

Quarterly Investment Bulletin

April 2024

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Headlines

- ❖ Inflation is now felt to be under control in developed markets.
- ❖ UK inflation fell to 3.4% in February which was slightly lower than anticipated.
- ❖ Equity market returns continued to prosper in the first quarter.
- ❖ Equity market returns were more focused on earnings than on interest rates.
- ❖ UK interest rates remain at 5.25%.
- ❖ European inflation was down to 2.6%.
- ❖ The correlation between equities and bonds has moved lower in recent months.
- ❖ The US economy continues to strengthen despite higher interest rates.
- ❖ A number of stock markets reached all-time highs in the quarter.
- ❖ Early signs of market concentration broadening out are beginning to surface.
- ❖ The Japanese stock market has been a very strong performer this year in local currency terms.
- ❖ The Chinese economy has weighted down returns from Asia but this is beginning to change.



General Economic Overview – Quarter 1 2024

The record-breaking levels of equity markets have meant that investor confidence has returned this quarter, but there remains some caution because valuations are high and may have already taken all the positives for the year into account. Perhaps the subtle difference compared to recent quarters is that the focus has moved from interest rate cuts to earnings results, which have been very positive, especially in the US. It is perhaps a good sign that interest rates are losing their dominance over global markets as this has persisted for several years. That is not to say that the global economy has now entered a growth cycle, as there are a number of headwinds that could derail the current momentum.

Inflation, whilst seemingly heading downwards, has remained fairly static in recent months hovering around 4% in the UK (although recently dropping to 3.4%) and 3% in the US. The next stage of moving down to target will probably be the hardest as goods inflation has generally fallen whilst service inflation has remained sticky. Strong wage growth in the developed world has helped maintain consumer spending, even though savings made in the pandemic have largely been eroded. Central bank meeting minutes have been carefully analysed, with the acceptance that rate cuts are probably delayed until mid-year at the earliest. One factor for investors to consider is how sensitive the global economy remains to existing interest rates. The lagged effect of monetary policy is very difficult to judge for policymakers and the belief that they can get the timing of rate changes exactly right is probably unrealistic. The long and variable lags in monetary policy make forecasting future growth, or indeed recessions, difficult. This is part of the reason why central banks are being cautious about lowering rates too quickly. A counter to this is that there is less sensitivity to interest rates in the global economy than in the past, with overall private sector debt levels slightly lower than during previous periods when interest rates reached similar levels. Also, a substantial amount of existing mortgage debt has been financed at longer-term interest rates, particularly in the US. All of this makes it difficult to get monetary policy exactly right for the economic conditions.

The correlation between bonds and equities seems to have normalised in recent months which has helped traditional 60-40 portfolios as equities have continued to perform well but government bonds have seen yields rise slightly. Government bonds have produced a negative return so far this year whilst equities have continued to move ahead.

Equity Markets

Equity markets began the year in the same way in which they finished the previous one, with confidence improving as the momentum behind interest rate cuts made way for a more fundamental belief in the strength of company earnings. This shift is important because although markets will still move on interest rate speculation, this will be underpinned by seemingly more sustainable valuations based on company performance. A number of economists have suggested this could still be a bubble as valuations, especially in US technology stocks, look at best stretched, possibly overvalued. The counter to this is that recent earnings data has tended to support the valuations of a number of these companies, the most obvious in recent weeks being NVIDIA. Globally, the US is continuing to drive positive stock market momentum, but it is closely followed by Japan where the weaker yen and consistent inflation has propelled the main index past its 1989 highs. The UK has drifted slowly upwards but is less influenced by technology as a sector and is more likely to push ahead if the domestic economy can be seen to be



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picking up. European markets have performed well in comparison, recovering some of the ground lost as a recession looked more likely at the end of 2023. Asian stocks have picked up a little, focused mainly on those countries outside China such as India, Korea and Taiwan.

UK

After falling into recession in December, the UK economy began to grow again in the first quarter of the year, albeit only by 0.2% in January (source ONS). January was a strong month for retail sales and there was improved activity for housebuilders. Wage growth continued to slow in the three months to the end of January reinforcing the view that the Bank of England (BoE) might be in a position to cut rates earlier than expected. More recently the BoE governor, Andrew Bailey, indicated rates could be cut more than once in 2024 after inflation fell to 3.4% in February. He went on to say that the fight against inflation was still to be completed but the evidence was encouraging for rate cuts by the summer. The slowdown in total pay growth was ahead of analyst expectations which was positive for those wanting rate cuts sooner rather than later, but the BoE has noted that even if inflation hits 2% it will take longer to get it consistently back to target.

