CARTLIDGE MORLAND

INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY

7 AUGUST 2024

OVERVIEW

Over the first seven months of 2024, equity markets had performed well. Investor sentiment became increasingly positive as Europe and the UK emerged from shallow recessions, inflation rates moderated and the major central banks - with the exception of Japan - looked set to reduce interest rates during the year, although later than anticipated at the start of the year due to inflation proving stickier than expected. The European Central Bank (ECB) cut its main interest rates first in June 2024. The Bank of England (BoE) finally cut Bank Rate on 1 August 2024 for the first time since the start of the Covid-19 pandemic in 2022.

SO WHY THE SUDDEN EQUITY MARKET FALLS THIS MONTH?

Several factors combined which impacted on investor confidence – weaker US economic data leading to fears of a US recession, the US Federal Reserve failing to cut interest rates at its latest meeting, a surprise increase in Japanese interest rates, coupled with worries over corporate earnings.

With the ECB cutting interest rates and the BoE expected to do so at its August meeting, the US Federal Reserve kept its main interest rate at a level of 5.25-5.50% at its 31 July meeting, although US inflation showed signs of softening in the days following the Fed meeting. Manufacturing data indicated contraction whilst US employment figures showed growing weakness, with the unemployment rate ticking up to 4.3%. The rise in the three month average unemployment rate triggered fears that the US was on the brink of recession. Investors are worried that the Fed has left interest rates too high for too long and that their delay in lowering them would lead to a recession. The Fed had signalled just one cut in 2024 at its June meeting which was perhaps too pessimistic. It appears that an interest rate cut will now follow the Fed's September meeting.

Higher interest rates are supposed to cool growth, the employment market and inflation so weaker jobs figures should be expected. US economic growth was running at 2.8% pa in the second quarter of 2024. As the Fed has said, it considers trends in data rather than one set of figures when setting interest rates – the markets have not followed the same strategy. More recent economic data points to the services sector, the largest component of the US economy,

The Japanese equity market experienced the steepest falls in recent days following the Bank of Japan raising interest rates to 0.25% from a range of 0-0.1%. This move was unexpected but was taken because the BoJ believes that the economic prospects for Japan are improving, including wage growth. A higher interest rate will support the yen, which had experienced a prolonged period of pronounced weakness, which could stoke inflation further. However, with the Fed not cutting rates, the yen strengthened dramatically in a short period - and is likely to continue to do so if the Fed moves to reduce rates in September - and Japanese yen trades (where investors borrow in cheap yen and invest in higher yield foreign assets) were rapidly unwound leading to market volatility.

Corporate earnings have been fairly robust across the leading equity markets although there are some areas of consumer weakness. The falls in US equities experienced in recent days reflect the uncertainty surrounding the US economy and have brought valuations down from very high levels in certain sectors, including technology. The opportunities in AI had driven valuations of many US mega tech companies this year. Nevertheless, the large amount of spending on AI developments by these companies has yet to be realised in earnings so leading to investor nervousness.

Equity markets have recovered to some extent from the falls experienced in the first few days of August. Comments from Fed officials reassured investors that the Fed would take action, if required, to counteract any deterioration in the US economy, but the Fed believes that the economy does not appear to be in recession. The Bank of Japan has suggested that the central bank will not raise interest rates further whilst markets are unstable. Although monetary policy in Japan is tightening, it is still relatively loose with interest rates at 0.25%. The yen has stabilised against the dollar. Other Asian equity markets have followed suit in rebounding.

OUR VIEW

Compiled by Angela Cooper, MD - Investment Services.

Angela runs Cartlidge Morland's Investment Management team, with over 30 years' experience in investment research working for investment companies, leading UK national IFAs and wealth managers. Angela graduated from the London School of Economics and is a Chartered Insurance Practitioner.

The severe correction and bout of volatility experienced in equity markets at the start of August served to remind us that the value of investments can fall as well as rise. Corporate valuations do matter, not just market momentum. Macro economic factors are driving events - there are fewer active managers, with more passive traders following macro and momentum themes, with a high proportion of similar trades. A change in the economic narrative can therefore lead to sudden and dramatic market movements. Over the longer term 'value' is important and it can be accurately assessed whilst the sheer momentum upon which tracking positions rely can lead to extreme over/under valuation over prolonged periods. We do not ignore momentum in our management of client assets – and sometimes wish with hindsight that we had held greater exposure to it – but over the longer term, pricing will ultimately reflect 'value', just as water finds its own level. Profits need to be consolidated from time to time so relying solely on 'momentum' for further gains is dangerous and confers no protection against downside risks.

