Table of Contents

Dodging a Bullet

Last quarter I painted a scene of contrast between the ebullience of the end of 2023 and the chaos and volatility at the end of 2022. Now, well into the first quarter of 2024, a new era has dawned, and markets are grappling with how to cope with a dodged bullet.

In dodging a bullet I imagine one would vacillate between euphoria and relief, as well as the queasy jitters about what might have been. And that has been the pattern in markets for much of this year. Having dodged a recession bullet, there is a growing sense of confidence that inflation is receding, jobs and the economy are resilient and there are occasional bursts of euphoria for tech stocks. At times, though, there are the thoughts of what might have been. Concern for the state of commercial property prompts sell-offs in financial stocks, there is no tolerance for failure or disappointing earnings (c.f. SNAP and Tesla in the aftermath of disappointing numbers).

There are all eyes on politics in this election year with over 50% of the worlds' population going to the polls (including the UK, US and India). The drama in other geopolitical circles ebbs and flows but market remain strangely numb.

Key Developments since the last quarterly update:

- **Inflation seems to be in the home stretch?** The latest US inflation print in early February was a cheerful 3.1%, while economic growth was still exceptionally positive at 3.3% for the fourth quarter. There was some mulling over the "stickiness" of the components that remain. In the UK inflation showed a similar pattern (closing in at 4% in January) and even wage growth seemed to be more subdued.

- **Not a question but if but when?** Now that the "higher for longer" narrative is in the rear view mirror and central banks have sent unequivocal messages of pausing, the question of when rate cuts will appear has become a guessing game. Estimates have moved around dramatically from consensus of a cut in Q1 to diminishing probability of that, and now it even seems that Europe will be first to move compared to the Fed. The Bank of England recently poured cold water on a possibility of a rate cut in the near term.
- **Economic Growth Soldiers On.** After the recession that wasn't in 2023, economic growth has proven resilient in 2024 so far and corporate earnings and equity market performance has continued this theme. Employment figures remain robust across developed markets and in the US the S&P broached an important psychological barrier of the 5000 level, which is likely to lead to more momentum and record market levels have been recorded in the US, Europe and Japan.
- **Canaries No More.** The stories of commercial real estate write offs have multiplied and have almost moved beyond the canary in the coal mine status. The latest news of a Churchill Place sale in Canary Wharf for 60% less than it was bought for in 2017 is sure to send chills through the commercial property sector, while in the US we have seen confirmed evidence of effect of commercial property write downs on the momentum around banks.

