HYMANS ROBERTSON

Capital Markets Update

Autumn 2024

Ongoing disinflation paved the way for interest-rate cuts from the major central banks in the third quarter (Q3). These buoyed hopes of a soft economic landing, against a backdrop of slowing, but still solid, global growth.

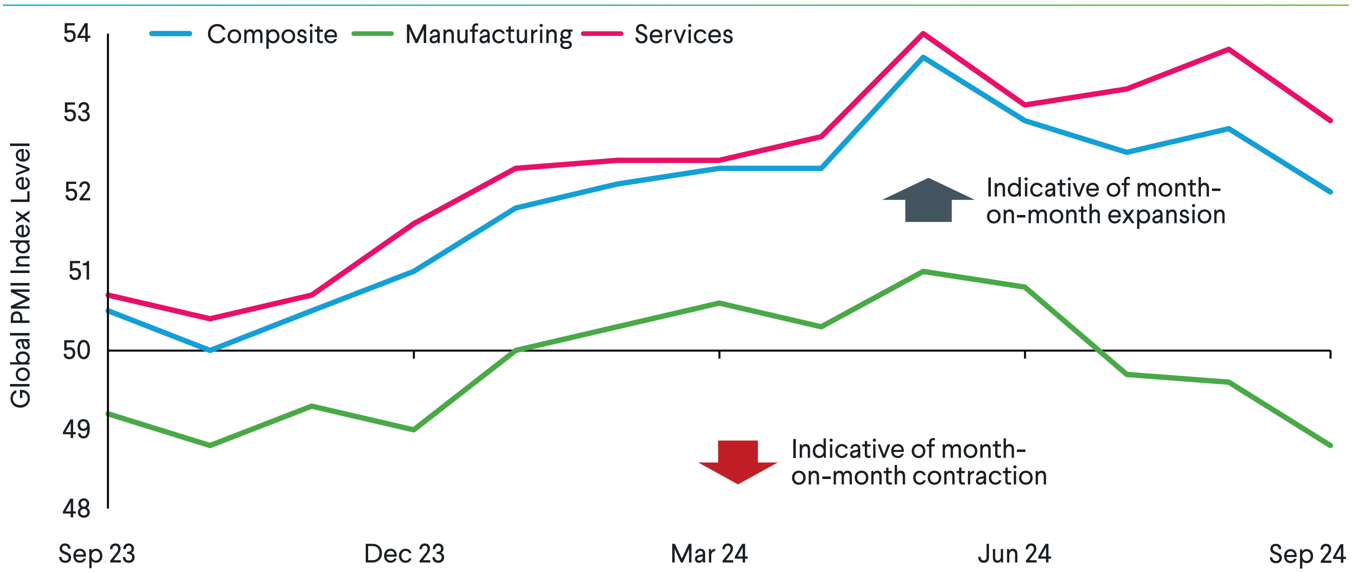
Both bonds and equities managed to produce positive returns in Q3, shaking off early-August volatility, as interest-rate cuts eased recessionary concerns and supported sentiment.

Global themes

Concerns that the US might be entering recession look unfounded, and recent data point to a more orderly and benign growth slowdown. Indeed, US Q2 GDP growth was stronger than expected. The rise in the unemployment rate was largely due to jobs growth being insufficient to absorb the increase in labour supply, as opposed to being driven by widespread layoffs. The housing and manufacturing sectors were weak, but should benefit the most from lower interest rates.

Economic data has been disappointing in the major advanced economies, prompting a re-emergence of recession fears in Q3. However, these data tend to be heavily weighted towards the industrial side of the economy, despite this accounting for a relatively small share of output, with less weight given to the more dominant services sector. This helps explain how, even as economic data have fallen short of expectations, growth forecasts rose over Q3. Following 2023's 2.7% expansion, global GDP is forecast to rise by a further 2.6% in 2024 and 2.5% in 2025.

