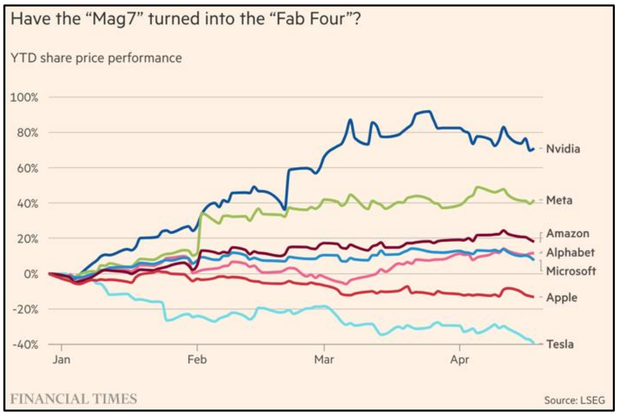
There may be trouble ahead…

The last update reflected on market relief that inflation seemed to have been tamed (or at least was falling) and that recessionary fears which had existed for much of the latter half of 2023 seemed to have passed (or at least been diluted) in the US - although those fears had been (just about) confirmed in the UK and Europe. The belief was that growth would soon be returning and that whilst some may be *technically* in recession, economies were bouncing back despite last year's severe monetary tightening.

However, things might not be turning out quite as rosily as people may have hoped?

Bullets continued to spray all over the markets, in some cases, unfortunately, quite literally - with continuing escalation of hostilities in Gaza and Iran briefly getting involved leading to fears of region-wide escalation, adding to an already protracted Russia/Ukraine conflict and global supply restrictions caused by Houthi attacks on shipping in the Red Sea, forcing major transporters to divert to the more expensive and longer route around the African Cape.

Equity markets continued to focus on technology stocks, specifically the "Magnificent Seven" (*Amazon, Apple, Google, Microsoft, Meta, Nvidia and Tesla*) although more recently several members have appeared to have lost some of their shine, with examples such as Tesla declaring disappointing results and Apple abandoning their self-driving / electric car project. Will life imitate art with only three surviving, like in the Movie?



Share buybacks have continued to focus investors' attention along with the ever-increasing theme of Artificial Intelligence.

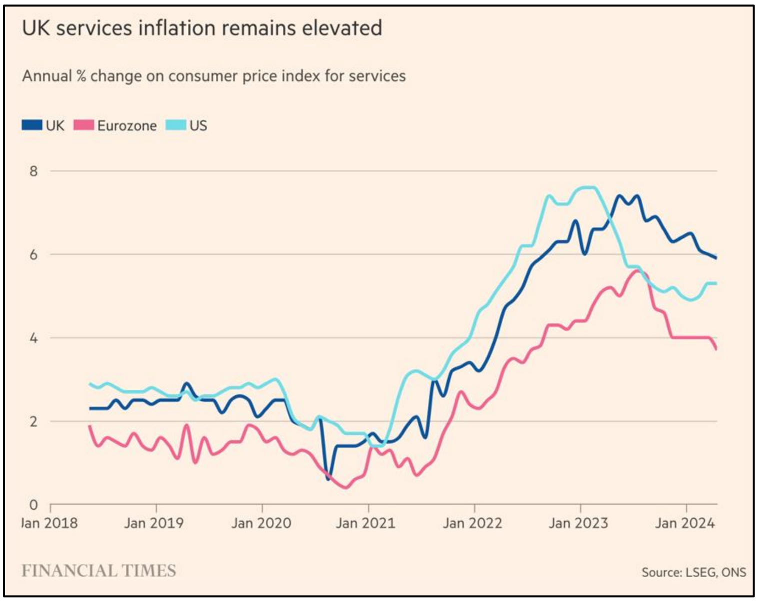
Major central banks maintained tight monetary policy throughout the first quarter continuing emphasis on data dependency and again pivoting to warning of rates being higher for longer. In contrast, Japan saw the end of its easy monetary regime with rates now positive.

