HYMANS ROBERTSON

Market Brief

Quarter 1, 2024

Q1 highlights

- Backward-looking GDP data releases showed the US economy was surprisingly robust at the end of 2023.
- That said, flash composite purchasing managers' indices (PMIs) suggest the worst may be over in Europe, as UK output expanded for the fifth consecutive month in March and the eurozone economy stabilised.
- At a global level, survey data suggest growth improved at the start of 2024, as the JP Morgan Global Composite PMI rose to an eight-month high in February.
- US inflation came in above expectations in January and February.
- Markets dramatically scaled back their expectations of the timing and size of interest-rate cuts in 2024, due to stronger US growth than expected, improving global growth momentum and signs the downtrend in inflation is slowing.
- But economic optimism and AI enthusiasm offset expectations of slower rate cuts, as equities recorded their best first quarter in five years and credit spreads fell, despite significant rises in sovereign bond yields.
- Gold prices rose 7.2% amid lingering inflation concerns, heightened geopolitical tensions and strong demand among central banks and Chinese consumers. Oil prices rose 12.5% against a backdrop of ongoing supply cuts and conflict in the Middle East.
- The trade-weighted US dollar rose around 2%, as the prospect of a sharp fall in interest rates faded. The Japanese yen fell almost 5% in trade-weighted terms.

Market performance to end March 2024

UK	Q1 24*	Q4 23	2024
EQUITIES	3.6	3.2	3.6
BONDS			
Conventional gilts	-1.6	8.1	-1.6
Index-linked gilts	-1.8	8.7	-1.8
Credit	0.1	7.3	0.1
PROPERTY**	0.3	-1.2	0.3
STERLING			
v US dollar	-0.9	4.4	-0.9
v Euro	1.4	0.1	1.4
v Japanese yen	6.4	-1.3	6.4

GLOBAL	Q1 24*	Q4 23	2024
EQUITIES	9.5	9.3	9.5
North America	10.2	11.8	10.2
Europe ex UK	9.5	6.9	9.5
Japan	18.7	1.9	18.7
Dev. Asia ex Japan	3.2	7.7	3.2
Emerging Markets	4.1	5.0	4.1
GOVERNMENT BONDS	0.2	5.3	0.2
High Yield	2.0	6.6	2.0
Gold	7.2	11.2	7.2
Oil	12.5	-18.6	12.5

Percentage returns in local currency ($ for gold and oil). All returns to 29/03/2024, *apart from property 29/02/2024
Source: DataStream and Bloomberg. FTSE Indices shown: All Share, All World, W North America , AW Developed Europe ex-UK, W Japan, AW Developed Asia Pacific ex-Japan, Emerging, Fixed Gilts All Stocks, Index-Linked Gilts All Maturities, iBoxx Non-Gilts, S&P GSCI Light Energy, Crude Oil BFO, ICE BofA Global High Yield, Gold Bullion LBM, MSCI UK Monthly Property and BBG Aggregate Government Total Return.

Fixed income markets

£ UNITED KINGDOM
UK 10-year bond yields rose by 0.4% pa to 3.9%

$ UNITED STATES
US 10-year bond yields rose by 0.3% pa to 4.2%

¥ JAPAN
Japanese yields rose by a modest 0.1% pa to 0.7%

€ GERMANY
German yields rose 0.3% pa to 2.3% pa

Sovereign bond yields rose significantly

Amid expectations that interest rates might be cut less than previously anticipated, sovereign bond yields rose sharply in quarter one. UK and US 10-year bond yields rose 0.4% pa and 0.3% pa to 3.9% pa and 4.2% pa, respectively, while equivalent German yields rose 0.3% pa to 2.3% pa. Despite the Bank of Japan raising rates and ending yield curve control, Japanese yields rose by a modest 0.1% pa, to 0.7% pa. This is perhaps due to expectations that monetary policy will remain accommodative regardless, and the Bank of Japan suggesting that it will act to prevent a disorderly rise in yields.

