

Investment Views October 2024

Strategy:

Rate Cuts Support both Bonds and Equities

Fixed Income:

Fed Moves Early, Buys Some Insurance

Equities:

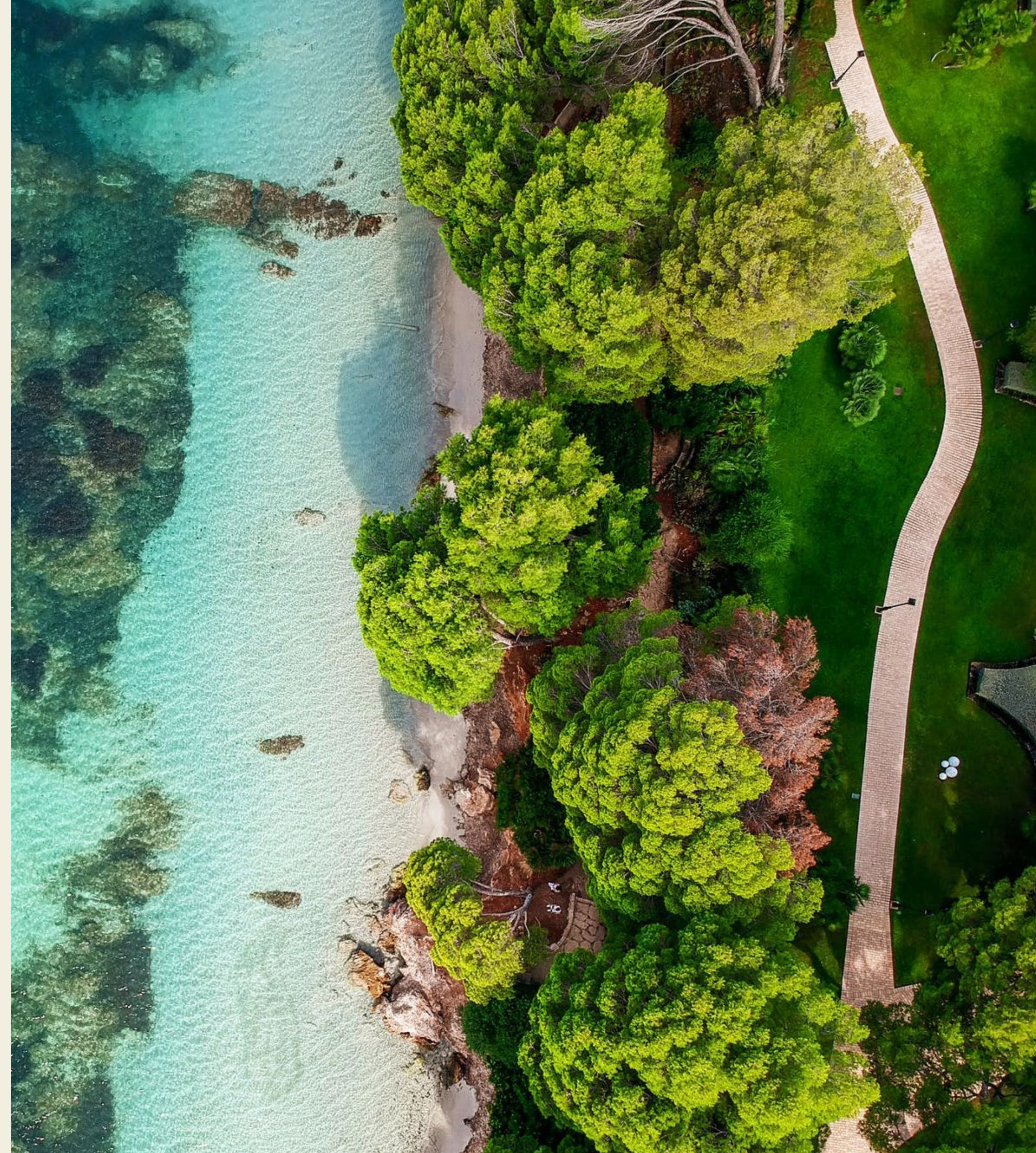
Five Consecutive Months of Positive Returns