Inflation, GDP & Interest Rates:

After initially showing further encouraging declines, confidence in inflation falling easily back in line has started to wane as inflation picked up slightly. Service sector inflation is continuing to prove stubborn such that headline levels are still nearly double target levels. US inflation rose from 3.1% (January) to 3.5% (March), although it has fallen back in the latest data to 3.4% (April). The US Federal Reserve Board (FED) prefers the personal consumption expenditure metric (PCE) as an inflation indicator, and this remained flat at 2.8% in Q1.

The picture in the UK was slightly better with inflation falling to 3.2% in March and again to 2.3% in April (4.0% December 2023). Behind this latest drop, however, is a significant cut in the regulated energy price cap – commentators speculate that the Prime Minister thinks that this headline figure is as good as it is going to get, because he promptly called a general election after that data was released.

The Euro area, meanwhile, had reasonable news, with mid-May releases of data showing modest GDP growth and stable month-on-month inflation at 2.4%, nicely down from the 7% it was running at last year; and with the all-important services inflation coming down again.



Major central banks pivoted their messaging as inflation numbers showed a reluctance to continue their end '23 declines, and official statements and unofficial comments focused on the importance of future data to indicate if monetary policy might be relaxed anytime soon.

One reason is that the US economy is showing resilience and healthy growth and might not therefore need stimulus from reduced interest rates, whilst the risk of inflation taking off still lingers.

The US, UK and European central banks all left interest rates unchanged over the period.

Only the European Central Bank is seen as having the right conditions to reduce rates any time soon, with the market predicting June, although given European 'inflationphobia', the market may be getting ahead of itself a little.

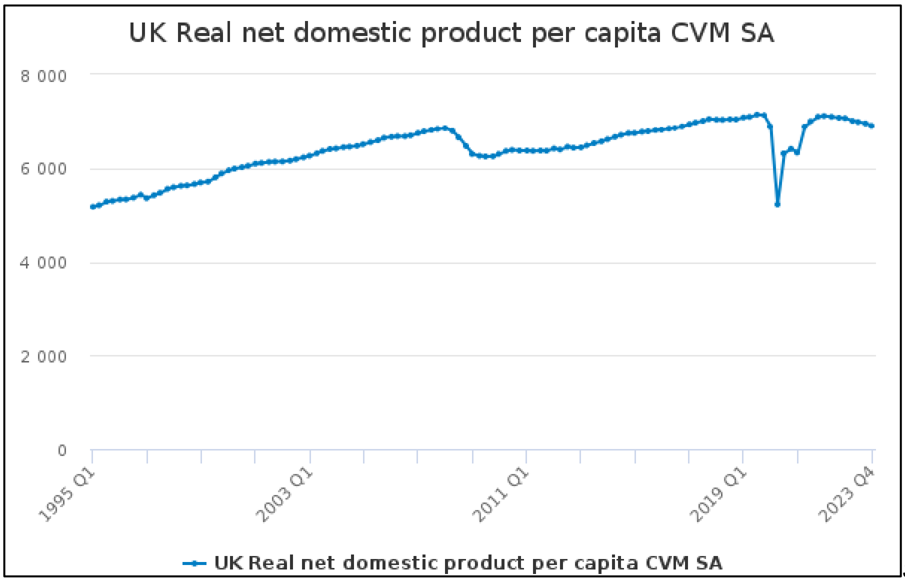
Market predictions of interest rate cuts in the US have fallen off a cliff; and if the FED doesn't do anything in the next couple of months, it is unlikely to do anything until after the elections in November for fear of being accused of political motivations (fairly or otherwise) – and there doesn't seem to be any great rush.

Meanwhile, the UK is unlikely to risk importing inflation in the short term as a drop in rates is likely to weaken Sterling – and for similar political reasons can't realistically do anything during the election campaign.

Economic Growth

In the US, the trusty consumer continues to show resilience. Q1 US GDP was released at a very respectable 1.6% (albeit down on Q4 '23 3.4%) with personal consumption accounting for the majority of the growth. Employment remained robust and manufacturing indicators have signalled expansion for the first time after 16 straight months of negative data.

Following a technical recession in the UK in the latter half of 2023, Q1 growth recovered slightly rising by 0.6% - although as some sides of the political spectrum might be pointing out over the coming few weeks, real net net domestic product *per capita* remains lower than it was in 2017.



Source: ONS

The Euro area, meanwhile, showed modest GDP growth of 0.3% as well as an equally modest increase in employment rates of 0.3%, but these are seen as steps in the right direction after a stagnant period.

