Watson French
WEALTH MANAGEMENT

Asset Class Commentary
April 2024

Inflation dealt yet another blow to investors' interest rate cut expectations this year as US inflation data came in 0.1% above expectations. This is the second month in a row that inflation has risen and has come in above expectations, prompting fears that price rises will become entrenched at higher levels.

Investors are currently betting that the UK, Europe, and other Asia Pacific countries will cut rates before the US. The US economy is stronger and there is no economic reason for the Federal Reserve to cut rates presently. The first US cuts now look more likely for September, 6 months later than investors had originally expected back in November 2023.

For the global bond sector this has resulted in increased inflows into European and Australian government bonds and to some extent, UK gilts. The level of supply in US government debt this year will be another concern for investors.

We think this increase in the supply of debt will keep yields higher than they would otherwise be when interest rates normalise.

The US economy is indeed a puzzle. The neutral interest rate (the rate at which economic growth is neither accelerated nor diminished) is estimated to be around 1%. With US interest rates above 5%, economic growth should not be so strong, but it is.

The consensus outlook for the US is for a soft landing or a "no-landing" this year (strong economic growth with inflation falling back to target). For equities this will be a big tailwind, but it does increase the risk of future inflation flare ups.

The UK entered a technical recession at the end of 2023, but low positive economic growth since has meant the UK will have moved back into very weak growth rather than contraction. UK equities have remained unfavoured owing to their perceived lower growth potential, although metal and mining companies have continued to provide support over the short term.

Japanese equities have continued to provide attractive returns for investors this year, offering a diversified return from US equities. The era of negative interest rates finally ended, and the Japanese Central Bank ended its yield curve control policy. This has been welcomed by investors as the country's deflation problem finally seems to be solved (at least temporarily).

For hedged overseas investors, returns have been eroded by a weaker Japanese yen. Although no longer negative, interest rates in Japan are much lower than other major economies and do not look to reach similar levels, resulting in a lower demand for the currency.

Globally, a big influence for the rest of the year will be whether China can restart its economic engine. Any further stalls will likely pull supply down, presenting inflation problems for the rest of the world.

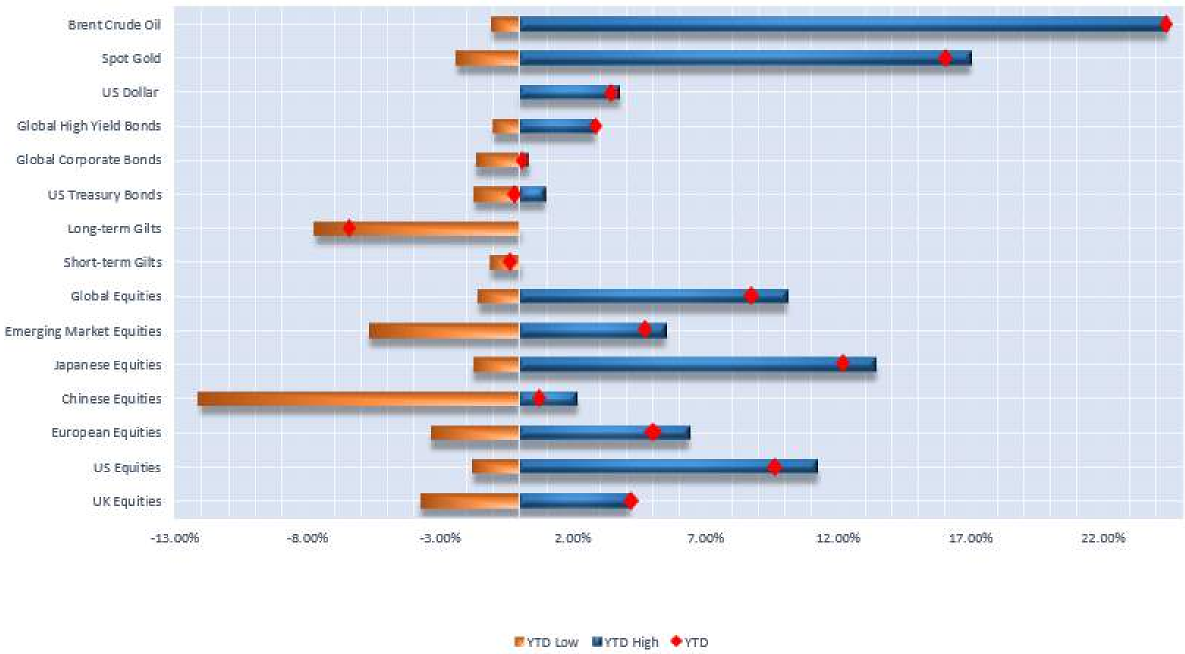
Conflicts in the Middle East have also pushed oil prices up and this will filter through into the global economy, potentially creating a short-term cushion for inflation.

