Watson French
WEALTH MANAGEMENT

Asset Class Commentary
August 2024

August has been an eventful month for global markets, marked by significant volatility and shifting economic indicators.

In the UK, the Bank of England's decision to reduce interest rates for the first time since 2020 was finely balanced. The central bank's cautious tone and the ongoing debate within the Monetary Policy Committee reflect the position that the UK faces, as interest-rate setters grapple with evolving inflation data and the outlook for economic growth. The pound weakened against other major currencies, and the FTSE 100 experienced its worst trading day in three months, primarily due to sharp declines in the financial sector.

In Europe, economic concerns deepened as the European Central Bank (ECB) kept interest rates unchanged while signalling the potential for further cuts later this year.

The Eurozone's inflation figures, which came in slightly higher than expected, coupled with disappointing GDP data from Germany, underscored the fragile state of the region's economy. The ongoing political uncertainties across the continent and fears of a US-led global recession further dampened market sentiment, driving investors towards safer assets like German Bunds.

In the US, weaker-than-expected jobs data and some disappointing company trading updates weighed heavily on markets, with major indices like the NASDAQ and Russell 2000 posting substantial falls. The looming threat of a recession has led to increased speculation about the Federal Reserve's next moves, particularly regarding potential interest rate cuts.

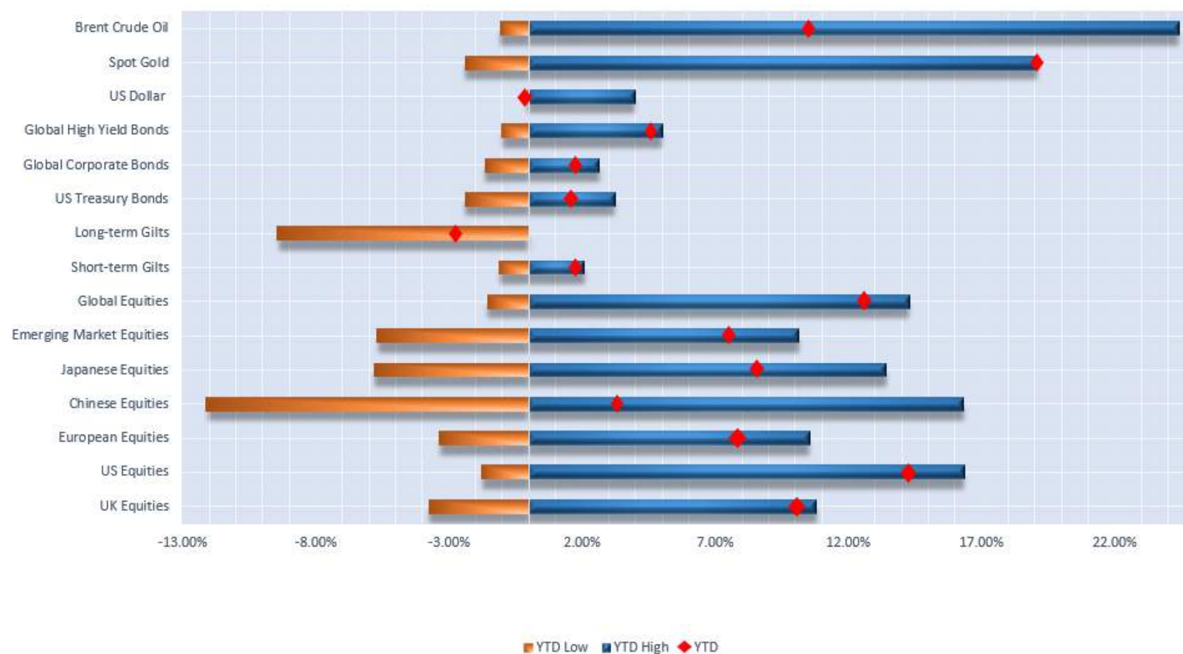
Japanese stock markets were also in the headlines as they experienced the worst daily decline since "Black Monday" in 1987, driven by a sharp appreciation of the yen and the unwinding of the yen carry trade (which involves borrowing money at low interest rates in Japan to deposit elsewhere in the world, such as the US, at higher rates).

