Watson French
WEALTH MANAGEMENT

Asset Class Commentary
June 2024

The European Central cut interest rates by 0.25% this month, leading the UK and the US central banks. Members of the bank reiterated that as inflation remains sticky, with particular focus on labour costs, further cuts are not a given.

Bond yields in the Eurozone ticked upwards, as the potential for future rate cuts looks more uncertain amid persistent inflation.

Usually, the US Federal Reserve is the leader in cutting interest rates, but with inflation ticking upwards in the US, the possibility of a rate hike is not entirely off the table. We believe we will continue to see divergence in interest rates between the US and the UK and Europe, but over the long-term most major economies are expected to keep interest rates higher for longer due to higher inflation.

A world of change where supply is under constant constraint is an inflationary environment, and this is certainly where we are.

Recent surveys show that investor confidence remains with US equities, with large-cap stocks expected to remain the outperformers this year. Much of this ties in with the general bullish outlook in particular with the theme of AI.

We have continued to see the mega-cap stocks dominate the headlines, with Nvidia recently releasing an upbeat earnings report that pushed its market cap above $3 trillion.

There are concerns about US equity valuations, but with earnings growing nicely instep with prices and valuations still lower than 2023 peaks, the risk of a bubble looks reasonably low at this point.

On the downside, we have seen weak demand for US Treasury bond auctions as investors become more concerned about US debt levels, with debt levels forecast to far outstrip GDP. Although unlikely to cause concern over the short-term, the long-term impact will mean higher than normal US bond yields.

Although the UK general election is creeping forwards, the effect on markets is expected to be small. Volatility may increase over the short-term, but the policies that both of the main parties have put forward are not expected to cause major moves in markets.

UK equities have had a much-needed boost to performance over the last three months, with the FTSE 250 finally reaching a neutral level after spending three years in negative territory.

The spread between high quality investment grade bonds and government bonds is as tight as it has been for a long time. Investors just don’t see much credit risk in high quality businesses, leading to a small premium for the extra risk. The rationale behind this makes sense, with businesses showing

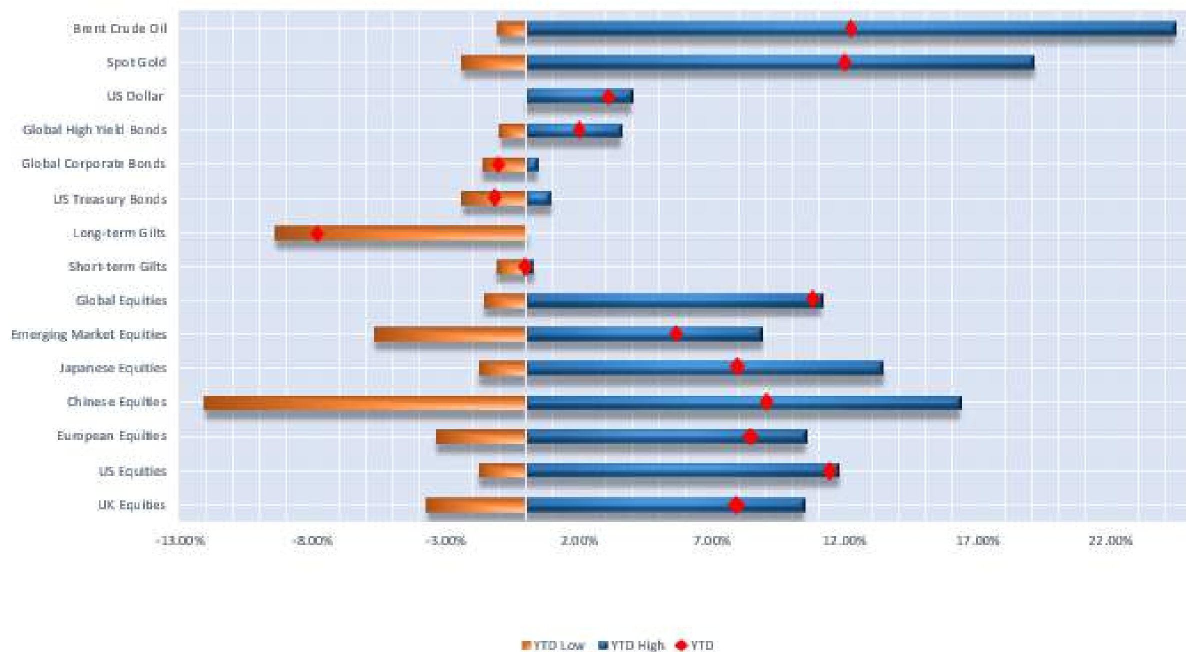
strong earnings and a much better ability to service the interest on their debt than was forecast six months ago.