Rate Cuts Support both Bonds and Equities

- Federal Reserve joins the global rate cut cycle
- Bonds and equities benefit from lower rates
- China announces support measures for their economy

The third quarter was an action-packed period for financial markets, and ultimately resulted in healthy returns for both bonds and equities. The MSCI World returned 6.36% in US dollar terms, while bonds generated similar returns and benefited from lower yields (higher prices) along with regular coupon income.

News flow was dominated by interest rate cuts by many central banks around the world, the health of the US labour market, domestic US politics, and rising geopolitical tensions. In September, the Federal Reserve cut interest rates by 0.50% from 5.50% to 5.00%. The Fed is the most important central bank in the world due to the international role of the US dollar, so this reduction was well received by financial markets and welcomed by both businesses and households.



STRATEGY

The US dollar weakened against a basket of major currencies, as expectations for further rate cuts in the US grew. In contrast, the Japanese yen appreciated sharply, reacting to the unexpected base rate increase in July and increased demand for safe-haven assets. Sharp moves in globally important currencies are seldom welcome, and this period of yen strength caused knock-on volatility in other asset classes. The Japanese equity market saw a remarkable 9.96% daily decline, before recovering quickly thereafter. Moves of this magnitude are not generally a sign of a healthy market, but if the adjustment happens in an orderly way, it can actually help to reset sentiment and positioning to more realistic levels.

The British pound and the euro strengthened marginally, as their respective central banks maintained cautious stances toward further interest rate cuts. Stock markets recovered this summer and optimism surrounded the UK economy, helped by the lifting of election uncertainty. UK equities have been cheaper than global peers for a number of years, but have lacked a catalyst to outperform. Medium-sized companies in the UK did outperform in the third quarter, but the positive sentiment was checked later as worries grew around the likelihood of tax rises. Europe's economy looked to be recovering earlier in the year, but manufacturing has continued to struggle. Germany, in particular, has been weak, but parts of Southern Europe have performed better and benefited from the strength in tourism.

Forward-looking economic indicators in China deteriorated during the quarter. A number of bellwether global companies have warned about economic weakness there, particularly luxury goods companies and auto manufacturers. Policymakers in China had appeared willing to allow the housing market to adjust lower and growth to slow, but in late September, the risks got too high, and they announced a number of major stimulus efforts. This change of tone was a catalyst for a major comeback in the Chinese equity market, which rallied 21.84% in the final week of the quarter.

21.84%

The percentage that the Chinese equity market rallied in the final week of the quarter.





STRATEGY

Commodity markets experienced divergent performance during the quarter. Gold prices surged, settling above \$2,600 as investors sought safety amid growing concerns about global economic stability. Meanwhile, WTI oil prices fell to \$68 a barrel, driven by expectations of weakening demand in China and increased supply. As a result, US gas prices fell to \$3.22 per gallon, providing relief to consumers and further boosting disposable income. The combination of lower gas prices and falling mortgage rates help to support consumer spending, even as broader economic concerns persist.

Overall, the willingness of the Federal Reserve and other central banks to cut interest rates to support economic growth and labour markets has been very supportive of both bonds and equities. For households and businesses, interest rate policy works with a lag, but financial markets respond much more quickly. Furthermore, markets move in anticipation of changes to interest rates, which is what we saw this summer. The US election and a worsening geopolitical backdrop are two of the risks to markets in the fourth quarter, but



Fed Moves Early, Buys Some Insurance

- Fed's bold rate cut aims to support economic stability
- US unemployment rises, signalling softening in the labour market
- Global bond yields fall as central banks ease monetary policy

The third quarter saw heightened volatility within fixed income, with significant shifts across global bond markets. Major movements in currencies, the yield curve, oil prices, and gold underscored the market's sensitivity to macroeconomic developments. Additionally, high volatility in the Japanese yen and an increased probability of deeper interest rate cuts reflected the broader uncertainty gripping global markets. These dynamics shaped the fixed income landscape as markets reacted to evolving central bank policies and economic data. The closely followed US yield curve, as measured by the spread between the 2-year rate and the 10-year rate, returned to positive territory for the first time in two years.