With a soft or no-landing looking more likely to investors, entry points into different maturities of bonds look clearer than they have been. Shorter duration is still preferred for its good yield and lower sensitivity to interest rate movements.

The spread of investment grade credit over government bonds has tightened (meaning investors are rewarded less for lending to quality companies when compared with governments), even as more companies look to issue new bonds before the US presidential election introduces new volatility into the market. The demand is far outstripping supply, pushing investors into higher yielding and riskier bonds in a search for income which is reminiscent of the decade before Covid.

Areas of focus

- Shorter-term bonds are still preferred. Historically, bonds based in the three to five year portion of the yield curve have tended to benefit the most from interest rate normalisation.
- US stocks continue to provide growth in portfolios, with more focus being placed on their cashflows rather than interest rate movements affecting their values.
- Industrial stocks have a potentially strong tailwind behind their long-term performance. The growth in AI requires huge datacentres, which are built by these industrial companies.
- UK equity indices have received a much-needed boost from mining, commodity and financial companies, having lagged in negative territory for much of the year.
- Long-term bonds have continued to experience negative returns this year as yields have moved higher. If inflation does become entrenched at higher levels, inflation linked bonds should provide some protection.
- Japanese equities should continue grow but headwinds such as rising interest rates may cause some friction.



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 as at 15/04/2024.

UK

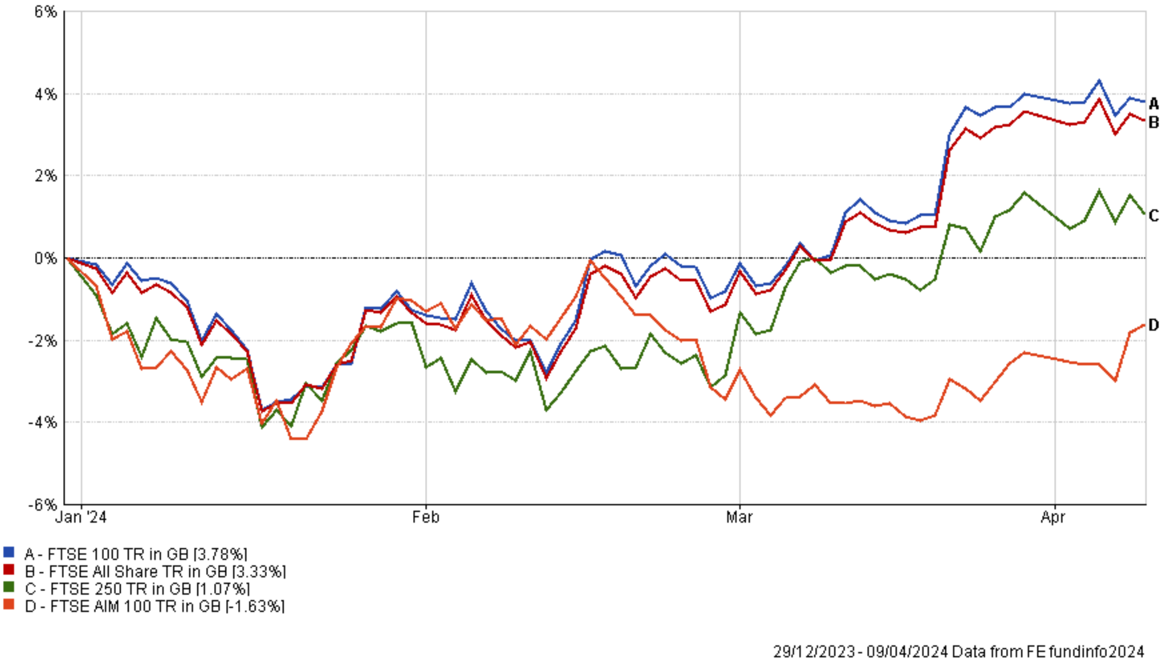
In line with expectations, the Monetary Policy Committee of the Bank of England voted 8-1 to keep interest rates steady at 5.25% at its latest meeting in March. Interest rates are still working to tackle inflation, with the rate of increase in CPI slowing to 3.4% in February, down from 4.0% in January. Falling food prices helped to bring inflation down last month, with the UK Shop Price inflation falling below 2% last month, the first time since December 2021.

