed the broad indices – a contrast to the US, where many active fund managers were underweight the “magnificent seven” technology stocks and have underperformed the indices as a result.

That’s not to say active managers don’t have a place in a portfolio – with equity values stretched (albeit not unreasonably), if there is a pullback in values, such as is likely when investors take profits, active managers will offer some protection. The US market offers a broad range of opportunities, and investing in the S&P 500 index currently means investing 32% of your capital into just 10 companies – a concentration of risk some will prefer to avoid.

Global investors are very much underweight the UK over the shorter-term. Although stock market valuations are more attractively priced relative to the US, current low valuations reflect sluggish economic growth and a chronic lack of long-term innovation.

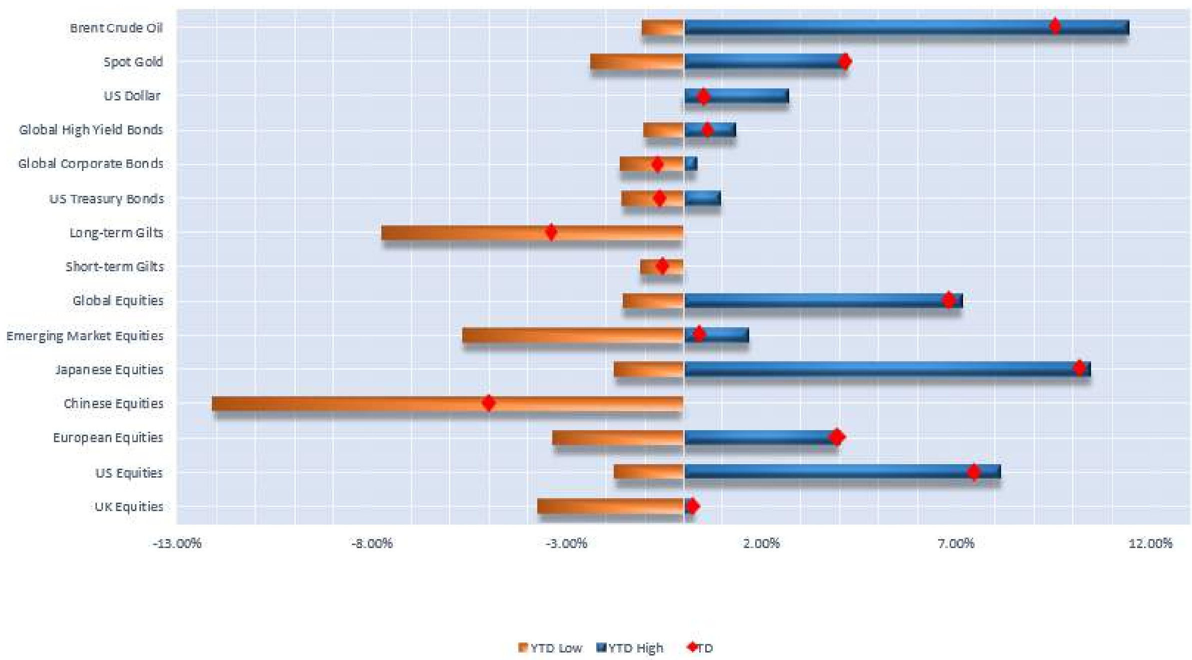
In the bond markets, investors have increased their positions in high-yield (riskier) bonds on the face of stronger economic growth.

This may be a double-edged sword, we think. If interest rates remain higher than expected this puts pressure on these companies, potentially leading to higher default rates and lower returns. And on the other hand, if interest rates do come down these high-yield bonds are less sensitive to interest rate changes and their values will rise by less relative to other types of bonds.

Although they have an attractive yield, so do other less-risky bonds. For example, the yield difference between much safer treasury bonds and high yield bonds is 3.2% (down from a three year high of 6%) and with this spread tightening, the rationale for taking on the additional risk of high yield bonds is less clear.

