Watson French
WEALTH MANAGEMENT

Asset Class Commentary
May 2024

With interest rate cut expectations continuing to be pushed back, stock market momentum has held up throughout April and May and a slowdown does not look likely any time soon.

Interest rates are much higher than they have been for a long time, but companies and the consumer are still strong, potentially meaning financial conditions are actually much looser than markets are thinking. Therefore, we may not see much in the way of rate cuts if economic growth continues to drive forward.

That being said, markets are refocusing on the most important company fundamentals – that is, their earnings and cashflows. Global equities continue to post positive performance as strong company earnings and balance sheets have continued to attract investors into equities. Any movements downwards in rates will help equities, but it is earnings that are now back into focus for investors.

The AI theme has and will continue to drive markets. Aside from the mega-cap technology stocks that have benefitted the most from this theme, many other industries stand to benefit and their values potentially do not reflect their full earnings potential once the transformative long-term effect of AI is taken into account.

Nvidia has laid the foundations of AI; now other companies will build on this. Companies that are already incorporating and detailing how AI will fit into their business models have broadly started to see increases in share price performance (although other factors will also be driving this).

There are differing views on whether stocks (in particular the mega-cap tech stocks) are over-valued. When we look back to the Dot Com bubble in the late 90s, valuations are nowhere near as stretched as they were back then. Balance sheets and company earnings are much stronger and growing, and the P/E ratios, although elevated, do not appear to be overstretched.

Japanese equities continue to be favoured by investors, despite some headwinds from a weak currency. The Japanese Yen is at its weakest point versus the US Dollar in over 30 years, but much of this is a function of very low Japanese interest rates versus much higher US interest rates.

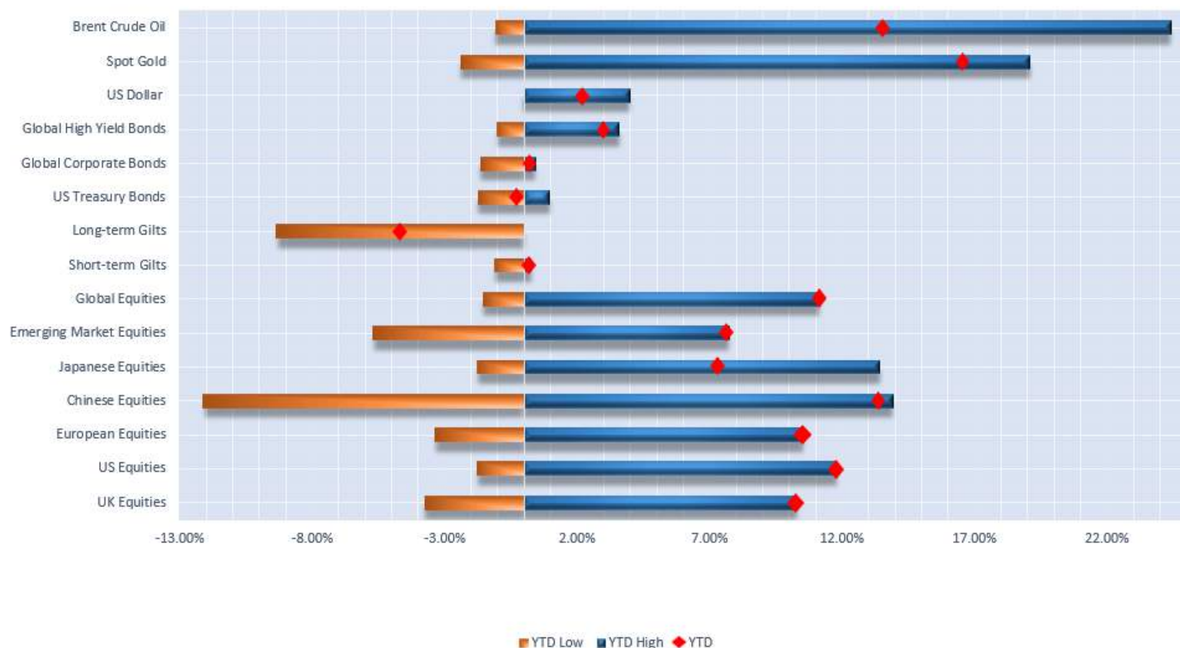
In response, the Japanese central bank has stepped in to limit the damage of the falling Yen by buying the Yen and selling the Dollar. A weak Yen will result in different outcomes for different types of Japanese companies (benefitting exporters, for example) and being selective in Japanese companies is therefore important in present conditions.