Also as expected, the UK's technical recession seems to have been short-lived, lasting only two quarters. Data released this month shows that the UK grew by 0.1% between January and February. After a 0.3% rise in GDP between December and January, GDP would need to fall 1% month on month in March for the economy to contract over Q1. This scenario is unlikely.

While GDP is rising, overall output remains 0.2% down year-on-year. Output in consumer-facing services such as restaurants and hairdressers, down 5.7% YoY, shows the impact of the cost-of-living crisis on 'luxury' goods and services.

At the start of the year, interest rate cuts in the UK seemed imminent, with many predicting that interest rates would be cut as early as March. With GDP stronger than initially predicted by the BoE, there is currently no clear path for monetary policy going forward. The consensus now, however, is for two 0.25% cuts this year – but as we have recently seen, this is quite likely to change as in the months ahead.

The BoE now expect inflation to drop below its 2% target in the second quarter of this year. This can largely be explained by the Chancellor's decision to freeze fuel duty in the spring budget, which is likely to lower overall energy costs for the remainder of 2024. Although annual wage growth in the UK remains high at 6%, it is expected to fall alongside consumer prices.



YTD performance of major UK stock market indices

UK equities performed well in March, with sectors such as energy, materials and financials outperforming. After a positive month for UK equities, the FTSE 100 is up 4.13% year-to-date (although they remain relatively cheap when compared to overseas counterparts).

Small-cap UK equities (shares in smaller companies) continue to struggle with high interest rates, with the FTSE AIM 100 down 1.63% this year and struggling to gain traction during March.

	Yield as of 01/04/2024	YTD change
2Y Gilt	4.18%	5.29%
10Y Gilt	3.94%	11.30%

Gilt Yields in March 2024

Gilt yields fell slightly again in March. Yields have still increased when compared with the start of the year, with the 10Y gilt yield having risen 11.30% since 1st January. While there is a potential opportunity for excess returns in UK fixed-income assets, there is likely to be continued volatility as markets adjust to the changing views on monetary policy.

US

The high-flying large technology companies, which collectively have been pulling markets forwards over the last year, took a breather in the month of March as the market rally broadens to include previously unloved smaller cap stocks.

YTD Performance of US Markets

The Dow Jones Composite Average was the best performer of the US indices in March, gaining 2.49%, with the Russell 2000 and S&P 500 booking gains of 2.45% and 2.36% respectively. The real surprise comes in the form of the NASDAQ 100 showing a rare loss of 0.21%. Of course, down months are very common in regular market conditions but the bar for this index has been set extremely (and unrealistically) high in recent times.

The big questions that need to be answered continue to be; can US economic growth remain resilient? And when will the central bank start to cut interest rates? We believe the answers to these two vitally important questions lie in earnings and inflation (earnings being the main contributor to share prices and inflation for bond yields).

The Q1 2024 earnings season is set to kick off this week with key financial companies such as J.P. Morgan and Blackrock reporting on April 12th. The "Magnificent Seven" technology companies will then report later on in the month. FactSet estimates that S&P 500 earnings will grow at a rate of 3.60%, marking the third consecutive quarter of earnings growth. On December 31st, 2023, this same estimate was 5.7%.

A hot topic to watch will certainly be which sectors look strong and which sectors look weak, this will enable analysts to have a better gauge on the real temperature of the economy. Eight sectors, including communication services and information technology, are set to grow revenues on a year over year basis, whereas three are set for a decline, led my materials.

