

Investment Views August 2024

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Market Tremors

Fixed Income:

Japan Rocks the Boat

Equities:

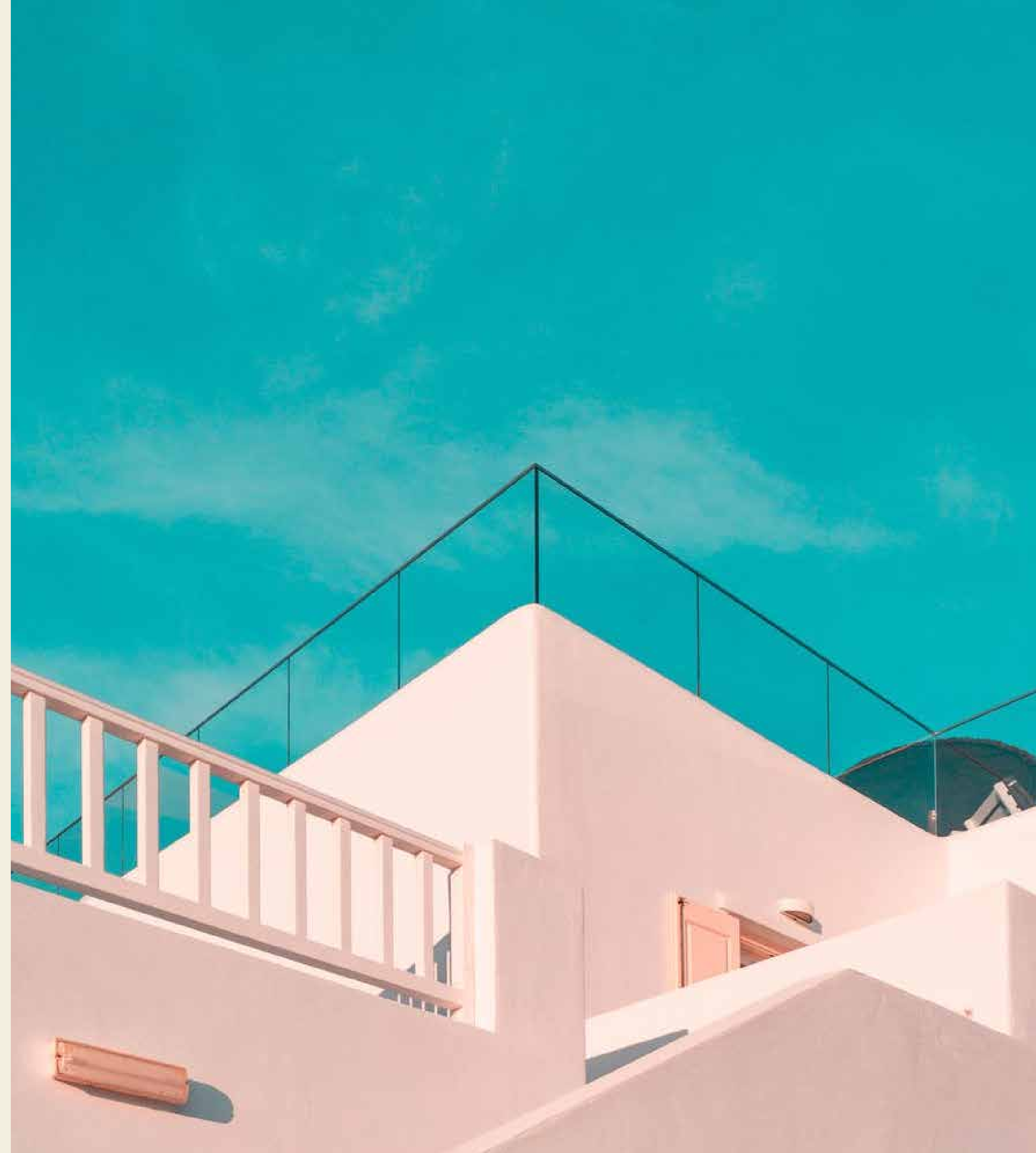
The Great Rotation

Market Tremors

- Global rate cut cycle in full swing
- Rate hikes in Japan caused volatility
- Fragility building in the US labour market

July was an eventful month for financial markets amid a slowing US economy, a hawkish Bank of Japan, company earnings results and rapid swings in US election polls. Uncertainty and volatility reigned. The trends of large-cap outperformance, particularly Technology related companies, suffered an abrupt reversal in mid-July. Small and Medium sized companies outperformed, led by cyclical sectors such as homebuilders and regional banks. The initial catalyst for this rotation was a combination of a lower-than-expected inflation reading in the US and worries around the ability of Technology companies to profit from Artificial Intelligence (AI).