While over the short-term Japanese equities do look attractive, investors will need to balance the potential for returns with other regions, such as the UK, to decide on how much they will allocate to the region.

The UK rebounded from its technical recession, posting positive economic growth of 0.6% for the most recent quarter. The Bank of England has delayed any interest rate cuts and is still looking closely at the labour market to decide when to cut. If economic growth remains positive, again, we may see less cuts that originally anticipated. UK equities meanwhile continued to post positive returns, with the FTSE AIM index finally above water after spending much of the year in negative territory.

Areas of focus

- Japanese equities remain favoured, particularly exporting companies which are benefitting from a weaker Yen.
- Short-dated bonds continue to offer attractive yields with less downside risks relative to long-term bonds.
- Inflation linked bonds, although often longer dated, offer inflation protection over the medium term.
- Gold prices have continued to rise as gold is seen as a long-term inflation hedge.
- Chinese equities have posted positive performance since the middle of April, but long-term tailwinds persist, and investors should not get ahead of themselves.
- Despite good performance this year, investors' preference for UK equities has continued to decrease as thematic and growth opportunities lie in Europe and the US.
- US equities continue to post positive returns with momentum continuing to carry the rally.

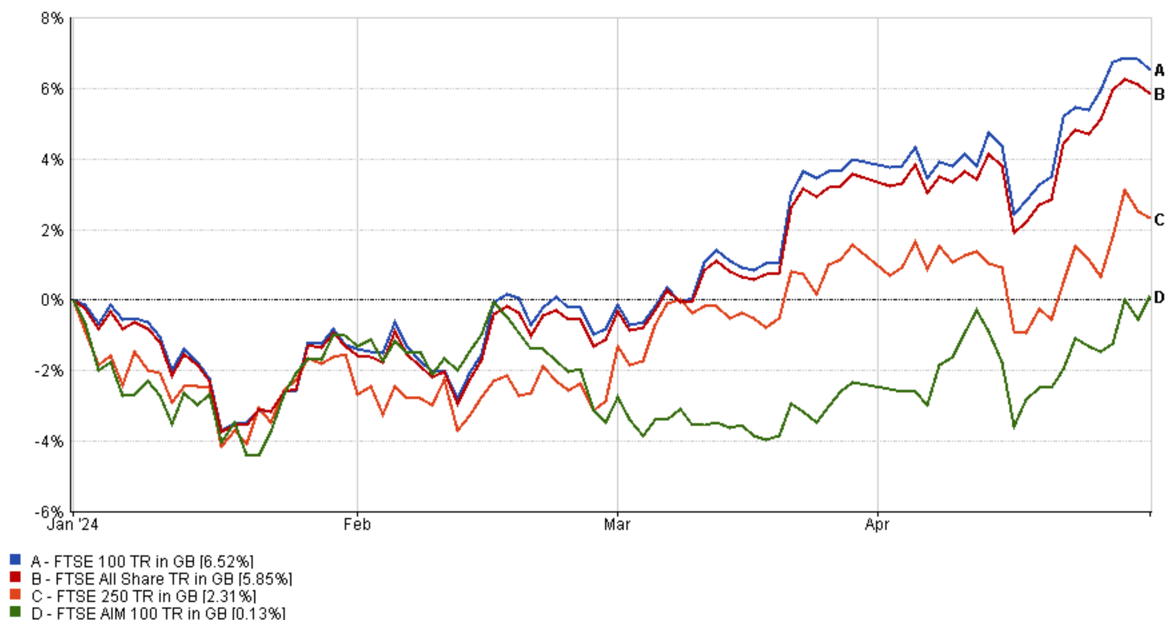


Selection of assets 2024 YTD returns and range of returns as at 16/05/2024 (the two ends of the bars represent the range of YTD returns and the red dots represent the current YTD return). Indexes used: FTSE All-Share, Russell 3000, STOXX Europe 600, MSCI China, MSCI Japan, MSCI Emerging Markets, FTSE 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 CPI dropped by more than expected in March, to 3.2%, down from 3.4% in February. A reduction in food prices helped to achieve this reduction, while a slight increase in motor fuels caused an upward contribution. Core CPI also fell year-on-year, down to 4.2% from 4.5% the previous month.

