HYMANS ROBERTSON

Market brief

September 2024

QUARTERLY HIGHLIGHTS

- Yields on sovereign bonds fell and prices rose in the third quarter (Q3). This was due to falling inflation and interest-rate cuts from the Bank of England (BoE), European Central Bank (ECB) and US Federal Reserve.
- Global equities fell sharply in early August, following the release of some disappointing US economic data and an unexpected BoJ rate increase, before rallying to produce decent positive returns. Interest-rate cuts against a backdrop of slowing, but solid, growth and falling inflation, buoyed hopes of a soft economic landing.
- 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.
- Emerging markets notched up the strongest regional performance in Q3, as Chinese policymakers delivered a raft of monetary and fiscal stimulus. 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.
- Credit spreads rose amid the early-August market volatility, but credit markets regained their poise to end the quarter a little tighter.
- The trade-weighted Japanese yen rose 8.7% in Q3 as the BoJ unexpectedly raised interest rates, while the equivalent US dollar measure fell around 2.7% as market-implied interest rates fell. Sterling gained 3% as signs of stubbornness in underlying inflation pointed to a more modest pace of interest-rate cuts than elsewhere .
- Despite rising tensions in the Middle East, oil prices fell 16.8% in Q3 as renewed softness in global manufacturing activity, slowing US growth and Chinese property market weakness weighed on demand.
- Gold prices continued their ascent, rising 13.2%, as interest-rate cuts and geopolitical tensions lent support.

Market performance to end September 2024

UK	Q3 24	Q2 24	2024
EQUITIES	2.3	3.7	9.9
BONDS			
Conventional gilts	2.3	-0.9	-0.2
Index-linked gilts	1.4	-2.1	-2.5
Credit	2.3	-0.1	2.2
PROPERTY**	1.0	1.7	3.4
STERLING			
v US dollar	6.1	0.1	5.2
v euro	1.9	0.8	4.1
v Japanese yen	-5.6	6.4	6.8

GLOBAL	Q3 24	Q2 24	2024
EQUITIES	5.1	3.5	19.1
North America	6.2	3.9	21.6
Europe ex UK	1.7	0.6	12.0
Japan	-5.0	1.4	14.4
Asia Pacific ex-Japan	8.3	6.3	20.3
Emerging Markets	9.7	6.9	22.0
GOVERNMENT BONDS	3.8	-0.9	2.1
High Yield	4.9	1.4	8.4
Gold	13.2	5.1	27.5
Oil	-16.8	-1.1	-7.4

Percentage returns in local currency ($ for gold and oil). All returns to 30/09/2024, *apart from property 31/08/2024
Source: DataStream and Bloomberg. FTSE Indices shown: All Share, All World, North America, AW Developed Europe ex-UK, Japan, 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

Sovereign bond yields fell as inflation and interest-rate expectations eased

US 10-year Treasury yields fell significantly by 0.6% pa to 3.8% pa, as inflation and interest-rate expectations eased and the Fed delivered its first interest-rate cut of the cycle – larger than usual at 0.5% pa. Equivalent German yields fell by 0.4% pa to 2.1% pa, as growth and inflation releases both came in lower than expected. UK 10-year gilts underperformed, declining by 0.2% pa to 4.1% pa, as stubborn wage and core inflation made the BoE more equivocal about the pace of future interest-rate cuts. Despite the surprise increase in Japanese interest rates, equivalent Japanese yields fell 0.2% pa to 0.9% pa, as the BoJ rowed back from its earlier hawkish comments.

UK 10-year implied inflation, as measured by the difference between conventional and inflation-linked bonds of the same maturity, eased by 0.2% pa to 3.3% pa, while the equivalent US measure fell 0.1% pa to 2.2% pa. Eurozone implied inflation fell more, by 0.3% pa to a below-target level of 1.7% pa.

Credit spreads generally tightened

Credit spreads rose amid equity market volatility in early August, but regained their poise to end the quarter slightly tighter. Global investment-grade credit spreads fell marginally, then remained at a relatively low level versus history at 1.0% pa. Equivalent speculative-grade credit spreads, which rose as much as 0.6% pa above end-June levels in early August, ended the quarter 0.2% pa lower at 3.3% pa – a low historic level. Tighter credit spreads likely reflect both strong yield-driven demand and benign default forecasts (consistent with a soft economic landing) made by the major credit rating agencies.

