JOHNSTON CARMICHAEL WEALTH

Market Update

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SQUARE MILE INVESTMENT SERVICES
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A market and economic commentary on the first quarter of 2024.

Macro Backdrop

The first quarter of 2024 unfolded with a striking contrast of economic resilience and global tension. The United States, for example, continued to display surprising strength, with GDP growth estimated at around 3% and a still-robust labour market. Europe, as well as the United Kingdom, enjoyed a more positive - or less negative - economic picture compared to recent quarters. Consumer spending in the UK improved, with signs of inflation markedly ticking down and a possible resurgence in the property market. Additionally, the UK labour market showed signs of loosening, potentially providing some relief to wage pressures, a factor that has kept services inflation (e.g. hospitality and education) elevated.

However, this optimistic economic narrative was rivalled by a deteriorating global environment. Tensions between the West and China continued to escalate, fuelled by accusations of espionage and restrictions on trade, such as China's potential ban on Intel products. The ongoing invasion of Ukraine by Russia has cemented the end of the so-called peace dividend in Europe, whilst Israel's, what many are now perceiving to be, heavy-handed war against Hamas has returned the Middle East to a hotbed of instability.

Despite these geopolitical headwinds, interest rates remained the focal point for markets in the first quarter of 2024. The Federal Reserve in the US surprised some by considering potential rate cuts despite a strong labour market and economic growth, although the matter of when to cut rates is increasingly becoming a political battleground, as November's election starts to loom. This shift in stance likely stems from an improved inflation situation, which is also apparent in the UK and Europe. It is an open debate as to which central bank will lower interest rates first, although most are agreed it will be this year for nearly all.

However, a notable outlier emerged in Japan. The Bank of Japan, after decades of deflationary pressures, surprisingly raised interest rates. Many commentators are increasingly positive on the Japanese economy, especially as wages have also been rising, after a lengthy period of languishing.

Bond Markets

The first quarter of 2024 painted a complex picture for bond markets. Early enthusiasm, stemming from an optimistic end to 2023 regarding imminent rate cuts, quickly met a dose of economic reality. As data throughout Q1 pointed to surprising resilience in major economies, a sharp correction ensued, particularly for longer-duration bonds. This stemmed from the simple fact that with the likelihood of imminent rate cuts diminishing, the appeal of these bonds, which are more sensitive to changes in interest rates, also waned. This phenomenon played out across various durations and regions, from the US and Europe to Japan.

Later in the quarter, inflation data published in several developed economies, including Australia, the UK, and Switzerland, threw another curveball, with numbers dropping off sharply, supporting the notion that enough action has been taken to slow inflation. The US has struggled taming inflation in the face of a highly resilient economy, but numbers are steadily dropping. This data strengthened the case for potential rate cuts later in the year, reigniting investor interest in bonds as an asset class. Given the current environment where yields are significantly higher compared to the near-zero interest rate environment of the past decade, bonds offer a more attractive risk-reward proposition than they have in a very long time.

However, the bond market is not without risk. Any moves upward in inflation could send bond prices on a downward trajectory, and if the economic backdrop weakens this may lead to an uptick in corporations defaulting on their debt repayments.

Equity Markets

The first quarter of 2024 presented an optimistic narrative across most equity markets. The US remained dominated by the "Magnificent 7" - a group of very large mostly Artificial Intelligence-associated companies like Apple and Microsoft that have enjoyed significant rallies. Market discussions around concentration have evolved over the past year, becoming increasingly nuanced. Recent performance trends among the "Magnificent Seven" stocks illustrate this complexity, with companies like NVIDIA soaring while others, such as Apple, face challenges like antitrust lawsuits and a reduction in demand. This, coupled with the fact that the rest of the US market trades at a much lower valuation, suggests there is perhaps room for a broadening of market returns as the year progresses as investors seek better value and improve diversification.

Across the pond, the UK Spring Budget offered little in the way of major changes. Alongside negligible tax cuts, the chief announcement was the introduction of the British ISA, a new investment account allowing additional tax-free savings and investments. This policy is seen as a deliberate, though perhaps unambitious, government attempt to boost domestic investment. Perhaps more measurably fuelling optimism was Governor of the Bank of England Andrew Bailey's comments suggesting rate cuts are firmly on the cards for the near future. This was supported by recent revisions to GDP confirming a recession, alongside more optimistic voting activity (for rate cuts) within the Monetary Policy Committee, who decide where rates lie. This triggered a rally in the FTSE 100, pushing it to an all-time high, indicating perhaps the beginnings of a renewal of confidence - or at the very least a slowing of the rate of dissatisfaction - for the UK market. Given the extremely cheap valuations of UK companies, small changes to the economic picture could have outsized outcomes.

In another interesting development, exposure to China and Korea through Asia ex-Japan and Emerging Markets funds was the cause of some headwinds. Weakening Chinese consumer confidence due to lacklustre economic data and an increasingly authoritarian government stance dampened investor sentiment. The Korean market, heavily linked to the health of the Chinese consumer, suffered similar declines. However, both markets showed signs of life towards the end of the quarter, with rallies attributed partly to potential policy support from China and signs that deflationary pressures may be easing.

Finally, Japan's stock market continued its remarkable rally, reaching its highest level since 1989 this quarter. This revival can be attributed to several factors, including corporate reforms, persistently loose monetary policy and a renewed focus on shareholder value through increased dividends.

Outlook

As we journey through 2024, the global landscape appears increasingly uncertain. With numerous upcoming elections, shifting economic dynamics, and escalating tensions with key nations like China and Russia, investors may feel uneasy about the future. However, amidst these challenges lie opportunities. The optimism surrounding potential rate cuts would be supportive for strong fixed income returns into 2024, and aligns with the rally witnessed in equity markets recently.

Whilst clear pathways exist towards a positive year for both fixed income and equities, any number of unforeseen economic or geopolitical developments could swiftly alter the trajectory. This is precisely why we maintain a diversified approach.

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