Mortgage payments are beginning to hit the pocket of the consumer and the proportion of total loan balances with arrears rose to a seven year high in the three months to the end of December 2023 (source BoE March 2024). As a comparison this is still well below the figure in the first quarter of 2009 during the GFC. The average mortgage rate is still above 4.5% for a two-year fixed which is well ahead of the 1.29% average for 2020 and 2021. The UK stock market has performed strongly this year in absolute terms but not in comparison to other developed markets. UK equities have lagged behind peers, and sectors such as banking and energy which dominate the index have failed to keep pace with the rapid growth of tech stocks. UK stocks have traded at lower valuations than US markets, but recent under performance has left the market looking cheap. Whilst US and European markets have hit new highs, the UK is yet to eclipse its February 2023 peak, and global investors are starting to see opportunities here.

US

The US market seems to have entered 2024 as it left 2023. After a volatile start to the year, a more consistent momentum has been established, led once again by the technology sector. Unlike Q4 last year, the shift in investor confidence has not been based on expected interest rates but more on the strength of company earnings and the potential for the US to avoid any kind of recession. Earnings results in the first quarter of the year have generally been ahead of analyst predictions and there have been some stand out results, led by NVIDIA in the technology sector. Companies in the S&P 500 collectively beat earnings per share expectations by 7% during the fourth quarter earnings season (source JP Morgan February 2024).

The impact of higher interest rates has been mitigated by ongoing expansionary fiscal policies in the US. Several pandemic-related tax moratoriums, including student loan repayment deferrals, remained in place throughout 2023 and significant multi-year, multi-trillion-dollar stimulus programmes have been introduced, such as the CHIPS and Science Act, the JOBS Act, and the Inflation Reduction Act. These fiscal stimuli are now being reduced, and the further reduction in central bank's holding of government bonds and credit, along with higher rates, is part of the move to monetary tightening. While these infrastructure spending programmes will support economic activity for some time, governments will



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have to turn their attention to how they will balance the books at some point. A 6% budget deficit in the US at a time when unemployment is near a record low is simply not sustainable, particularly given the central bank is no longer buying government debt. A deficit at this level would also suggest that whoever ends up running for President in 2024 will not be doing so on the promise of major tax cuts. Economic growth in the US was 3.3% in the final quarter of 2023 and 2.5% for the full year, which was well ahead of other G7 economies. According to Focus Economics this looks set to continue in 2024, with their panel predictions averaging around 2% for the next four years. This bodes well for the global economy as well, although it may put pressure on inflation if consumer spending increases. There are some notes of caution as the amount of consumer savings has come down and credit card debt and defaults are on the rise.

Europe

European markets have perhaps surprised investors more than most this quarter as core data on economic growth has started to improve. Notably, the Frankfurt stock market index hit a record high on the 26th March as comments from European central bankers boosted investor expectations of interest rate cuts by June. After another mild winter, energy shocks have been removed from the forefront of investor minds and supply side issues have been largely overcome for the time being. Central banks have started to sound more dovish, and this has been reflected in some unexpected rate moves in Europe. The Swiss National Bank (SNB) unexpectedly reduced borrowing costs by 25bp to 1.5% – the first cut in nine years. The SNB said that it aimed to address lower inflationary pressures and an appreciation of the Swiss franc. Meanwhile, Norway's central bank kept its policy rate unchanged at 4.5%. Purchasing managers' index (PMI) surveys showed that the output of goods and services in the eurozone came close to stabilising in March, with a first estimate recording only a marginal decline, according to S&P Global. The eurozone composite PMI rose to a nine-month high of 49.9 from 49.2 in February (PMI readings above 50 indicate an expansion in activity).

The outlook for Europe has certainly improved over the last quarter but there remain some structural headwinds that will take longer to play out. The remodelling of China to challenge the traditional global manufacturing hubs in sectors such as automobiles and in luxury goods is just one example that is hitting countries such as Germany and France. Germany is going through a difficult period and is only expected to grow by around 1.4% in 2024 (source FT March 2024). This is a consequence of supply chain problems in 2022 which resulted in countries re-thinking how they protect against future shortages of goods and services, challenging the previous decade's transition to greater globalisation.

Asia & Emerging Markets

The Chinese stock market entered 2024 under pressure, with poor economic data and concerns over weakness in the property market. Property has been a key driver of growth in China and is also important for its wealth effect as around 80% of individual savings is invested in property. Property investment in China fell by -9% in the January to February period compared to a year earlier, slowing from a -24% drop in December, according to official government data. Property sales by floor area fell by 20.5% in the first two months of the year, after dropping -23% in December. The slower pace of declines in property investment and sales came after Beijing rolled out numerous pro-growth measures to arrest the country's years long real estate slump. Most investors remain cautious about China's property sector as developers continue to grapple with high debt levels and weak homebuyer demand.