Recent economic data and market events have therefore provided the first significant challenge to the positive sentiment which had built up in the first half of 2024, and on the whole markets have proved reasonably resilient.

Areas of Focus

- The Bank of England's rate cut signals a shift in monetary policy, but the persistent inflation concerns and market reactions suggest continued uncertainty.
- With a more finely-balanced economic outlook in the US, which now includes a potential recession and weaker-than-expected jobs data, US markets are likely to remain volatile.

- The sharp decline in Japanese equities highlights the risks associated with currency fluctuations and the unwinding of carry trades.
- The major US technology stocks' long-term growth potential remains but the short-term outlook is less certain, prompting a cautious approach from investors.
- With the prospect of further interest rate cuts in the UK and Europe, bond markets have seen a rally, particularly in UK gilts and German Bunds.



Selection of assets 2024 YTD returns and range of returns as at 19/08/2024 (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

The Bank of England (BoE) made a significant move at its latest meeting on August 1st, opting to reduce interest rates for the first time since early 2020. The central bank cut the base interest rate by 0.25%, bringing it down to 5%. This decision marks a pivotal moment in the UK's monetary policy cycle, as the BoE navigates the complex economic landscape following a series of rate hikes in response to persistent inflationary pressures.

The minutes from the August meeting reveal that the decision by the Monetary Policy Committee (MPC) was far from unanimous, highlighting the ongoing debate within the committee over the most appropriate course of action. Of the nine members, five voted in favour of the rate cut, with Governor Andrew Bailey casting the decisive vote. The remaining four members, however, argued

that holding the rate steady at 5.25% would be more prudent, citing concerns about inflation and the potential for economic overheating.

In the aftermath of the BoE's announcement, financial markets reacted swiftly. Traders increased their bets on further rate cuts this year, with current expectations pointing to the possibility of two more reductions before December.

The central bank has remained cautious in its communications, offering no explicit guidance on whether additional rate cuts are on the horizon. This has left market participants speculating about the BoE's next moves, as they weigh the potential impact of global economic uncertainties.

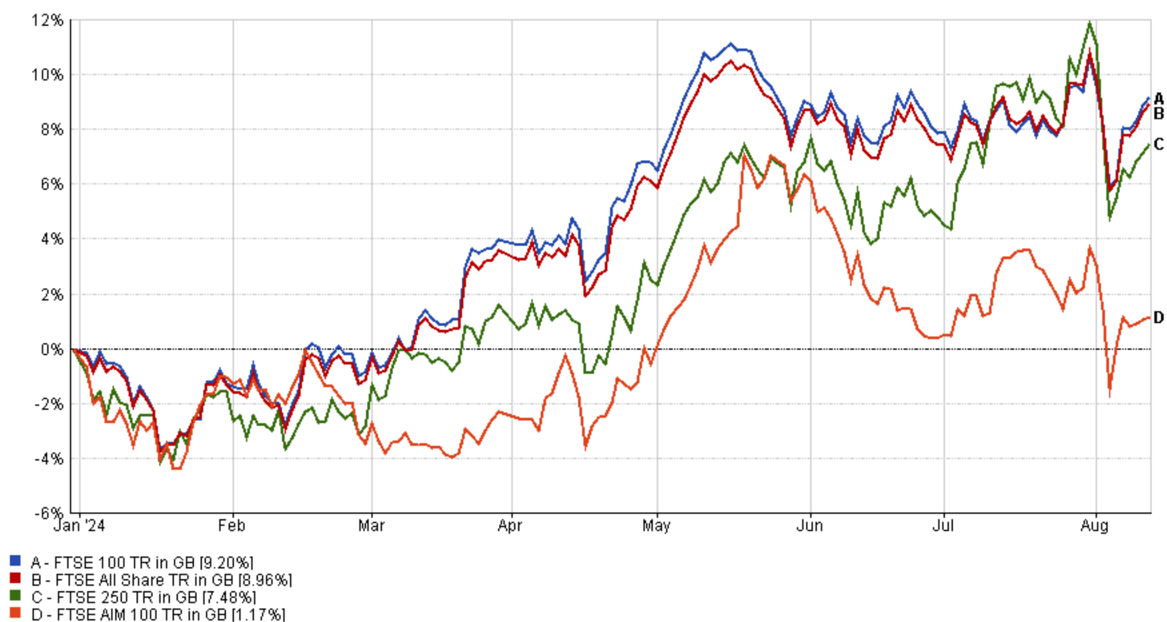
The decision to lower interest rates has been viewed as an early boost for Prime Minister Keir Starmer and the newly elected Labour government, which has made reducing government debt a key priority.

