Watson French
WEALTH MANAGEMENT

Asset Class Commentary
September 2024

Global Central Bank monetary policy remains front and centre as investors weigh up what impact the new direction of interest rates will have on investment markets. With the Bank of England and European Central Bank having already implemented their first interest rate cuts, the Federal Reserve followed suit.

In the UK, GDP data failed to show any growth for the second consecutive month as services activity grew slightly but was offset by a decline in manufacturing. The jobs market showed signs of cooling with vacancies and wage inflation falling lower. Both stagnant economic growth and a weaker jobs market will give the Bank of England more room to cut rates further after their initial August cut.

The upcoming Budget on 30th October will come into focus as the new Labour government lays out its plans to get UK finances back on track. Prime Minister Keir Starmer has reiterated that the budget will be “painful”, however he is reluctant to say how, except for reassuring taxpayers that there will be no change to income tax or national insurance. It is widely expected that capital gains tax, inheritance tax, and the pensions tax relief regime will be up for reform.

In Europe, the President of the European Central Bank, Christine Lagarde, delivered a 0.25% interest rate cut after CPI inflation fell to 2.20% and GDP was revised lower. This was mostly expected, and most European government bonds rose on the news as yields fell. Germany, which tends to be seen as the engine house of Europe, contracted by 0.10% in Q2 after an upward surprise in Q1. The uptick experienced in the French services sector could also prove to be short-lived as the Paris Olympics and Paralympics comes to an end.

In the US, the yearly Jackson Hole Economic Policy Symposium revealed Fed Chair Jerome Powell’s intentions for the September Federal Open Markets Committee meeting, which ended up being a 50 basis point cut. Volatility remains high in equity markets as investors weigh up the rich valuations of the high-flying technology stocks. This is not helped by the forever-changing probabilities of the US election outcome. Equity and bond markets alike should welcome the base rate cut.

China’s property market crisis remains unresolved as the government in Beijing announced various policies in an attempt to rescue what is proving to be a pretty dire economic situation. The reverse wealth effect from falling property values is taking its toll on the Chinese consumer, who remains relucent to go out and spend, opting to save for a raining day instead. Chinese equity markets have taken another hit in recent months as a result.

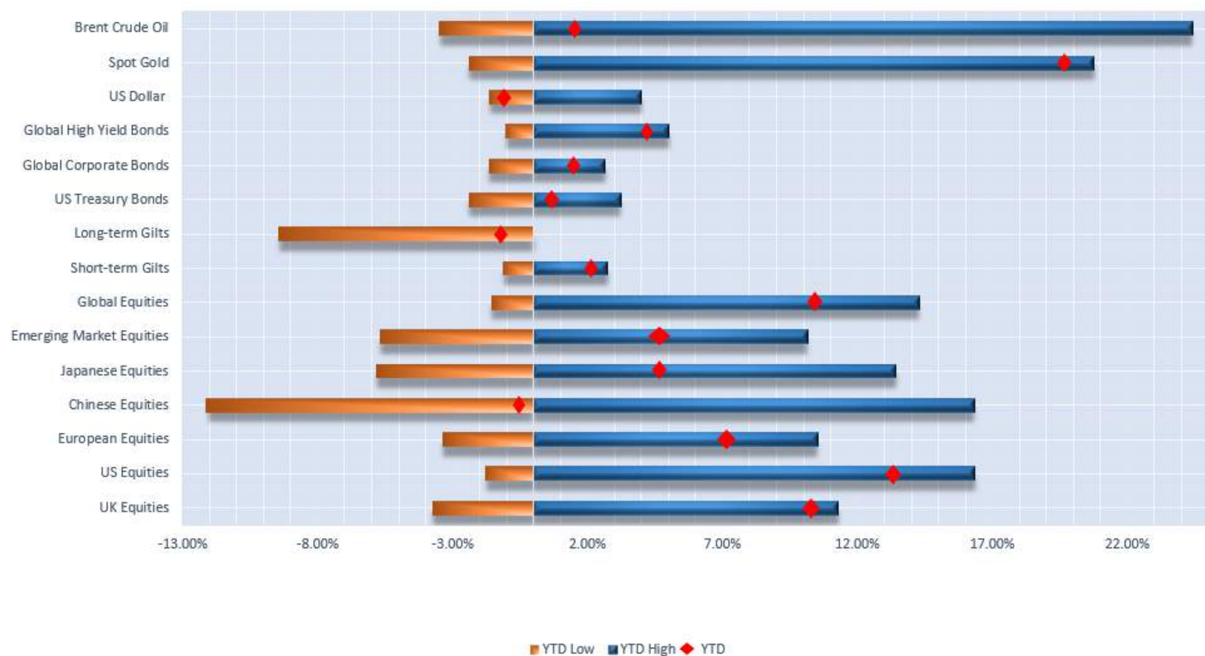
The Japanese market has mostly recovered from last month's devastating 12% drop, retracing a good proportion of the lost value. The Yen however continues to strengthen with the dollar-yen exchange rate currently around ¥140. This will likely continue as the Bank of Japan stays committed to normalising monetary policy, which means raising rates in the face other nations cutting (although rates remained unchanged for now in the bank's September meeting).