Areas of focus

- US equities perform strongly, although some of the bigger companies face near term headwinds including high earnings expectations.
- Japanese equities continue to offer growth potential at more attractive valuations.
- Chinese equities continue to struggle. Any relaxing of interest rates will help to support values, but longer-term problems such as ageing populations present a problem.
- UK equities remain out of favour. A lack of technology companies is a clear gap in the UK market.
- Investors have increased their allocations to high yield bonds, but default risk and a lack of interest rate sensitivity mean the high yield on offer is not a free lunch.
- European equities have rebounded as inflation has come down markedly in the Eurozone.



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

Data released last month showed that the UK economy shrank by 0.3% in the final quarter of 2023. This negative figure followed a reduction in GDP of 0.1% in Q3 of last year, which means that the UK economy is now in a technical recession. The Q4 GDP figure fell more than initially predicted, due to a simultaneous decrease in services, manufacturing, and construction output.

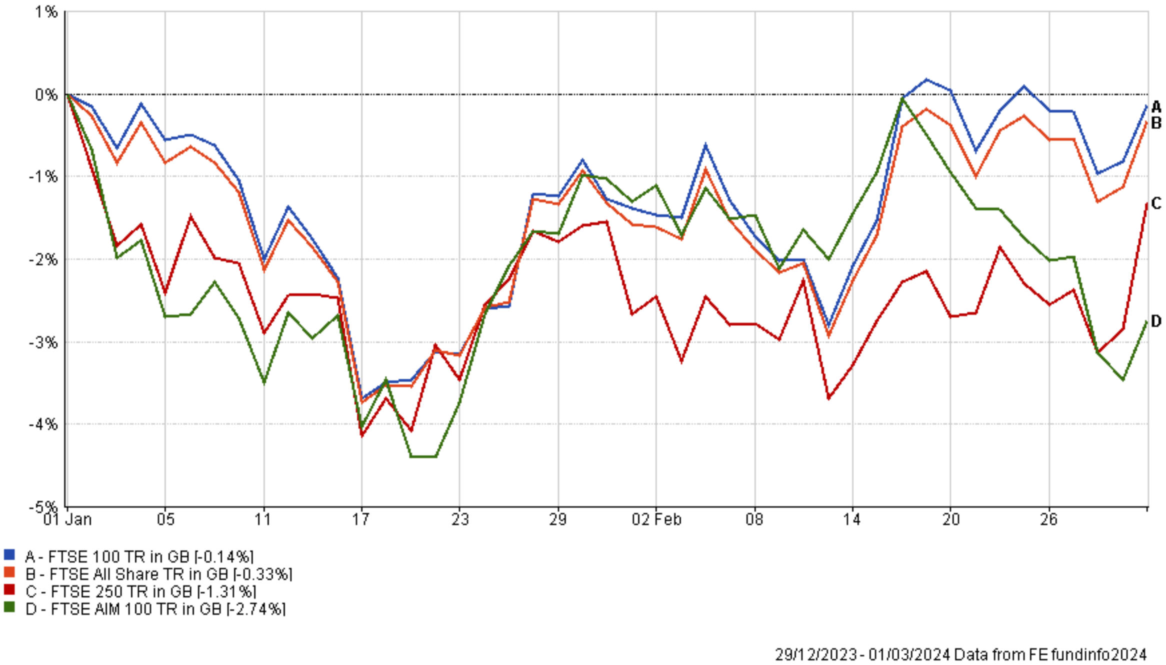
One of the most widely used definitions of a recession is two successive quarters of negative growth. While this means that the UK is in a technical recession, many economists believe that this will be shallow and short lived.

A deep recession is typically characterised by an increase in unemployment and an associated fall in the standard of living of the population. With economic indicators pointing to an ever-robust labour market, it is clear that the economic contraction has – so far, at least – been relatively minor. UK unemployment fell to 3.8% in the last quarter of 2023 while wage growth continues to remain higher than inflation.