Central banks globally adopted a more accommodative stance during the quarter, reflecting growing concerns over economic growth. Most



notably, the Federal Reserve delivered a rare and pre-emptive 50 basis points (bps) cut, despite the backdrop of strong economic growth. This ‘insurance’ cut was not fully priced into the market, which had expected a more gradual approach. Despite resilient economic performance, markets are now pricing in an additional 100bps of US base rate cuts by the end of the year due to continued moderation in inflationary pressures.

Broader signs of a weakening US labour market have also begun to emerge, with the unemployment rate rising to 4.3%. While some distortions due to temporary weather-related layoffs and immigration are at play, the underlying trend points toward softening employment conditions. This has raised concerns about the strength of consumer spending and the overall economic trajectory heading into year-end. Other central banks, including the Bank of Canada, Swiss National Bank, European Central Bank, and Bank of England, also reduced their respective rates, as inflationary pressures eased and growth concerns mounted. With global growth and exports slowing, the People’s Bank of China unveiled its largest stimulus package since the pandemic, cutting key rates and reducing the reserve requirement ratio for banks. However, doubts remain about the long-term impact of these moves, as weak credit demand persists despite China’s attempts to stabilise growth.

Volatility in fixed income markets surged before settling toward the end of the quarter. As a result, US mortgage spreads tightened, given the perceived increased certainty surrounding the path of US base rates. Freight rates, reflecting rising supply chain pressures, surged to their highest levels since 2022. These pressures are expected to worsen due to the East Coast US port strikes, further complicating supply chain dynamics and adding to inflationary risks.

US bond markets experienced significant movements, with the 2-Year Treasury yield declining by 120bps—one of the steepest moves during the quarter. This reflects expectations of further rate cuts from the Federal Reserve. The 10-Year Treasury also saw a decline, falling to 3.75%. Notably, inflation-protected securities (TIPS) underperformed US nominal treasuries, as speculation of a broader US economic slowdown gathered pace and investors became less concerned about



inflation. However, financial conditions have now eased substantially, which is already starting to boost activity.

In Europe, German 10-year Bund yields fell by 0.47%, reflecting mounting concerns over a weakening German economy. The UK also saw a drop in Gilt yields as the Bank of England moved to ease monetary policy. Japan’s bond markets remained relatively stable, as the yen’s sharp appreciation during the quarter reduced pressure on policymakers to raise interest rates in the near term.

Given the decline in government bond yields, the US 30-year fixed mortgage rate fell by 0.64% during the quarter, settling at 6.69%. This decline in rates triggered a resurgence in refinancing demand, but there was little sign of an uptick in new home purchases, which would be needed to boost the housing market and support consumer confidence. Further declines could be ahead, with borrowing rates likely to fall below 6% if US Treasury yields remain stable.

The corporate bond market remained relatively stable. US investment-grade bond spreads were unchanged, while high-yield bonds saw a minor decline to 299bps over US Treasuries, reflecting bullishness among investors and little pricing in of recession risks. Corporate borrowers continued to benefit from easing inflation expectations, which reduced overall borrowing costs, though volatility in global commodity markets remained a concern for some sectors.