Whilst it is worrying to see portfolios drop in value in a few days, such falls need to be taken in context as highlighted by the charts below. Over six months, with the exception of the Japanese market, the major equity markets are still showing positive returns. Our portfolios are managed with a longer term view and are fully diversified by asset class, region, funds and risk. Following the painful normalisation of bond yields in 2022, we rebuilt our fixed interest allocation over 2023, taking advantage of high yields and the prospect of lower interest rates. When equity markets correct, lower risk fixed interest assets such as gilts and high quality corporate bonds offer portfolios downside protection. We would expect to see volatility in markets continue as mixed economic data emerges, central banks take differing monetary policy decisions based on this data and in the immediate future thin trading over the summer holiday period. There are fewer rational calming influences and therefore more scope for extreme reactions.

OUR VIEW continued overleaf

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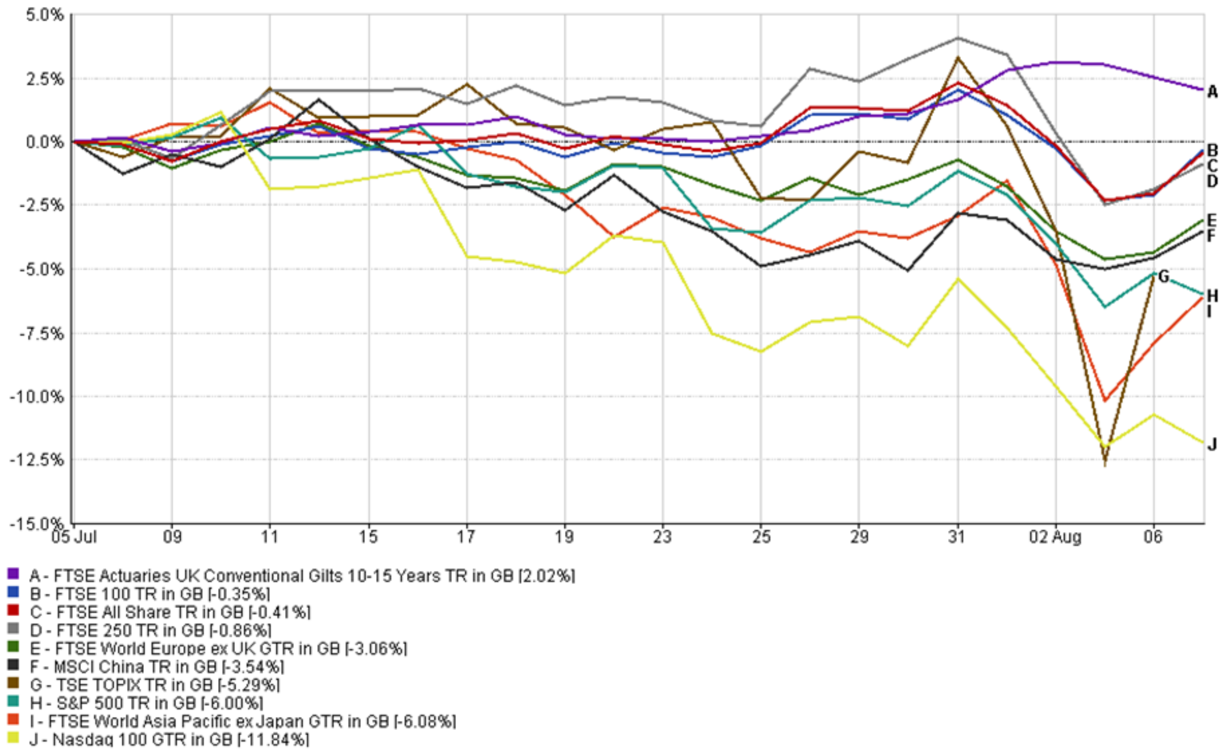
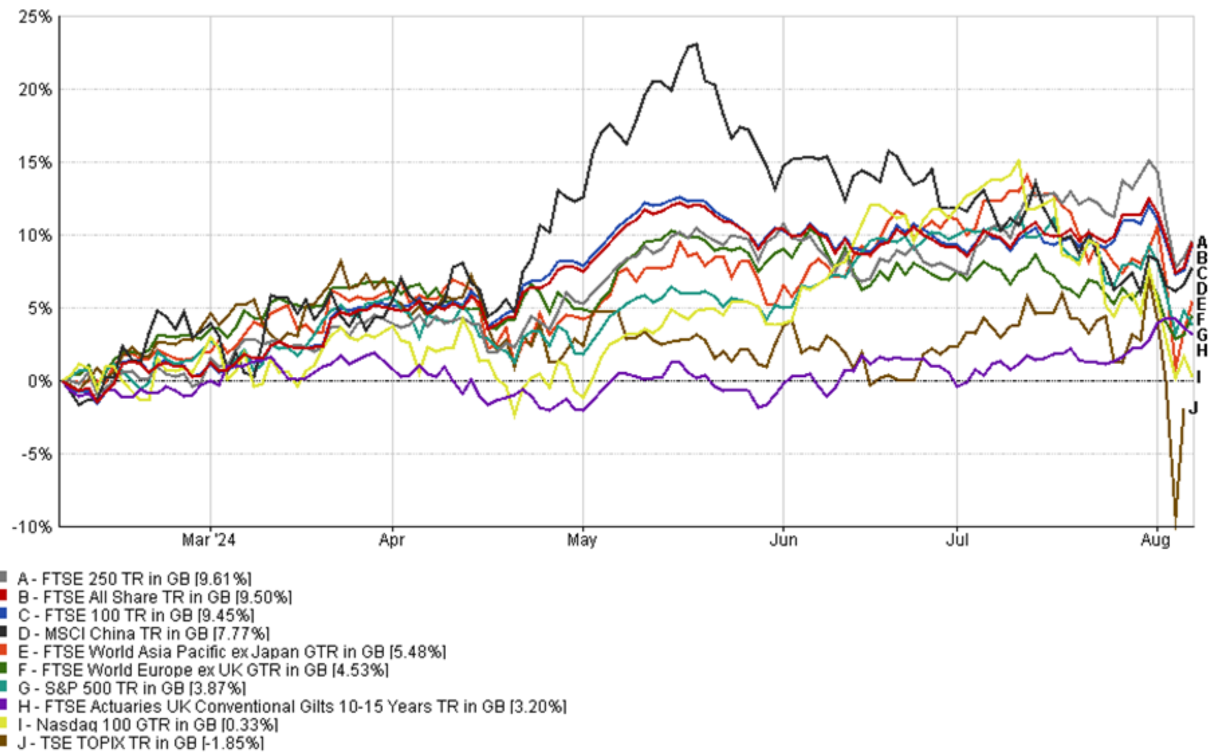
OUR VIEW continued