***

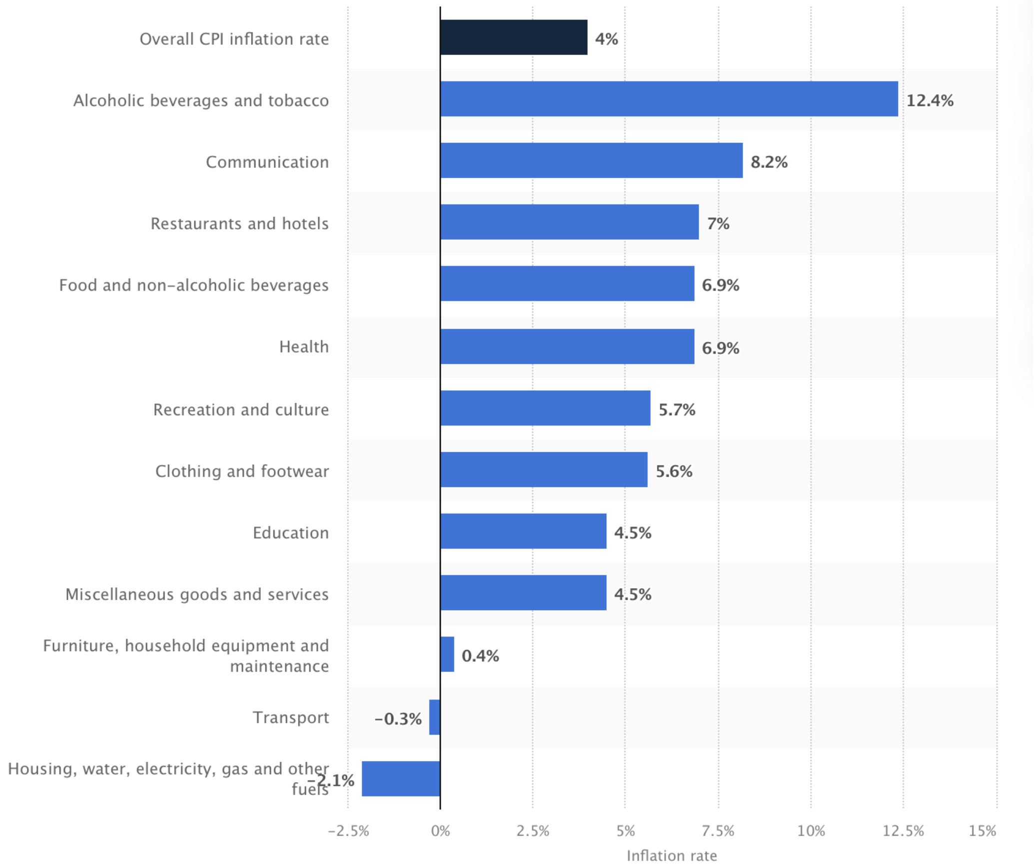
Current Macro Snapshot

Economic growth – Goldilocks burns her hands

Last quarter we suggested that the UK economy was stirring to life after being "stuck" and its stock market significantly underperforming the US and its European neighbours in 2023. This month it was confirmed that it had officially slipped into a recession after two consecutive quarters of negative growth – showing -0.3% in the quarter to the end of December and -0.1% in the previous quarter. While these numbers are hardly steep declines it was still a significant divergence with economies such as the US where economic growth in the fourth quarter was a robust 3.2%. There were even a few positive headlines in the mix for the UK:

> Bank of England's Andrew Bailey sees signs of 'somewhat stronger ' UK growth

Inflation is weakening on a global scale – dropping to 3.1% in the US and 4% in the UK (2.8% in Europe). This is confirmatory evidence that some of the Covid imbalances have worked their way out of the system but some elements such as services remained sticky. Food and energy prices have dropped globally and the breakdown of UK inflation is as below, and there was a lot of discussion about what is and is not "sticky" in this context and concern that the "last mile" as inflation heads down will be the hardest.

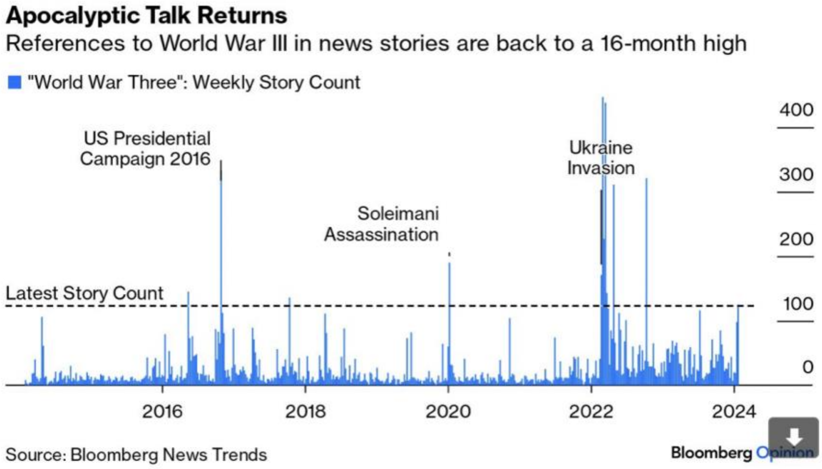


Continuing the "good news is bad news and bad news is good news" phenomenon that gripped markets last year this signs of robust job creation and economic growth (at least in the US) sparked a sell off as investors feared overheating.

