Q1 2024 Market Update

Following on from the strong fourth quarter of 2023 for equity and bond markets, equity markets performed strongly in the first quarter. After a faltering start to the year, which reflected investor nervousness as inflationary concerns and the path of interest rate cuts became momentarily uncertain, global equity markets looked beyond the immediate term concerns and performed well. This confidence was not reflected in bond markets, which faltered as inflationary concerns weighed on prices.

In this environment, pleasingly, our investment strategies performed well - posting strong positive returns for the quarter across the board and exceeding benchmarks.

Asset Class Returns (GBP)

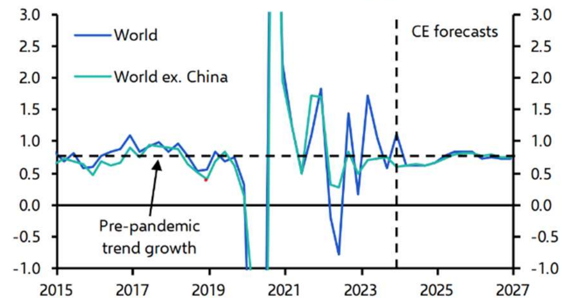
EQUITIES	Performance
MSCI World (ACWI)	9.29%
FTSE 100	3.99%
S&P 500	11.57%
Eurostoxx 50	11.43%
Nikkei 225	14.25%
MSCI Emerging Markets	3.28%

BONDS	Performance
UK Gilts	-1.86%
UK Index Linked Gilts	-1.87%
UK Corporate Bonds	0.16%
Emerging Market Debt	3.26%

PROPERTY/ COMMODITIES	Performance
Global Property	-0.05%
GOLD	7.21%
OIL	12.52%

In the quarters ahead, economic activity in most of the world are expected to be characterised by soft landings. GDP growth will likely be below trend, but significant recessions are not anticipated, with the US continuing to outperform other advanced economies. China's growth trajectory will transition from a cyclical

Chart 1: GDP (% q/q)



upturn to facing structural challenges. Inflation is projected to decline further across regions, prompting major central banks to commence rate cuts around mid-year, potentially exceeding market expectations.

Equity returns have had another strong quarter in Q1 and, in contrast to the last quarter of 2023, the rally has broadened out. The best performing equity market in GBP terms was the Nikkei 225 (up 14.25%), and the poorest performing equity market was the MSCI Emerging Markets Index (up 3.28%).

In stark contrast to the quarter before, **UK Bond markets** have not fared too well in local currency terms. Renewed inflationary concerns and the associated increase in rate expectations in Q1 led to declines in bond prices.

Global property prices fell 0.05% on the quarter, in contrast to the previous quarter's increase. The maintenance of high interest rates globally has facilitated this drop from the previous quarter.

The price of **Brent Crude Oil increased over the quarter**, finishing 12.52% higher, reflecting the OPEC+ decision to extend output cuts and increasing geopolitical tensions across the globe.

Economic Outlook – On course for a soft landing

Global – This year we expect GDP growth to come in below trend, meaningful recessions to be avoided, and the US to continue outperforming its Developed Market peers. As the drag from past monetary tightening fades, growth should pick up towards trend rates going

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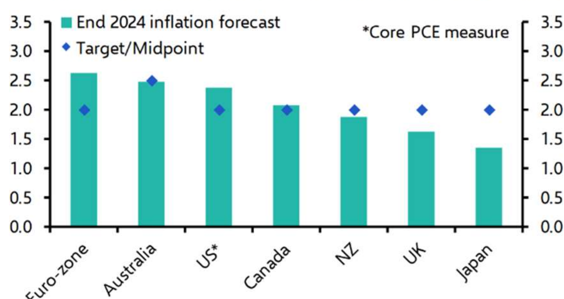
into 2025, although growth in China will succumb to structural headwinds. Inflation should fall further, allowing central banks to cut policy rates back to neutral levels.

