October 2024
Issue No. 33

GLOBAL INSIGHT

Overview

- In our Market Review, we see that the historically worst performing month for financial markets finished with major asset classes showing positive returns.
- We delve into the Chinese stimulus package and comment on its likely success.
- We outline the historic changes in the US Presidential Race and highlight the potentially significant macroeconomic consequences of the policies outlined by both candidates.
- In our Investment Outlook, we will attempt to contextualize the key macro developments and market movements highlighted in the Market Review.
- We illustrate that financial conditions remain easy as liquidity expansion continues, driving asset prices higher, consistent with a "soft landing" scenario.
- We put forward our house view that considerations yield an overall impression of broad resilience, but with pockets of weakness that warrant ongoing caution.
- We believe that the underlying economic environment and corporate fundamentals continue to favour risk assets and therefore remain constructive on the prospects for equities.

US500 Blue Chip Index vs Hang Seng Index

Source: *LSEG Datastream*

Inside this issue

The Highlights

- Has the Fed shifted momentum?
- Will the summer slowdown in the US economy continue?
- Will the US Presidential election prove to be a major influence on global growth?
- Will now prove to be the bottom of the economic cycle?
- What are the prospects for future returns when we are facing high starting valuations?

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Based upon information available up to and including:

11th October 2024

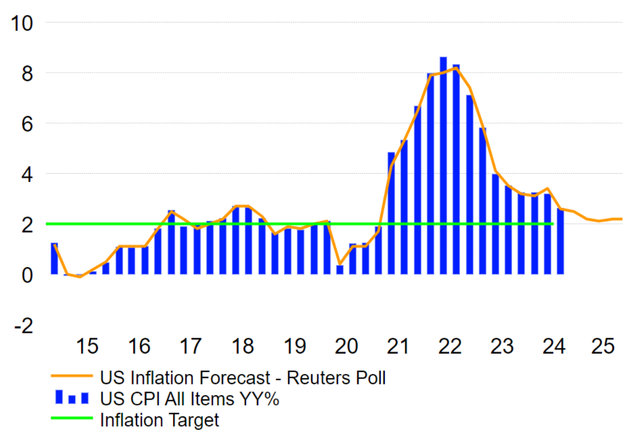
Key Issues in Charts

Sterling continues its rally against the dollar

- Following the market turmoil triggered by the UK government's 2022 mini-budget, GBP/USD saw a sharp decline, reaching a low of around 1.0350.
- Currently, strength in Sterling is coming from the expectation of less central bank cuts from the BOE than the Fed in the US. This follows the BOE's 25bps cut, compared to the Fed's recent 50 bps cut.
- While the path's for rate cuts are almost entirely data dependant, so far the BOE seems to be acting more hawkish than the FED with wage growth, services inflation and economic growth all closely watched by MPC members.

US Inflation—Actual vs Forecast

- The chart compares the US inflation forecast from a Reuters poll of economists, with the actual US CPI year-over-year figures in blue, highlighting the progress made on inflation and the outlook for CPI according to economists.
- Both the forecast and actual inflation show a sharp increase between 2021-2022, reflecting the surge in prices following the COVID-19 pandemic, with inflation peaking well above the Federal Reserve's 2% target, before falling sharply lower through 2023 and 2024.
- The Economists poll shows expectations of inflation falling near or at the target level, followed by a small uptick to just above target rate.



EM Equities at lowest vs US equities since 1969

- Emerging market (EM) equities are trading at their lowest relative valuation to US equities in over 50 years.
- The current valuation level is below -1 standard deviation from the mean, indicating extreme undervaluation of EM stocks compared to US stocks, which could signal potential for mean reversion.
- Considering the pathway for rates in EM nations, the progress made on inflation in EM countries and the upside prospects for nearshoring as businesses look to move away from China, we maintain our allocation and our positive house view on Emerging Markets.

