

Investment Views September 2024

Strategy:

It's all About the Labour Market

Fixed Income:

Rate Cut Hopes Shift Markets

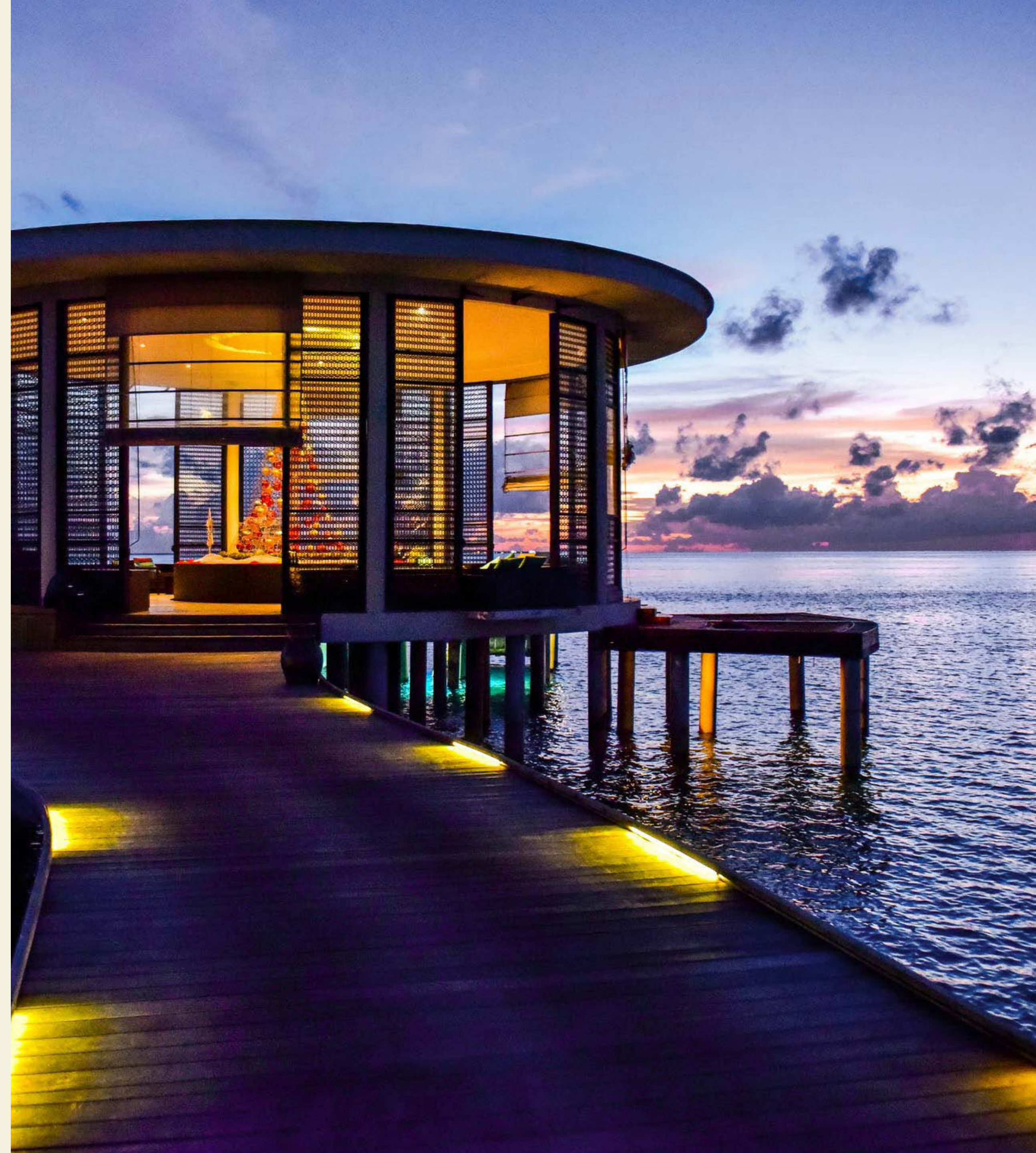
Equities:

A Bout of Volatility

It's all About the Labour Market

- Fed shifts their focus to employment
- Data is mixed and the outlook is uncertain
- Interest rate cuts will help support growth

Equity markets recovered quickly from the sell-off in July and August, but bond yields remained low, as an air of fragility persisted over the outlook. Sentiment around global growth has soured as the US labour market has softened, Europe's recovery has struggled to gain traction, and China has continued to disappoint. Inflation in the US has fallen substantially to 2.5%, down from its peak of 9.1% in the summer of 2022. However, central banks tend to focus on the core inflation rate (which excludes food and energy) as a gauge of underlying pressure. The core inflation rate has fallen to 3.2%, down from a peak of 6.6%. With an inflation target of 2%, this raises the question as to whether it is the right time to cut interest rates yet.