One concept which we have discussed previously is that of "multiple expansion", where share price rises quicker than earnings, causing the price to earnings ratio to rise. The P/E ratio is a simple way to determine if a company is over or undervalued. Currently the 12-month forward

P/E is 20.5 and the 10-year average is 17.7. This would suggest that either earnings need to grow further or share prices need to decrease. Other possibilities include valuations rising more slowly or prices moving sideways whilst earnings catch up.

The greatly anticipated CPI inflation data for March came in hotter than expected and higher than February's 3.20% increase, rising 3.50% from a year ago. Core CPI (which excludes the more volatile items like food and energy) came in unchanged at 3.80%. The main contributors to the rise were shelter and energy costs, as we have seen the price of crude oil continuously rise in 2024, now above $87 per barrel. This release was watched closely by market participants in attempt to understand the future path for interest rates with higher inflation giving the Federal Reserve less room to cut.

The next Federal Reserve meeting will take place on May 1st, where rate cuts have been priced out to just a 4.20% chance. The consensus for the timing of the first cut now becomes July 31st, which is quite a remarkable change given that at the start of the year, markets had predicted rates being 50 basis points lower than where they actually are today.

The Fed meeting minutes offered something for everyone, suggesting that Jerome Powell was concerned that inflation is not moving lower quick enough to warrant immediate policy easing, but that he does see lower interest rates at some point in the year.

	Yield as at 10/04/2024	Yield as at 10/03/2024	Change
2 Year US Treasury	4.94%	4.48%	+0.46%
10 Year US Treasury	4.50%	4.08%	+0.42%

US Treasury Yields from 10/03/2024 to 10/04/2024

In the bond market investors continue to ponder the validity of the rate cuts that they have already priced in, walking back expectations to later on in the year. Bond yields rose after the release of the latest inflation data, with the 2-year yield pushing close to 5.00% and the 10-year yield breaching 4.50%.

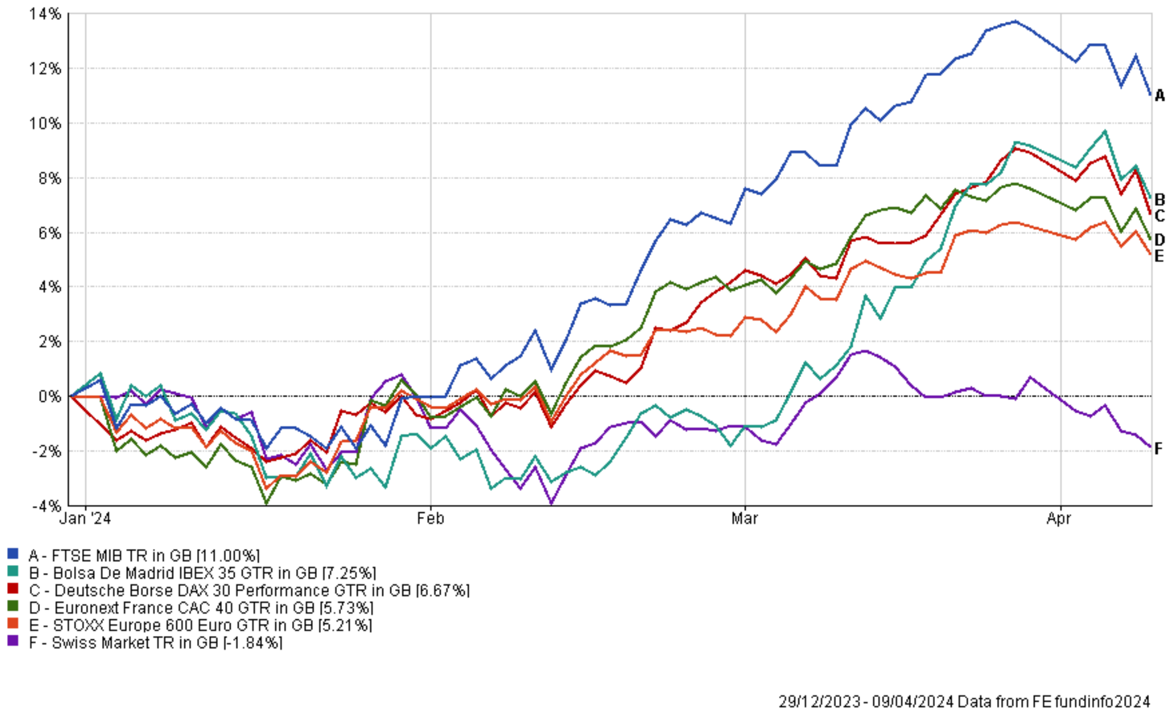
This news was not well received by bond market investors, adding more misery to an already tough start to 2024. The relief rally at the back end of 2023 was short lived (or perhaps put on hold until Mr Powell sees fit).