Markets Review

The third quarter lived up to its reputation for anxiety, volatility, flash crashes, and central bank action, however, by the end of the notoriously worst month for risk assets, September, both equities and bonds had given positive returns over the quarter. Most of the volatility came from the market switching focus from inflation to employment, the other side of the Fed's two-pronged mandate, and showing signs of weakening. A major catalyst for the spike in volatility indices was the August unemployment report that rose to 4.3% against expectations of 4.1%. This led to fears that the Federal Reserve (Fed) was 'behind the curve', with suggestions that they have been too slow to lower interest rates and provide support for the economy, risking a hard landing. In addition to this, the rise in unemployment in July triggered the "Sahm rule" which indicates a recession has started when the three-month moving average unemployment rate is 0.5% or more higher than the lowest point of the last twelve months, an economic indicator that has previously been a signal that the US economy is in recession. However, the "Sahm rule" was designed for a decline in labour demand not a rise in employment supply leaving economist Claudia Sahm herself to argue that the rule may not apply this time[i].

As we predicted, Fed Chair Powell used the Jackson Hole Symposium to underline the Fed's view of the data and surprised many by his dovish speech. He unambiguously declared:

"The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

Following the speech, speculation had moved from when the first cut would materialise to whether the cut in September would be 25bps or 50bps and - to the surprise of some - the FOMC voted for a 50bps cut at its September meeting. It is not unusual for the Fed to start an easing cycle with a larger-than-normal cut in rates, but then it is unusual to start easing when the underlying economy is as resilient as it is currently showing, so this is an important shift in momentum.

The quarter was also marked by heightened tensions in the Middle East, and a flash crash at the beginning of August not helped by a surprise rate hike by the Bank of Japan. Japan was the best performing stock market in dollar terms in July largely due to the performance of the Yen, and the technical unwinding of the carry trade leading to Yen short covering during July and into August. Borrowing in Yen and transferring the funds into a higher yielding currency, such as the Mexican Peso, has been a very crowded trade over the past twelve months so when the different elements started moving rapidly to negatively impact the return participants looked to reverse the trade causing tensions within markets particularly the Japanese stock market, and volatility indices such as the VIX. However, these events proved to be short term and Japanese stocks bounced back to finish the quarter down only 4.2% although speculation regarding future tightening by the Bank of Japan remains.

The leading driver behind the performance remains the US equity markets or more specifically investor perception of the change that Artificial Intelligence (AI) will make to the world and the companies that are set to benefit the most.

These six stocks are the only S&P500 constituents with a market capitalisation of over $1trillion and with a total size of approximately $18trillion.

Investors need to have an investment view on these six powerful mega-tech stocks even if they do not own them.

Microsoft, Meta, Amazon, and Google represent 40% of Nvidia's sales.

Nvidia reports that its largest customer represents 13% of sales.

Global equities finished 6% higher in dollar terms with the US gaining 5.5% and Europe 2.2% while emerging markets buoyed by a weaker dollar and strong China markets outperformed developed markets. The Chinese Central Bank (PBoC) in an unusual western-style announcement on September 24 lowered bank reserve requirements, cut interest rates by 0.1%, and stated that it will provide funds to brokers to buy stocks. The announcement pushed Chinese stocks higher, leaving the Shanghai SE up 17.4% on the month, and 12.4% on the quarter, and the Hong Kong index up 19.3% on the quarter.

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Hang Seng Index YTD

Source: *LSEG Datastream*

The commitment to further action if needed may be enough to lift sentiment as well as asset prices and deliver a rebound in consumer demand and the ailing property sector, although growth still appears to be tracking well below the 5% target. There remains a reluctance for corporates and consumers to increase their borrowing due to already highly leveraged positions after the property slump, so, in our opinion, making more stimulus available without addressing these concerns in the longer term may not be enough.