Lower interest rates reduce the cost of servicing government debt, providing the government with more fiscal space to implement its policy agenda.

In July, house prices rose more than expected, with the latest data indicating that UK house prices have increased by over 2% in the past twelve months.

This upward trend is likely to continue, as the recent rate cut by the BoE is expected to bolster buyer confidence and stimulate demand. The combination of increased buyer sentiment and Labour's pledge to address the housing shortage by building more homes has contributed to a positive outlook for the UK construction sector.

Analysts are optimistic that these factors will drive further growth in the housing market, supporting broader economic recovery efforts.



YTD Performance of UK Equity Markets

The Bank of England's (BoE) decision to cut interest rates initially damaged the UK stock market. The cautious tone from the Bank of England, particularly concerns about the potential for persistent inflation, led to a negative shift in market sentiment.

This news caused the pound to weaken against other major currencies as investors interpreted the rate cut as a sign of potentially softer economic conditions. This reaction can be expected, as lower interest rates typically reduce the yield on a currency, making it less attractive to investors.

Despite an initial uptick in performance, the FTSE 100 ended 1% down on 1st August – its worst trading day in over three months. Losses were driven by significant declines in the financial sector – large UK banks such as NatWest, HSBC, and Lloyds fell by 7.4%, 6.8%, and 5.2% respectively.

The recent sell-off (covered in more detail in this month's US section) also affected stock markets globally. In the UK, the FTSE All Share lost 2.14% and wiped out all of July's impressive performance. The index has recovered some lost ground in recent days, however.

The recent market turbulence reflected broader investor anxiety about global economic stability, with fears of global recessions on the rise. As a result, investors flocked to safer assets, leading a rally in global bond prices, with UK gilts being no exception.

	Yields as of 01/08/2024 (%)	Monthly change (%)	YTD Change (%)
2Y Gilt	3.58%	-13.06%	-7.00%
10Y Gilt	3.89%	-10.61%	9.50%

UK Bond Yields as at 01/07/2024, monthly change and YTD change

As shown above, gilt yields fell significantly over July and have continued to fall further in August. Shorter dated bonds have been more affected by the recent market turmoil, meaning that the yield curve is no longer inverted (interestingly, an inverted yield curve – where short term interest rates are higher than long term rates – is usually held to be a reasonably accurate predictor of impending recession).