Central banks - where do they go from here?

As inflation hovers tantalizingly close to the level that central banks target a question arises as to when will central banks have seen enough? Estimates as to the timing of interest rate changes have diverged dramatically and initially coalesced around expectations of a 1Q rate cut – which, in fairness, no central banker had even indicated. These expectations slowly subsided and as economic growth has remained robust have moved steadily further out in the year. Sterling remains somewhat weak relative to the dollar year to date losing around 0.4%, but is still up over 7% for the last 12 months.

The sense of current conditions being too good to be true was occasionally punctuated by fears of geo-political chaos, and as the chart below shows tensions between the US and Iran as well as the continued attacks on ships in the Red Sea have sparked sensational news stories.



There is also a pending sense of uncertainty with over 50% of the world's population due to go to the polls this year with elections in over 60 countries and some major economies included. This map shows those that had been evident as of the beginning of the year but more could have been added since. Many cite the tendency of election campaigns to become increasingly nationalistic and divisive as augmented sources of uncertainty and maybe elaborate economic promises that distort consumer behaviour (c.f. tax cuts). There is also the potential for distorted fiscal behaviour in the run up to an election, all of which is disruptive for markets.

Individual Asset Class Performance.

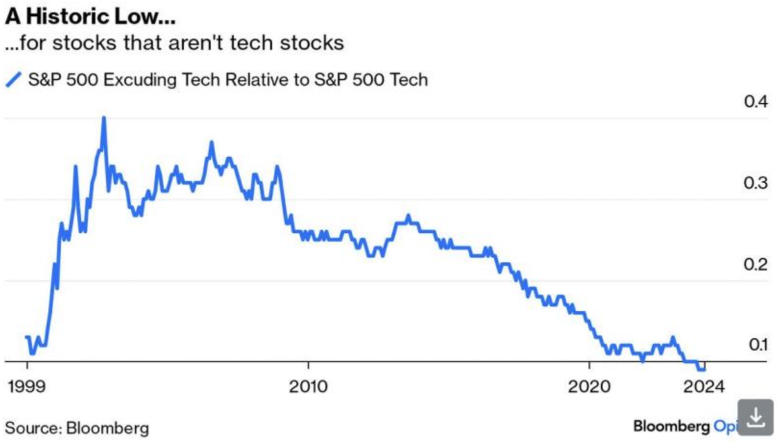
- Equities
- Fixed income
- Real Estate and Real Assets

The chart below shows recent performance in main equity indices (at March 3, 2024):

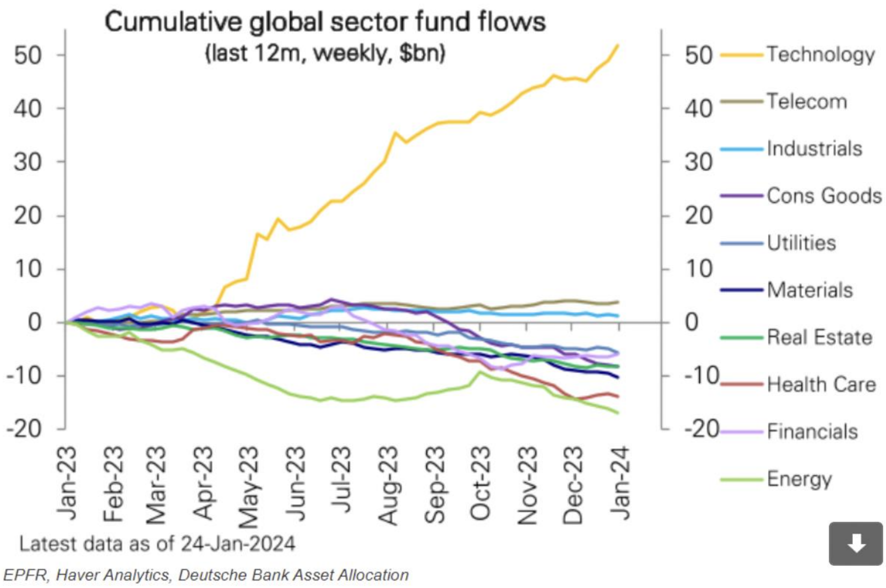
Equity Index	**Last 12 months**	**Year to date (March 3, 2024)**
FTSE 100	-3.72%	-1.4%
S&P 500	26.74%	7.57%
Nasdaq	36.81%	7.97%
Dax (Europe)	13.6%	5.51%
Hang Seng	-21.29%	-5.19%
Shanghai Comp	-7.22%	2.45%
Nikkei 225	41.64%	19.82%

