PERSPECTIVE PRIVATE WEALTH

Q2 2024 Market Update

Financial markets failed to maintain the pace set in the first quarter, with returns being relatively benign across asset classes. This was reflected in the performance of our model portfolios, however, overall 2024 is looking like it will be a good year for investors – even with the current political uncertainty and challenging geopolitical landscape.

Some signs of nervousness set in during the quarter due to concerns over the general path of inflation and interest rates in the immediate term. This has since subsided. The snap election called by the Conservative party in the UK also hindered financial markets due to the uncertainty associated with general elections. Fundamentally the change in government is not expected to significantly disrupt the path of interest rates or economic growth, similarly the US elections in November are also not widely expected to change the path of economic growth – regardless of the outcome. We expect equity markets to remain relatively buoyant over the second half of 2024 with the US market leading the way.

Asset Class Returns (GBP)

EQUITIES	Performance
MSCI World (ACWI)	2.73%
FTSE 100	3.75%
S&P 500	3.85%
Eurostoxx 50	-2.46%
Nikkei 225	-6.70%
MSCI Emerging Markets	4.57%

BONDS	Performance
UK Gilts	-1.16%
UK Index Linked Gilts	-2.13%
UK Corporate Bonds	-0.37%
Emerging Market Debt	0.79%

PROPERTY/ COMMODITIES	Performance
Global Property	-0.37%
GOLD	4.08%
OIL	-1.13%

In the quarters ahead, equities are expected to outperform most other assets, as the hype around AI builds and lower inflation facilitates more monetary easing in some places than investors are discounting. The tech-heavy US stock market is expected to remain at, or near, the front of the pack. Most other “risky” and “safe” assets are anticipated to lag equities during this period, but their outright performance could still be quite healthy. Commodities are, however, a notable exception.

Equities generally delivered strong returns overall in Q2 – as did industrial and precious metals. The best performing equity market in GBP terms was the MSCI Emerging Markets (up 4.57%), and the poorest performing equity market was the Nikkei 225 (down 6.70%).

As was the case in the quarter before, **UK Bond markets** have not fared too well in local currency terms. Smaller-than-expected inflationary falls and an absence of rate cuts in Q2 led to declines in bond prices.

Global property prices fell 0.37% on the quarter; a steepening in the decline felt in the previous quarter. The maintenance of high interest rates globally has facilitated this sharper fall from the previous quarter.

The price of **Brent crude oil marginally decreased over the quarter**, finishing 1.13% lower, indicating a slowdown in the considerable price movement from the previous quarter.

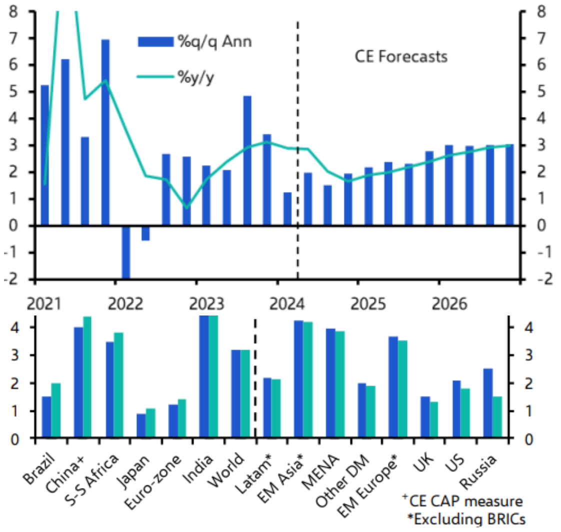
Economic Outlook – Recovery signs clouded by political uncertainty

Global – While the global economy is still struggling, a recovery seems set to take hold as the adverse effects of the previous surge in inflation subside. This is all happening against a backdrop of political uncertainty. But while there are risks of a worse outcome, it is expected that inflation will generally continue to ease and that fiscal policy will be tightened gradually. This should allow central banks to loosen policy a bit more than markets anticipate and see world GDP growth return to its potential pace of just over 3%.

Most economies are benefitting from recent falls in inflation which have boosted real incomes significantly. Meanwhile, labour markets are still resilient and unemployment rates are expected to remain low. Fiscal policy is still fairly supportive in most cases and few governments intend to tighten it significantly.