Falling yields and a weaker dollar drove strong returns from emerging market debt

Hard-currency debt, as measured by the J.P. Morgan EMBI Global Diversified Index, returned 6.2% pa in dollar terms, as a fall in US Treasury yields alongside a 0.3% pa decline in hard-currency spreads supplemented income. Local-currency emerging market debt, as measured by the J.P. Morgan GBI-EM Global Diversified Traded Index, returned 9.0% pa in dollar terms, as yields fell and index currencies, in aggregate, strengthened almost 5% against the US dollar.

Global equities

Value outperformed growth and small-cap outperformed large-cap stocks

Global equities fell sharply at the beginning of August. Despite this, global equities bounced back and the FTSE All World Total Return Index finished the quarter up 5.1% in local-currency terms. Interest-rate cuts against a backdrop of slowing, but solid, growth and falling inflation, buoyed hopes of a soft landing for the global economy.

We saw a notable reversal in equity market leadership in Q3, as parts of the stock market that had previously suffered the most from high borrowing costs generally outperformed. Value outperformed growth and small caps outperformed large-cap stocks, in anticipation of the disproportionate benefit that small-cap stocks (typically heavily indebted) derive from interest-rate cuts. Utilities, which are often highly indebted and regarded as bond-like proxies due to their stable cashflows and defensive qualities, were by far the best-performing sector in Q3 as interest rates and bond yields fell. Industrials, financials, consumer staples, consumer discretionary and basic materials also modestly outperformed, in that order.

Energy was the worst-performing sector and the only one to deliver negative returns, as oil prices fell sharply against a backdrop of weaker demand. The technology sector also notably underperformed, despite reporting stronger-than-forecast results. Given high valuations, a moderation in the scale of earnings outperformance was enough to cause some high-profile tech stocks to fall. Healthcare and telecoms also underperformed, albeit modestly.

Emerging and Asia Pacific ex-Japan outperformed, as did North American equities

Emerging markets and Asia Pacific ex-Japan staged a late-quarter rally, making them the best and second-best performing regions over the quarter. They benefited from officials unveiling a raft of policy support: the People's Bank of China's (PBoC) reduced its policy rate by 0.2% pa, lowered banks' reserve requirement by 0.5% and cut interest rates on existing mortgages by 0.5% pa. The central bank's governor suggested more policy stimulus might be on the way, and also revealed support for the stock market itself: the PBoC will provide loans to companies to buy back their own shares and allow securities companies and institutional investors to borrow, using shares and stock exchange-traded funds as collateral.

Despite the technology sector's underperformance, North American equities were the only other region to outperform in Q3, as the Fed's larger-than-expected interest-rate cut brought relief across sectors. US value stocks outperformed notably, while small-cap stocks rallied in anticipation of the benefit from expected rate cuts.

Japanese stocks trail peers

Japanese stocks sold off sharply in early August, dropping more than 12% in the biggest one-day fall since 1987. The selloff was prompted by the BoJ's decision to hike interest rates, which coincided with a weak US datapoint, causing the interest-rate differential between the US and Japan to narrow. Consequently, the yen appreciated sharply, and investors began rapidly unwinding yen carry trades that were reliant on cheap Japanese borrowing costs. Sentiment improved following reassurances from the BoJ that it would closely consider market stability in future policy decisions, but Japanese stocks still ended the quarter 5% lower in local-currency terms.

Despite producing modest positive returns, Europe ex-UK and the UK also underperformed, in that order. Disappointing growth data, fresh signs of global manufacturing weakness and subdued Chinese activity have weighed on Europe's export-oriented markets. While UK economic data has been stronger and generally exceeded expectations, uncertainty around the UK autumn budget has weighed on consumer and business confidence. Exposure to the underperforming energy sector also detracted.

Currencies, commodities and property

The trade-weighted Japanese yen rose 8.7% as an unexpected interest-rate rise, intervention by the BoJ and the unwinding of yen carry trades all supported the yen's rapid appreciation. The equivalent US dollar measure fell around 2.7% as interest rate-differentials between the US other developed markets narrowed. Sterling gained close to 3% as signs of stubbornness in underlying inflation pointed to a more modest pace of interest-rate cuts than elsewhere.