Whilst this shows that progress is being made in tackling inflation, investors should not get ahead of themselves (as they did towards the end of last year). The consensus view is that we will see three interest rate cuts by the Bank of England this year, starting in the summer. However, as we have been frequently reminded this is most definitely subject to change.



YTD Performance of Major UK Stock Market Indices

UK equities outperformed last month, with the FTSE 100 index up by 6.52% year-to-date and 2.43% during April. Flows into traditionally undervalued sectors such as financials and resources helped the index reach all-time highs towards the end of April, and the index continued to rally into early May as commodity prices rose.

Increased takeover interest also helped to boost UK stock prices last month. This again highlights the valuation differential between the flagship UK index and its overseas peers, even after a strong month for the index.

Smaller companies in the UK also had a good month in April in terms of outright performance. The FTSE AIM 100 year-to-date performance is now positive, albeit only marginally, after rising 2.5% last month.

	1st May 2024	YTD change
2 Year Gilt Yield	4.52%	13.85%
10 Year Gilt Yield	4.37%	23.45%

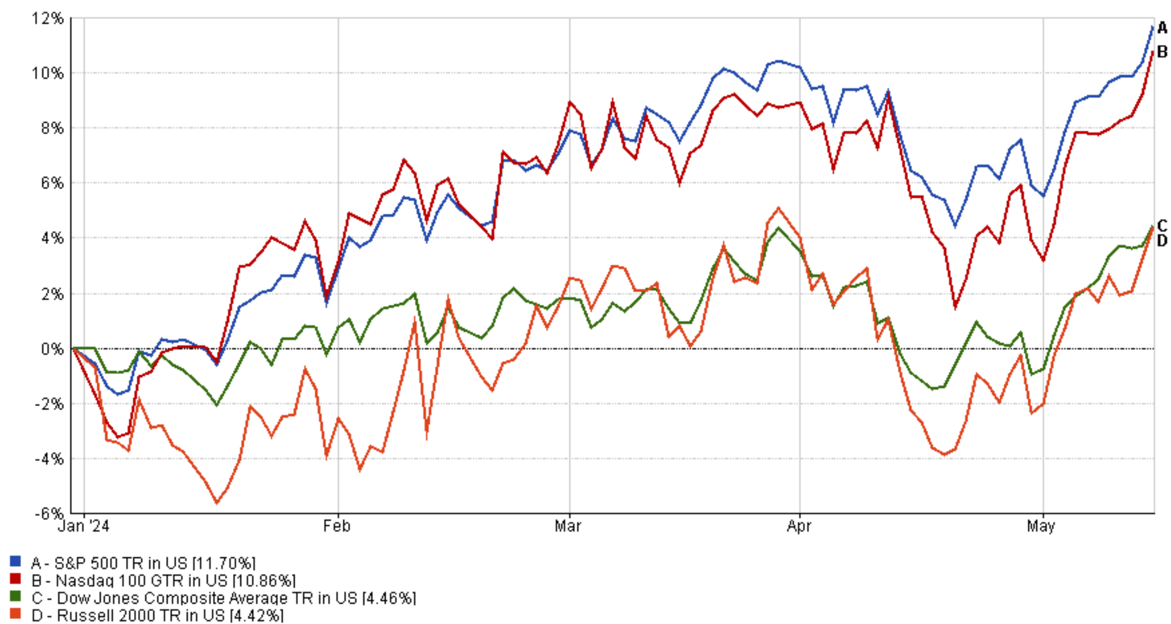
UK Gilt Yields as at May 1st, 2024, and YTD Change

Yields on UK government bonds also rose again last month. The 10Y government bond yield has so far risen 23.45% year-to-date, in a clear sign that investor optimism around rate cuts last year was misplaced. While the latest inflation data shows that inflation is coming down, it is not decreasing at the pace investors previously expected.

US

US equity markets recovered in early May after an April which saw all major indices decline. The Russell 2000 was the biggest loser in the month, losing 6.09% - however, it has since recouped 6.57% to achieve a similar level to where it started last month.

The NASDAQ 100 performed similarly despite the vastly different makeup of the index, continuing the theme of a broadening market rally. The NASDAQ 100 dropped 4.63% in April and has now risen 7.44%. For reference, the S&P 500 dropped 3.91% then rose 5.84%, and Dow Jones Composite fell 4.34% in April only to gain 5.23% back in May.