Chart 1: survey data support forecasts of slowing, but still solid, global growth in the near term



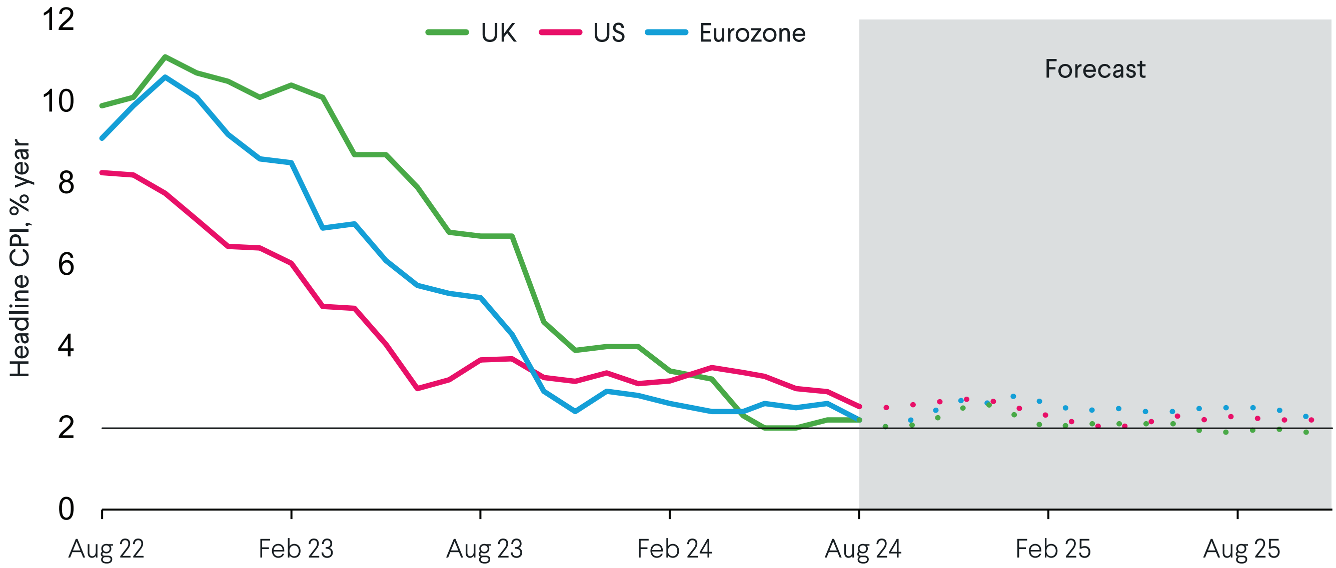
Source: Bloomberg

J.P. Morgan's Global Composite Purchasing Managers' Index, which aggregates activity across the global manufacturing and service sectors, suggests the pace of global growth eased at the end of Q3 (Chart 1). The index still indicates solid global growth, but a broad-based loss of momentum across regions and widening disparity between sectors raises some concerns. Service sector business activity rose for the twentieth consecutive month in September, albeit at a slightly reduced pace, while manufacturing production decreased for the first time since December 2023 following a third month-on-month decrease in new orders. Marked divergence was also evident among the major economies in September. The US, Japan, and UK all expanded at solid rates, while data suggest the more manufacturing- and export-oriented eurozone economy contracted at the end of Q3. Amid ongoing property-market weakness, which continues to weigh on private investment and investor confidence, Chinese activity showed signs of stalling at the end of Q3. However, global employment stabilised in September, having fallen in August, providing some relief from recent labour market worries.

US headline CPI inflation fell more than expected in August to 2.5% year on year, while equivalent UK and eurozone inflation, at 2.2% in both regions, was largely in line with expectations (Chart 2). While inflation developments leave scope for central banks to lower interest rates, some factors still point to the pace of cuts being quite gradual:

- core remains above headline inflation, at 3.2%, 3.5%, and 2.8% in the US, UK, and Europe, respectively
- wage growth is still elevated across the major advanced economies
- business surveys point to a recent reacceleration in input cost inflation in the labour-intensive service sector.