It is expected that further falls in inflation will allow the global monetary policy easing cycle to continue and broaden. By the middle of next year, 20 of the world's 30 major central banks will be cutting interest rates, with the US Federal Reserve joining the party this September. Following a soft spot around mid-year, growth in most economies is expected to accelerate towards the end of 2024 and into 2025. GDP growth in the US, UK and Emerging Europe will outpace consensus expectations, but the euro -zone and parts of Latin America will underperform. So too will China once policy support fades and structural forces weigh on growth again from next year. Indeed, its slowdown will be a key factor preventing average global growth from meaningfully exceeding the 3% mark.

Chart 9: Real GDP

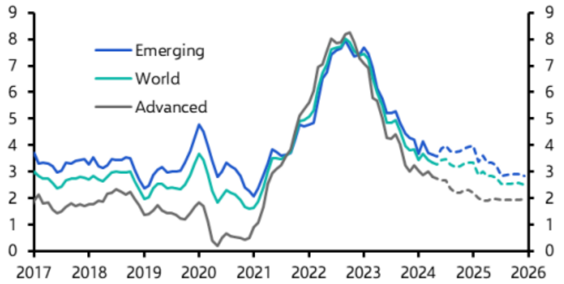


The risks to this view are skewed to the downside and stem from domestic politics. Concerns over India's election seem overdone – while Modi emerged with a weakened mandate, he will govern with a stable coalition which is unlikely to upend the reform agenda. Moreover, it is unlikely that the change of government in the UK will alter its recovery prospects. However, the US election later this year could trigger inflationary, growth-sapping tariffs in the short term – however major disruption to the path of improved economic growth is considered to be unlikely. Meanwhile, the presidential election in Mexico and the snap parliamentary election in France have added to fiscal risks for both economies.

US – Core inflation is expected to be back to the 2% target by early next year, allowing the Fed to begin cutting interest rates from this September. GDP growth will remain a little lacklustre this year but, as the shift in monetary policy begins to boost rate-sensitive spending, growth should reaccelerate in 2025 and beyond.

The unemployment rate will continue to edge gradually higher, due to increasing labour supply – thanks to strong immigration and rising participation – rather than any genuine weakness in labour demand.

Chart 4: Headline CPI Inflation (%)

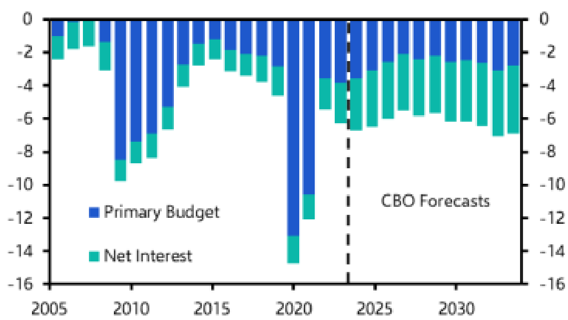


Consumption growth will drive the economic expansion as households, mostly protected by fixed-rate debt, remain unaffected by higher interest rates. Wealth gains from the stock market will also boost consumption, particularly for higher-income households. However, lower-income households, having depleted pandemic savings, are struggling with rising loan delinquencies.

With regard to the presidential election, it is still too close to call. A win for the Democrats would maintain the status quo, whilst a Trump victory could usher in higher tariffs and curbs on immigration. The latter could trigger a short term spike in inflation - risking a recession.

Given the adverse outlook for the budget deficit, it's unlikely that either party will promise any new deficit-financed fiscal stimulus, although both would move to extend most of the Trump-era tax cuts, worth up to 1.5% of GDP per year, which are scheduled to expire at end-2025.