Macro Snapshot

As we entered 2024, with annual rates of inflation in developed economies having peaked in 2022, concerns about further interest rate hikes had been eliminated and replaced by thoughts on how quickly, and how far, interest rates would fall. While the broadly accepted narrative has not really changed and investor sentiment has remained strong, the predicted *timing* of **US** interest rates cuts has been pushed back dramatically.

As referenced above, initial market expectations had been for as many as seven US rate cuts starting as soon as Q1 2024 but these expectations dramatically reduced over the period to one (possibly two), potentially after the November US election date.

Very recent whispers from the fringes (and no one dare say it too loudly) are that the FED's next move could possibly even be upwards in interest rates. Although this is definitely not a consensus view, the first quarter if the year illustrates how rapidly consensus views can change.

The US, the world's largest economy, continued its steady momentum, instilling confidence in global equity markets and dispelling fears of imminent economic turmoil. While European economies faced greater challenges, in particular the UK, where economic output has stagnated, the much anticipated economic fallout from interest rate increases has yet to materialise.

In **Europe**, improvements in the GDP forecast drove up economic-sensitive stocks while banks benefited from announcements regarding enhanced shareholder returns. Eurozone inflation cooled throughout the quarter. Addressing the European Parliament in February, European Central Bank (ECB) President Christine Lagarde sought to temper expectations of an immediate interest rate cut, emphasising the central bank's cautious approach to avoid the potential need to reverse any cuts – but the market still thinks that Europe might ‘go first’.

The **Japanese** central bank ended its negative interest rate policy, yield curve control and halted its purchases of equity exchange traded funds and real estate investment trusts. Furthermore, new governance regulations requiring that management focus on shareholder returns have prompted strategies like share buybacks and increased dividend payments and this has supported Japanese stocks. The country still grapples, however, with challenges such as an ageing population and historically low birth rates, which pose obstacles to achieving the productivity growth necessary for sustaining Japan's prosperity. The JCB had to intervene in markets to try to support the extremely weak Yen – which, although theoretically supportive of its high-tech exporters, runs the risk of starting to import significant inflation (as well as lots of annoying tourists which are starting to become a bore, apparently).

The **British** economy had entered a technical recession in the last quarter of 2023. This downturn came as momentum from post-pandemic spending of pent-up savings waned and the adverse effects of elevated inflation and interest rates, A.K.A. the ‘cost of living crisis’ began to impede economic activity. The BoE's Monetary Policy Committee opted to maintain rates at 5.25% at its March meeting. The yearly inflation rate, as indicated by CPI, has declined from its peak of 11.1% in October 2022 to 2.3% in April 2023, marking the lowest pace of price increases since September 2021, but prices are still increasing.

The climate agenda has been given new impetus as the energy crisis revealed the dependency of industry and consumers on carbon-based fuels – often produced in countries controlled by dictators or unelected autocrats with values that don't align with liberal democracy. While the measurable reality is still that we live in a richer, safer and healthier world than we once did, the stresses of geopolitics look very real indeed, and peaceful co-development is the historical exception rather than the rule.

A secondary effect of climate change has been the significant increase in the prices of various soft commodities, such as cocoa (which has moved from $2,000 per ton to over $10,000), where yields have dramatically reduced as a result of weather fluctuations; although little of this increased price will find its way back to the farmers, leaving little scope for investment in new tress that might be more resilient over time compared to the current old-growth plantations. Consumers should prepare for continuing 'shrinkflation' in their easter eggs..

Globalisation is still very much alive, as measured by trade flows and foreign direct investment (FDI) and portfolio investment – yet there are significant changes already underway and protectionist activities are on the rise.

Figure 6. **World trade volumes still near records, despite tariffs and sanctions**

Source: Aviva Investors, CPB World Trade Monitor, US Treasury, Census Bureau, Macrobond as at 31 March 2024.

Equities

The chart below shows recent performance in the main equity indices in local currency (L/c) terms (as May 20th 2024).