That said, investors are collecting a healthy yield whilst they wait. In our view, the bond market still presents some attractive opportunities across the curve with a preference for the short end at present.

Finally, a note on the US dollar. The DXY index, which shows the dollar measured against a basket of other currencies (mostly the euro), is currently at 106.04, a number not seen since October 2023.

The foreign exchange market is driven by lots of different factors, one of them being interest rate differentials. Investors have started to believe that the Fed will hold their nerve longer than other central banks such as the European Central Bank (ECB) and the Bank of England (BoE). Stronger currencies tend to benefit foreign investors as they will get more of their local currency in exchange for their appreciated dollars.

Europe



YTD Performance of European Markets

Italian and Spanish stock markets continue to soar in March as the outlook turns positive for 2024 and beyond, supported by attractive valuations and resilient economic data. As a comparison, Europe is currently trading at a 14 P/E ratio, which highlights the stark difference in how investors value European equities compared to their US counterparts. The two economies certainly have structural differences, but European equity investors will be looking to close this gap.

The Spanish Bolsa De Madrid index experienced gains of 10.33% in March, outperforming all other European stock markets by some distance. The next best performers were Italy's FTSE MIB with a monthly return of 5.43% and Germany's DAX 30, up 4.11%. France's CAC 40 posted gains of 3.36% and the Swiss Market grew 1.84% - the latter being one of the few European markets still down year to date.

The key driver of Spanish stock market performance has been the strength of major corporations in its economy.

For example, fashion brands such as Zara, Bershka, and Pull&Bear, which all have huge international presence, have managed to grow net profits by over 30% compared to last year. Additionally, the banking sector, led by BBVA, Banco Sabadell, and Caixabank S.A, have all experienced uplifts because of higher interest rate margins as a result of the sustained higher rates in the European Economic Area. This momentum will hopefully be carried into the summer as the tourism sector is expected to beat its 2017 high.

Many of the tailwinds have not been exclusive to the Spanish economy but have also helped the Italy's. Month on month retail sales grew 1% in January compared to December, annual inflation remains low at 0.8% in February, and services PMI rose from 51.2 to 52.2 (a score above 50 indicating growth).

These strong fundamentals have allowed the Italian stock market index to have its longest winning streak since 2008, with five months of consecutive gains.

	Yield as at 10/04/2024	Yield as at 10/03/2024	Change
2 Year German Bond	2.98%	2.76%	+0.22%
10 Year German Bond	2.44%	2.27%	+0.17%

German Bond Yields from 10/03/2024 to 10/04/2024

Europe's largest economy and "engine room", Germany, also looks strong as industrial production rose more than expected in February due to construction growth. Investors in Europe also watch Germany's bond market in attempt to gain key insights in the economic backdrop of the entire European area. The similarities with the US Treasury market are clear, except for expectations of lower nominal rates (due to lower terminal rates) and the belief that the Fed will keep rates higher for longer relative to the European Central Bank (ECB).

Christine Lagarde, President of the ECB, confirmed this sentiment following its latest meeting as she held rates steady for a fifth straight meeting, but gave a strong suggestion that rate cuts are ahead.