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Wages were also under pressure in 2023 with some workers in both the private and public sectors seeing declines in nominal pay. In this environment it was no surprise that consumer spending deteriorated, and it was the property sector and consumer facing names which suffered some of the largest price declines. After appearing indifferent to the moves in the stock market for much of 2023, authorities now seem to have realised its potential impact on the wider economy and have attempted to support markets, both by buying stocks, and by encouraging a more supportive narrative. Recently, President Xi welcomed many top level US chief executives to China in a bid to persuade them the country is still a good destination for inward investment.

In other parts of the Chinese economy, data was more positive. Industrial production rose an above-forecast 7% in January and February from a year earlier, up from December's 6.8%. Fixed-asset investment grew 4.2% in the first two months of the year compared to the previous year, rising from 3% in December amid higher infrastructure growth. Retail sales rose more than expected over the two-month period as consumption surged during the week-long Chinese New Year holiday but eased from December's increase. The urban unemployment rate was 5.3%, while the youth jobless rate edged up to 15.3%.

For the savings rate to fall significantly, the social security welfare safety net will need to be built out and granting residency rights for migrant workers in cities (the much discussed Hukou reform) would be a significant positive. It remains in the interests of the Communist Party for the economy not to collapse, as its legitimacy is based on delivering rising living standards despite a lack of political freedoms. There are still risks in Chinese equities, but if the economy continues to stabilise and growth recovers in the second half of the year there is the potential for the market rally to be maintained as valuations remain low.

India is the second largest economy in Asia and has benefitted from the economic reforms put in place in 2017 which are now delivering on their original aims. Other notable achievements have been the nationwide biometric social security system which has reduced fraud and ensured payments go to those they were intended for. These improvements will continue to impact positively over the next decade on both companies and the wider economy. On the ground in India, roads, airports and metro stations are much improved as the build out of infrastructure continues. The availability of electricity will benefit not only productivity but also the education of the young, and the overall mood in the country is very positive. India has positive demographics, and in fact is struggling to provide quality jobs for younger members of the population, which the Modi administration is seeking to address through the build-up of manufacturing. Over time India should benefit from the plans of multinationals to reduce supply chain dependency in China. Fund managers visiting India report a visibly more dynamic and buoyant economy compared to the pre-Covid period.

Latin America, traditionally an area troubled by inflation, saw a swift response by most of the region's central banks when inflation soared in the immediate aftermath of the coronavirus pandemic, and this has transformed their credibility. Brazil and Mexico raised rates in the first half of 2021, while Chile, Colombia and Peru followed later that year. In contrast, banks in the major western economies delayed until 2022. In Latin America, central banks have followed the example of their developed world counterparts by acting independently of politicians and introducing inflation targeting, together with flexible rather than rigid exchange rates.



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External factors can be important for emerging markets and although Xi has sought to improve China/US relations, the election remains a wild card. China is grappling with its domestic economic slowdown and so now is not the time for it to up the ante on Taiwan. The US election is important for the entire emerging world with Trump, if elected, promising to impose additional tariffs on all imported goods and threatening specific China targeted policies. That said, valuations generally remain favourable, and many countries have an improving or positive fundamental economic background. In the past, US dollar strength has been a headwind emerging market central banks, but by raising interest rates earlier their domestic economies are in a relatively strong position. Over the medium term, emerging markets should benefit from their attractive demographics (excluding China) together with an abundance of labour and skilled workers, a factor especially true of India. Some countries will also benefit from multinationals pursuing a China Plus One policy in order to achieve manufacturing diversification. Valuations in emerging markets look attractive by historic standards and if the Chinese economy continues to stabilise and shows recovery in the second half of the year the region offers potential for further gains.

Japan

Like many developed world stock markets, the Japanese market has delivered positive returns so far this year. The strong returns have been matched by the continued weakness of its currency which, as Japan is a large exporter of goods, has been to their advantage. This may not continue as in March the Bank of Japan (BoJ) ended an era of negative interest rates, raising borrowing costs for the first time since 2007, which will drive demand for the currency upwards. Following a 7-2 majority vote, the BoJ lifted its overnight interest rate to a range of zero to 0.1%. At the same time the BoJ also removed its yield curve control policy, put in place in 2016 to support its monetary easing measures by capping yields on 10-year Japanese government bonds. The currency remained relatively unmoved as the bank signalled that borrowing costs would not increase sharply whilst inflation remained above its 2% target. This change in policy is due to changing financial conditions in the economy – inflation has returned, and companies have been able to increase prices alongside stronger wage growth, which suggests inflation can be stabilised at positive rates. This is all good news, especially for Japan's exporters, but it does not solve the inherent structural problems that exist, including an aging population, sluggish consumption, high public debt, and low growth rates. None of these have short term solutions but the government are well aware of the issues and have been developing policies to combat them. The short-term outlook for Japan continues to look positive for equity investors and could benefit from any recovery in Asia and China.