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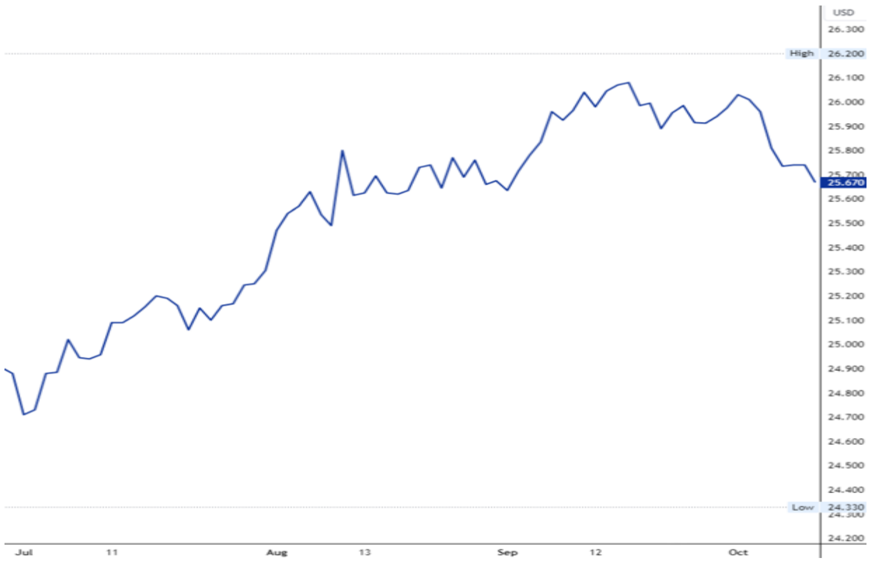
Bond markets delivered strong quarters for both US and European bonds. The quarter was the second strongest total return since the third quarter of 2012, and for global credit it was the third best, and US Treasuries and European Government Bonds outperformed cash[ii].

On a risk / return basis, we feel that credit spreads remain too narrow, both investment grade and US high yield are creating good absolute returns for some investors because with default rates so low so that the yields on offer still outweigh the potential for loss.

Although, on a risk / return basis, we feel that credit spreads remain too narrow, both investment grade and US high yield are creating good absolute returns for some investors because with default rates so low so that the yields on offer still outweigh the potential for loss. The US Treasury yield curve dis-inverted during September and currently sits at +25bps 2yrs-30yrs, which has been a strong historical indicator of a recession. In our opinion the indicators of a looming recession such as overleverage, credit market stresses, high default rates, and other signs of growing imbalances in the economy are currently absent, but against the backdrop of an easing cycle fixed income investment remains interesting. However, the quarter has been dominated by fears of slow-

Vanguard Global Aggregate Index ETF



Source: *LSEG DataStream*

ing employment and a rising unemployment rate causing rapidly changing interest rate expectations in the US. More recently, the September jobs report in the US saw the economy add 254,000 jobs versus consensus of 150,000, the unemployment rate fell to 4.1% from Augusts 4.2%, job openings increased again, and wage growth remains sticky. We suggest that the resilience of the US economy could once more question the easing cycle, especially now that the Fed has delivered a 50bps cut which if rates stay higher for longer could suggest that the best returns for bonds may be behind us.

The unemployment rate in Europe set a new record low in July of 6.4% although Barclays calculate that employment expectations and economic sentiment are still below long-term averages. The European automakers are struggling with Chinese competition and there are threats of factory closures in Germany as well as profit warnings from most of the major companies including Stellantis, VW, Marcedes, and BMW. Europe's recovery looks fragile to us with GDP growth of 0.3% in first quarter, and 0.2% in the second with Germany and France looking particularly challenged. Germany's IFO survey of business sentiment fell again in September for a fourth consecutive month to 85.4 from 86.4 in August after the economy contracted in the second quarter. A contraction in the third quarter would indicate that Germany is in recession, if it is not already, with the business climate index in manufacturing falling to its lowest level since June 2020. France received a boost from the Paris Olympics, but its savings rate is now above pre-pandemic levels. The European Central Bank (ECB) followed the Fed's move in September, cutting 0.25%, but many economists are pushing for another cut in October in line with the ECB's "meeting by meeting" approach after September's Purchasing Managers Index Survey (PMI) data continues to point to economic weakness.