The global interest rate cutting cycle is now underway with almost all major central banks cutting rates or considering it. In July,



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central banks in China, Hungary and Canada cut rates. They were followed by the UK, Czech Republic and Mexico in early August. The all-important Federal Reserve has not cut rates yet and is waiting for more evidence that a fall in inflation is sustainable. The Fed has suggested that a rate cut will be forthcoming in September. Inflation is a crucial variable in the decision making, which is why the better (lower) than expected reading for June helped drive a rally in cyclical stocks in July.

While inflation is still very much in focus, worries have shifted more towards growth and in particular the health of the US labour market. There has been a lot of debate recently around whether the Fed is being too slow to cut interest rates and risks tipping the economy into recession by holding interest rates too high for too long. Moves by central banks are well known to have “long and variable lags”, meaning that it takes time for policy moves to filter through to the real economy. Aggregate economic data has held up well, but because of these policy lags, waiting for economic data to deteriorate before cutting interest rates can leave policymakers “behind the curve”. With economic data holding up and inflation still above target, interest rate cuts in the US can be framed as risk management to help support the labour market. This shift towards worries about growth, rather than inflation, has meant that bonds have more attractive diversification benefits than they have for the last couple of years.

With so many global central banks cutting interest rates, the Bank of Japan’s recent move to raise interest rates led to market volatility. Japan is an important country due to the size of its financial system and higher rates were a catalyst for a rally in the yen and unwinding of investor positioning across a range of risk assets. The Japanese stock market fell 12% in one day, the worst day since 1987. Other risk assets such as Emerging Market currencies and high-flying Technology stocks also suffered. The outperformance of large Technology-orientated companies had been a strong

12%

The percentage that the Japanese stock market fell in one day.