STRATEGY

Achieving this goal is one side of the Federal Reserve’s dual mandate. The other is to achieve “maximum employment”. For the first time since the onset of the pandemic, there is now rough alignment between the number of people seeking work and open positions in the US. In recent years, it has been relatively easy for people who lost their job to find another one. This supported wage growth, but as the labour market has come into better balance, wage growth has cooled.

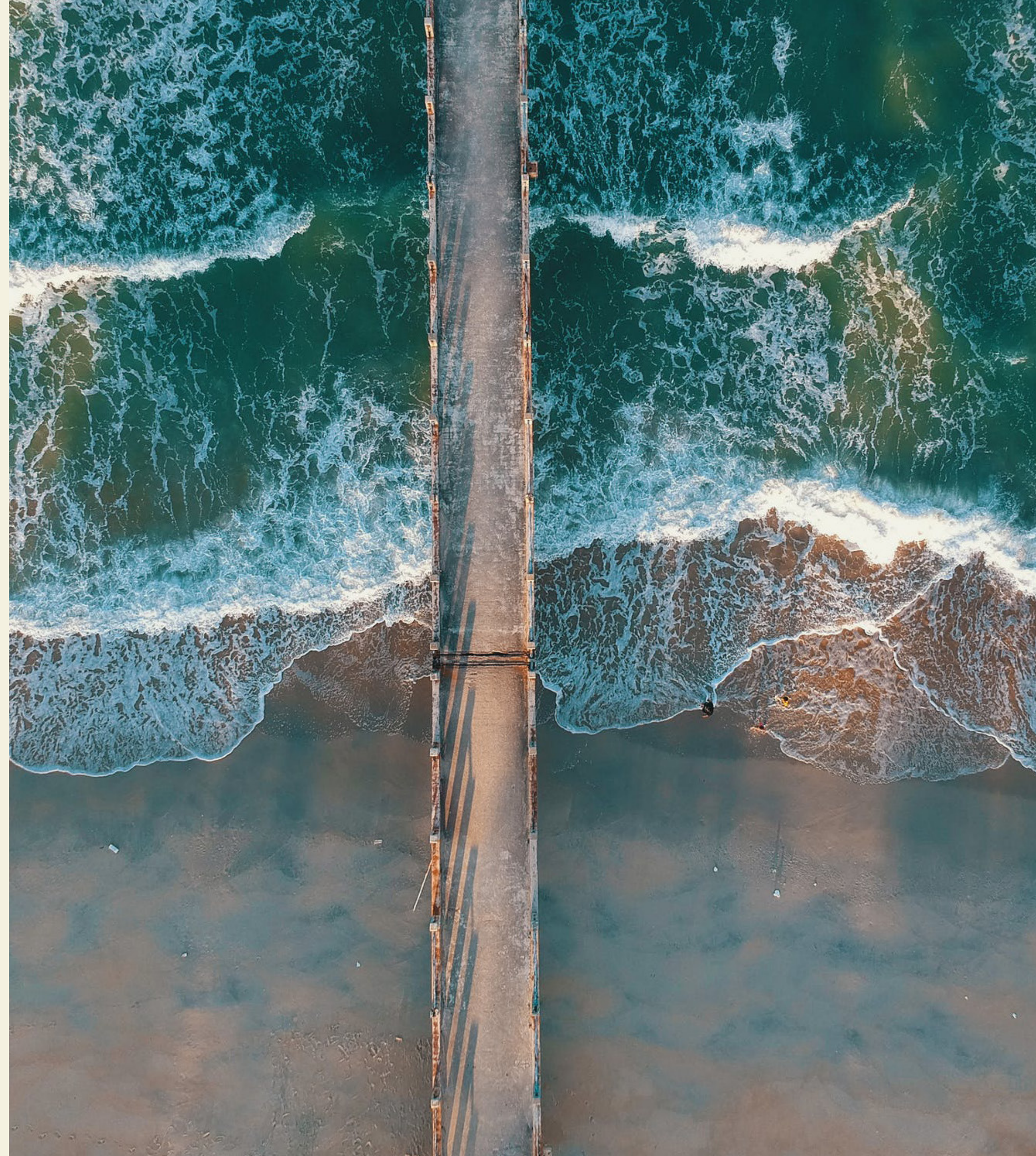
The US labour market is more flexible than many other developed countries, meaning that companies can quickly adjust the size of their workforce based on economic conditions. This leads to a situation where the unemployment rate rarely goes sideways for long. Historically, this has created a dynamic where the labour market reaches a tipping point, past which conditions can deteriorate quite rapidly. Simply put, job losses can lead to more job losses in a vicious circle. The US labour market conditions may now be approaching a tipping point. This is important for investors and helps to explain why bonds worked well as a diversifier as equities sold-off in early August.