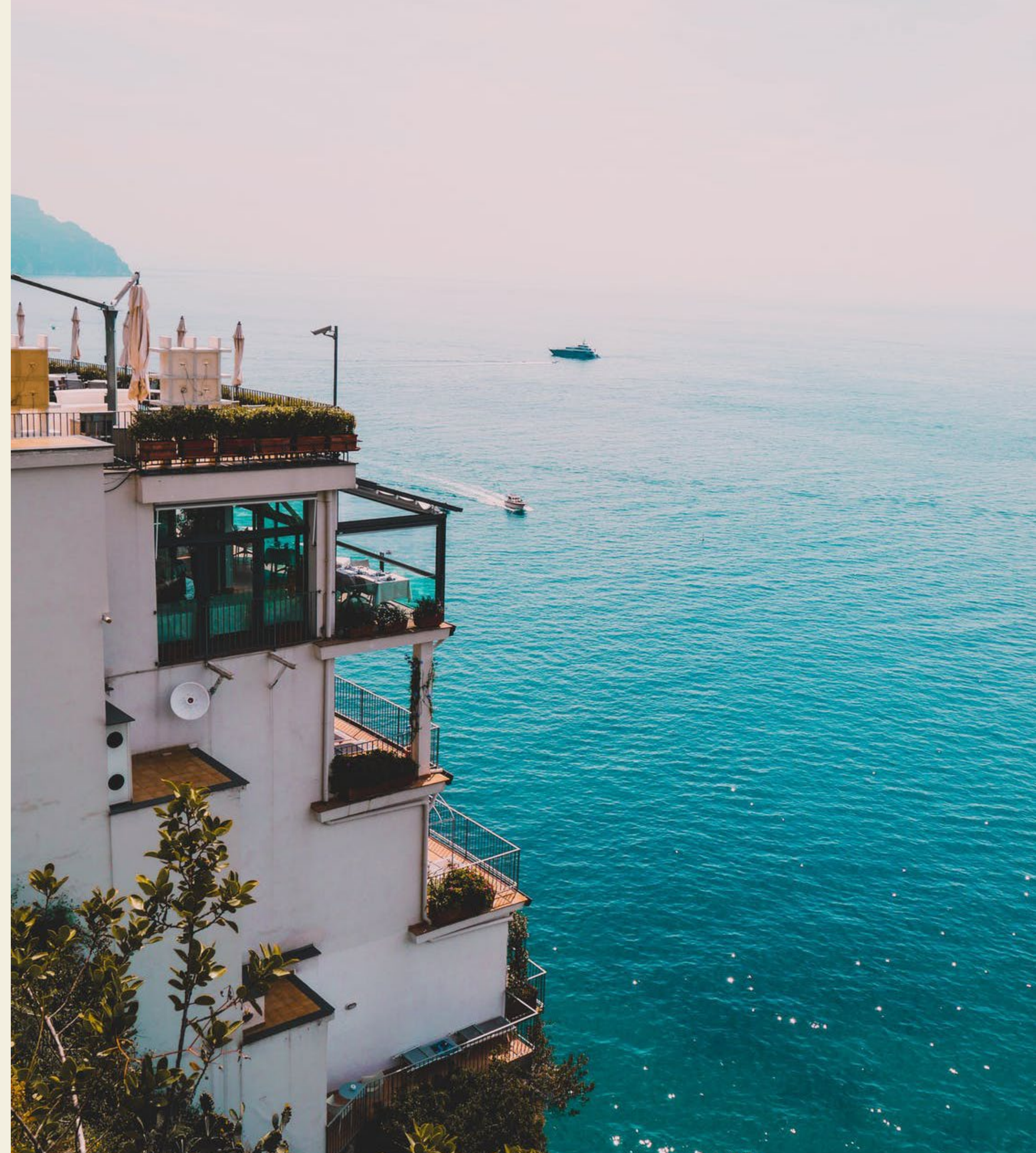
Looking ahead to the final quarter of 2024, the US election will dominate markets. We remain cautious on US interest rate duration risk given that the market has already fully discounted 250bps of base rate cuts over the next 12 months. Any further capital gains in short-dated US Treasuries can now only be generated if base rates fall below the Federal Reserve’s estimate of neutral (2.75-3.00%), which is only likely if we see a recession - a scenario that is not our house view. In risk assets, credit spread valuations remain rich, but US macro data is still robust, despite strains in the employment market, and central bank support reduces the risk of a volatility event. Global liquidity is also rising as we approach the January 2025 US debt ceiling, which may further boost risk assets.