With the UK economy in a technical recession and consumer spending slowing, it could be argued that interest rate cuts are just around the corner. The decision to loosen monetary policy is not as clear cut as it may appear, however. The Bank of England will need to find a balance between weak growth and the inflationary effects of rising wages.

The UK economy is very focused towards the service sector, accounting for approximately 81% of UK economic output. While core inflation (CPI) has slowed from its record high levels, service sector inflation remains relatively high, at 6.5%. If rates are cut too early, before service sector inflation is suppressed, inflation could begin to rise again. This would be very damaging for UK equities and bonds alike.

UK house prices have also started to increase, according to the monthly surveys from Nationwide and Halifax. While increased borrowing costs caused a slight reduction in house prices last year, limited supply caused prices to remain more stable than expected. The likelihood of interest rate cuts later this year has meant that borrowing costs have been falling, and this has led to increased demand for mortgages. If mortgages become more affordable, housing demand will continue to rise.



YTD performance of major UK stock market indices

UK equities continue to underperform, especially when compared to their US counterparts. After a slight rally in February, rising 1.25% over the month, the FTSE 100 still finds itself down year-to-date.

Several disappointing earnings announcements and profit warnings also caused reductions across UK equity markets, but this was company specific. Shares in St James Place, a FTSE 100 constituent, fell 30% after it announced a cut in dividends and put aside £460 million to pay for potential redress to customers.

	Yield (%) as of 01/03/2024	YTD change (%)
2Y Gilt	4.56	14.69
10Y Gilt	4.21	19.07

Gilt Yields in March 2024

With Bank of England rate cuts being pushed further and further into the future, the value of fixed income assets fell over February.

As shown above, yields have risen substantially when compared with the start of the year. The yield curve remains inverted, however, indicating that markets still expect interest rates to be lower in future.

US

YTD Performance of US Equity Markets

US equity markets continue to soar in the month of February as the rally broadens to include the smaller companies, which have previously somewhat missed out – the Russel 2000 index, which includes such smaller companies, was up by 4.17% in the month.

The famously tech-heavy NASDAQ 100 also rose by 4.14% and the S&P 500, which is also increasingly dominated by technology companies, added 3.99%.

The Dow Jones Composite Average, which includes blue chip or the more "traditional" names, was still up a healthy 0.99% but this is very much overshadowed as investors remain focused on the opportunities offered by Artificial Intelligence (from which the tech companies stand to gain most).

Year to date the NASDAQ and S&P are up 7.26% and 7.22%, respectively, whilst the Russell and the Dow lag with reasonable gains of 2.17% and 1.07%. The Russell 2000 is the only one of the four indices not to be at its all-time high, down 12.70% from its peak in November 2021.

The big news this month was the blow out earnings posted by Nvidia, now the third-largest company in the S&P 500 index with a $2.26 trillion market cap.

Nvidia reported that total revenue had risen by 265% from a year ago after demand for chips related to AI continues to rise. Net income came in at $12.29 billion during Q4, a 769% rise (not a typo!) from $1.41 billion this time last year.

With this, we must also issue an immediate update from our commentary last month where we reported that Meta set a record for the single day largest market capitalisation gain in stock market history; Nvidia now holds the record, with a whopping $277 billion single-day gain.

Markets remain starry eyed and optimism about the potential efficiency gains that the prospect of Artificial Intelligence offers are outweighing any negative sentiment resulting from the Federal Reserve walking back future rate cuts. The next Federal Open Market Committee meeting will take place later this month where "no change" is the strong consensus – note that just three months ago, the chance of rate cuts in March was priced at over 75%. A 0.25 to 0.50% cut is now priced at 71.60% for June of this year. If the last anecdote says anything, this is subject to change.