	L/c %	L/c %
Equity Index	**Last 12 months**	**Year to date**
		20-May-24
FTSE 100	8.80	9.12
S&P 500	26.51	11.18
Nasdaq	31.82	11.16
Dax (Europe)	15.31	12.04
Hang Seng	0.95	15.19
Shanghai Comp	(6.43)	7.57
Nikkei 225	26.82	16.75

Global stock markets performed strongly for the most part in Q1 with several markets reaching all time highs - continuing the trend seen in late 2023. In the US, the earnings season brought good news for *some* of the 'Magnificent Seven', enabling stock markets to overcome the broader disappointment that could have been expected to come from the higher-for-longer interest rates message. However, divergence within the group became apparent as performance has become more nuanced. **Nvidia** notably led with a stellar return of over 80%. **Meta** and **Amazon** also produced impressive returns of 37% and 18% respectively. The performance of **Apple** and **Tesla** was, however, more disappointing with both companies seeing their share prices decline, reflecting weaker-than-expected demand for their products. Other sectors that performed well included energy and financials.

The continued dominance of just a few stocks in driving US stock market returns becomes increasingly concerning, with increasing numbers of commentators identifying the risk of calamity if Nvidia, for example, were to announce an issue with its supply chains, a chip that wasn't quite as fast as they'd hoped, or – and they say this quietly – a slow down in earnings growth!

More concerning for the AI narrative which is driving markets ahead, may be the growing realisation that in a few years' time, there might not in fact be enough electricity generating capacity (or sufficient wires to move it around) to run AI data centres as well as the coffee machines and air conditioning of US citizens. Something has got to give?

The sector trends driving US stock performance were repeated in most major markets over the period with improving economic conditions boosting the more economic sensitive sectors. **European** consumer discretionary and industrial sectors were amongst the top performing sectors whilst utilities, consumer staples and real estate continued as laggards.

The **UK** saw financials, industrial and the energy sectors outperform as inflation undershot the Bank of England's forecasts leading the market to price in earlier monetary policy easing - although this has yet to be delivered of course.

The **Japanese** market showed strong performance in the first quarter, with the Nikkei 225 index finally surpassing the previous peak ***set in 1989***, helped by weakness in the yen which dropped to multi-year lows. Japan stands to gain from advancements in technology, especially in artificial intelligence (AI), leveraging its strengths in machinery and electronics manufacturing.

Foreign investors played a leading role in driving the rally, fuelled by the increased optimism over Japan's positive economic cycle and evidenced in large-cap stocks, particularly 'value' stocks in the automotive and financial sectors.

Nikkei index – it can take a LONG time to recover from a burst bubble…

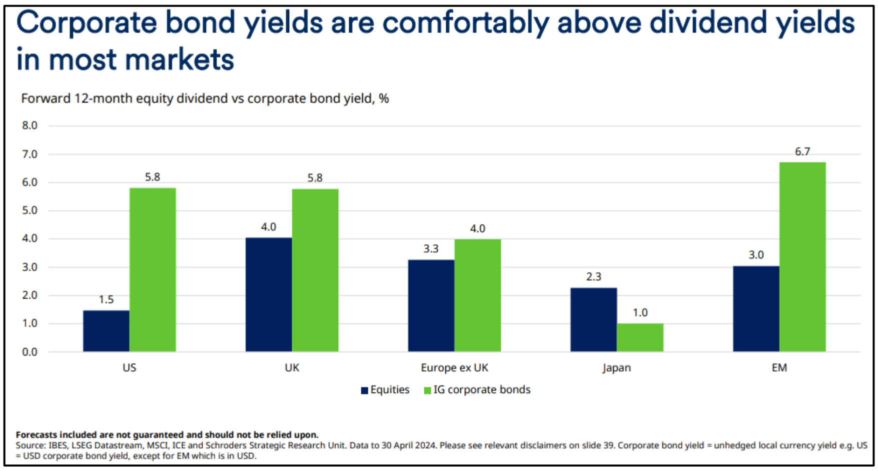
source: CNBC markets data

The rest of Asia saw more dispersed returns with **China** continuing to be the poor relation and this having knock-on effects on the Hong Kong market. Chinese stocks had ended Q1 lower as investors continue to be cautious on the market as the domestic property problems continue. Several stimuli have been introduced in May around mortgage rules and payments but these are still insignificant given the size of the problem. In contrast, Indian stocks continued to attract investors and performed well in Q1.