Commodity markets remain divided as gold breaks to new all-time highs just north of $2,600 an ounce. Brent crude dropped by more than 10% during the last month to just breach that all important phycological level of $70 a barrel.

Many commentators attribute gold's spectacular rise to increased central bank stock piling and a lower opportunity cost relative to government bonds. Oil's slide can be explained by the lowering of OPEC's 2024 and 2025 demand forecast. The 2025 demand forecasts were revised down from 1.78 million bpd to 1.74 million bpd.

Areas of Focus

- The UK economy attempts to rebuild under a new Labour government after sluggish GDP data and the Bank of England leaves interest rates unchanged.
- The European Central Bank points to another interest rate cut in an attempt to spur on economic growth.
- The US Federal Reserve cuts interest rates by half a percentage point as the 2024 Presidential Election race heats up.
- Beijing steps up to provide necessary support to a struggling property market that has damaged consumer confidence.



Selection of assets 2024 YTD returns and range of returns as at 19/09/2024 (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 cut rates for the first time in four years on 1st August. The BoE Governor, Andrew Bailey, gave no indication as to further rate cuts – but warned that prices may rise in the short term.

A substantial drop in UK manufacturing activity meant that the economy failed to record any GDP growth for a second consecutive month. The UK jobs market also shows signs of slowing, with the latest data indicating that vacancies and wage inflation are falling.

Cooling wage growth and a slight uptick in CPI caused investors to dampen their expectations of a second BoE rate cut on 19th September, so the decision to leave rates unchanged came as no surprise. Markets now expect the central bank to cut rates by 25 basis points at least once more this year.

Despite uncertainty around the timing of a second BoE rate cut, the UK housing market witnessed a recovery in September.

The latest data from Rightmove indicates that the average asking price for UK homes increased by 0.8% in September after a drop of 1.5% in August. This increase marks the largest monthly price increase since 2016 and compared with this time last year, house prices are now 1.2% higher.

Economists believe that prices have increased due to falling interest rate expectations and greater political certainty.

While the new Labour government has pledged to reform the UK housing planning system and set targets for new houses, the shortage of supply is likely to cause elevated price increases in the short- to medium-term.

The new Chancellor, Rachel Reeves, will deliver her first Budget speech on 30th October. The autumn Budget is all but guaranteed to include tax increases, with Kier Starmer forewarning that those with "the broadest shoulders should bear the heavier burden" to help address the £22bn "black hole" Labour claim to have discovered in the public finances.

With rises in income tax, National Insurance, VAT and corporation tax rates ruled out, it is likely that the burden will be placed on investors in the form of higher capital gains tax (CGT) rates, inheritance tax and/or lower pension tax relief benefits – although this is not guaranteed and there is much speculation.

YTD Performance of UK Equity Markets

Despite some early volatility, the FTSE 100 increased over August - mainly due to its relatively high exposure to Healthcare and Consumer Staples. The three main contributors to performance for the major UK index were AstraZeneca, Glaxo SmithKline and Unilever. The FTSE 100 has now increased by 10.33% year-to-date.

Speculation around the upcoming budget is also influencing markets. There is evidence that some investors are selling investments due to fears of a rise in CGT. This is leading to an increase in market volatility.

The FTSE AIM index has continued its decline and is now negative by over 2% year-to-date. High interest rates continue to hurt UK small caps.