Inflation in the UK is proving a little stickier than elsewhere, the MPC would like to see inflation "squeezed out of the system" entirely before embarking on an easing cycle. Labour supply remains very tight which leaves the UK workforce with bargaining power, despite a surprising drop in consumer confidence in

Despite the absence of traditional recession indicators such as overleverage, credit market distress, and rising default rates, fixed income remains compelling amid a global easing cycle.

Additionally, the relatively stable macroeconomic backdrop reduces the likelihood of significant credit events, further supporting a favourable risk-reward profile in fixed income markets.

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UK inflation remains more persistent compared to other regions, with the MPC focused on eradicating inflation before considering an easing cycle.

A tight labour market continues to give workers strong bargaining power, despite an unexpected dip in consumer confidence in September.

Forecasts indicate a gradual 150bps reduction in UK rates by the end of 2025, with the next cut anticipated in November. This outlook has bolstered sterling, which appreciated 5.7% against the dollar and 1.9% versus the euro over the quarter.

Falling interest rates, a weaker dollar, and a worsening geo-political back drop is a good environment for gold as a safe-haven asset, and the price has continued to strengthen to as high as $2,670 /oz during September

September. Forecasts suggest a more gradual 150bps decline in UK rates by the end of 2025 with the next cut expected at the November meeting. This has been good news for sterling which has strengthened 5.7% versus the dollar, and 1.9% against the Euro over the quarter. The Labour government is gearing up for the Autumn budget by taking the opportunity to announce a £22bn perceived "black hole" in the country's finances and forewarning the need for tax rises. Investors are focusing on capital gains tax, inheritance tax, and employer national insurance contributions, with the major taxes declared off-limits. Anecdotally, Labour has been accused in the press of being too negative about economic prospects and there felt like a distinct effort to be more upbeat at the party conference in September. However, many investors see Chancellor Rachel Reeves walking a fine line between fulfilling party spending commitments when markets are very sensitive about increased government borrowing. We see the shadow of the Liz Truss mini budget still looming large over changes in government borrowing as reflected in the fact that the ten-year Gilt yield has moved from 3.75% to 4.20% at the time of writing.

The third quarter has been decisive for US politics following President Biden's poor performance during the first televised debate with former President Donald Trump during late June. The collapse of support in the polls led to major Democratic grandees and party fund raisers calling for him to step aside as the Democratic candidate. On July 21 President Biden announced he would not be seeking a second term with just an unprecedented four months to go until the election. Also surprising was the appointment of Vice President Kamala Harris as the Democratic nominee without a nomination fight which has seen fundraising rise significantly, and a rapid closing of the gap between the candidates. It now seems an extremely close election on November 5 only adding to the risks geopolitics could have on the macro-outlook in the fourth quarter and beyond. Furthermore, fiscal policies of both candidates have highlighted the growing fiscal deficit in the US, and we believe this is being reflected in ten-year Treasury yields rising from 3.62% to 4.03% now.

Falling interest rates, a weaker dollar, and a worsening geo-political back drop is a good environment for gold as a safe-haven asset, and the price has continued to strengthen to as high as $2,670 /oz during September, a 30% rally this year. We believe central bank buying particularly China up until April this year, and other Emerging countries concerned with reducing reliance on the dollar and dollar assets after Russia invaded Ukraine have been responsible for the break in the traditional relationships to real interest rates and the dollar having only recently returned during this quarter. In late July India cut import tax on gold to 6% from 15% just ahead of the traditional gold buying season in the fourth quarter, and Russia also announced that it was increasing gold purchases from oil and gas reserves. New highs for the gold price might lead to some investors questioning its position as a safe haven, and traditional portfolio diversifier, however, geo-political concerns remain elevated, and recession fears remain among some investors.