Central bankers in the US are aware of this, and as a result they have shifted their focus from the inflation side of their mandate to the employment side. At a recent presentation, the Fed Chair went as far as to say “we will do everything we can to support a strong labour market... we do not seek or welcome further cooling in labour market conditions”

There are two different measures of employment in the US, one surveys households and the other surveys firms. Over the last year, the survey of households has been a lot more downbeat than the survey of firms. According to the household survey, 44k net jobs have been lost over the last year. The survey of firms suggests that 2.4m jobs have been created. Counting the number of jobs in a country with around 345m people is obviously challenging, but this discrepancy creates a real issue for policymakers.

44k

Net jobs lost over the last year.





STRATEGY

The key question is whether the Federal Reserve has pivoted quickly enough to prevent the labour market reaching a tipping point. We continue to believe that the US will avoid recession, but it is a close call. Furthermore, with bond markets already pricing in multiple rate cuts and equities expensive versus history, we maintain a modest underweight to equities versus benchmark. For portfolios with alternative assets, the overall risk level is close to benchmark due to the volatility inherent in hedge funds, gold and commodities.



Rate Cut Hopes Shift Markets

- US Treasury yields decline on rate cut expectations
- Global economic data mixed; UK strong, fiscal tightening looms
- Dollar weakens, gold rises; commodities show mixed performance

US Treasury yields broadly declined during the month, reflecting rising expectations for interest rate cuts from the Federal Reserve. The 2-Year Treasury yield dropped by 34 basis points (bps) to 3.87%, while the 10-Year yield fell by 13 bps to 3.79%. This downward movement in yields indicates that the market is increasingly anticipating easier monetary policy in response to signs of slowing growth.

Inflation expectations eased, with the 5-Year breakeven inflation rate falling to 2.03%. At the same time, the US yield curve steepened, as markets are pricing in a more aggressive approach to rate cuts in the near term. The yield curve has been inverted for the last two years, meaning that short-dated bond yields have



been above long-dated bond yields. This has historically been a good recession signal, but the curve is now close to un-inverting as interest rate cuts come into view.

Globally, similar trends played out in bond markets. Although, the UK's 10-Year Gilt yield edged up to 4.01%, reflecting improving economic data, while Japan's 10-Year bonds declined amid wild moves in the yen and Japanese equity markets which may have tempered the Bank of Japan's hawkish rhetoric.

The annual Jackson Hole symposium solidified expectations that the Federal Reserve is gearing up to cut rates. In his address, Fed Chair Jerome Powell expressed increasing confidence that inflation is on a “sustainable path” back to the 2% target, while also acknowledging the labour market's quicker-than-expected cooling. This reinforced market expectations for a front-loaded easing cycle, with now a 32% probability of a significant 50bps rate cut at the September FOMC meeting. Globally, most central banks are also expected to follow suit.

In the US, macroeconomic data presented a mixed picture. Non-farm payrolls grew by only 114,000 jobs, falling well short of the expected 175,000, signalling a weakening labour market. The headline unemployment rate also reached 4.3%, which along with several other employment indicators point to a rapidly slowing job market. However, consumer spending remained resilient, with retail sales and consumer confidence both exceeding expectations. US nominal growth also still remains around 5%. Meanwhile, inflation stayed elevated, with July's Consumer Price Index (CPI) rising 2.9% year-over-year, although the rate of price increases appeared to be moderating.

Globally, the economic landscape was also less encouraging. Europe and China both saw disappointing data, with their respective economic surprise indices falling. The UK was the outlier, with buoyant data at odds with a Bank of England which was keen to reduce borrowing costs. Although, the UK

4.01%

UK's 10-Year Gilt yield reflecting improving economic data.

government is expected to implement tighter fiscal policy, including significant tax hikes, even as it ramps up spending in targeted areas. These measures could place downward pressure on economic growth, which in turn may prompt the Bank of England to consider a more dovish monetary stance to offset fiscal tightening – both are bullish for UK bonds.