Five Consecutive Months of Positive Returns

- Interest rate cuts shift market dynamics
- Rotation into defensive equity sectors
- Value outperformed Growth for the first time this year

September marked the fifth consecutive month of positive returns for the MSCI World Index, culminating in a strong third quarter, with the index returning 6.36%. The MSCI World Index is at an all-time high, and it has been a strong year for equities so far, with a return of 18.86%. The third quarter was eventful and we believe that the fourth quarter will be equally as interesting given the uncertainty surrounding the US election.

The third quarter can be summarised by a rotation mainly driven by a pivot in US monetary policy. In July, we saw a lower-than-expected Consumer Price Index (CPI) print which increased confidence that the Federal Reserve would start cutting interest



rates and led to the Russell 2000 (smaller companies) posting the best weekly return versus the S&P 500 on record. At the beginning of August, investors were surprised by a weak July US jobs report. This, coupled with some other weak data points, led to a temporary sharp sell-off, which saw the S&P 500 down 6.08% in three days, before recovering by the middle of the month.

The US yield curve moved sharply, pricing in more interest rate cuts. Interest rate sensitive stocks, such as utilities and real estate rallied, while investors also positioned themselves defensively, leading to strong gains in healthcare and consumer staples stocks. This time, the Russell 2000 underperformed, as the fear of recession outweighed the benefits of a lower interest rate environment. In September, we witnessed the first US interest rate cut since March 2020. The 50bps cut which was only partially priced in, with many economists expecting only 25bps. The market’s reaction was surprisingly subdued on the day of the cut, however, the S&P 500 rallied 1.70% the following day.

The best-performing sectors in the third quarter were Utilities (up 17.58%) and Real Estate (up 16.61%), reflecting investors repositioning for a lower interest rate environment. Utilities is now the third best performing sector year-to-date, an impressive result given the low volatility and defensive characteristics of the sector and the positive stock market backdrop.

The weakest sectors this quarter were Energy (down 2.41%), Information Technology (up 1.52%), and Communication Services (up 2.82%). Oil remained weak at around \$70 per barrel (West Texas Intermediate) despite geopolitical risks, as the positive supply story appears to be driving the price. Information Technology and Communication Services are still the best performing sectors year-to-date, having been the best performers in the first and second quarter. However, they lagged in the third quarter as investors rotated out of the higher beta sectors into more defensive and interest rate sensitive sectors. This rotation led

17.58%

The percentage that the Utilities sector risen year to date..

to the widest sector dispersion in a quarter so far this year. It also marked the first time this year that: value outperformed growth, small caps beat large caps, and the market capitalisation weighted S&P 500 lagged the equal-weighted S&P 500.

Historically, defensives outperform cyclicals in the initial months following interest rate cuts. Cyclicals then tend to outperform three to five months after the first rate cut in a soft-landing scenario. In a recession scenario, cyclicals continue to lag defensives. We believe that the key determinants of equity returns for the fourth quarter will be economic data releases signalling whether we will have a soft-landing or a recession, as well as the third quarter earnings season which will give us an idea of how healthy business activity is and whether AI can drive the markets higher. This information will impact the rate at which the Federal Reserve eases and is likely to drive equity market returns.

Although the US presidential election is important, history shows that elections do not tend to be a key driver of returns in the long-term. Additionally, there are a wide range of potential outcomes, which include the balance of power in different branches of Congress. Even if we knew the outcome, there is no guarantee as to how the result would translate into market outcomes. With a well-diversified portfolio, we believe 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