At the time of writing the oil price has been more concerned with the threat of recession and falling Chinese demand over the summer than concerns over the potential for the Middle East conflict to escalate. Having started the quarter at $88.75/brl Brent crude fell to as low as $72.55/brl by the middle of September. The latest escalation in the Middle East has brought into focus the possibility of protracted direct confrontation between Israel and Iran which may affect Iranian infrastructure and may lead to restrictions in the Straits of Hormuz. This seems to have finally led to a reaction in the oil price which has risen above $80/brl once more. We do not think that the current price levels are high enough to impact global growth and inflation prospects, however, further escalation in hostilities may focus investors on the potentially wider implications.

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In summary, we remain cautiously optimistic believing that the scene is set for a soft landing. Barclays see the global economy growing at 3.2% for 2024 with the US maintaining 2.6%, Europe managing 0.7% while China slows to 4.8%[iii]. With inflation gradually falling back to target, employment and consumer spending in western economies remaining resilient, and corporate margins still seem to be expanding this hardly feels like an environment for pending recession to us. However, the result of the US presidential election could have significant macroeconomic consequences this time around due to the policies of both candidates. The Democrat policies of raising corporate taxes would hit earnings and taxing unrealized gains for high-rate taxpayers would be negatives for equities assuming that Harris can secure Congressional approval. Trump would also require approval to extend expiring tax cuts, however, foreign policy including the implementation of trade tariffs can bypass Congress with significant implications for global growth. It is, therefore, plausible that any full-year forecasts could be de-railed by geo-politics during the fourth quarter by developments in existing conflicts and / or the election result on November 5. Normally, we would say that financial markets rarely allow politics to drive returns but there is a possibility that 2024 could be one of those times.

We remain cautiously optimistic believing that the scene is set for a soft landing.

[i] The World In A Week - Sahm Rules are meant to be broken - Beaufort Financial Plus - Financial Planning & Advice

[ii] Chris Iggo _ Iggos Insight _ Shaken, not stirred _ October 4, 2024

[iii] Barclays _ Global Macro outlook _ All eyes on the US _ September 12, 2024

[iv] Zahra Ward-Murphy _ Absolute Insight _ Gold – useful but stretched _ October 2, 2024

Inflation has moderated, growth and consumption have decelerated, liquidity has been abundant, aggregate household and corporate balance sheets have been robust , volatility has been subdued, and monetary policy has been increasingly accommodative.

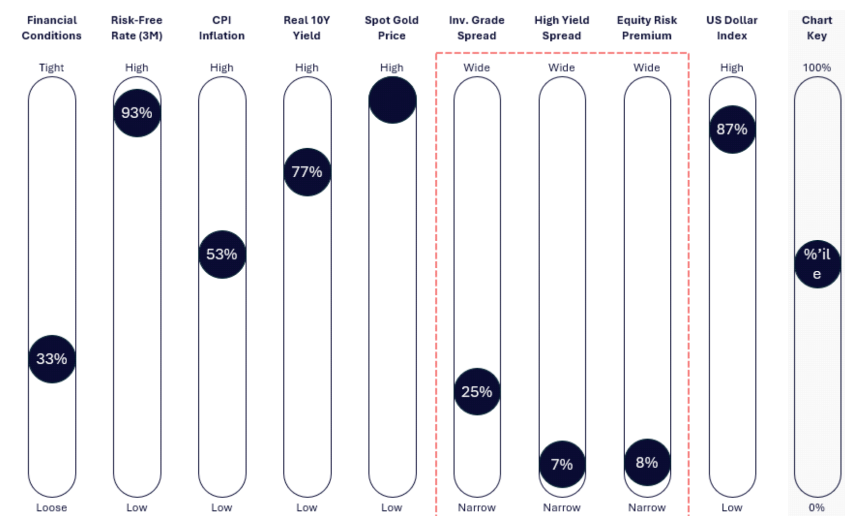
Investment Outlook

Having reviewed the key macro developments and market movements in the prior quarter, this section will focus on current valuations in the context of long-term ranges alongside year-on-year changes, and the prospects for future returns and correlation relationships. All these elements influence our asset class views and positioning as we navigate the final quarter of 2024 and beyond. We'll also provide further historical context to the Fed's recent 50bps interest rate cut, as the performance of risk assets after the first rate cut of an easing cycle has varied markedly.