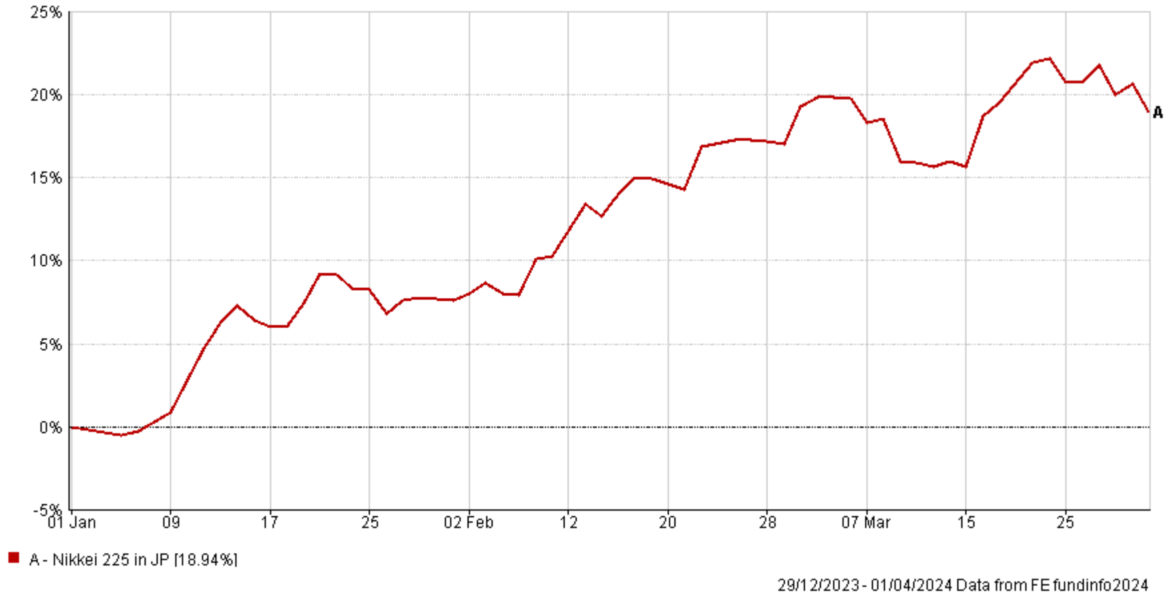
As inflation ticks back up across the Atlantic and Fed Chair Jerome Powell points to continued restrictive policy, Lagarde does not see this being the case in Europe. Markets are currently pricing in a 25-basis point cut in June, which will likely be a positive catalyst for already-rising equity markets. That said, equity markets are famously forward-looking, meaning that an environment with lower rates may well be already baked into the price.

Japan

Last month, the Bank of Japan raised interest rates for the first time since 2007, increasing the rate from -0.1% to between 0 and 0.1%. The Bank of Japan also officially ended its yield curve control framework in March, which saw the central bank buying Japanese government bonds to control long-term interest rates.

After some volatility, Japanese inflation appears to have settled at around 2%. Prices began to increase in Q2 2022 as a result of the supply-side issues caused by COVID-19 lockdowns and the Russia-Ukraine conflict.

Annual wage negotiations in Japan resulted in an average pay rise of 5.28% - the average largest pay increase in 33 years. While it is not known how much of this will be deployed in the economy, it is a positive sign that the country's era of deflation is coming to an end.



YTD performance of Nikkei 225 in Japanese Yen

This positive macroeconomic backdrop caused a rally in Japanese stock markets last month, and the Nikkei 225 has now increased by almost 19% in the first quarter of this year, reaching a record high – finally surpassing a previous peak reached over 34 years ago.

For a UK investor invested in the Nikkei 225, YTD gains would be only 11.60%, however. This is because the Japanese Yen has depreciated significantly against the other major currencies, reaching its lowest level in 34 years.

Looking forward, the outlook for the region looks promising. Efforts to improve corporate governance in Japan is likely to help boost capital efficiency and the shift from deflation to inflation will help with demand in the economy. With the Japanese stock market reaching an all time high in recent weeks, a short term pull back could be likely as investors consolidate gains.

The yield on Japanese government bonds is rising, at 0.87% compared with 0.63% at the start of 2024. However, with bond yields relatively flat compared to their western counterparts there is undoubtably more potential for returns from the equity sector in Japan.

Whilst inflation is positive for Japan, there will likely be some obstacles ahead. A continued weak currency could negatively impact demand in the region. If the Japanese populus believe that inflation is temporary, and the economy is set to return to deflation, individuals may choose not to spend. After decades of falling prices, there is likely to be a deflationary mindset that is entrenched amongst some of the older generation in Japan, who oppose the idea of rising prices.

Robert Dougherty, Associate IFA
Ryan Carmedy, Graduate Trainee IFA
Harry Downing, Graduate Trainee IFA
April 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.