Even though the "risk premium" may be small, the absolute yield is high. Investors have preferred to hold low quality (high yield) debt over investment grade credit. Although the yield is better and the spread is not as tight, we see the default potential in this sector as being higher, especially as interest rates remain high and a greater number of low-quality companies come to refinance over the next few years.

Once again, a strong month for equity markets with performance continuing higher, while bond market yields ticked up on the back of persistent inflation.

Areas of focus

- US equities remain in favour as they have a greater exposure to the AI trend.
- Investment grade bonds still offer attractive yields even with the credit premium small due to quality businesses strong ability to service their debts.
- Although valuations are high, Indian equities still present attractive long-term returns.
- With the property sector looking to have reached its bottom, the asset class presents an attractive case for re-entering the sector.
- Japanese government bonds remain very much out of favour, with extremely low yields relative to US Treasuries. The Japanese Yen is still being used as a source cheap credit to finance investment in higher yielding currencies (a carry trade).



Selection of assets 2024 YTD returns and range of returns as at 11/06/2024 (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

On 22nd May, Rishi Sunak announced that a UK general election will take place on the 4th of July. Whilst this announcement came much sooner than many had anticipated, a CPI reading of 2.3% had been announced earlier that day – the lowest figure in three years.

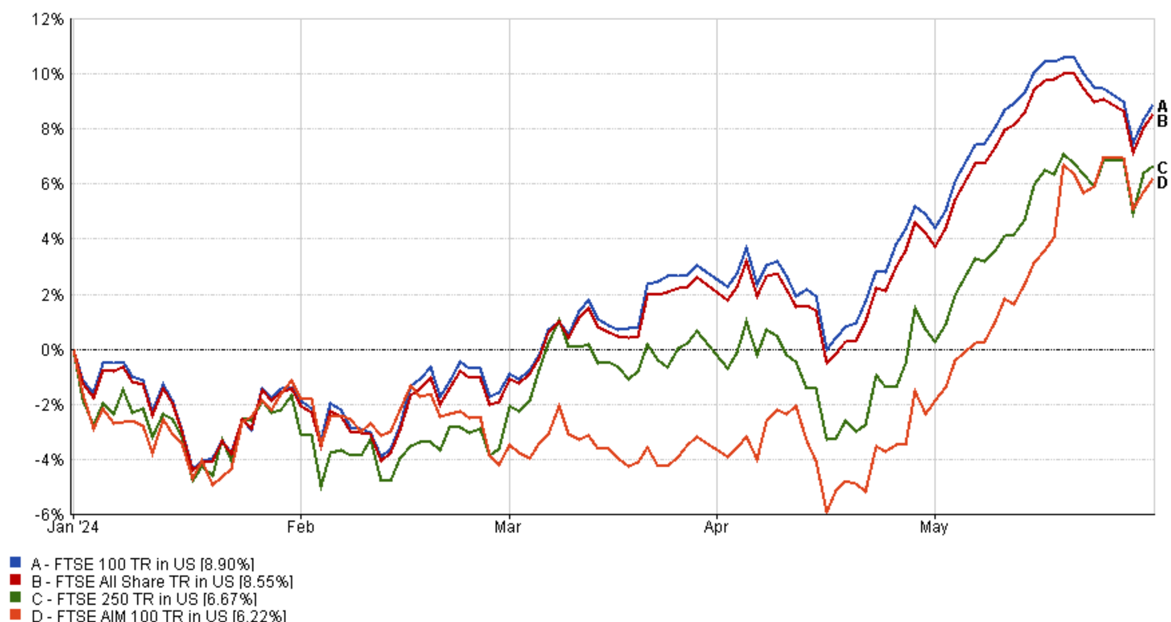
While Rishi Sunak declared that inflation was back to normal, the figure was higher than anticipated by the Bank of England. Services inflation also remained high, at 5.9%, dampening the hopes of a June rate cut from the Bank of England.