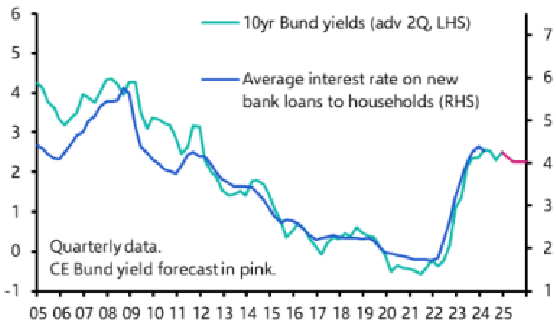
Chart 15: Federal Budget Balance (% of GDP)



Euro-zone – The euro-zone has come out of a long period of stagnation and will expand at a moderate pace over the coming two years. The recovery will be faster in some southern economies, such as Spain, than in core economies, notably Germany, while the outlook for France is now clouded by political risk. Headline and core inflation will continue to fall, allowing the ECB to cut interest rates a little more quickly than markets expect.

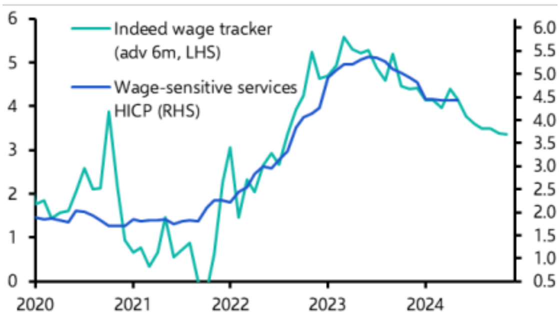
Whilst real household incomes and exports are set to continue on an upward trajectory, investment across the region will remain subdued. Looser monetary policy will do little to boost GDP growth; policy rates will fall only gradually and cuts are discounted in the markets. This suggests that lending rates won't fall far.

Chart 18: Bund Yields & Average Interest Rate on New Bank Loans to Euro-zone Households (%)



The labour market remains tight and official measures of wage growth were surprisingly high in Q1. Recent data points to a slowdown in Q2, suggesting that wage-sensitive services inflation will continue to decline, albeit gradually. Core goods inflation will probably fall a little further too in the coming months.

Chart 22: Euro-zone Indeed Wage Tracker & Wage Sensitive Services HICP (% y/y)

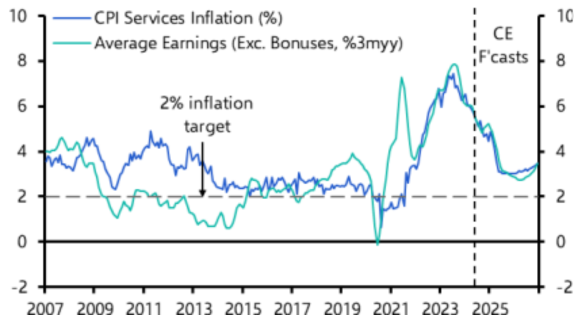


UK – Over the next two years, the UK is expected to go from lagging the euro-zone to leading it as CPI inflation is lower and GDP growth is higher. Despite the Labour victory, the path for the economy may not be much different.

That's because Labour's fiscal policies are very similar to the Conservative Party's policies. As a result, the economic recovery is anticipated to exceed expectations over the next few years regardless of who wins the election. As the dual drags on, activity from higher interest rates and higher inflation fade, the economy is expected to grow by 0.7% in 2024 and 1.2% in 2025 and 1.4% in 2026.

This suggests the unemployment rate may have already peaked at 4.4% in the three months to April. Moreover, the previous weakness of GDP and some improvement in supply in 2024 may mean services inflation drops from 5.7% in May to 3.5% in early 2025 and wage growth falls from 5.9% in April to 3.0% by the end of 2025.

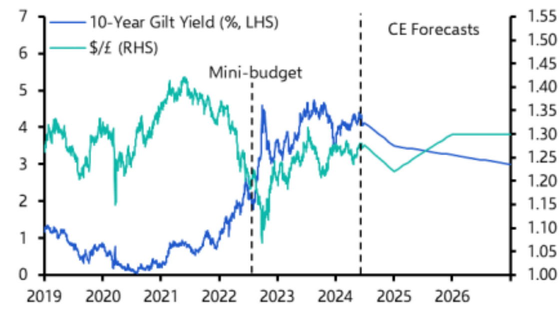
Chart 36: Services CPI Inflation & Wage Growth



CPI inflation will fall from 2.0% in May to 1.8% in June and then stay below the 2.0% target until late in 2026. That would mean UK inflation is lower than in the euro-zone and in the US.