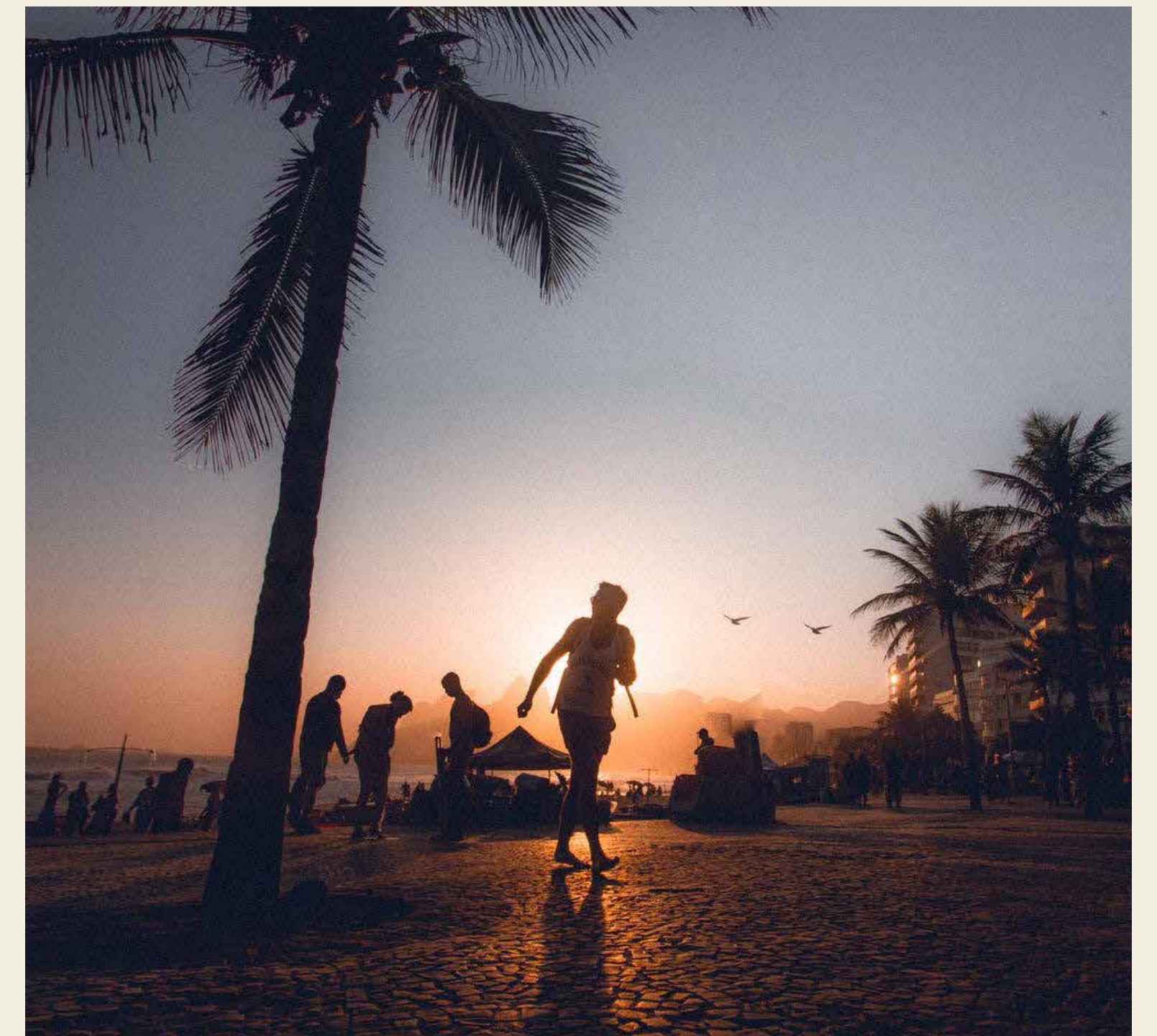




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market theme helped by strong earnings growth. It has been thought that these companies have earnings that are more resilient to the economic cycle. The exposure to structural growth areas such as could computing, AI and a shift to digital advertising have helped these companies grow earnings through the cycle.

US politics was also in focus during July following a poor debate performance by President Biden. He has since pulled out of the Presidential race and Vice President Kamala Harris has secured the Democratic nomination, changing the calculus of the US election. However, for the time being at least, economic factors will be more important for financial markets than domestic politics.