Chart 2: Inflation is expected to remain close to, but slightly above, major central bank targets



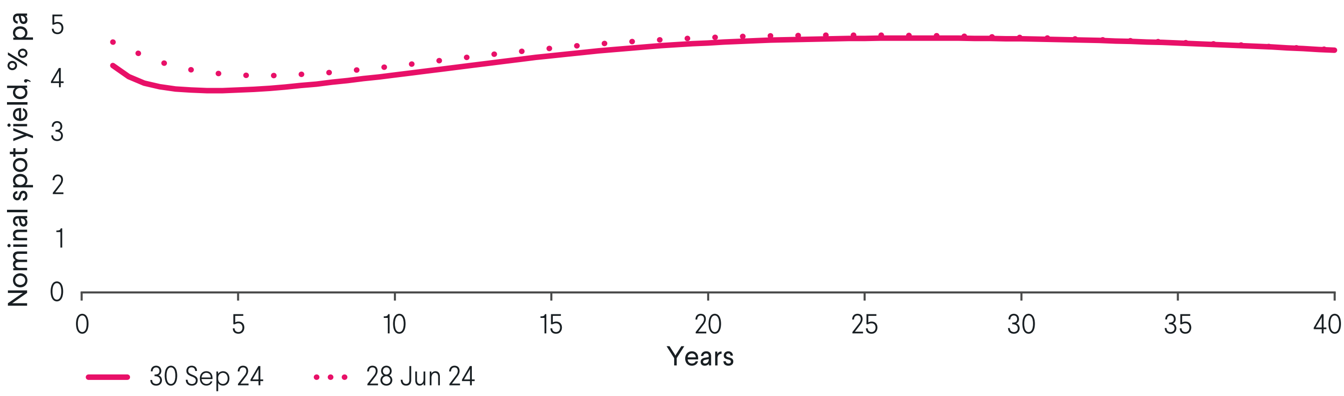
Source: Datastream and Consensus Economics

As of September 30, markets were pricing in an additional 50 basis points (bps) of cuts from the US Federal Reserve in 2024, followed by a further 135bps in 2025. This would reduce the US Fed Funds rate to 3.0% pa, and implies a relatively aggressive pace of interest-rate cuts. Given signs of stubbornness in underlying inflation, a slightly more gradual reduction in UK interest rates is expected. In the absence of a more pronounced slowdown, the likely extent of near-term interest-rate cuts looked fully priced by the end of Q3.

Government bonds

UK gilt yields fell in Q3, as the Bank of England cut interest rates and markets priced in more to come. As a result, the front end of the curve now looks reasonably priced, but longer-term yields remain relatively attractive (Chart 3). Furthermore, gilt yields have risen in early Q4, amid a rise in global yields following better-than expected US jobs data, and as some market jitters ahead of the UK's autumn budget start to creep in. While market-implied inflation eased in Q3, it still looks expensive relative to our estimate of fair value, reinforcing our preference for conventional over index-linked gilts.