	Yields as of 02/09/2024 (%)	Monthly change (%)	YTD Change (%)
2Y Gilt	3.75%	0.80%	-6.13%
10Y Gilt	4.03%	3.47%	12.16%

UK Bond Yields as at 02/09/2024, monthly change and YTD change

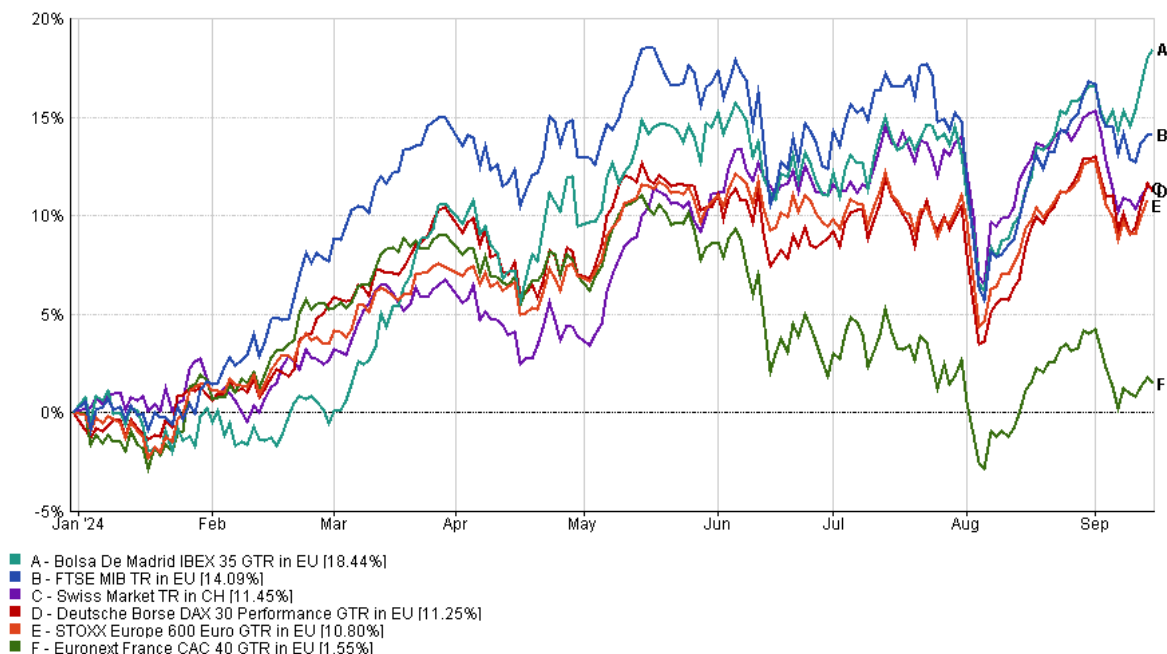
With expectations of a second BoE rate cut being pushed further into the future, gilt yields increased slightly across the board over August. With interest rate expectations ever changing, it is likely that the bond market will witness further volatility in the months ahead.

Europe

In more central bank news, the ECB cut rates by 25 basis points on 12th September – a move that was widely expected by markets. The decision to cut rates was relatively straightforward for the ECB, given that CPI inflation in the Eurozone fell to a three-year low of 2.2% last month, while GDP figures were revised down.

Futures markets are pricing in further quarter-point cuts at each of the three remaining ECB meetings this year.

The Paris Olympic Games appears to have had a positive effect on the Eurozone economy (France in particular), as athletes and spectators boosted spending. Consequently, output in the French private sector reached its highest level in 17 months.



YTD Performance of European Equity Markets

European equities have performed well year-to-date, with the pan-European STOXX 600 returning 10.80% since January. It appears that investors have forgotten about the recent political shocks and are more focused on looser monetary policy.

The exception to the rule is French equites, with France's CAC 40 index relatively flat over the year. France is yet to settle its political difficulties, and this is having a negative effect on markets.

With the latest ECB rate cut already priced into markets, European bonds yields were unchanged over the month of August. The 10 Year German Bund yield finished the month at 2.30%.

USA

YTD Performance of US Equity Markets

US markets stabilised after the sell-off at the start of the August caused by some slightly disappointing economic news and the unwinding of the yen carry trade (covered in last month's commentary).

The major stock market indices finished the month mostly flat, although volatility is still high. The S&P 500 and Nasdaq 100 remain dominant as large caps continue to push higher, owing to resilient consumer spending and strong corporate earnings. Falling inflation, a central bank cutting base rates, and a split election are also all welcomed by investment markets.

Since our last asset class commentary, Nvidia posted its Q2 earnings report. The company has been the highlight of this year's market rally, gaining 147.25% year to date. This has caused Wall Street to place higher and higher expectations on the company to grow with each passing earnings report. In its latest report, revenue was up $30 billion (or 122%) and ahead of analysts' $28.7 billion forecasts. However, shares fell over 9% immediately after the earnings call, slashing around $280 billion off the company's market cap. The reason? Q3 forecasts were not as high as investors' lofty expectations.