Fed Chairman Jerome Powell confirmed this whilst testifying in front of congress last week, where he reiterated that interest rate cuts are expected this year but policy moves will be dependent on incoming economic data, adding that there is not enough evidence to suggest that inflation is at its 2% target yet.

In terms of inflation data, the PCE-deflator, one of the Fed's favourite inflation measures, showed mixed signals.

On one hand, inflation was shown to decelerate from last year (falling from 2.6% to 2.4%). However, the monthly data actually accelerated by 0.3% from last month. Just like the UK, this increase can mostly be attributed to the services sector, which is more labour intensive. This highlights that the labour market is still tight, and the Federal Reserve may have to keep policy restrictive to ease wage pressures.

	01/02/2024	08/03/2024
2 Year US Treasury Yield	4.21%	4.50%
10 Year US Treasury Yield	3.88%	4.07%

US Treasury Yields from the start of February 2024

Treasury yields have been back on the rise on the sentiment that rates might not be coming down as quickly as first imagined.

The two-year yield rose 39 basis points to 4.50% and the ten-year yield rose 19 basis points to be back above 4.00%. This depressed prices slightly as yields move inversely to price.

The US yield curve has now been inverted for over 20 months and a growing number of market commentators are suggesting a rare false positive from the famous recession predictor. The normalisation of the curve will more than likely be a result of base rates moving down at the short end rather than increasing at the long end (i.e. 2-year rates are more likely to fall than 10-year rates are to rise).

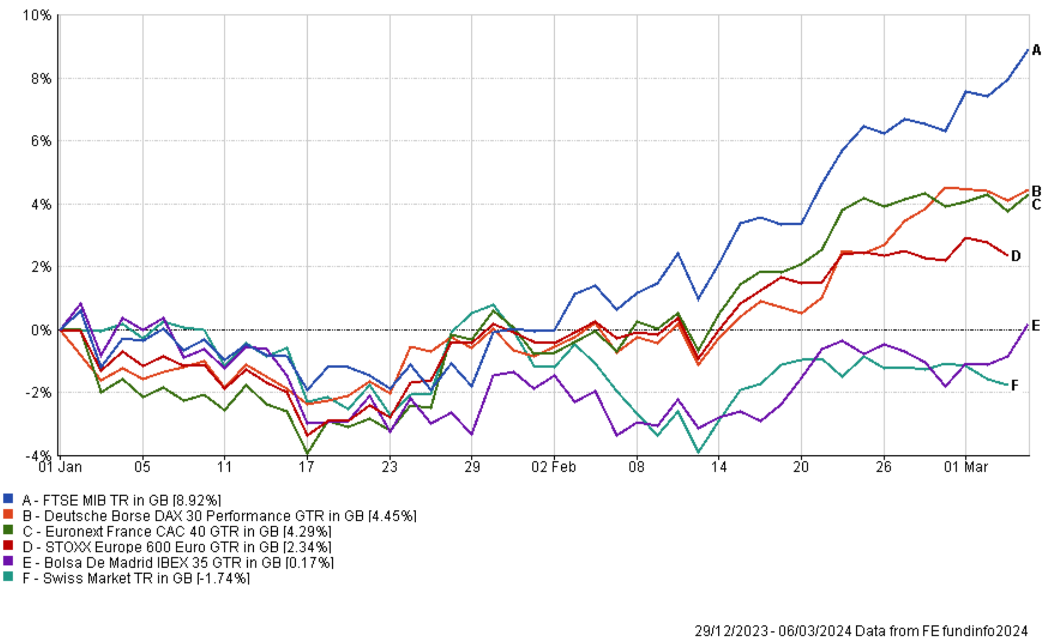
US Personal Interest Payments from 1960

Another topic being discussed is the rising US consumer debt. As shown above, personal interest payments in the US are now over $570 billion. Perhaps the rising interest rates from the last two years are finally feeding through to the US consumer (the well-known "lag effect").