Credit spreads fell towards post-pandemic lows

Credit spreads fell sharply across regions and credit ratings over Q1, reflecting the improved outlook, but strong yield-driven demand from institutional investors also played a part. Sterling and European investment-grade credit spreads fell 0.2% pa to 1.1% pa, while equivalent US spreads fell 0.1% to 0.9% pa. Speculative grade spreads fell more, with European spreads narrowing 0.4% pa to 3.5% pa and equivalent US spreads coming down 0.2% pa to 3.1% pa. Despite spread tightening, sterling investment-grade total returns were broadly flat, given the rise in underlying sovereign bond yields. Speculative-grade credit markets outperformed, with US high yield producing a total return of 1.5%. This reflects both greater spread tightening and lower interest-rate sensitivity, given the shorter duration, in speculative-grade markets.

Inflation expectations edged higher

UK 10-year implied inflation, as measured by the difference between conventional and inflation-linked bonds of the same maturity, rose 0.2% pa, to 3.6% pa, as nominal yields rose more than real yields. Equivalent US implied inflation rose by the same amount, to 2.4% pa, while German implied inflation rose 0.1% pa, to 2.1% pa.

Moody's expects defaults to fall

Moody's predicts that the current 12-month speculative-grade default rate of 5.0% will mark the current cycle's peak. With global growth expected to stabilise at only modestly lower levels in 2024 and the prospect of interest-rate cuts on the horizon, it forecasts that the default rate will decline to 3.5% by the end of 2024, below long-term averages. The forecast is underpinned by healthy corporate balance sheets, limited near-term refinancing requirements and anticipated easing in financial conditions.

Hard- outperforms local-currency debt as spread tightening offsets a rise in yields

Despite a rise in underlying treasury yields, hard-currency emerging market debt, as measured by the JPM EMBI Global Diversified Index, returned 2.0% in dollar terms as credit spreads fell 0.5% pa. Local-currency debt, as measured by the JPM GBI-EM Global Diversified Traded Index, returned -2.1% in US dollar terms as yields rose modestly and index currencies, in aggregate, weakened against the dollar.

Global equities

Mixed sectoral pattern with technology outperforming

Global equities recorded their best first quarter in five years, with the FTSE All World Total Return Index rising 9.5% in local-currency terms, as optimism about the US economy and AI enthusiasm offset expectations of slower rate cuts. Technology stocks notably outperformed as massive earnings-beats by some high-profile US technology companies benefited the sector more broadly. Also outperforming, but to a much lesser extent, were cyclical sectors, such as financials, energy and industrials (in that order). Basic materials was the worst-performing sector, which some commentators suggest is linked to concerns about slowing demand for, and the over-supply of, electric vehicles. This has led to falls in the prices of some industrial metals, such as lithium. Outside basic materials, the main underperformers were defensive sectors, such as consumer staples, utilities, telecoms and healthcare (in that order) which tend to underperform in strong positive markets.

Japanese outperformance continues

Japan strongly outperformed over the quarter. Further yen weakness lent support to the export-heavy index, and rising prices for domestic chip-related stocks and growing enthusiasm around corporate governance reforms led Japanese equities 18.7% higher. Given its large, above-average exposure to the technology sector, US equities outperformed, but to a lesser extent. While European equities continued to lag the US and Japan, they marginally outperformed over the quarter.

UK and emerging stocks lag

Emerging markets underperformed as investors remained concerned about China's growth prospects amid ongoing property market weakness and disappointment with policy stimulus unveiled so far. The UK was the worst-performing region over the first quarter. Having very little exposure to the outperforming technology sector, and above-average exposure to consumer staples and basic materials, weighed on performance, but economic weakness contributed to UK-listed companies underperforming global peers across almost all sectors.