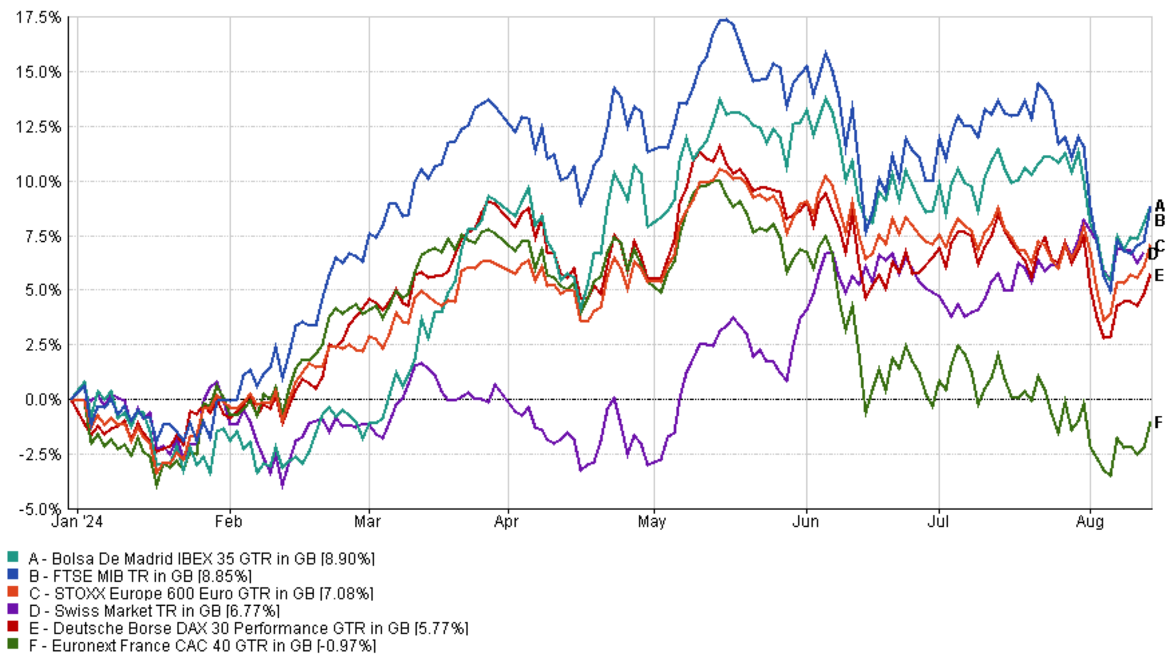
Europe

In July, the ECB left rates unchanged while heavily suggesting that a cut in September was a real possibility, and reiterated that its interest rate decisions will be dependent on the data.

Views on further rate cuts by the ECB are somewhat mixed. Most economists predict two further rate cuts this year, in September and December. However, this is less than the market is currently predicting, with interest rate futures pricing in four rate cuts by the end of 2024.

Eurozone inflation unexpectedly increased in July, to 2.6% - economists were predicting a rise of 2.5%. Core inflation stayed at 2.9%, and core services inflation fell by 0.1% to 4% in the region. Overall, the inflation data led to no change in the likelihood of a September rate cut.

The latest data suggests that Europe's GDP grew by 0.3% during Q2 2024. While positive, Germany remained a concern, reporting a quarterly GDP figure of -0.1%. In addition, July's GDP data indicates a further slowdown.



YTD Performance of European Equity Markets

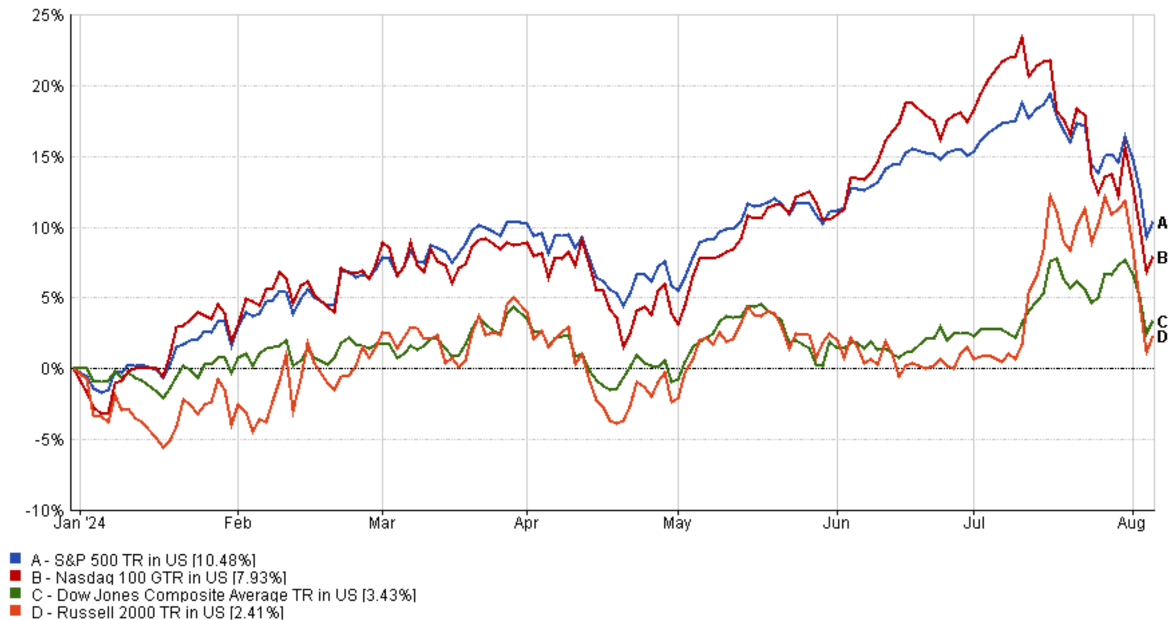
European stocks largely lagged the US and UK. The main STOXX Euro 600 index fell by 0.7% over the month, led by negative returns in the consumer discretionary and IT sectors. An unexpectedly low Purchasing Managers' Index (PMI) figure hinted to a deeper downturn in the European manufacturing sector, and this damaged European equities further.