Making up over 7.50% of the Nasdaq 100, the index dropped 3.30% in a single day (all of which has now been regained). Examples like this highlight the inefficiencies in even the largest, most liquid markets and show that markets can be swayed as much by investor sentiment as they are fundamentals.

The Federal Reserve had its annual Jackson Hole Economic Policy Symposium in August as investors watched closely for clues on what is to come. The major soundbite came in Fed Chairman Jerome Powell's speech where he all but confirmed the long-awaited interest rate cut, stating "the time has come for policy to adjust" and "the upside risks to inflation have diminished, And the downside risks to employment have increased".

As of 15th September, three days before the next Federal Open Markets Committee (FOMC) meeting, markets priced in a 50:50 chance of either a 25 or 50 basis point cut. The committee eventually opted for the higher of the two, with Powell stating that "the US economy is in a good place and our decision today is designed to keep it there". The 50-basis point cut likely considered the fact that the Federal Reserve does not meet in October, with the next meeting coming on 7th November, two days after the US election.

	Yield at 15/08/2024	Yield at 15/09/2024	Change
2Y Treasury Yield	4.10%	3.60%	-0.50%
10Y Treasury Yield	3.92%	3.66%	-0.26%

Monthly Change in US Bond Yields

Bond markets reacted favourably to the month's developments, as bond prices move inversely to interest rates. The "bull steepening" we have discussed previously has continued and the yield curve has finally "un-inverted" after suggesting this in last month's commentary.

The next development to follow will be how low bond market investors believe rates can go before they cash in on their gain and move away from the diminishing bond yield. This process will likely not happen immediately, as the Fed has shown its reluctance to move rates too low too quickly.

The Fed has a dual mandate (meaning it has targets for both inflation and employment). Looking at the data, CPI inflation fell to 2.50% in August from 2.90% in July and the nonfarm payrolls came in at 142,000 in August, below the 161,000 forecasts. Both data points would seem to allow the interest rate cutting cycle to continue.

According to Charles Schwab, there have been 14 rate cutting cycles since 1929 and 12 of them saw positive S&P 500 returns in the 12 months following the first interest rate cut. The two negative periods however came in both 2001 and 2007 after the dot com bubble and mortgage crisis respectively.

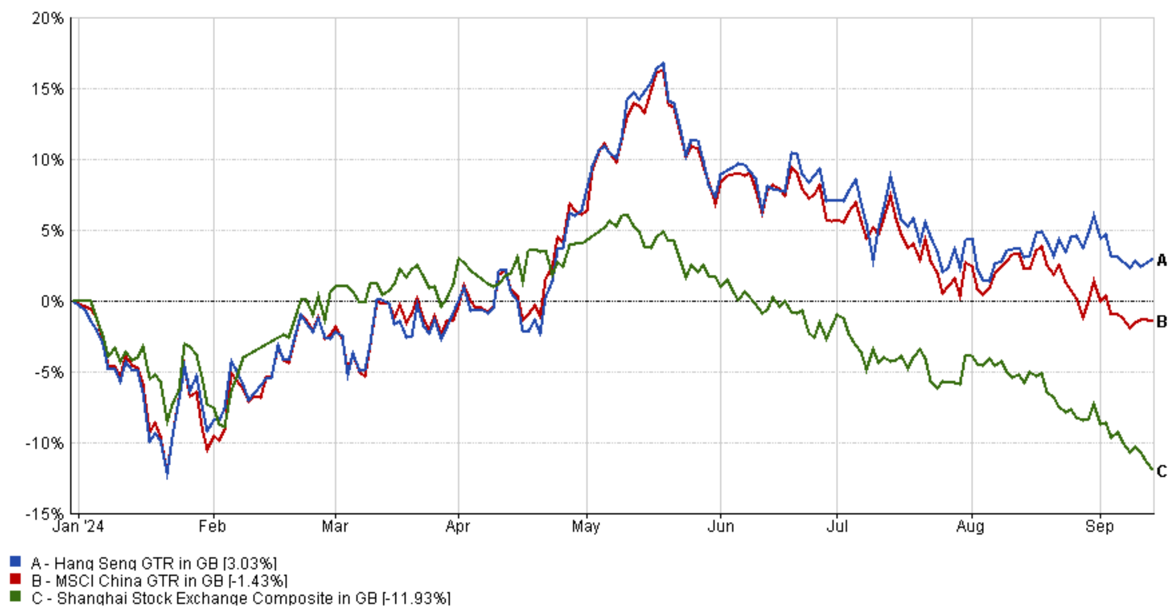
In our opinion, the market effect has more to do with the reason for the cuts as the mere fact of the cuts themselves. Looking "under the bonnet" of the economy is important and based on our research, the US economy looks relatively robust.