Bank of England officials are unable to make public comments during a campaign period and this makes it very difficult to gauge the current tone of the central bank. The Monetary Policy Committee are due to meet on the Thursday 20th June, two weeks before the general election.

If a decision is made to cut rates at this meeting, there is a strong chance that the central bank will be accused of being political and lacking true independence. For this reason, many investors see rates being held at 5.25% at the June meeting, before being cut in August.

After two months of consecutive declines, UK house prices grew by 0.4% in May. The average cost of a home in the UK is now £264,249, up 1.3% when compared with the start of the year. With house prices rising again, consumers are expected to be more willing to spend this summer, helping economic activity.

For now, however, it appears that consumers are acting cautiously. In recent months, spending on credit cards has decreased drastically and the rate at which people are saving is increasing. In April, a record £11.7bn was placed into tax efficient ISAs, as the population prepares for lower interest rates later this year.



YTD Performance of Major UK Stock Market Indices

UK stock markets rallied in May, until the announcement of a general election caused a slight pullback in performance. Despite a minor adjustment, the FTSE 100 increased 4.32% over the month, increasing 8.9% year-to-date.

Smaller UK companies had a stellar month, with the FTSE AIM 100 increasing 8.25%. Falling inflation and an improved GDP growth outlook also caused the UK Smaller Companies sector to outperform last month.

In recent weeks there has been growing optimism surrounding UK equities. Valuations continue to be modest, when compared to counterparts in other regions, even after the recent strong performance. Company takeover activity continues to rise, and this newfound confidence in the UK is slowing trickling down into the smaller companies.

Markets dislike uncertainty, and it is likely that there will be added volatility in UK stock markets in the run up to the general election. Currently, however, there is no fear among investors surrounding a likely change of government, with markets performing well and the pound appreciating – and some believe that a Labour administration would bring some much-needed stability to the UK, attracting both foreign and domestic investment into the economy.

	Yield as at 01/06/2024 (%)	YTD change (%)
2Y Gilt	4.346	9.33%
10Y Gilt	4.223	17.21%

UK Gilt Yields as at 01/06/2024 and YTD change

Yields on UK government bonds fell slightly over May but continue to remain elevated relative to the start of 2024. With no clear sign of where interest rates will be over the coming months, the UK bond market seems somewhat directionless.

US

YTD Performance of US Equity Markets

Since our last asset class commentary, the four major US equity markets have moved mostly sideways, all four finishing the month of May in the green. Unsurprisingly, the NASDAQ posted the

largest gain of 7.14% on the back of another blow out earnings report from Nvidia, and the S&P 500 also benefitted from this effect with a return of 5.27%. The Russell 2000 and Dow Jones Composite Average gained 4.64% and 2.71% respectively.

Nvidia, now the second largest company in America by market capitalisation ($2.95 trillion), reported a 461% increase in earnings per share from a year ago. During the earnings call the company also announced a 10-for-1 stock split and an increase to their dividend. A stock split was historically used by companies to make their share price more affordable to investors (although with fractional shares this is now less relevant). A 10-for-1 stock split means that if you own one share of a company that is trading at $1,000 before the split, you will end up owning ten $100 shares afterwards – essentially the same effect as cutting a pizza into more slices.

A significant concern for investors in US equities has been the concentration of the large technology companies in the index, the "Magnificent Seven" now accounting for around 30% of the S&P 500.

This concentration then becomes self-fulfilling, as passive investment funds have to buy more of these big names in order to track the index, pushing prices up even further. Although difficult to measure, estimates say that 15% of all US stocks are held by passive investment managers.