In 2023, central bank-induced recessions were averted as several factors, such as robust private sector balance sheets, favourable supply chain conditions, declining commodity prices, and improvements in labour supply, worked together to counteract the impact of higher interest rates. While some of these positive influences are diminishing, tight monetary policy still exerts pressure on economic activity. Consequently, global growth is expected to remain below trend in the upcoming quarters, although significant recessions will probably be avoided.

A mixture of softening demand and improving supply should see softer labour markets across Developed Markets. Coupled with favourable supply chain conditions, stable commodity prices, and a notable decrease in rent inflation in the US, inflation should align with central bank targets in the latter half of the year. Despite signs of stubborn inflation in certain Developed Markets in recent months, overall trends do suggest a return to target levels.

Chart 6: End-24 Inflation vs. Central Bank Targets (%)

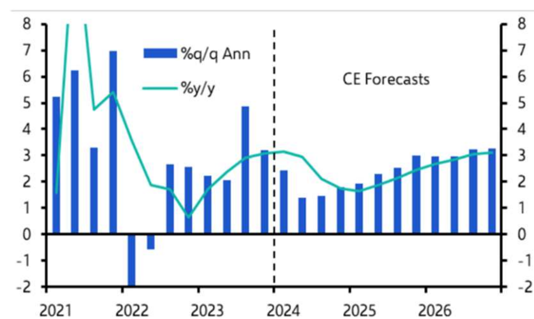


GDP growth across much of the emerging world will fall short of consensus expectations this year, though Asia will fare better than other Emerging Market regions and India will continue to be a particular bright spot. While inflation could fall at a slower pace from here, the monetary easing cycle in Emerging Markets is expected to broaden out. In China, the cyclical recovery underway is set to continue in the coming months as more stimulus comes through.

US – GDP growth is expected to fall below potential in the near term as the effects of past policy tightening feed through. But the US is expected to still outperform its Developed Market peers, and a cyclical recovery is anticipated to be in motion later this year. Inflation should soon resume its downward trend, albeit with future upside risks from tariffs and immigration limits.

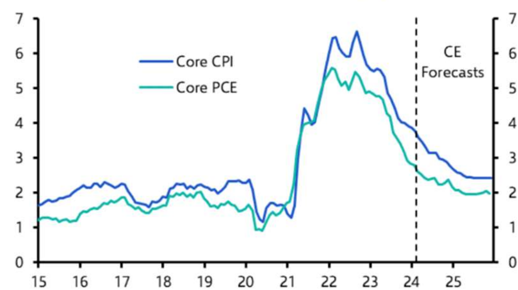
While it is expected that GDP growth will slow to below potential in the coming quarters, a rebound later in the year is anticipated as monetary policy shifts from being a headwind to a tailwind. However this is dependent on there being no meaningful changes in government policy. However, a potential Donald Trump victory in the upcoming presidential election could usher in a new trade war and immigration restrictions - which could fuel inflationary pressures.

Chart 9: Real GDP



With the impact of higher interest rates evident in rising household delinquency and corporate bankruptcy rates, a near-term recession can't be ruled out entirely. Falling commercial property values, particularly for offices, will remain a threat to regional banks. Nevertheless, banks are no longer tightening lending standards as aggressively.

Chart 13: Core Inflation (%)



With most measures of labour market slack returning to pre-pandemic levels, nominal wage growth is expected to fall well below 4% this year. When combined with the acceleration in productivity growth, that should be reflected in a more marked decline in labour-sensitive core services inflation. Despite the disappointment to start the year, core inflation is expected to resume on its downward path soon.

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The Fed and markets anticipate a reduction in interest rates by 50bp this year. However, a 100bp cut is possible, with the first cut expected to begin in June, followed by an additional 100bp cut next year, bringing the fed funds rate to a low of 3.25% to 3.50%.

Euro-zone – The euro-zone economy should grow more slowly than most expect over the coming years. Subsequently, inflation will keep falling but the ECB is expected to only start cutting interest rates in June at the earliest.

The negative terms-of-trade shock caused by the surge in energy prices in 2022 has now largely reversed. But just as looser fiscal policy softened the blow from higher energy prices, the gains from lower prices have been offset by tighter policy. And the fiscal stance will be tightened further over the coming years.