With the Bank of England signaling a near-term rate cut, a 25 basis point reduction from 5.25% to 5.00% is expected in August, with rates potentially reaching 3.00% by 2025. That would catch out investors as they have assumed that rates will be 4.00% next year. It also explains why 10-year gilt yields are expected to fall from 4.10% now to 3.50% this year and the pound to weaken from $1.27 to $1.22. But the risk is inflation proves stickier and rate cuts are a bit smaller than anticipated.

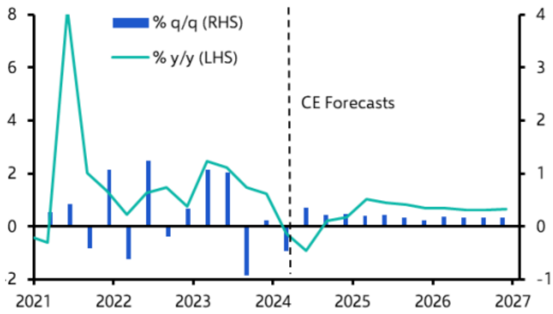
Chart 40: 10-Year Gilt Yield & $/£



Japan – A rebound in real household incomes should ensure that the recent slump in output turns into above-trend GDP growth of 1% over the next couple of years. Regardless, inflation will continue to slow as the influence of the previous import cost shock fades and wage growth cools again. The upshot is that the window for monetary policy tightening is closing rapidly.

Japan's economy has been wobbly recently as GDP has fallen in two out of the last three quarters. The latest leg down mostly reflects shutdowns at major carmakers in the wake of scandals. However, the recent composite PMI indicates that this won't prevent a rise in activity this quarter.

Chart 25: Real GDP



Real household incomes should soon start to rise again as tax cuts are set to boost incomes by 1.3% from June. Moreover, real wages will pick up as inflation cools and wage growth rises. Accordingly, consumption growth should turn the corner as soon as this quarter.

The phasing out of electricity and gas subsidies will keep headline inflation close to 3% for now. However, with the import cost shock now dissipating, consumer prices excluding fresh food and energy have almost stopped rising.

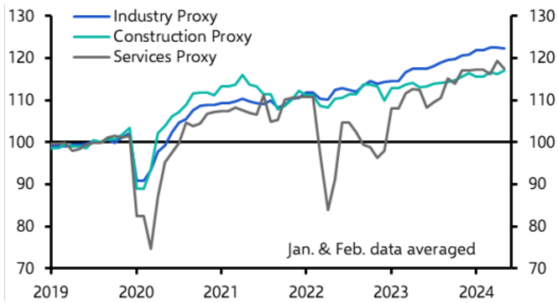
The Bank of Japan expects inflation to rebound to 2% over the next couple of years as the large pay hikes in this year's spring wage negotiations (Shunto) feed through. Mounting expectations of further policy tightening has resulted in 10-year JGB yields climbing above 1% for the first time since 2014.

The yen has hit fresh lows against the dollar despite the most aggressive FX intervention on record. Recent moves have had little to do with changes in interest rate differentials, but the yen's extreme undervaluation is expected to result in a renewed strengthening over the rest of the year.

China – China's economy is on course to expand by 5.5% this year, buoyed by policy support and strong exports. But the medium-term outlook remains less sanguine.

The China Activity Proxy (CAP) suggests that the economy is now 20% larger than in 2019, less than the 25% rise shown by the official GDP figures. But both measures point to growth exceeding 5.0% y/y so far this year. The CAP breakdown shows that industry has been the star performer in recent years, while construction has lagged.

Chart 58: CAP – Sector Proxies (2019 = 100, seas. adj.)



The economy is set to continue to make good headway in the near-term. Admittedly, consumers are still holding back as indicated by the elevated household savings rate in Q1 and negative wealth effects from falling property prices. Confidence may improve somewhat over the coming months however, given the recent tightening of the labour market.

As such investing will remain the key engine of domestic demand, with infrastructure investment due to reaccelerate soon thanks to a ramp up in government borrowing.