The figure below reflects current prices of key US-based market measures as percentiles relative to their respective twenty-year (20Y) histories, at the time of writing. For example, a reading of 100% reflects that the measure is at a 20Y high, while the opposite is true for a reading of 0%. There are two key observations here, detailed below.

Risk assets have responded favourably to this environment.

Macro and Markets Barometer



Sources: *Federal Reserve Banks of St. Louis and Chicago, LSEG Datastream, Robert Shiller via Yale Department of Economics*

Investment grade spreads, but more markedly high yield spreads and the equity risk premium are close to 20Y lows.

High yield spread and equity risk premium have been narrower (i.e., the 'risk compensation' lower) only 7% and 8% of the time, respectively.

Firstly, financial conditions - an index published by the Chicago Federal Reserve that comprises 105 measures of financial activity, spanning risk, credit and leverage – stands at 33%ile, meaning we're currently in the 'easiest third' territory of the past 20Y. This is consistent with the unfolding 'soft landing' narrative as inflation has moderated, growth and consumption have decelerated but remained resilient, liquidity has been abundant, aggregate household and corporate balance sheets have been robust in aggregate, volatility (apart from short-lived episodic spikes) has been subdued, and monetary policy has been increasingly accommodative. The Fed has joined other major central banks in commencing its easing cycle, with the risk-free rate now at the 93%ile (a year ago: 99%ile) having made significant progress with curbing inflation: CPI is at 53%ile (declining steadily from a year ago 80%ile and two years ago 98%ile).

Secondly, risk assets have responded to this environment, as reflected in the coral-dotted box in the above chart. Investment grade spreads, but more markedly high yield spreads and the equity risk premium (respectively, the additional return that investors demand over risk free assets for assuming the incremental risks that these asset classes embody) are close to 20Y lows. Indeed, over the past 20Y, the high yield spread and equity risk premium have been narrower (i.e., the 'risk compensation' lower) only 7% and 8% of the time, respectively. All these measures have tightened over the past year.

The outlook for bonds and equities depends significantly and variably on the prospects for interest rates, inflation and growth.

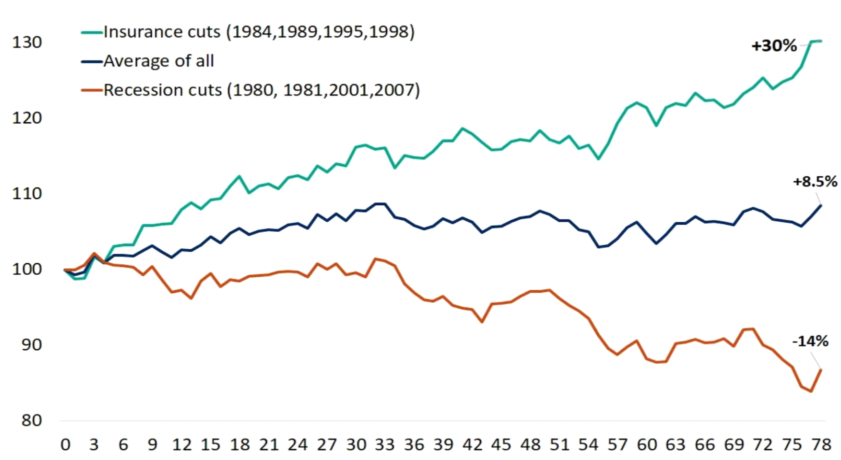
The outlook for bonds and equities depends significantly and variably on the prospects for interest rates, inflation and growth. Critically, bonds have a monotonic relationship with interest rates and inflation, such that inflationary pressures and rate hikes to combat these pressures are detrimental to fixed income prospects. Disinflationary trends, as we have observed over the past two years, reduce the discount rate of a bond's contractual coupon-based cash flows, increasing the present value of those distributions and, therefore, the bond's price. Bonds perform a further function in a portfolio context, providing diversification to equity exposure in the event of a shock to growth expectations: a negative growth shock typically leads to an equity selloff and safe-haven demand for high quality bonds. On a three-year trailing basis, the correlation for stocks and bonds was negative from the turn of the millennium, until Covid-related growth, inflation and interest rate level and volatility shocks conspired to push these correlations into strongly positive territory, such that both asset classes initially suffered (2022) before both delivering positive returns broadly since. As growth and inflation moderate, and with the Fed having joined the ranks of accommodative monetary policy, might this cross-asset correlation revert to a negative regime again?