One important point to note is that the shaded areas on the graph above represent recessions, and this particular indicator is always at a high just before a recession. This chart is not adjusted for inflation but shows that personal interest payments are up 38.17% from last year.

The final thing to mention is that the stage is now set for Biden vs Trump: Round 2 with Biden passing his fitness checks and Trump winning his appeal to the Supreme Court to be allowed to stand at all. No surprise that the Trump-nominated judges favoured his side's arguments. Markets historically perform slightly better after a Republican win. However, in reality, there is relatively little difference between share price performance under either party.

Europe



YTD Performance of European Equity Markets

European markets rebounded in February after a lacklustre start to the year as eurozone inflation shows signs of cooling. The big leader was the Italian FTSE MIB with a gain of 6.38% in February. The German DAX 30 and French CAC 40 also showed promising performance with gains of 5.41% and 4.68%, respectively. The Bolsa De Madrid of Spain and the Swiss market remained flat.

Broadly speaking, European markets severely underperformed their US counterpart in 2023 after outperforming in most of 2022. One reason for this was the region's overreliance on Russian energy, the supply of which was clearly disrupted by the start of the Ukraine war. However, pressures should ease as supply chains adjust and two successive warm winters have kept energy stocks high.

In 2024 so far, European equities have largely kept pace. One major development that moved markets was the latest European Central Bank meeting. ECB President Christine Lagarde held the central bank rate at current levels, as expected.

Markets are now widely pricing in a cut for June, in line with other global central banks. Staff projections for inflation were also updated from 2.70% to 2.30% and meeting its 2% target in 2025. Eurozone inflation is currently 2.60%, down 0.20% from January. The economic growth forecast was also adjusted down to 0.60% from 0.80% and further out, was also reduced to 1.50% in 2025. Just like weather forecasts, however, economists' predictions must be taken with a pinch of salt.

	01/02/2024	08/03/2024
2 Year German Bond Yield	2.57%	2.79%
10 Year German Bond Yield	2.15%	2.27%

German Government Bond Yields from the start of February 2024

In bond markets, the German 10 Year Government Bond yield has risen 12 basis points to 2.27% from the start of February. The 2 Year yield rose 22 basis points to 2.78%, reflecting similar dynamics to the US yield curve. That said, yields in Europe are starting from a lower base because of the ongoing recession in parts of the EU and weaker long term growth prospects in comparison to the US and Emerging Markets.

When looking at Europe, each country must be taken individually and this is no more evident than Italy's performance in 2024 compared to say France or Germany. Italy's economic growth for the final quarter of 2023 was 4.20% higher than levels seen before than pandemic, which has skewed more recent data. This is double the pace of France, UK, and Germany.

Most of this growth can be attributed to the generous tax relief on home improvement implemented by the government in 2020. If nothing else, this highlights the fact that fiscal stimulus can be beneficial if done in the right way.

China

Last week, during the National People's Congress, the Chinese Communist Party set out its economic targets for 2024. One of the key goals set out by the Chinese government was its c. 5% GDP target for the year ahead.