The sharp divergence in Asia builds on the divergences in evidence in 2023, although the outperformance in Japan has recently been diminished by a weakening Yen.

Equity markets have surged confidently past prior limits in the last few weeks, with the most notable milestone being the S&P passing 5000. The fickle investor behaviour continued – with Tesla seeing a sell-off in response to disappointing sales figures (it remains down over 24% year to date) while pharmaceutical stocks were forced to defend their post-Covid drug portfolios as Covid treatments and vaccines saw dramatic declines in demand. The focus shifted to obesity drugs, other vaccines (such as for RSV) and oncology treatments, where M&A has been significant. As the chart below shows, non-tech stocks have shown significant under-performance and this has made some active management challenging.

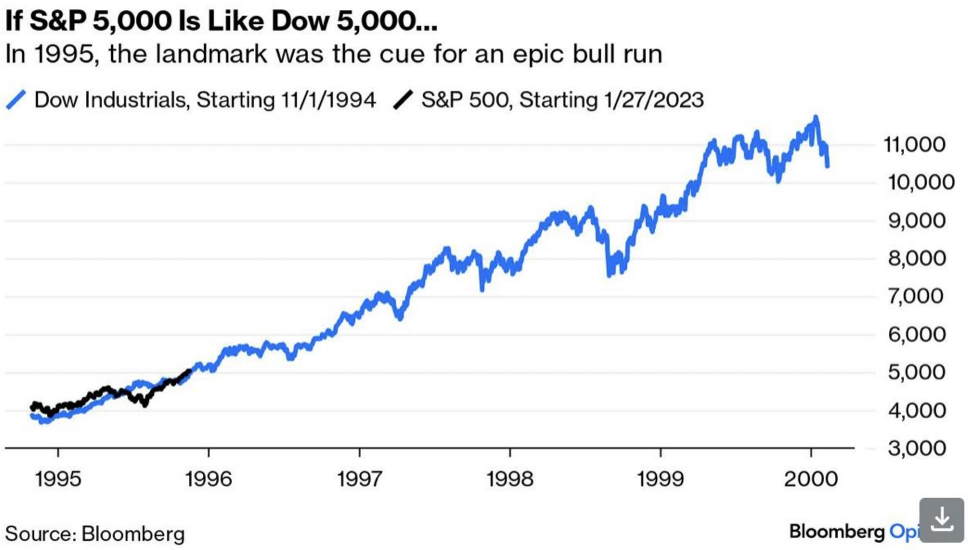


The flows shown below show incontrovertibly where the flows have been – and they have for the most part followed the money – into tech.



Active management is also challenged by the increasing short-termism that is creeping in to markets, with shorter holding periods and the increased involvement of passive investors and day traders.