On a three-year trailing basis, the correlation for stocks and bonds was negative from the turn of the millennium, until Covid-related growth, inflation and interest rate level and volatility shocks conspired to push these correlations into strongly positive territory.

Firstly, the scale of The Fed's 50bps rate cut was the largest initial cut since the Financial Crisis in 2007, prompting market participants to suspect that the economy was weaker than perceived, and that The Fed may be behind the curve. These fears were largely allayed, and 'animal spirits' reignited, by strong jobs data, albeit a lagging indicator. Whether or not the first rate cut of an easing cycle turns out to be, with the benefit of hindsight, precautionary (recession averted) or reactionary (recession ensued) has significant implications for subsequent medium-term performance, as reflected in the chart below. Considering the last eight rate cutting cycles since 1980, four preceded a recession (equities -14% on overage over the next 18 months) and four averted one (equities +30%). The average performance across all eight episodes was +8.5%, not dissimilar from long term equity returns. Therefore, a critical question for prospective risk asset returns becomes whether the recent rate cut will evade or precipitate a recession.

The Fed's 50bps rate cut was the largest initial cut since the Financial Crisis in 2007.

S&P500 returns 18 months following first Fed rate cut



Source: *FactSet via Edward Jones*

Fears around the Fed's initial rate cut were largely allayed, and 'animal spirits' reignited, by strong jobs data, albeit a lagging indicator.

The point of departure in the current rate cutting cycle is markedly different to previous cases.

Secondly, the two charts below, courtesy of Jim Paulsen[v] use red dots to denote the first interest rate cut in a cutting cycle that subsequently turned out to have preceded a recession ('episodes'), apart from Covid (excluded, as that period was disconnected from economic fundamentals). These are contextualised against a key economic measure in each chart, showing that the point of departure in the current rate cutting cycle is markedly different to previous cases. In the below, left chart, liquidity - as captured by monetary supply relative to economic growth - is higher. The below, right chart reflects corporate health: the highest reading of corporate cash flows to GDP. Readings for other measures, not shown here, include the narrowest high yield credit spread, the highest productivity growth and efficiency, and the highest margins relative to GDP. In combination, distinct from previous periods when rate cuts preceded recessions, the recent rate cut is into an environment characterised by moderate inflation, high levels of liquidity and solid aggregate corporate health. While rate cuts have a habit of preceding recessions, various measures suggest this one is into a more robust environment than in episodes past.

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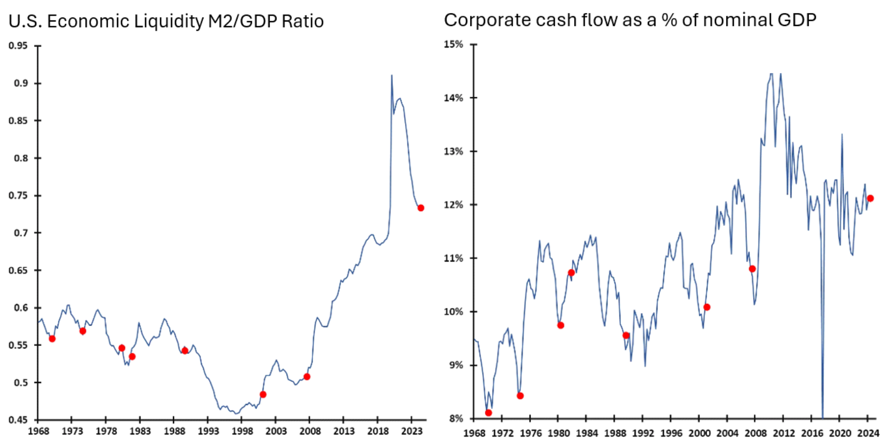