The political environment in Europe, outlined in last month's Asset Class Commentary, continued to add volatility over the month.

The global sell-off on August 5th and fears of a recession in the US also affected the European stock market, with the MSCI Europe down over 2% in response to the wider market turmoil.

Like the UK, European investors flocked to safer assets such as government bonds on the news and yields fell accordingly – the yield on the on the 10-year German Bond dropped to a six-month low of 2.10%. Because of the inverse relationship between bond yields and prices, this made it a good month for bond holders.

USA



YTD Performance of US Equity Markets

After a mixed July, which saw the Russell 2000 gain 11.09% and the NASDAQ 100 lose 2.24%, US markets started August with significant declines.

The Russell and NASDAQ gave up 5.56% and 4.30% respectively in the first week of this month; meanwhile, the S&P 500 index gained 0.92% in July, only to fall by 3.79%, and the Dow Jones Composite Average gained 5.19%, then gave up 3.04%.

The reasons for the broad declines centre around three main pieces of news; weaker than anticipated US jobs data, various idiosyncratic risks to individual companies, and a stock market crash in Japan (which will be discussed later).

Firstly, the jobs data. In July the US labour market added 114,000 jobs, which is much less than the 175,000 forecast and the previous month's gain of 179,000 jobs. On top of this, the unemployment rate rose to 4.30%, which is significantly higher than the 3.70% at the start of 2024 and represents a fourth consecutive monthly increase.

This spooked some investors as it triggered the famous "Sahm rule", which is commonly held to be a recession indicator.

The Sahm rule (named after economist Claudia Sahm) states that the initial phase of a recession has begun once the three-month moving average of the unemployment rate is half a percentage point

higher than the twelve-month low. In this case, the twelve-month low is 3.50% and the three-month moving average is now 4.13%. It is noteworthy that this rule has been 100% accurate when applied to data going back to the 1970s.

A recession will come as a surprise to many investors who have come around to the idea of a "soft landing" for the US economy. However, investors must remember that the yield curve inverted nearly two years ago, another recessionary indicator that has only provided one false signal since 1955. The problem with this indicator compared to the Sahm rule is that it provides little help on timing.

This being said, the severity of a recession is unknown and may still prove to be relatively "soft", as the Federal Reserve are in a position to provide monetary support if required. The two monetary tools used are, in the main, reducing interest rates and employing quantitative easing, last seen during the Global Financial Crisis of 2008 and the Covid pandemic.

Quantitative easing is the process by which the central bank purchases securities, such as government bonds, in order to provide liquidity to the private sector. This in term increases demand and therefore prices of the securities, putting further downward pressure on interest rates.

In terms of interest rates, markets currently price in a 100% chance of a cut in September – a 36.5% chance of a cut of 0.25% and a 63.5% chance of a cut of 0.50%.

The consensus view (81.1%) also now predicts that rates will be at least one percent lower by the end of the year. Jerome Powell confirmed this at the recent Federal Open Market Committee meeting on 31st July, stating that "further progress" has been made towards the 2% inflation target and a "real discussion" has been had about cutting rates.