Chart 3: Longer-term gilt yields remain relatively attractive



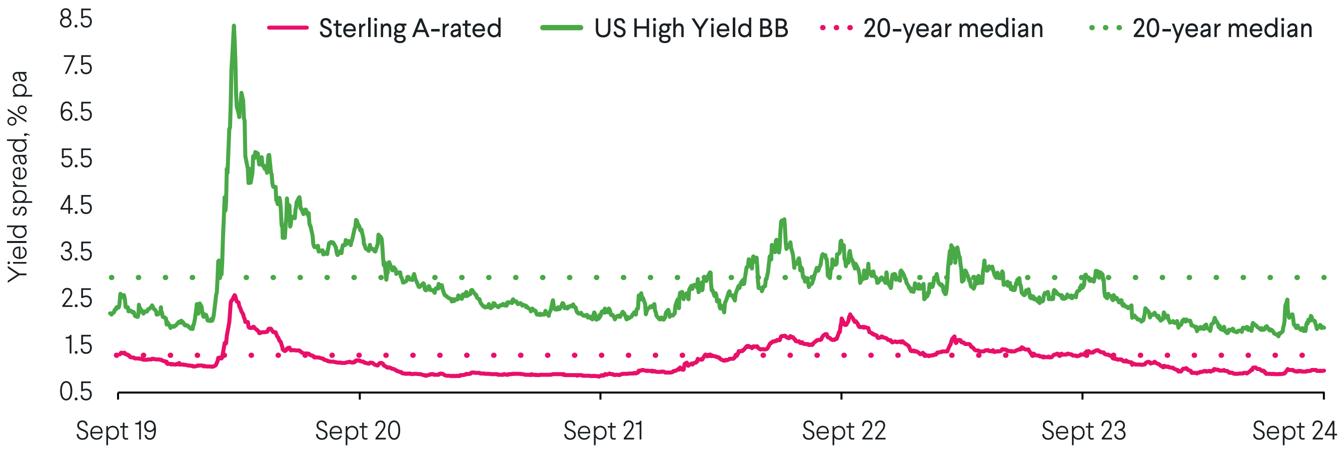
Source: Bank of England

Demand for gilts has improved, as foreign investors and financial institutions have increased their holdings, and bid-offer spreads, or the costs of trading gilts, have normalised. However, heavy supply is likely to prevent long-term yields from falling too far, and the autumn budget poses a further upside risk to gilt supply. The prospect of changes to debt definitions to allow more borrowing to fund investment is a welcome development, but the government still has to maintain market confidence. We see scope for heightened gilt-market volatility around the budget, but expect the government to proceed cautiously. Policymakers are likely to only use a portion of the headroom created by changes to debt definitions, and we expect the key fiscal rules to be maintained, with medium-term tax rises helping to balance day-to-day spending.

Credit

Credit spreads rose amid equity market volatility in early August but regained their poise to end the quarter slightly tighter. Moreover, spreads remain very low relative to historic averages in both investment- and speculative-grade fixed interest markets (Chart 4). While interest coverage, or the number of times earnings cover debt interest – a key debt affordability metric – has fallen from post-pandemic highs and is likely to come under further pressure as debt is refinanced and effective interest rates move higher, it is relatively healthy in both investment- and speculative-grade credit markets. As a result, the major credit rating agencies expect the global speculative-grade default rate to fall below long-term averages over the next 12 months. Amid strong yield-driven demand, credit spreads already reflect the very benign default environment. While the dramatic rise in yields over the past few years might have enhanced the strategic role of fixed income credit, very tight spreads would still see us adopt an underweight position relative to strategic benchmark

Chart 4: Credit spreads are low versus historic averages, particularly in high-yield bond markets