Currencies, commodities and property

Gold prices rose 7.2% amid lingering inflation concerns, heightened geopolitical tensions, and strong demand among central banks and Chinese consumers. Oil prices rose 12.5% against a backdrop of ongoing supply cuts and conflict in the Middle East. The trade-weighted US dollar rose around 2%, as the prospect of a sharp fall in interest rates faded. The Japanese yen fell almost 5% in trade-weighted terms. While the Bank of Japan exited negative interest rates in March, monetary policy remains comparatively accommodative, and markets continue to bet on a wide interest-rate differential between Japan and its major developed market peers.

The MSCI UK Monthly Property Total Return Index rose 0.3% in the first two months of 2024, despite a 0.7% decline in capital values, in aggregate. The 12-month total return to end-February was 0.7%, as income offset a 4.9% fall in capital values. Over 12 months, capital values fell most steeply in the office sector, declining 16.5%, compared with a 5.1% fall in the retail values and a 1.5% rise in industrial values. While values continue to fall in the office sector month on month, the pace of decline in the MSCI UK Monthly Property Capital Value Index, which is now almost 26% below its June 2022 peak, has slowed in recent months.

The global economy

Data released in the first quarter revealed that the US economy grew more quickly than previously envisaged, at an annualised quarterly pace of 3.4% in the final quarter of 2023, amid ongoing resilience in consumer spending. Meanwhile, European data showed the UK entered a technical recession, as GDP fell 0.3% in Q4 following a 0.1% contraction in Q3, and the eurozone economy flirted with one, after stagnating in Q4. The Japanese economy also narrowly escaped recession, eking out a 0.1% expansion in Q4, following a 0.8% contraction in Q3.

But survey data suggested that the worst may already be over in Europe. Flash PMIs indicate that UK output rose at a solid pace for the fifth consecutive month in March. Meanwhile, the eurozone economy stabilised as a modest recovery in service sector output gained momentum and the pace of decline in manufacturing output eased. Flash data also suggested that US business activity increased further at the end of Q1 amid a marked upturn in manufacturing production. March data added to evidence that global growth improved at the start of 2024 and also suggested the expansion is becoming more broad-based. A sustained increase in service-sector activity was accompanied by signs that a nascent recovery in global manufacturing activity is gaining traction.

Backward-looking GDP data and coincident survey data pointed to an economy with much stronger momentum than previously anticipated: consensus forecasts for year-on-year US GDP growth in 2024 jumped from 1.4% in January to 2.2% in March. At the same time, global growth forecasts for 2024 have been revised up to 2.4%. While European and UK forecasts are much weaker, the majority of economists think the worst of the downturn in Europe is in the rear-view mirror and expect the majority of economies in the region to recover, albeit weakly, in 2024. Indeed, much better-than-expected survey data suggest the UK recession is already over and point to decent growth in Q1.

Surveys suggest that better activity data have been accompanied by a reacceleration in customer prices in both the manufacturing and services sectors in recent months. Indeed, an unexpected rise in year-on-year US headline CPI inflation, to 3.2% year on year in February, further fuelled fears that the downtrend in inflation is slowing. Equivalent UK and eurozone measures, however, eased to 3.4% and 2.6%, respectively. The equivalent core measures, which exclude volatile energy and food prices, came in at 3.8%, 4.5% and 3.1% in the US, UK and eurozone, respectively. Not only is UK core inflation still more than double the Bank of England's target, but elevated services and wage inflation, both running at 6.1% year on year, highlight persistence in underlying price pressures.

Amid better-than-expected economic data and sticky inflation data, markets have scaled back expectations for the timing and number of interest-rate cuts in 2024. At the end of Q1, markets expect two to three cuts from the major central banks in 2024 down from six to seven at the start of the year. The recent shift brings markets more closely in line with the banks' more cautious messaging as to the likely timing and extend of interest-rate cuts. In March, the Bank of Japan (BoJ) raised rates for the first time in 17 years, from minus 0.1% pa to a still accommodative 0.0–0.1% pa. Inflation has exceeded the BoJ's target for 22 months and data from annual wage negotiations bolstered the case. The BoJ also stopped yield-curve control and exchange-traded fund purchases.

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