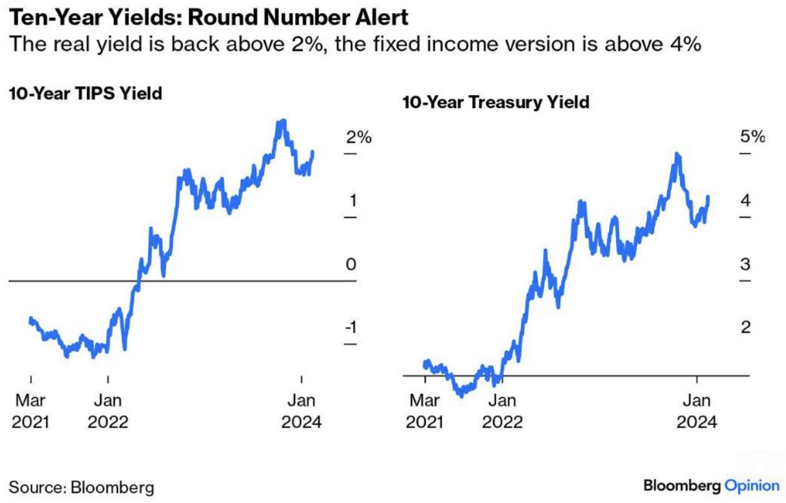
There is a strong sense that the 5000 milestone being passed will be a further boost for equity markets, and pundits have pointed to past breakthroughs as evidence for this.



Fixed Income: Peak Rates, Now What?

As central banks unite behind a pause, the consensus is settling around us having reached “peak rates”. This places a “best before date” on the current high cash yields, and to the relief of homeowners may also promise a relief from higher mortgage rates. While last quarter we showed evidence of yields trending down, they have been more volatile recently, trending upwards in the US (see below) as well as the UK.

Spreads are quite tight within corporate bonds and high yield, suggesting risk appetite is high, and this could be challenging for this area going forward.



The Office, 2024 edition - More than a Canary

We spoke last quarter about the performance of listed real estate as a proxy for illiquid assets such as directly held real estate – which only really trades when transactions happen. This index has been negative again this year, but only slightly. There has been a chill on many real estate sectors all year and, for example, 2023 saw the lowest transaction volume in US residential real estate in 30 years. A few data points have cropped up such as news that Boston Properties had purchased a 29% interest in 360 Park Avenue South, an office block in a prestigious midtown Manhattan location, for $1 from its joint venture partner, the Canadian pension plan CPPIB, which had purchased the stake for $71 m, while we noted above the steep discount on the sale of the office building in Canary Wharf v. its purchase price in 2017.

The complexity and opacity of commercial real estate and the fact that they are not readily marked to market is a barrier to true information on this asset class, but by all accounts there is worse news to come on the office side.

Declining office use and a focus on efficiency have long been focuses of this asset class and most managers have de-emphasized it long ago in favour of industrial and other property types such as hotels and self-storage. As a result, the Pension Fund will have very little exposure to office properties, but it is a notable sector as for many investors news about the office sector tends to define a sector. A declining interest rate environment, when it happens, should lessen the headwind for all real estate sectors.

Outlook

If last year was the comeback year, this year might be the *transitional* one. This unusual descriptor was frequently used in earnings statements this year by companies who were still figuring out how the higher rates would impact consumers, companies and the economy. They were literally in a mode of "wait and see". In coming months we will be watching in particular:

- **Which Central Bank moves first and why.** We have moved from "higher for longer" to a "higher for how much longer?" and the first move to ease by a developed market central bank will be the "shot heard around the world".
- **More Indicators from Commercial Property**. As commercial property continues to become unstuck and properties start to change hands, this is likely to lead to a cascade of valuation corrections and more write downs by commercial lenders. Investors have already been astute to distinguish between banks with the highest percentage property exposure but there are bound to be some unpleasant surprises if this comes to light.
- **Geopolitics and elections at the forefront.** This factor has not changed since last quarter, with elections mounting related newsflow will be top of mind for the media and the public. We will continue to watch developments carefully as markets seem to remain fragile with little mood for volatility and surprise.

***

March 3, 2024