YTD Performance of US Equity Markets

Year to date the S&P and NASDAQ still lead, being up 11.70% and 10.86% respectively with the Russell and Dow playing catch up (with gains of 4.42% and 4.46%).

Markets are being driven by the same forces that have been at play for months now; a resilient economy, the prospect of lower rates, and the Artificial Intelligence "revolution". Being an election year, this will likely continue albeit with the potential for volatility as the presidential polling day approaches. Election years have historically provided good tailwinds for markets as the sitting administration does whatever it takes to prop up markets.

At present, the biggest risk facing the market is that inflation proves to be sticky, giving the Federal Reserve no room to cut interest rates or perhaps even forcing a rate hike. This is not our base scenario, but the probability is not zero. We have still not seen the recession that was widely predicted at the beginning of 2023, and economic data is yet to turn. Higher rates still pose a risk but for now, markets continue to "climb the wall of worry".

Earnings season has been in line with expectations with nothing abnormal to report. The majority of companies have beaten expectations, albeit these were set at a low bar, with companies not meeting their projections being punished.

US economic growth for the first quarter of 2024 came in below estimates at 1.60% (growth of 2.40% was expected), showing signs of a slowdown from the blow-out numbers in the second half of 2023. Unsurprisingly, investors took this opportunity to take the temperature on the all-important inflation data that comes with the release. The Personal Consumption Expenditure (PCE) index rose at an annualised pace of 3.40%, up from the previous quarter's figure of 1.80%. Two heavy blows in terms of data put the spotlight onto Fed Chair Jerome Powell, where a hawkish tone was expected.

At the Federal Reserve's meeting on 1st May, Powell kept rates unchanged and essentially ruled out the next decision being a hike. As expected, this gave markets the confidence to continue to rally after the first negative month of the year. Barring any surprises, the first rate cut is now expected on 18th September at a 72.60% probability. Although inflation is still above the Fed's 2% target and the labour market is still strong, Powell will be very aware of the fact that the effects of higher rates are still to feed through the economy.

	1st April 2024	1st May 2024	15th May 2024
2 US Treasury Year Yield	4.71%	4.97%	4.74%
10 US Treasury Year Yield	4.32%	4.64%	4.34%

US Treasury Yields from the start of April 2024

The table above highlights the volatility currently present in the bond market. Rates rose rapidly, sending prices lower, during the month of April as investors got the news of hot inflation before dropping back to previous levels after Powell ruled out a hike. Rates remain elevated compared to the 4.14% and 3.80% low for the 2- and 10-year yields at the end of 2023, back when rate cuts were expected as early as March.

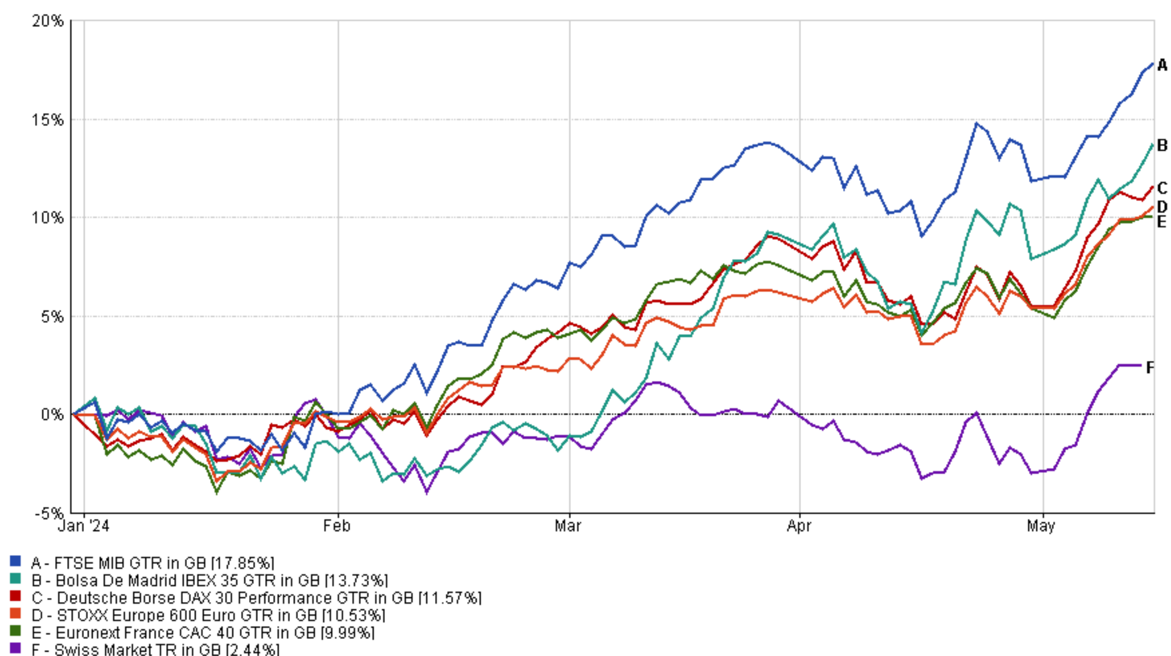
Bond market investors will likely be keen to wait until rates do come down to capture the capital appreciation they have long been waiting for whilst continuing to receive a healthy yield, but the big risk here is the opportunity cost of being out of the equity markets.