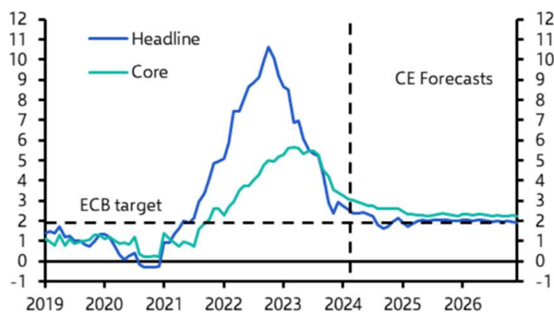
Meanwhile, consumption growth is expected to slow as aggregate real household disposable income flat-lines from plateauing employment and reductions in nominal wage growth. The near-term outlook for investment is also poor. The slowdown in the housing market suggests that construction investment will fall.

Firms' demand for credit to fund investment is declining amid low levels of industrial capacity utilisation. Meanwhile, firms have reported a deterioration in their external competitiveness and exports have fallen in four of the past five quarters.

Consequently, the economy is projected to grow slowly this year. It will probably remain sluggish over the coming years too, as fiscal policy remains restrictive and weak demographics start to weigh more heavily on growth in the labour force.

Although headline inflation may drop to 2% in the summer, it is expected that the core rate will remain elevated for an extended period.

Chart 23: Euro-zone Consumer Prices (% y/y)

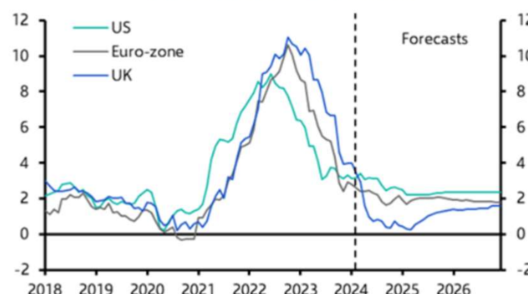


Relatedly, forecasts for the deposit rate stipulate a decrease from 4% to 3% by year-end and 2.25% by early next year. As such, the benefits of lower rates are not expected until 2025.

UK – Investors expect the Bank of England to cut interest rates this year from 5.25% to 4.75%, however given the likelihood of CPI inflation falling to just 0.5% later this year, these expectations could fall short. As such, lower inflation and interest rates are likely to contribute to a stronger economic recovery than most expect.

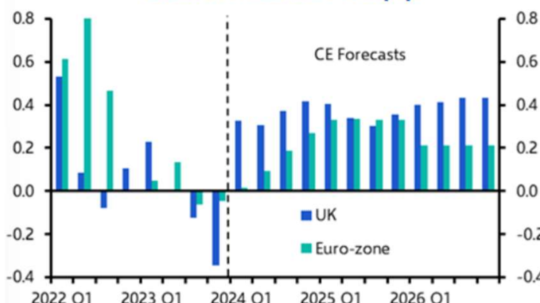
The recession probably ended in Q1, marking the shortest (two quarters) and shallowest (0.5% real GDP decline) on record. Despite this, the economy has shown no growth over the past two years, with the full impact on inflation yet to be realised. As a result, wage growth and inflation are expected to decline significantly, with CPI projected to fall from 3.4% to 0.5% later this year and remain below the 2% target for the next two years, placing UK inflation below that of the US and euro-zone.

Chart 35: CPI Inflation (%)



Nonetheless, a slightly stronger economic recovery than previously anticipated could occur for three reasons. Firstly, a larger drop in inflation will elevate real wages, expected to surpass 2007 levels by 2026. Secondly, the recent reduction in national insurance will boost household disposable income by 0.5-1.0% starting in April. And lastly, declines in mortgage rates are easing the drag from past interest rate hikes, prompting a rebound in

Chart 39: Real GDP (%q/q)