Source: *Jim Paulsen, Paulsen Perspectives*[i]

Thirdly, there are some nuances within corporate and consumer health. The comments above relate to large cap equities, which are forecast to continue to grow their revenues and profits, as well as expand margins. For 4Q24 S&P companies are expected to report revenue growth of 5.1% and earnings growth of 14.6% (rising to 5.9% and 14.9%, respectively, for 2025, per FactSet). The profitability picture is less sanguine for their mid and small cap counterparts, with Apollo's Torsten Slok[ii] calculating that, while only 6% of S&P 500 (large cap) constituents currently have negative earnings, that proportion rises to 14% for the Russell MidCap Index and 42% for the Russell 2000 Index. For the US consumer, excess savings (which peaked at over $2.3tr in August 2021) had been spent by the time of writing. By wealth bracket, the less-well-off half of consumers exhausted excess savings by mid-2023, turning to credit card debt. However, as labour markets have eased since (recent data notwithstanding) annual growth in credit card debt as decelerated to negligible levels. For now, the aggregate demand picture, with the top two income quintiles accounting for over 60% of consumption, is resilient. However, cracks are emerging elsewhere.

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Combining the above considerations yields an overall impression of broad resilience, but with pockets of weakness that warrant ongoing caution. Therefore, we continue to participate in the equity markets via investments in established, profitable, large cap companies and target government bonds for their yield as well as defensive credentials. To that end, the chart below shows how the correlation between equities and bonds evolves around pivotal points in the interest rate cycle. The red vertical bars indicate rate cutting cycles, with the correlation declining prior to – and during – previous rate cutting cycles. The current episode has thus far been consistent with this historical trend: the correlation has declined from +0.5 in the past year to zero currently, offering the potential for valuable diversification should this measure decline further. Within bonds, we are positioned along the curve, targeting the short end for higher yield (and potential capital appreciation resulting from rate cuts) and the medium-to-long end for potential capital appreciation borne of safe-haven demand arising from growth or disinflation shocks. While weary of longer duration bonds' vulnerability to currently high debt levels (c.$1 of every $6 in net Federal receipts services debt), fiscal indiscipline after the election and inflationary pressures, the risk/reward is compelling, with a 100bps rate fall / rise embodying a gain / loss of +12% / -4%.

Within bonds, we are positioned along the curve, targeting the short end for higher yield (and potential capital appreciation resulting from rate cuts) and the medium-to-long end for potential capital appreciation borne of safe-haven demand arising from growth or disinflation shocks.

Although risk premia (credit spreads and the equity risk premium) are tight to respective 20Y histories, we believe that the underlying economic environment and corporate fundamentals continue to favour risk assets and therefore remain constructive on the prospects for equities. Simultaneously, we remain overweight cash and government bonds given favourable risk / reward potential and as diversifiers set to preserve capital in the event of a disruption to currently optimistic expectations of a benign investment environment. We retain our positions in liquid alternative trading strategies and gold, while largely avoiding credit, wary of currently limited compensation relative to default and liquidity risks.

The risk/reward for bonds is compelling, with a 100bps rate fall / rise embodying a gain / loss of +12% / -4%.

[i] Paulsen Jim _ Paulsen Perspectives: It's Different This Time! (Where have I heard that before?) _ September 23, 2024

[ii] Slok Torsten _ The Daily Spark: The Share of Companies with Negative Earnings _ September 30, 2024

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