Fixed Income

The global debt markets saw a reversal of performance relative to their equity counterparts as yields rose (i.e. prices fell) in most major markets as inflation continued to be the primary focus. As already mentioned, the initial expectations for significant monetary easing in terms of timing and amounts were reversed as inflation proved sticky and the central banks pivoted their messaging. This saw 2-year US treasury yields rise to above 5% and US, European and UK 10 year benchmark yields rise by 0.34%, 0.40% and 0.26% to 4.21%, 3.94% and 2.03% respectively.

Credit markets continued to see record amounts of issuance which was easily absorbed by investor demand given the nominal high level of yields and the desire to lock in yield levels that haven't been seem for many years. Despite the rising yields and increased supply, the added yield differential that high quality credit offered ('Investment Grade credit spread') narrowed over the quarter, leading credit markets to outperform government debt. Corporate bond yields remain well above dividend yields in many markets. *Source : Schroders*



Real Estate and Real Assets

Real estate values have fallen in most key markets over the last two years mainly due to the sharp rise in interest rates and fears of economic downturns. US commercial real estate prices peaked in March 2022 and have fallen by 16% from there, obviously depending on property quality and location. With anticipation of interest rate declines during Q1, there have been the nascent signs of price recovery and investors returning to the market – but we are not out of the woods.

Starwood, a $10bn US REIT (Real Estate Investment Trust) – maybe a canary in the coal mine. It has put limitations on withdrawals and is widely reported to be running out of credit lines; if the situation cannot be resolved, they will face possible bankruptcy and firesale of assets which would do the market further damage.

With banks' capital being more controlled, much Real Estate debt financing is now coming from the private markets and there has been significant interest in quality property loans. Sector choice remains important with retail still being avoided but storage and high quality multi purpose units have seen some positive price moves.

This theme of a flight to quality in both Real Estate debt and equity markets is repeated around the globe.

Meanwhile, in the world of infrastructure investing, and talking of canaries in coalmines, Thames Water's biggest investor revalued its stake in the company to zero. The Canadian pension fund Omers wrote off its 31.7% stake its annual report published in mid-May.

It is too early to say whether there will be significant contagion into other UK water companies and indeed across the infrastructure sector, but this acts as a salutary reminder that infrastructure investing is not risk free, especially when highly leveraged to boost returns -Omers valued its stake in Thames Water at £700m at the end of 2022 and £990m at the end of 2021.

Private Credit

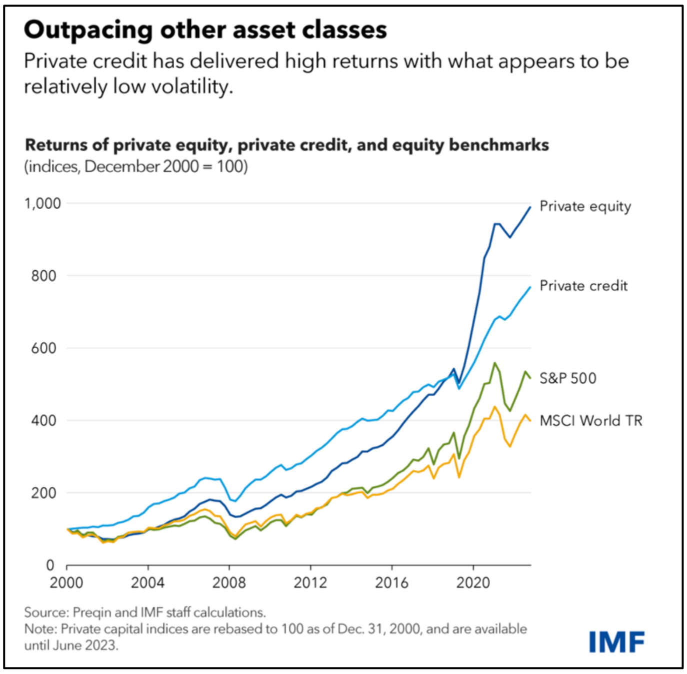
Private credit continues to appear highly resilient and with fund managers on the whole not reporting significant upticks in credit distress.