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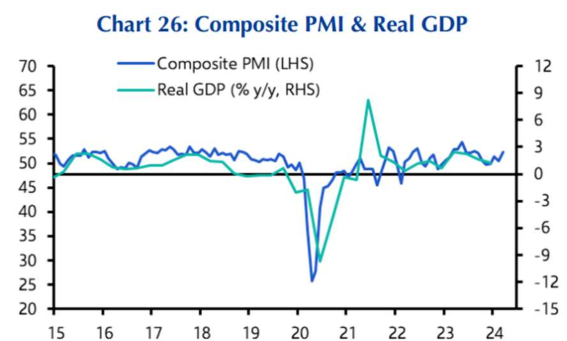
housing activity and prices. As such, GDP growth could reach 0.5% this year and 1.5% in both 2025 and 2026, surpassing consensus forecasts and outpacing the euro-zone's growth trajectory.

Japan – The economy is expected to recover this year but will only eke out modest growth. Whilst the
Bank of Japan has now abandoned ultra-loose policy, price pressures are not strong enough to require policy tightening.

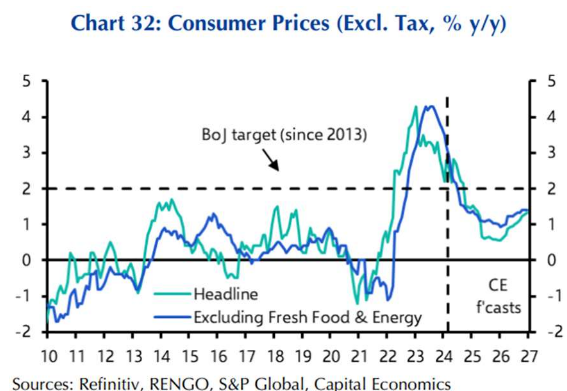
Recent GDP activity has exhibited volatility, increasing the likelihood of another contraction in Q1. However, expected growth in consumption due to rising wage growth and the slowing of inflation, indicates a potential turnaround.

Chart 26: Composite PMI & Real GDP



Inflation has slowed over the past year with non-energy goods inflation now declining rapidly. And although this year's spring wage negotiations resulted in the largest pay hikes in 30-years, slowing inflation means next year's wage negotiations should result in smaller pay hikes. All this means that inflation should fall below the BoJ 2% target by year-end and further moderate next year.

Chart 32: Consumer Prices (Excl. Tax, % y/y)



Sources: Refinitiv, RENGO, S&P Global, Capital Economics

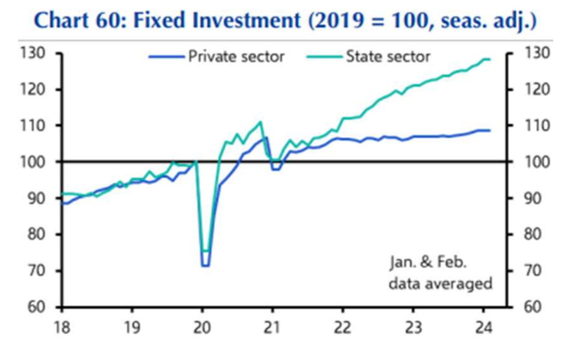
The BoJ lifted its policy rate into positive territory this quarter and relinquished control over 10-year bond yields, however it is unlikely to embark on a full-fledged tightening cycle, with the policy rate expected to remain at 0.1% in the foreseeable future.

China – China's economy has fared better lately, and policy support will remain a near-term prop to growth, however the medium-term outlook appears less sanguine.

The labour market looks to be softening again, which doesn't bode well for wage growth. Alongside increasingly negative wealth effects from property price falls, this makes an acceleration in consumer spending unlikely.

The main near-term prop will come from investment, which is being buoyed by policy stimulus. Rate cuts are doing little to boost capital spending by private companies, which remain wary. But fiscal support is lifting investment by the state sector, with the looser fiscal stance outlined at the National People's Congress suggesting that government borrowing will increase in the coming months.

Chart 60: Fixed Investment (2019 = 100, seas. adj.)



The drag from the property downturn may also alleviate somewhat in the near-term. Regulatory barriers to home purchases have decreased, and affordability has significantly improved. Sales have overcorrected relative to underlying demand, with the primary impediment being homebuyers' lack of confidence in developers' ability to deliver presold homes.