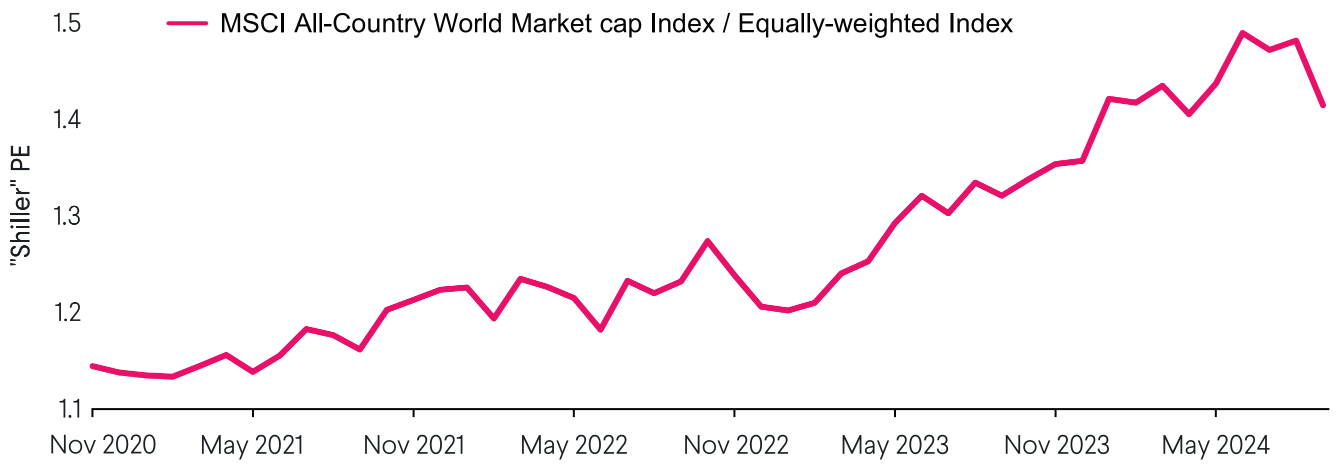
Source: ICE Index Platform

Affordability metrics in the floating-rate loan markets are much weaker, and defaults higher. As a result, spreads in the loan market, around long-term median levels, are less tight than those on similarly rated high-yield bonds. Having said that, loan market fundamentals, having instantly absorbed rate rises, will now be seeing some relief from interest-rate cuts. Or, in contrast to high-yield bond markets, loan affordability metrics will be improving, more quickly, from a relatively weak position.

Equities

Global equities fell sharply in early August, following the release of some disappointing US economic data and an unexpected rate increase from the Bank of Japan, before rallying to produce decent positive returns. Emerging markets notched up the strongest regional performance in Q3, as Chinese policymakers delivered a raft of monetary and fiscal stimulus to combat subdued activity and address deflation concerns. Japan was the only developed-market index to end the quarter in the red, due to the yen's strength and the subsequent unwinding of yen carry trades. The equity market rally broadened in Q3, with 'value' stocks outperforming 'growth' and small caps outperforming large-cap stocks, as investors anticipated the benefits of lower interest rates.

Chart 5: High index-level valuations mask wide dispersion within the equity market



Source: Datastream

A large rise in stock prices since the beginning of the year has taken the global equity price-to-earnings ratio above long-term averages, while above-trend earnings mean cyclically adjusted valuations are even higher. However, although valuations are elevated, there is wide dispersion within markets.

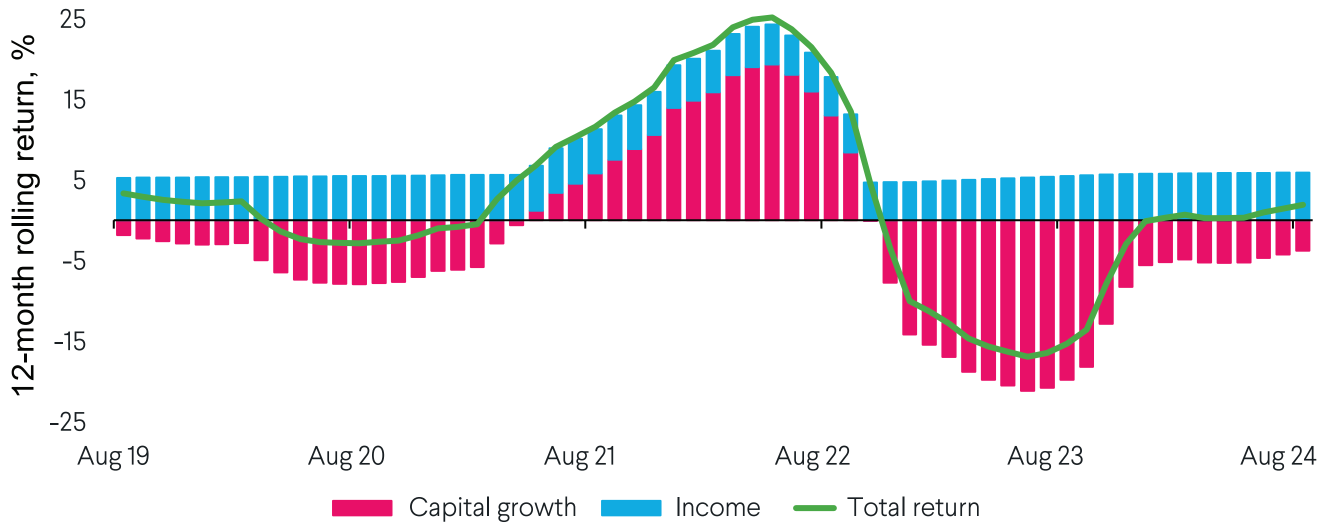
Given the relatively narrow market leadership and rising concentration of the last few years, the market-cap-weighted global index trades at around a 40% premium to the equally weighted equivalent, despite Q3's rotation in leadership (Chart 5). Similar disparity in valuations can be seen between growth and value, as well as large versus small-cap stocks. Given their higher debt loads and lower interest-coverage ratios, small caps stand to disproportionately benefit from interest-rate cuts, which could sustain further equity-market gains, provided the earnings outlook is intact. Despite recession fears due to downside economic surprises in Q3, full-year earnings per share growth forecasts for 2024 and 2025 were little changed over Q3, standing at a robust 9.3% and 13.3%, respectively.