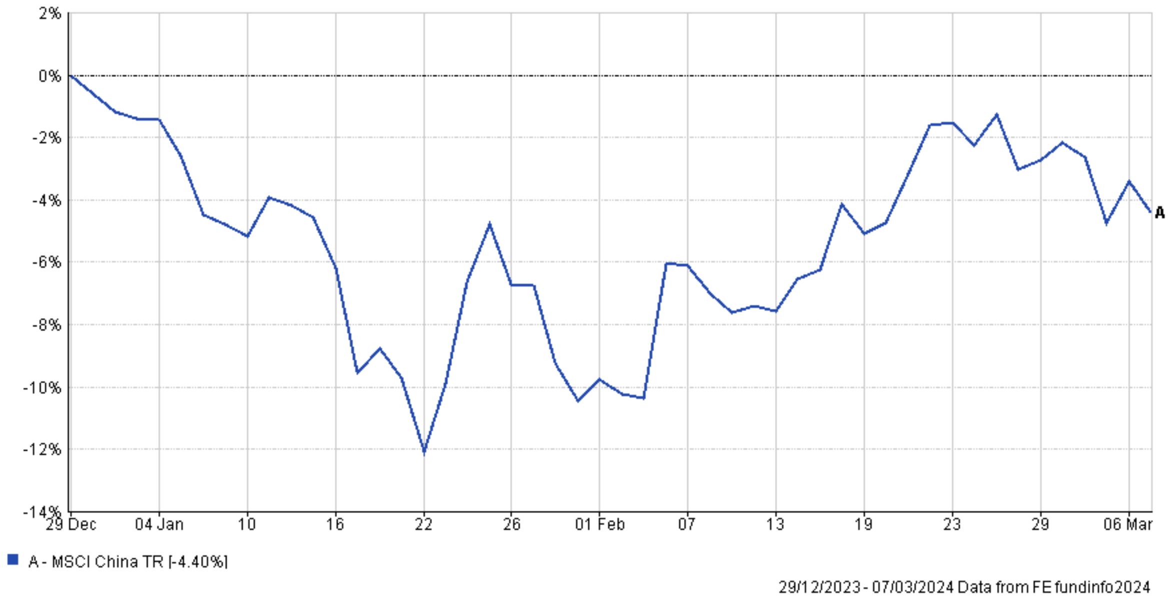
The Chinese economy grew by 5.2% last year. However, this was at a time where the economy was fuelled with optimism, hoping for a strong recovery after 3 years of Covid-19 restrictions were lifted.

This year there is limited optimism surrounding the economy and achieving GDP growth of 5% will certainly be a challenge.

The main issue in the region is deflation and the effects that this is having on consumption. Chinese house prices also continue to move lower in 2024, and this is heightening the issues with consumer confidence in the region. An economic theory known as the "wealth effect", which suggests that people spend more as the value of their assets rise and vice versa, is certainly causing issues with consumption in the region.

It is still unclear whether the present deflationary environment in China is transitory or whether it could be a more widespread, longer-lasting, issue within the economy. The Chinese economy should and will use the Japanese economy as a case study for deflation and the damaging effects that it can have on an economy.

A struggling Chinese economy is now also affecting global equities. Apple witnessed sales fall 24% year-on-year in the first six weeks of 2024, while Tesla's stock price fell approximately 7.2% last week after Chinese sales declined 19% year-on-year in February. With consumption in the region weak, prices of Chinese exports are falling. This is increasing the competitiveness of Chinese exports, and western companies are unable to compete on price in many cases.



YTD performance of MSCI China

Chinese equity markets reached five-year lows in January. However, the Chinese government announced several supportive interventions last month, including a cut to mortgage rates and curbs on short selling. There was also more buying from state-run financial institutions, inflating stock prices.

Consequently, the MSCI China Index gained 8.43% in February. Despite this rally however, the index remains in negative territory year-to-date, down 4.4%.

The state interventions aimed at increasing stock prices are very much short-term solutions. For Chinese equities to perform well over the medium- to longer-term, there needs to be real fiscal policies in place to boost consumer confidence in the region.

The deflationary environment in China is also an issue that cannot be ignored. While asset prices are falling, there is no incentive to purchase goods and services, since they can be bought at a lower price later. This can lead to a deflationary spiral, which China will need to avoid if the economy is to hit the government's ambitious 5% GDP target this year.

An increase in consumption within the region is also needed to boost the profitability of Chinese companies and it is likely that the preventative short-term solutions currently in place will not achieve this.

While the outlook for the Chinese economy is questionable, investors should watch the region closely over the coming months. Given the recent underperformance in China, there could be increased potential for returns.

With increased volatility on the horizon, stock selection is likely to be key this year in China. Active investment management is thus preferred when investing in the region.

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March 2024

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.