Export support may decrease later this year. Chinese export volumes have surged by 20% over the past year, outpacing stagnant global trade. This increase in global market share, driven by aggressive price cuts, is unsustainable, with prices stabilising recently. Flooding foreign markets with inexpensive goods also poses the risk of provoking a protectionist response.

The big picture is that policymakers are still neglecting to address the structural imbalances undermining Chinese growth. The current focus on supply-side stimulus may exacerbate the

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situation, providing short-term relief but risking a more painful adjustment later on. It is therefore likely that growth will slow more than expected over the medium term.

Asset Allocation Views

Bonds – Long-dated government bond yields in Developed Markets have generally fallen back due to expectations of more rate cuts by central banks. Meanwhile, Emerging Market bonds may see their spreads narrow, but concerns about fiscal and political situations in certain countries, like South Africa and Brazil, may limit further narrowing. Overall, good returns are anticipated from bonds as central banks globally cut rates and risk sentiment remains positive.

Corporate bonds – Corporate bond credit spreads decreased overall in the first quarter, with a minor increase noted in late March. However, this decline was overshadowed by rising "risk-free" rates, resulting in historically low credit spreads. As a consequence, we expect corporate bonds to marginally outperform sovereign bonds, although potential underperformance may occur in countries with dovish monetary policies, such as the UK.

Equities – Equities, particularly in the US, have shown robust gains in the past quarter, as the rally has broadened due to increased participation from various sectors. This participation has been driven by an improvement in investors' assessment of the economy and appetite for risk, which is apparent from the compression of risk premia across most financial markets over the past few months. Strong valuations, particularly in the US, have boosted equity returns and are expected to remain a driving force in the coming year, supported by the ongoing stock market bubble fuelled by AI enthusiasm. Consequently, the S&P 500 is projected to reach 6,500 by the end of 2025.

Emerging market equities – Emerging Market equity valuations have generally recovered well so far this year, albeit by less than Developed Market equities, in part due to optimism about China. Emerging Market equities will perform broadly in line with non-US Developed Markets, in aggregate, although the outlook for Emerging Asian stock markets is brighter. Chinese equities are expected to receive a further boost to valuations on the back of supportive domestic policy.

Commodities – Energy commodities have fared well so far this year, with the price rises in oil and coal more than offsetting a drop in natural gas prices. In particular, the increase in oil prices largely reflects the OPEC+ decision to extend output cuts and the increasing geopolitical tensions across the globe. OPEC+ is set to increase output in the latter half of the year and slowing economic growth in China may weigh on oil demand, translating to a fall in the price of Brent crude from ~$89pb now to $75pb by end-2024, and to $70pb by end-2025.

Industrial metals – After a weak start to 2024, industrial metal prices have picked up recently on the back of signs of solid demand in China. Loose fiscal and monetary conditions in the coming months should support demand for industrial metals, and supply growth for most of these metals is unlikely to be as robust as over 2023. Whilst industrial metals prices are set to rise over 2024, the medium-term outlook is less optimistic due to the sharp forecasted downturn in China's construction sector in the coming years.

Precious metals – The price of gold has continued to surge this quarter despite rising US real yields, a stronger US dollar and falling ETF holdings (which are a proxy of investment demand). This upward trend has stemmed from increasing demand from central banks as well as buying from China. At its current price level, consumer demand will be weak and as such, the price of gold is set to drop from ~$2,250 per ounce now to $2,100 by end-2024 (and $2,150 by end-2025).

Final Word

In summary, 2024 is expected to be a good year for financial markets, with greatest opportunity in equity markets, whilst bond markets are also expected to post positive returns this year as Central Banks adopts aggressive monetary loosening policies (with the exception of Japan).

We are comfortable with our current asset allocation positioning across our portfolios however will shortly be providing recommendations to enable us to capitalise more efficiently on the current opportunity set.

Scot Laing (CFP™)(Chartered FCSI)
Managing Director
Sources: Capital Economics; Bloomberg; FE Analytics
Publication Date: 30/04/2024

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