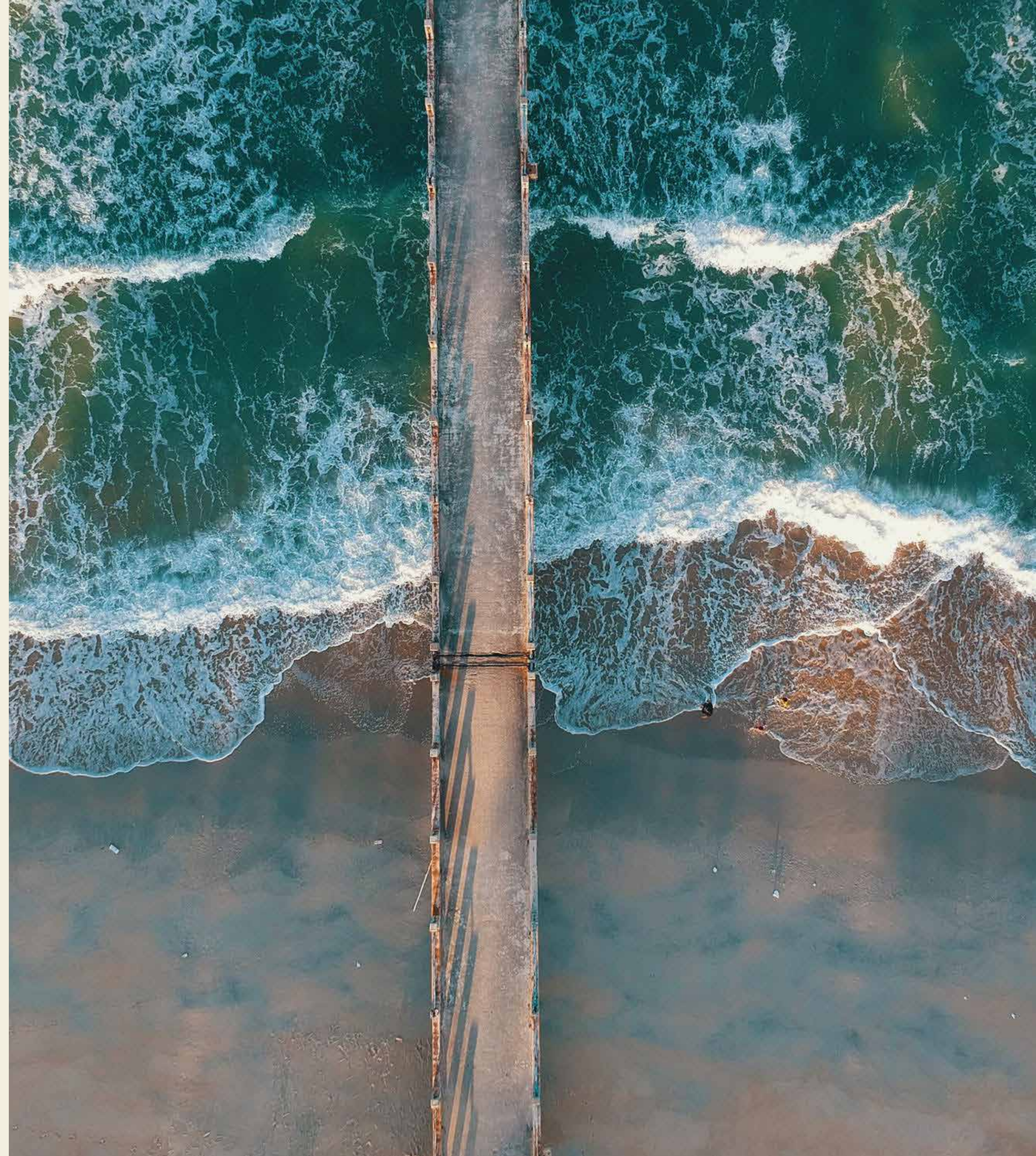


Japan Rocks the Boat

- Mixed economic data but bias is negative
- Credit resilient in volatile markets
- Inflation protection is attractively priced

Liquidity during the summer months is always light. As a result, the macro-economic news flow can have a disproportionate impact on financial markets because trading desks are less well-staffed than usual with people on vacation. This period of negative seasonality has coincided with the build-up to the US election and it's unlikely that markets will remain subdued even when the holidays are over.

Economic data releases across all major regions, bar the United Kingdom, came in weaker. This prompted the market to price in further easing cycles across the developed world. Despite firming economic data, the Bank of England cut rates by 25 basis points in early August and the US Federal Reserve will likely follow by



the same degree in September. This follows similar moves earlier in the year by Canada and the European Central Bank (where prices have recently trended higher again).

Rising odds of imminent rate cuts led to substantial declines in global bond yields, with the 10-year US Treasury falling 43bps to 4.03%. There were smaller, but still meaningful, moves lower in all G10 government bond yields apart from Japan. Expectations for lower growth also prompted a move lower in copper and oil prices, with inflation expectations following suit as 2 and 5-year US inflation breakevens declined to below the US inflation target. Declines in benchmark interest rates also drove a decline in 30-year fixed US mortgage rates to 6.4%, leading to declines in mortgage spreads even though fixed income volatility rose.

In a month overloaded with headline acts, the grand finale was the Bank of Japan which unexpectedly raised their base rates to 0.25% and halved the size of their quantitative easing program. Whilst this move seems trivial relative to the multiple interest rate hikes we have seen in the US, the signal effect for financial markets was substantial. The Japanese yen was the most favoured component of the 'carry trade', where investors borrow at cheap rates in yen and then invest in higher yielding assets and/or equities abroad. This spooked markets, with the yen rallying to below 150 versus the US dollar, as shorts were closed out (investors bought yen). Given complicated global linkages, risk assets suffered globally.

Credit spreads widened in July but only marginally. Average investment grade corporates only cheapened by 7bps and US high yield 16bps; almost a rounding error in the context of the more aggressive declines in US technology and Japanese equities. As a result, and with global growth showing signs of slowing, we find little reason to risk capital at this time and prefer to maintain a

43bps

Indicates the fall of the
10-year US Treasury.

defensive portfolio tilt. However, the moves lower in US inflation protected securities have provided an opportunity to lock in a hedge that would benefit from better-than-expected growth and the geopolitical tensions in the Middle East.