The 2024 presidential election race is heating up with current vice president Kamala Harris' campaign gaining traction. Current odds at the bookies have Kamala Harris at 16/19 and Donald Trump at 11/10, meaning that Harris is now the favourite with implied probabilities of 54.29% vs 47.62%. A keen eye may notice that these probabilities are over 100% – the extra 1.91% plus the small chance of a third candidate is the bookies' margin.

The key battleground state to watch is Pennsylvania which carries 19 electoral college votes, conveniently where the most recent debate was held. Kamala Harris was widely considered to have beaten Trump on the night.

Investment markets favour certainty and political stability and are therefore fond of the idea of a split congress – Republicans and Democrats each controlling either the House of Representatives or the Senate. This may prove to be more important than who becomes President as significant bills will struggle to get passed, leaving most legislation unchanged and therefore predictable.

China



YTD Performance of Chinese Equity Markets

China's economy remains relatively stagnant in 2024 compared to other developed economies. Whilst the stock markets of other nations, such as the US and UK, have posted gains of over 10% this year to date, Chinese equities have struggled to squeeze out positive returns. The Shanghai Stock Exchange and MSCI China have lost 11.93% and 1.43%, respectively. The Hang Seng, however, is in positive territory by 3.03%. Since May of this year, all three indices have declined over 10% each.

These woeful market returns have mostly been a result of the lingering property market crisis, weak consumer spending and manufacturing struggles.

House prices in China have seen consistent declines all year, including the largest month on month decline since 2014 in April. With most of a typical Chinese household's wealth tied up in the home, it

is not hard to see why this has become such a large issue. Property developers such as Evergrande and Country Garden are also being hit hard, both facing huge debts and the prospect of liquidation. As the property sector makes up nearly a third of China's GDP, this issue is certainly systemic and the consequent "negative wealth effect" weakens consumer sentiment.

To combat this, Beijing has stepped in with various measures including reducing the minimum downpayment for first time buyers from 20% to 15%. Local authorities have also been given permission to buy unsold properties in order to convert them into affordable housing and easing lending restrictions placed on banks.

As seen in the US, when the consumer is strong the economy can flourish. However, the opposite is also true – a case in point being China. Retail sales growth has been extremely sluggish, Q2 2024 numbers decelerating from 3.2% annual growth to just 2%, this being an 18-month low.

This data becomes even more staggering when you consider that China was meant be the catalyst for global growth coming, out of its extended zero covid lockdowns in late 2022 and early 2023. The government has set an official growth target for 5% in 2024, which seems unlikely to be achieved at present.

Chinese consumers have been reluctant to go out and spend, especially on high margin luxury goods. Chinese consumers tend to be more cautious than their western counterparts with high savings rates and therefore it is unlikely that this will change in the short term. (For reference, the long-term average savings rate in China is 44.30%, with the same measure in the US being 8.44%.)

The second part of this is declining wages, which also reduces the non-savings element of disposable income. Finally, fears of deflation (inflation is currently hovering around 0.50%) means that consumers are delaying purchasing in the hope of being able to buy the same goods at a lower price in the future.

At a company level, the manufacturing sector is also showing signs of contraction with PMI (Purchasing Managers' Index) readings of below 50 for several months now – a PMI above 50 indicates growth and below 50 signals contraction. PMI reports are widely accepted as a leading indicator as the manufacturing sector typically can provide insights into future consumption. When paired with low consumption, a downward spiral can rapidly appear. As consumers consume less, manufacturers manufacture less, then there is less for consumers to consume and so on.

In response to this negative data and sentiment, the People's Bank of China has kept monetary policy accommodative. In July, markets were surprised when the central bank announced that it would be cutting both major short- and long-term interest rates in the first large move since August 2023. The seven-day reverse repo rate was cut to 1.70%, the 1-year rate was lowered to 3.35%, and the 5-year rate was cut to 3.85%. Policy changes like these tend to put a downward pressure on exchange rate, however the move has been subdued due to the recent unwinding of the carry trade, which was also taking place with the Chinese Yuan in the same way as the Japanese Yen.

Looking ahead, investors will be keeping a close eye on the Chinese property market in search of a sign it has reached the bottom. This may come in the form of government policies or perhaps shifting

consumer sentiment. The global economy avoiding a recession and continuing to grow may help the Chinese manufacturing sector.

As always geopolitical tensions are also in play when investing in China and the outcome of the US election in November may not help, especially in terms of Trump's proposed trade tariffs, if elected.

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September 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.