Exports will remain a near-term source of strength. Rapid expansion of low-cost capacity is allowing Chinese firms to capture market share in many sectors.

Although economic growth is likely to hold up this year, there are reasons for caution further ahead. Concerns about debt risks mean that fiscal policy will be tightened before long. And much of the necessary downward adjustment in construction activity has yet to take place.

Meanwhile, growth in manufacturing capacity cannot continue to outpace domestic goods demand indefinitely. Overcapacity is causing deflationary pressure and financial strains in the corporate sector. And export markets will eventually become a less viable dumping ground as foreign tariffs are made less leaky.

The leadership is likely to promise wide-ranging reform at the upcoming Third Plenum but, in China's context, reform can mean more of the same. The constraints that weakened growth over the past decade will sap growth further over the years ahead.

Asset Allocation Views

Bonds - Returns from DM bond indices were a mixed bag in the second quarter of this year, with DM government bonds faring poorly in aggregate especially in US-dollar terms. It's a similar story for EM dollar-denominated bonds, which had a modest return in the second quarter as both risk-free rates and spreads pushed their yields up. Overall, decent returns from both DM and EM bonds are anticipated as they benefit from looser monetary policy, however the upside will be limited by threats to fiscal sustainability in some large economies.

Corporate bonds – Corporate bonds fared relatively well over the second quarter, despite the small rise in their yields. And, although that rise was driven in part by wider credit spreads, they are still near historical lows, which indicates that there is little room for them to drop much further. Nonetheless, there don't appear to be any economic factors that could cause a significant rise in the near future.

Equities – The global equity rally continued in the second quarter of 2024, but gains were less broad-based than in Q1. Equities in the US and Taiwan fared well as enthusiasm around AI tech continued to build, boosting their respective regional indices. But major equity indices elsewhere generally made little ground, at best. Continued enthusiasm around AI technology should help the rally broaden back out again, with equity markets set to make large gains. In particular, the S&P500 is projected to reach 6,000 by the end of this year and hit a peak of 7,000 next year.

Emerging market equities – Lower commodity prices will be a headwind for some EM equities, especially in Latin America and EM EMEA. In some Latin American countries, such as Brazil, challenging fiscal and political situations are expected to keep risk premia fairly elevated. Given the likelihood of the AI bubble inflating further, the MSCI Taiwan Index, and to some extent the MSCI Korea Index, could continue to rally given their tech-heavy compositions.

Commodities – Oil prices have remained high over recent months thanks in large part to constrained supply. A continuation of OPEC+ voluntary production cuts in Q3 is expected, alongside resilient demand from EMs, to help support oil prices over the coming months. But supply is expected to increase over the course of the year, thanks to a combination of rising OPEC+ supply and increasing supply from other sources including Brazil and Canada. As such, Brent crude oil is forecasted to fall from ~$85 per barrel now to $80 and $70 by end-2024 and end-2025, respectively.

Industrial metals – Industrial metal prices got slightly detached from their fundamentals last quarter, having initially rallied on the back of supply concerns. This exuberance has a bit further to unwind; and these prices will face downward pressure over the coming years from a bigger slowdown in China's construction sector than many seem to be expecting. While the green transition demand is expected to keep prices elevated relative to recent years, it is unlikely to be sufficient to prevent them falling back from current levels.

Precious metals – Prices of precious metals were very volatile over the second quarter, with most of the prices still being up a long way over the year so far. The high precious metals prices appear slightly at odds with their traditional macroeconomic drivers. This is probably due to strong central bank and retail demand this year, notably from China which also helps to explain the premium on Chinese gold prices. Current forecasts suggest the price of gold will settle at around $2,200 per ounce, and that of silver to around ~$27.50 per ounce.

Final Word

Whilst uncertainty and challenges in the global economy remain, the backdrop of political uncertainty is unlikely to significantly impact the path of economic growth in Developed Markets. We remain confident that our current positioning across portfolios remains appropriate for the environment we currently face. That being said, we will be looking to alter exposures to UK Equities whilst also adding further to developed market government bonds, acknowledging the outlook that interest rates could well fall faster than markets currently anticipate in the UK and US.

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Sources: Capital Economics; Bloomberg; FE Analytics
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