That said, the risk of investing in an equally-weighted index fund (i.e. one which invests in all companies equally, rather than in proportion to their size) is that you miss out on significant returns – according to UBS, 34% of the S&P 500's gain this year can be attributed to Nvidia with another quarter being attributed to Alphabet, Microsoft, Meta, and Amazon.

On one side of the market, there are extremely profitable companies, such as the ones mentioned above, being rewarded (even over-rewarded) for great earnings reports.

And on the other side, there are companies which are also being rewarded (in terms of share price) for quite the opposite. During the highly speculative market rally of 2021, unprofitable companies such as GameStop and AMC saw huge price surges caused by trading activities such as a "short squeeze". This trend resurfaced in the month of May.

A short squeeze is when investors who have bet against a company ("shorted it") are forced to cover their bets by buying back the stock at a higher price. This causes prices to go even higher and the process repeats.

A group of investors on the social media website Reddit saw this as an opportunity. Two years later and after a peak to trough decline of over 75%, the "meme stocks" are back (a meme refers to an internet craze).

The resurgence in interest was prompted by a Twitter post by the group's leader, "Roaring Kitty", and the stock is now up over 150% again. If nothing else, this story highlights the fact that markets are not always rational! For context, GameStop posted losses of $32.3 million during the quarter with sales down 29% from last year.

	1st May 2024	6th June 2024	Change
2 Year US Treasury Yield	4.97%	4.73%	-0.24%
10 Year US Treasury Yield	4.64%	4.28%	-0.36%

US Treasury Yields from May 2024

US Treasury yields moved lower during May on the hopes of globally lower yields after the European Central Bank cut its benchmark rate. That said, US investors should not expect rate cuts anytime

soon, as the two economies are in fairly different circumstances – whilst in the European Economic Area inflation is generally under control at 2.60%, the US is still battling with inflation of 3.40%.

Furthermore, as Europe has recently struggled to produce strong economic growth, the US economy appears to be as hot as ever, despite the higher interest rates. According to the CME FedWatch tool, markets expect rates to be cut in the US no earlier than 18th September with two cuts by the end of the year being the consensus.

Bond market investors will welcome these cuts but will have to keep one eye on the US bond auctions. The most recent auction saw $70 billion of five-year notes met with weak demand – high supply and low demand being a highly unfavourable combination for asset prices.

The US currently has debts of over $34 trillion, which is alarming in itself. However, somewhat more alarming is the interest that they have to pay on this debt, which in 2024 is expected to exceed the entire military budget. Of course, this debt burden can be relieved with lower rates, but the Federal Reserve must show its political independence.

The US election drama is heating up as Donald Trump was found guilty on all counts in the hush money trial, marking the first conviction of a former US President. Although it is unlikely that this will lead to incarceration, there is nothing in the constitution to state that a president cannot run from behind bars if he were to be elected on November 5th.

Despite the controversy, Trump is still leading most polls and heavy favourite at the bookies at 5/6 with his opposition, Joe Biden, at 13/8. Betting markets often provide more insight than polls because they are able to adapt in real time to developments (as opposed to the polls, which carry a lag and the potential for some sampling bias). Our view is unchanged that the US election will only influence markets marginally, the main impact being increased volatility.

Europe

The European economy maintains its recovery, albeit slowly. The latest GDP data released showed that the region grew by 0.3% in the first quarter of this year.

While inflation appears to be on a downward trajectory across the region, it remains sticky. Average inflation in the bloc ticked up slightly in May, rising to 2.6% from 2.4% in April.

This did not stop the European Central Bank which, ahead of the European Union's Parliamentary election in early June, took the lead and cut interest rates by 0.25 basis points. This marked the first rate cut in the region in almost five years and reduced the main interest rate from an all-time high of 4% down to 3.75%.

Christine Lagarde, the president of the ECB, warned that inflation was likely to stay elevated above the ECB's target of 2% "well into next year" but assured markets that the rate cut would add some much-needed stimulus the European economy.

The interest rate path moving forward is unclear, and the ECB has made no explicit commitment to future cuts. It is widely anticipated that there will be no further rate cuts this summer, but the decision will be largely dependent on the data.