	1st July 2024	1st August 2024	Change
2 Year Treasury Yield	4.76%	4.16%	-0.60%
10 Year Treasury Yield	4.47%	3.98%	-0.49%

Monthly Change in US Bond Yields

Bond markets reacted favourably to these developments, further evidence of the "bull steepening" that we discussed in our July Asset Class Commentary. The yield curve appears to be "un-inverting", which reflects an effectively functioning yield curve as lending money for a longer period of time should be compensated with a comparatively higher yield.

The two main idiosyncratic pieces of news we will consider relate to Intel and Apple. Intel announced in its quarterly earnings report the slashing of 18,000 jobs along with other cost cutting measures such as reducing capital expenditures and the suspension of its dividends. The earnings themselves were equally as poor, showing adjusted earnings per share of 2 cents compared to the 10 cents expected.

As a result, Intel's share price has fallen by nearly 35% since the report. Fears that these problems are systemic are rife as NVIDIA, a company in the same sector and a large part of the overall stock market capitalization, subsequently fell.

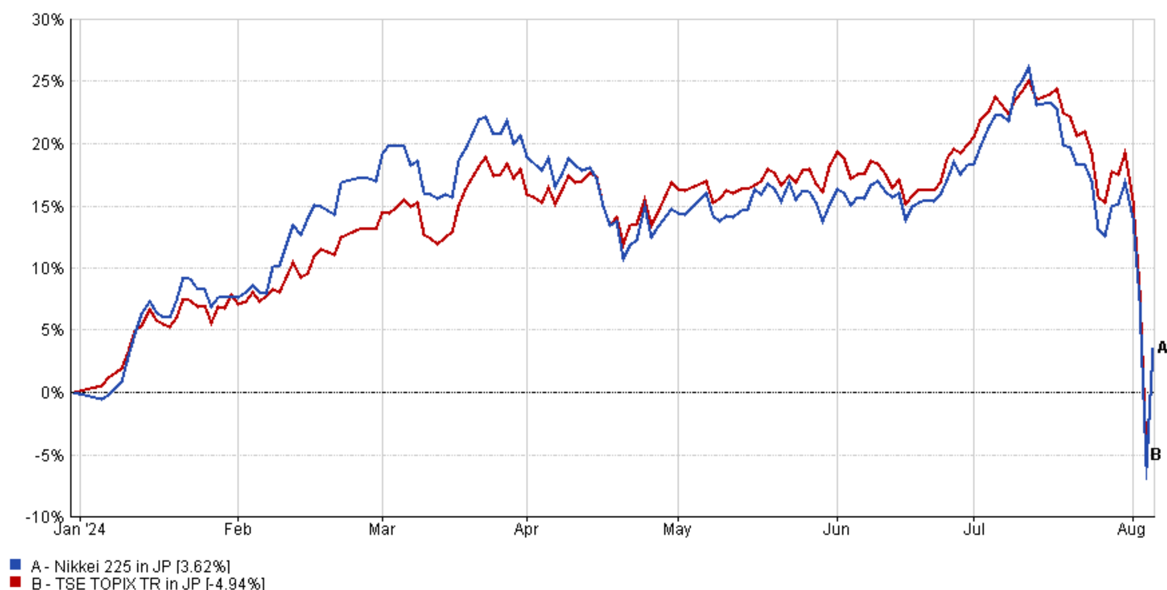
Apple was also in the headlines due one of its largest shareholders (behind only the global investment giants Vanguard and Blackrock) selling half of its position.

Warren Buffett's Berkshire Hathaway dumped roughly 390 million Apple shares in the second quarter of 2024, raising their cash pile to $277 billion. This can be seen as problematic to investors as it shows that the conglomerate cannot find good opportunities to invest in, and it takes a brave investor to bet against Mr Buffett.

With all these bearish developments, it is important to remember that markets tend to overexaggerate both positive and negative developments.