ONE MONTH INVESTMENT MARKETS STERLING TOTAL RETURNS



05/07/2024 - 07/08/2024 Data from FE fundinfo2024

SIX MONTHS INVESTMENT MARKETS STERLING TOTAL RETURNS



07/02/2024 - 07/08/2024 Data from FE fundinfo2024

Lower interest rates in UK, Europe – and shortly the US - reflect inflation being under control and the central bankers' return to a growth narrative. This is far more positive for equities than the contraction narrative represented by higher interest rates and the squeeze on consumers and businesses. These changed conditions ARE positive for equity markets.

In the US, however, economic growth has remained robust supported by soaring Federal spending, despite the contractionary effect of higher interest rates, which in consequence have taken a while to be effective. Over the past eighteen months or so, robust employment figures and continued economic growth have actually been regarded as negative by financial markets as they have acted as a deterrent to lower interest rates. Now there are signs of lower growth and potentially of the short mild recessions similar to those that occurred in UK/Europe in 2023, markets do not like that either. It seems unlikely the Fed has 'gone too far' on the basis of recent data but it does indicate there may now be scope for deeper interest rate reductions than expected over the remainder of this year. Markets will regard such interest rate cuts favourably when they occur.

If you have any queries please do not hesitate to contact your Cartlidge Morland consultant.

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