Currency markets reacted to the shifting interest rate expectations, with the US dollar broadly weakening over the month. In addition, Commodities had a mixed month. The Bloomberg Commodity Index declined, driven largely by a drop in West Texas Intermediate (WTI) crude oil, which fell to \$73 as concerns over weakening global demand grew. Gold, on the other hand, gained breaking through \$2,500, as real interest rates declined and investors sought safety amid economic uncertainty.



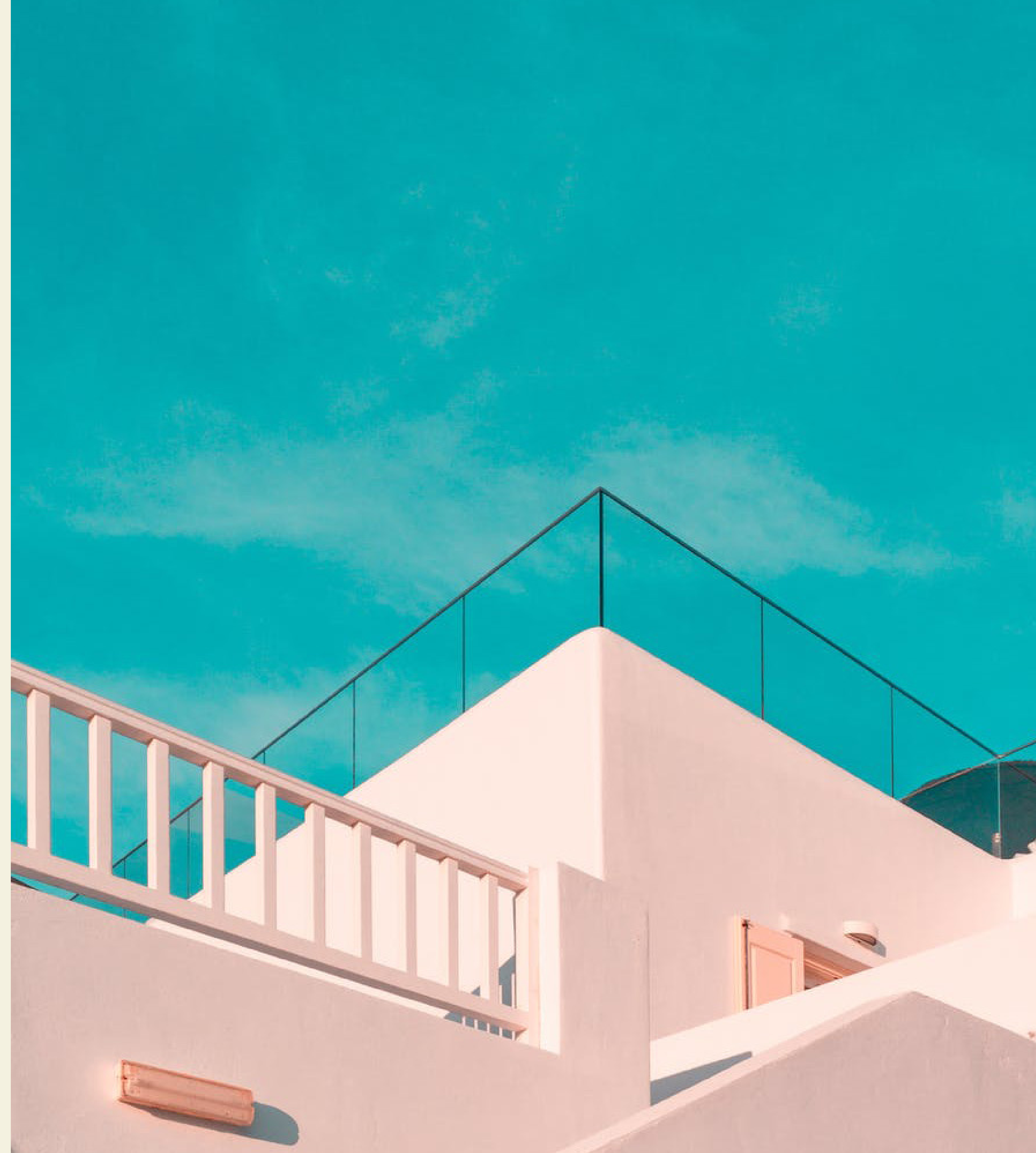
FIXED INCOME

With over 200bps of US rate cuts now fully reflected in bond yields, the market appears to have priced in a “soft landing.” Any additional gains in bonds would likely require the market to shift toward recession expectations, which is not our base case at this stage. However, the rapid deterioration in US employment data is increasing the probability of a broader economic slowdown.