In our view, the best strategy to deal with volatility is to zoom out and look at the larger picture. All of the long-term themes, such as artificial intelligence and the energy transition, remain unchanged. Holding a well-diversified portfolio aligned with an investor's risk tolerance over an adequate time horizon will put them in the best position to preserve capital and benefit from growth.

Japan



YTD Performance of Japanese Equity Markets

Japanese markets have stolen the limelight in recent weeks after experiencing their worst daily decline since 20th October 1987, the historic Black Monday. The main Japanese index, the Nikkei 225, was down 12.40% on 5th August and this sent shockwaves through global markets.

This comes after a good start to 2024 for both the Nikkei and TOPIX, which had posted gains of 26.18% and 25.02% respectively. Since the two indices year-to-date highs, the Nikkei has dropped 17.88% and the TOPIX 23.96%.

Investors have been reasonably bullish on Japan in recent months due to corporate reforms and improving market fundamentals. However, this was short lived.

The reason for the sudden decline can be attributed to a sharp rise in the Japanese yen. As local equity markets are priced in the local currency, a rise the value of the currency will make the market decline because you now require less units of the currency to buy the same equity value. (This is the reason why politicians tend to favour a weaker currency than a stronger one. For an example of this, see the Chinese currency manipulation.)

Over the last 20 years, the Japanese economy has seen very low inflation which only peaked at 4.30% in January 2023 due to pandemic-related supply chain issues, where other developed economies battled with double-digit inflation. There have also been many periods of deflation. The main reason for the stark difference is because of Japan's ageing population and relatively low consumer demand, given the fact that people tend to consume less later in life compared to whilst they are young and actively participating in the labour force.

As a result of low inflation, the Bank of Japan has been able to keep interest rates near zero since 1995, also being negative 0.10% from 2016. However, in its meeting on 31st July the central bank decided to increase the overnight lending rate for the second time this year from 0.10% to 0.25%. The central bank governor, Kazuo Ueda, explained that the decision was made because economic conditions and prices remained "on track". Ueda's tone has shifted over the last year from ultra-dovish to more hawkish, in an attempt to normalise the central bank's policy.

	1st January 2024 (YTD low)	9th July 2024 (YTD High)	6th August 2024 (Current)
USD to JPY	141.13	161.33	144.68

YTD change of the US Dollar vs Japanese Yen.

As shown by the chart above, the yen had been weakening against the US dollar (i.e. one dollar could buy more yen) in 2024 which is structurally beneficial for Japanese equities. However, the dramatic change in direction affects the global economy in more ways than initially meets the eye.

The main effect is the unwinding of a complex financial trading strategy known as the "yen carry trade". A carry trade is when investors borrow money in a currency which has low inflation and a low interest rate and then invests that money in a currency with high interest rates, pocketing the difference.

As an example, you would borrow £100 for a year from a bank with an interest rate of 1% and invest that £100 into a bank with an interest rate of 5%. At the end of the year, you will have £105, and after paying back the lender the initial £100 plus the £1 interest (the carry), you will be left with £4.

This is a perfectly valid way making money but does not generally yield a significant amount. To magnify this "risk free return", investors will leverage up and borrow as much money as possible from the first bank, often putting up significant collateral for this privilege. This is where the problem arises.

Firstly, as the Bank of Japan increases interest rates (and as the US interest rates are cut), the spread between the two rates narrows and the money made on the trade gets smaller.

Secondly, as Japanese inflation is now higher than before, the real return (after accounting for inflation) also diminishes.

Finally, as the yen appreciates, the exchange rates eat into the return as an investor will get less yen for every dollar converted. As the trade gets less and less profitable, investors who have borrowed

large sums are required to post more collateral to maintain their loans and this is usually funded by selling equity holdings, hence the large-scale indiscriminate selling.

At present, global markets have managed to keep any systemic risks reasonably well contained. The central bank has walked back talks of further interest rate rises and markets have recovered in response. It is yet to be seen if any further cracks will appear or if this will prove to be a minor blip in the Japanese recovery.

Harry Downing, Associate IFA
Ryan Carmedy, Associate IFA

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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.