With close to 200bps in US base rate cuts now fully priced into bond yields, financial conditions have eased and, as we saw in the first quarter after the Federal Reserve's December pivot, the economy is likely to receive a boost to sentiment and confidence. US nominal growth, according to the Atlanta and Cleveland Federal Reserve banks, still remains above 5% and for market pricing to be validated economic data needs to weaken substantially over the remainder of 2024. Due to these moves, we are taking some gains in short dated bonds and adding to cash, very short dated securities and (for multi-currency accounts) adding to government bonds in Canada, Sweden and the UK where duration dynamics are more favourable.



The Great Rotation

- Small cap stocks rally
- Technology-related earnings exceptionalism fading
- Consumers feeling the pinch

July was not a quiet month. A weaker than expected CPI print on July 11 was the first data point to surprise investors. With inflation somewhat conquered and increased confidence that the Federal Reserve would start cutting interest rates, the great rotation commenced. The Russell 2000 index printed the best weekly return versus the S&P 500 on record. Large market capitalisation technology stocks lagged, the equal-weight S&P 500 outperformed the S&P 500, and value beat growth. The prospect of a lower interest rate environment was not the only driving force. Steady economic growth data; the increased probability of a US Republican sweep at that time and a renewed focus on the converging earnings growth rate of the S&P 500 versus that of the equal weight S&P 500, acted as a catalyst. Small capitalisation stocks tend to be sensitive to US economic growth, which is why



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the prospect of interest rate cuts and a Republican sweep drove the Russell 2000 higher. Smaller companies tend to benefit more from lower interest rates, as 30% of Russell 2000 companies' outstanding debt is floating rate.

The S&P 500's earnings growth trajectory has recently been meaningfully higher than that of the equal-weight S&P 500. This has largely been due to the stratospheric revenue growth achieved by some of the large market capitalisation technology companies, such as Nvidia. The estimated growth rates are now converging, with the earnings growth differential in 2024 expected to be 5%, but decreasing to closer to 0% for the following two years. Despite this, there is a wide valuation gap between the two indices, with the S&P 500 trading at 20x blended forward earnings and the equal-weight S&P 500 trading at 16x blended forward earnings. The rotation has helped partially narrow this gap and the rally we have seen this year to some degree is now broader and appears to be healthier, however the valuation discrepancy still remains on investors' minds.

The second data point which surprised investors was the weaker than expected July jobs report. This, coupled with mixed large market capitalisation technology earnings, a weakening US consumer, the Bank of Japan increasing interest rates, and the escalating conflict in the Middle East, culminated in a three-day stock sell-off which saw the S&P 500 down 6%. The sell-off was exacerbated by leverage, crowding, and poor liquidity, which further pressured large market capitalisation technology stocks. The Russell 2000 reversed and this time underperformed as the fear of a recession outweighed the potential benefits of a lower interest rate environment. The yield curve moved sharply, pricing in more interest rate cuts, with the latest count just over four 25 basis points cuts this year.

July also saw the majority of the S&P 500 companies report second quarter earnings. Overall, companies kept on beating expectations. However, aggregate sales surprised by only 0.7%,

6%

The percentage that the S&P 500 fell in a three day period.

which is below the 1.9% average recorded for the last two years. Aggregate earnings-per-share surprised by only 4.1%, the lowest reading since the fourth quarter 2022. The key takeaway from this earnings season, in our opinion, is the weakening consumer. We saw downbeat commentary from US companies like PepsiCo and Home Depot, with McDonald's introducing a \$5 meal deal, and KFC expanding its \$5 value menu to capture more diners. European airlines have also talked about a softer second half. Ryanair warned that consumers were becoming more cautious, while Wizz Air recently introduced an all you can fly plan for €499 annually to try to entice customers. US companies selling into China, such as Nike and Starbucks, as well as European luxury brands such as LVMH, highlighted a challenging Chinese market. The weakening consumer story was flagged in the last two quarters but this time it appears to be broader based and for this reason we remain underweight the Consumer Discretionary sector.



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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	EQUITIES (MODEST UNDERWEIGHT) \$	CASH (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT INFLATION PROTECTION
Equities Regional		JAPAN EMERGING MARKETS EX CHINA
Equities Sector	CONSUMER DISCRETIONARY UTILITIES	ENERGY HEALTHCARE