YTD Performance of European stock markets

European equities hit all-time highs in May, fuelled by growth in the tech sector. Financials, which make up a large portion of the European stock market, also provided some price support. The Euro STOXX 600 index has now increased 10.69% year-to-date.

European banks are enjoying increased interest rate spreads (the difference between the interest rate charged on loans and the interest rate paid on deposits) and this is increasing their profitability.

An ECB rate cut was also being priced into markets during May, which helped to boost investor sentiment over the month.

In fixed income, the two-year German Bund yield (often used as a benchmark for the Eurozone) increased slightly in May.

The yield also moved marginally higher on the news of the interest rate cut, which seems somewhat counterintuitive. However, investors were not assured by the comments made by Christine Lagarde – and interest rates are no longer expected to decrease gradually.

Political uncertainty has also led to further increases in bond yields in recent days, especially in France, where President Emmanuel Macron called a snap election following a surge in the support for the far right during the European parliament elections. This could be a calculated risk, but it remains to be seen whether his gamble will pay off.

Commodities

29/12/2023 - 10/06/2024 Data from FE fundinfo2024

YTD Performance of Commodity Markets

Commodities have had a mostly positive start to 2024 with the Goldman Sachs Commodity Index gaining 9.41%, high energy and metal prices being the main contributors. Industrial policy along with the focus on energy transition have increased demand, which has been constructive for prices. The lingering geopolitical risk has also helped to push up prices, especially in traditional "risk off" investments such as gold, which has been pushed above all-time highs set in 2020.

A barrel of crude oil is currently trading at $77.51, around 10% off its year-to-date high of $86.91. Crude oil is currently in an environment commodity traders call "backwardation", meaning that future prices are projected to be lower than current prices. The opposite is "contango" (future prices being higher than current prices).

Most commodities can be traded at "spot", meaning that the commodity is delivered today, or with futures, meaning that the commodity is delivered at a set date and price in the future. This allows producers to lock in prices and reduce the risk of the market moving in an unfavourable manner.

The likely reason for future lower prices will be higher global production, as supply is projected to increase to a record 102.7 million barrels per day as non-OPEC countries ramp up production. Demand also remains high at around 1.1 million barrels per day because of a strong global economy.

As always, the oil market is as much decided by OPEC policy as it is by basic supply and demand, and OPEC have decided to extend their cuts until the end of the third quarter, essentially neutralising the extra supply from the rest of the world. However, there will likely come a time when the OPEC members favour income rather than prices, opting to sell more barrels into the market.

Precious metals have had various tail winds to help push up prices in 2024 – large central bank demand, geopolitical tension, and the prospect of lower interest rates. An ounce of gold currently costs £1,810.36, below the April all time high of £1,931.95.

Central banks are the largest purchasers of gold, buying one in every eight ounces bought globally to diversify their asset base away from their local currency and the US dollar (the global reserve currency). The Chinese central bank has increased its gold holding for 18 consecutive months to a total of 72.80 million ounces.

Investors also tend to rush to “safe heaven” assets such as gold in times of uncertainty to reduce portfolios’ correlation to traditional equity and bond markets. Although gold does not produce any actual cash flow (such as the dividends from equities and interest on bonds), it tends to track inflation as it is an extremely durable real asset.

Finally, as investors speculate that interest rates will be lower in the future than they are now, the opportunity cost of holding gold goes down.

Grains have been the worst performing commodity during 2024 due to the plentiful supply of corn, soybeans, and wheat. Grains tend to be the most “supply elastic” commodity of the entire sector, meaning that prices will be extremely sensitive to changes in supply. The main reason for increased supply is the favourable weather in South America – considering the El Nino weather phenomenon, supply from Argentina is up 26% from 2023.

Industrial metals have been a large beneficiary of a strong global economy and the energy transition. Metals such as copper are going to be vital to electrify our economy as it is the main input in manufacturing cables and is used in virtually all electronic equipment, explaining the heavy inflows.

Although it might be reasonable to assume that prices will continue to rise further as the energy transition progresses, the market will likely revert to a sustainable level as more supply comes online and more projects become viable with higher prices. There is a saying in commodity markets that “the best cure for high prices is high prices”.

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