Historically, equity and bond markets have been negatively correlated (as equities rise, bond markets fall and vice versa), which provides the fundamental reason for diversifying across both asset classes as a long term investor.

This is because as equity markets rise due to higher growth, inflation tends to follow which results in higher rates and lower bond prices. However, since 2020 the correlation between equities and bonds has actually been positive, meaning both markets move in the same direction at the same time (one of the reasons 2022 was so painful for traditional diversified investors). The point here being that going forwards, bond markets are likely to rally as rates come down, but equity markets may rally even more. This is why diversification and holding these assets in the right proportions for an investor's long term risk profile is essential.

Europe

Following in the same vein as the US, European markets recovered after their first monthly decline of the year. In April the Swiss Market and German DAX 30 were the worst performers, posting losses of 3.62% and 3.15% respectively, before gaining 5.56% and 5.77% since the start of May. The Bolsa De Madrid, FTSE MIB, and CAC 40 were down 1.14%, 1.50%, and 2.05% in April to then post gains of 5.40%, 5.34%, and 4.38% in the first half of May.



29/12/2023 - 15/05/2024 Data from FE fundinfo2024

YTD Performance of European Equity Markets

The Italian FTSE MIB continues to be one of the best performers in Europe, if not the world, year to date being up 17.85%. On the other hand, the Swiss Market lags behind the rest of Europe, up just 2.44%.

The broader STOXX Europe 600 is up a very respectable 10.53% as investors start to believe Europe can make up a larger percentage of a global equity portfolio than was previously forecasted. Valuations across Europe do look reasonable; however, this is likely a product of lower growth potential compared to their US counterparts.

The much-welcomed news this month was that the Euro area came out of recession in the first quarter, with GDP growth of 0.3% after the previous five quarters of stagnation. Foreign demand was the biggest contributor to growth, with Germany being helped by its construction sector and France led by household consumption.

Inflation remained unchanged at 2.40% in the month of April, annoyingly just above the 2% inflation target of the European Central Bank, who now feel as if they are in a position to cut rates in June. Further cuts are signalled as being “data dependent” rather than “Fed dependant”. The Swedish and Swiss central banks have already started to cut rates due to lower inflation rates in these countries compared with the rest of Europe.

One effect to watch out for with a doveish ECB is a devaluation of the Euro. As the interest rate investors get paid on their euro accounts decreases, so too does the attractiveness of holding the currency as a foreign investor. The impact of this is that foreign goods, such as oil, become more expensive as when they are denominated in another currency, such as dollars. Fortunately, for the UK investor the pound will be able to buy more in the European stock market. The big caveat to this is that if the currency continues to devalue, any gains made will be eroded when converting back to pounds.

	1st April 2024	1st May 2024	15th May 2024
2 Year German Bond Yield	2.86%	3.11%	2.91%
10 Year German Bond Yield	2.30%	2.59%	2.43%

German Government Bond Yields from the start of April 2024

On the bond markets, German government bond yields acted similarly to US bonds in April and the start of May with higher global inflation data, before ECB President Christine Lagarde giving reassurance to markets in the same way as Powell.

The most recent government bond auction in Germany was met with high demand as investors expect this to be one of the last auctions to pick up bonds at present high rates of interest.

As the rate paid on a bond (its coupon) stays constant until maturity, when interest rates eventually get cut, the bonds that have higher coupons will rise in price so that they will yield the same as the new issues. Again, currency exchange rates can dampen these gains if investing in a foreign currency but as with equities, diversification across international bond markets is important.

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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.