Oil prices fell 16.8% in Q3, as renewed softness in global manufacturing activity, expectations that US growth will slow from its recent above-trend pace, and ongoing Chinese property market weakness weighed on demand expectations. Gold prices continued to rise, rising 13.2%, as expectations of interest-rate cuts and geopolitical tensions lent support.

Income drove a 1.0% rise in the MSCI UK Property Total Return Index in the quarter to end-August as aggregate capital values were little changed. Over a 12-month basis to end-August, the total return index rose 1.9% as income more than offset a 3.8% fall in aggregate capital values. Capital values continued to fall the most in the office sector, down 11.7% on an annual basis, though the pace of monthly declines has been easing over the past two years. Retail capital values have stabilised somewhat in recent months, but remain 4.1% below the level seen this time last year. In contrast, industrial capital value rose a 0.4% over the 12 months.

The global economy

Stronger-than-anticipated US growth in Q2, which was confirmed at an annualised quarterly pace of 3.0%, has alleviated recent concerns that the US might be entering a recession. Indeed, data suggest the recent rise in unemployment, which contributed to the global equity sell-off in early August, was largely due to jobs growth being insufficient to absorb the increase in labour supply, as opposed to being driven by widespread layoffs.

Final GDP data showed the UK economy expanded at an above-trend quarterly pace of 0.5% in Q2, following 0.7% growth in Q1. Eurozone growth has been weaker, given its greater reliance on the struggling manufacturing sector and lacklustre demand from China: GDP growth in Q2 was revised down to 0.2% quarter on quarter in Q2, following a 0,3% expansion in Q1. Meanwhile, the Chinese economy expanded at a relatively subdued pace of 0.7% quarter on quarter in Q2, against a backdrop of weak consumption and ongoing weakness in the property market.

More timely purchasing managers' indices released in Q3 pointed to robust near-term global growth, as solid service sector expansion offset renewed manufacturing weakness. However, there has been a widening imbalance across regions and sectors. Service providers have experienced an ongoing expansion in activity, while conditions in the manufacturing sector have deteriorated further, with output, new orders and employment all contracting.

Global employment edged lower in August – the first job losses signalled by the survey since April. The US, China, and eurozone were among those to register cuts, whereas Japan, the UK, India and Brazil were some of the nations to see increased staffing. Average input and output charges both rose in August, albeit at slightly weaker rates than in the prior survey month, consistent with ongoing disinflation from elevated levels. September's flash data tended to support recent trends. US and UK surveys pointed to ongoing solid, but slowing, expansion, while eurozone data suggested the economy contracted in September.

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. Core inflation is still higher, at 3.2%, 3.5%, and 2.8% in the US, UK, and Europe, respectively. However, despite a larger-than-expected rise in UK core inflation, the downwards trend in underlying inflation pressures is largely intact.

Amid ongoing disinflation, the major central banks reduced interest rates in Q3. The ECB delivered its second cut of this cycle, reducing the deposit rate by 0.25% pa to 3.5% pa, while the BoE lowered interest rates by 0.25% pa to 5.0% pa. The Fed shifted focus to the employment aspect of its mandate and kicked off its rate-cutting cycle with a bumper 0.5% pa reduction in the Fed funds target range, to 4.75–5.0% pa. Market-implied interest rates also fell dramatically in Q3. At the end of June, markets were expecting the Fed funds rate to end 2024 at 5.0% pa and fall to 4.8% pa by the end of 2025. By the end of September, markets were expecting the Fed funds rate to end 2024 at 4.3% pa and fall to 2.9% pa by the end of 2025. In contrast to the other major central banks, the BoJ raised rates by 0.25% pa in Q3, with the rise and, more pertinently, hawkish rhetoric taking markets by surprise.

For and on behalf of Hymans Robertson LLP

Chris Arcari
Head of Capital Markets
chris.arcari@hymans.co.uk
0141 566 7986

Robert Kotlar
Investment Research Analyst
robert.kotlar@hymans.co.uk
0141 566 7793