Inflation protection now offers compelling value, and we have taken the opportunity to lock in gains on nominal bonds while reallocating to inflation-linked securities. In multi-currency accounts, we have increased our exposure to safe-haven currencies such as the Japanese yen and Swiss franc. However, our allocation to the US dollar, traditionally a go-to during times of uncertainty, remains smaller than usual, given the dovish outlook on growth and interest rates.

The first US rate cut will be pivotal in setting the direction for global bond yields. Alongside this, the release of the updated ‘dot plot’ will provide valuable insight into the Federal Reserve’s internal outlook. While recent meeting minutes have signalled a dovish stance, there has been some inconsistency, as individual Fed officials’ public comments have not always aligned with this tone.

Looking forward, September is historically a challenging month for risk assets, with negative seasonality often resulting in increased volatility. This, combined with the upcoming US election adds to the potential headwinds for markets over the coming months.



A Bout of Volatility

- Markets sold-off during the summer
- Recovery was then led by the defensive sectors
- Politics in focus, but the economy and earnings matter more

If you were fortunate enough to get away this August, you probably missed it. The S&P 500 tumbled 6% in three days. The Nikkei 225 dropped 12% in a day. However, two weeks later, we were back where we started. The MSCI World Index actually closed the month higher, returning 2.6%. For many, this was a buying opportunity, having missed the earlier rally and now given the opportunity to jump on the bandwagon. We were asked at the Bermuda Captive Conference what we thought about Money Market Funds and how they will perform in a falling interest rate environment. The speed of the rebound witnessed in August reminds us of the large sums of money parked in Money Market Funds which belong in other asset classes. As interest rates come down and Money Market Funds' returns diminish, we would expect some of the other asset classes to gain support.



EQUITIES

If we have a soft landing, which is not what the bond market is pricing in, then equities could have a solid 2025 despite the higher-than-average valuations. In this scenario, valuation multiples could remain stretched and with consensus EPS growth for 2025 of 14%, investors may reap double-digit returns. In a recession scenario, despite getting more interest rate cuts, equities will likely underperform as economic contraction outweighs the benefits of looser financial conditions.

Despite the swift recovery, the bout of volatility left a mark. Investors rotated into more defensive sectors, possibly due to the sharp sell-off or perhaps positioning themselves defensively ahead of the US presidential elections. Healthcare and Consumer Staples added 6% and 5% respectively. Interest rate sensitive sectors such as Real Estate and Utilities performed equally as well, as investors positioned themselves for lower rates. Energy and Consumer Discretionary performed poorly, returning -1% and +1% respectively, as fears of a weakening consumer and a spluttering China elevated. Europe and the UK outperformed the technology heavy US market. Japan underperformed Asia Pacific, as Japanese equities suffered from the volatility.

The fourth quarter will be eventful and is likely to result in more volatility. Not only will we see the first US interest rate cut since March 2020, but also the US presidential election, and companies reporting third quarter results. We believe the most important events are monetary policy and the third quarter earnings season. A soft landing and less interest rate cuts, versus a recession and more interest rate cuts, is likely to be the key determinant of equity returns. This will be influenced by what the companies report and

14%

EPS growth for 2025.

the guidance given by management. We will also get a read on AI and whether companies are making progress on monetising their AI offerings. Although the US presidential election gets a lot of air time, we do not believe this will be a key driver for equity returns in the short-term. The election is too close to call and, even if we knew the outcome, there is no guarantee that it would translate into market outcomes. With a diversified portfolio, our view is that most of the volatility from the US election can be mitigated.



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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	<div>EQUITIES (MODEST UNDERWEIGHT)\$</div>	<div>CASH (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)</div>
Fixed Income		<div>EMERGING MARKET DEBT INFLATION PROTECTION</div>
Equities Regional		<div>JAPAN EMERGING MARKETS EX CHINA</div>
Equities Sector	<div>CONSUMER DISCRETIONARY UTILITIES</div>	<div>ENERGY HEALTHCARE</div>