Property

The 12-month total return of the MSCI UK Property Total Return Index has risen as capital value declines are increasingly offset by more reliable income returns (Chart 6). In the 12 months to end-August, the total return index rose 1.9% as income more than offset a 3.8% fall in aggregate capital values. Monthly capital values continued to decline in the office sector, which faces structurally higher vacancy rates, though the pace of decline has moderated in recent months. Meanwhile, capital values have stabilised in the industrial and retail sectors.

Real rental growth, one of the key fundamental metrics we track, has now been positive for seven months, given strong nominal rental growth and UK CPI inflation that is only modestly above target. Furthermore, the latest Royal Institute of Chartered Surveyors survey suggests rising rents, alongside greater occupier demand and increasing capital-value

Chart 6: Annual returns have risen as income increasingly offsets slowing capital value declines



Source: MSCI IPD UK Monthly Property Index

expectations. The survey indicates that the market, in aggregate, is near the bottom of the cycle or in the early stages of an upturn. Ultimately, the continued improvement in the fundamental indicators we track for UK commercial property, alongside undemanding valuations, makes us less cautious on the asset class. But the technical picture is marred by selling pressure from open-ended property funds, which continue to work through redemption queues.

Conclusion

Concerns that the US might be entering recession look unfounded and recent data are consistent with a more orderly and benign slowdown in growth. The housing and manufacturing sectors are still weak spots, but they should benefit the most from lower interest rates. Resilient growth, falling inflation and the prospect of a steady and sustained pace of interest-rate cuts provide a reasonably positive backdrop for 'risk' assets.

Further equity-market gains may be tempered by elevated valuation multiples, though we acknowledge the wide dispersion within markets. The sectors most affected by high interest rates look much cheaper and likely to benefit most from interest-rate cuts.

The likely pace of near-term interest-rate cuts looks well embedded in the bond markets. However, we do still see an attraction in longer-term gilt yields, particular nominal gilts, even if the scope for volatility is high ahead of the UK autumn budget.

Debt affordability metrics in fixed-rate credit markets are likely to come under further pressure, but both leverage and interest coverage are starting from relatively healthy levels. Affordability metrics in the floating-rate loan markets are much weaker, and defaults higher, but these will already be experiencing some relief from interest-rate cuts. While the dramatic rise in yields over the past few years has enhanced the strategic role of fixed-rate corporate credit, very low spreads would still see us adopt an underweight position relative to the benchmark.

An ongoing improvement in UK commercial property market fundamentals, alongside undemanding valuations, sees us adopt a more positive view of the asset class, despite a still-weak technical backdrop.

We are overweight government bonds and cash, both of which could be used to exploit more attractive entry points in risk assets, should volatility increase. Tight spreads keep us underweight credit, while we are more neutral on equity and property markets: high valuations still have scope to undermine the former, while a weak technical picture might weigh on the latter.

Chris Arcari

Head of Capital Markets

chris.arcari@hymans.co.uk

0141 566 7986