Conditions for existing investors look good with higher interest rates benefitting returns as nearly all debt is floating rate. The short-term outlook, at least, continues to be favourable.

Detractors point to the fact that existing piles of debt may well be managing to pay the current high levels of interest but repaying the principal of all these loans – which at the end of the day needs to be refinanced, is a different matter.

Nonetheless, with huge amounts of dry powder in the private debt world, getting refinancing may not in fact be too difficult, if lenders are willing to get a little lax in their terms and conditions. Surely this is not just a ponzi scheme…? If so, will it's unwind bite this next vintage of commitments, the one after that, or just slowly work itself out as debt is refinanced into the public markets?

The one reassurance to investors should be that before private credit starts taking losses, the Private Equity that sits below them in the capital stack will have need to be wiped out altogether – in theory at least.



Outpacing other asset classes

Private credit has delivered high returns with what appears to be relatively low volatility.

Source: Preqin and IMF staff calculations.
Note: Private capital indices are rebased to 100 as of Dec. 31, 2000, and are available until June 2023.

Nonetheless, the IMF is suspicious; and included an entire chapter in its April 2024 Global Financial Stability Report entitled 'The Rise and Risks of Private Credit' and commenting in a blog 'Rapid growth of this opaque and highly interconnected segment of the financial system could heighten financial vulnerabilities given its limited oversight.'

However, in the absence of any actual evidence of dsitress, many scorn the report as a pretty obvious land grab by some folk whose jobs it is, after all, to monitor things. The main thrust of the argument is that Private Credit has been successful in growing market share - and because it's not traded, the IMF don't know what it's worth (and nor do investors). One should be suspicious of anything that doesn't conform to traded market norms, they say.

If it looks too good to be true, maybe it is? Perhaps they are right in the light of the Thames Water example – another private market asset that may have been carried at the wrong value for years.

Private Equity

PE continues to see investments being retained for longer with the absence of IPO releases given the continuing trends from 2023 where attractive IPO opportunities dried up with market illiquidity and lack of attractive multiples. There is still money looking for attractive investments but investors are being far more selective in their targets.

Outlook

As 2024 progresses, election risk should be built into markets with over 40% of the worlds' population going to the polls (India has already been going through their particularly complicated version of that experience during late April – and we now know that the UK will follow on (US) Independence Day). Given the nature of the candidates, the outcome of the US election will have huge ramifications on a variety of economic, social and possibly even constitutional levels and is currently too close to call.

This global electoral tsunami will likely have an effect on investor sentiment and be in the minds of central banks who will do their best to avoid being seen as politically coerced. Inflation is declining although still well above target levels but there is evidence that central banks' targets for inflation have been misguided and that interest rates should already have been cut given signs of economic slowdown (without the normally associated unemployment problem).

So:

Are markets correctly pricing in the size and speed of rate cuts? It looks as though the US' FED will be the last major central bank to cut rates – ECB is likely to cut earlier, but may delay further cuts and the latest UK inflation numbers may mean that they *should* cut in June too, but might not due to politics. Current views have the FED cutting once, perhaps twice, before September and then in December to avoid the November elections.

Is inflation really beaten or do the targets need re appraisal? Two percent inflation and two percent growth were the old targets for many major economies. Inflation remains stubbornly high, specifically due to service inflation which is not cured by higher interest rates. Recent geopolitical events have disrupted supply chains and weather has had an effect on crop productions likely to cause food prices to rise. The central banks remain nervous of these influences, and this could spill over to the markets.

If rates remain higher for longer, what effect will this have on some of the alternative asset classes? The vulnerable areas will be private debt, property and any other areas that are sensitive to refinancing needs and will include listed market such as high yield (below investment grade or 'junk' bonds). Default rates have been lower than many expected but credits will remain vulnerable if any are forced to re finance unexpectedly with rates at these levels. Market stress will likely be exacerbated the longer rates remain high.

Are equity markets in a bubble? Whilst Nvidia's earnings growth continues to be impressive, some cracks are beginning to show in the performance of other magnificent seven stocks. There appear to be more downside risks to US equity prices than upside potential, but this has been true for a while, and markets have continued to rally.

Central banks have a very tricky course to plot, and geo-politics too. Let's hope there is not too much trouble ahead…

24 May 2024