Fixed Interest

After a strong Q4 when the anticipation of US interest rate cuts drove yields down, this quarter bond markets have unexpectedly struggled. The shift in views causing this has not been that dramatic – most economic commentators still believe that interest rates will be cut by the summer, but the quantum of rate cuts has changed. At the end of last year many economists were predicting 4 to 6 cuts in US interest rates during 2024 but consensus now suggests three cuts are more likely. Investors are now more aligned with the language of central banks which have toned down the lofty expectations of late 2023.

This was reinforced at the March Fed meeting when the target range for the Fed Funds rate was kept unchanged at 5.25 to 5.5% and the median rate projection was maintained, indicating 75 basis points (bps) of cuts through 2024. There were also upward revisions to the 2025 and 2026 rate projections and a 10bps increase in the long-run rate estimate to 2.6%.



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The Bank of England kept rates at 5.25% but there was a shift in the votes, with two moving from favouring a hike to no change. Governor Bailey indicated that a rate cut was on the cards... but not yet. The majority felt that both wage growth and service price inflation were too high to justify an immediate move but a cut before the end of June is now a distinct possibility.

Government bond markets have not started the year well. After three months, the gains made at the end of last year have been largely eroded. This has been particularly noticeable in the UK, where ten year yields touched 3.5% in late December and are now trading around 4.0%, reflecting the change in interest rate expectations. Looking at market pricing, UK base rates are projected to be around 4.5% at year-end but at the end of last year the twelve month outlook was for rates to be below 4%. This may seem strange, given the weak growth picture in the UK, but we are seeing a global trend, with bond yields in the US and core Euro area retracting about half of their late 2023 gains. The reset is due to a combination of factors: growth being better than expected, disinflationary trends being tested by tight labour markets, and over exuberance in the run up to Christmas. Not to be left out, the ECB has also flagged future rate cuts although Christine Lagarde has indicated that the path of cuts will remain data dependent.

Credit markets continued to perform well with spreads staying around 12-month lows as we finish the quarter. The differential between BBB and B rated credits has now returned to the levels seen before the Global Financial Crisis. In fact, in the US the demand for corporate bonds has escalated to record levels as investors have rushed to lock in the highest yields in years, ahead of anticipated interest rate cuts later in the year. The flows have helped increase prices and reduce spreads to their lowest point in two years. The focus has been on quality and most cash has gone into investment grade assets. The average yield on US investment grade debt is around 5.4% with capital coming from a 'every channel and geography' according to US investor Brandywine Global. Even high yield has attracted asset flows despite the slight pick-up in defaults, with issuance at its highest level for three years.

There are risks, including the possibility that the central banks get the timing wrong on rate cuts which could lead to inflation falling below target (or even disinflation) and a deeper than expected recession. If this were to happen then the high yield market could suffer a greater number of defaults and increased uncertainty. This is not the expected result – a soft landing is more likely, with falling rates a consequence.

If rates start to fall in 2024 then bonds will become more attractive in terms of capital appreciation, and several managers are predicting this may be a rare opportunity to capitalise on a falling rate environment. Emerging market debt may also offer some opportunities as several countries have started to lower rates already.

We see a lot of volatility ahead, caused by investors looking to move assets out of cash and into other vehicles in an attempt to maintain yields. There are also several macro factors to consider – geopolitics in the Middle East, elections in the US and UK, a continued heightened focus on monthly economic indicators, and increased supply as central banks seek to offload assets built up in the pandemic.

Alternatives



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With equity markets performing very strongly, attention has moved away from alternatives which have continued to struggle in some areas. Expectations of interest rate cuts, which would be positive for property and infrastructure, have been pushed further out into 2024 which has meant that the momentum behind those interest rate sensitive assets has slowed. This started to reverse in the final weeks of the quarter when there appeared to be more certainty about interest rate cuts.

The property market has struggled recently across a range of sectors with offices still the focus of concern. Supply chain crises have hurt transport and logistics industries, but the warehousing real estate sector has proven remarkably resilient, in part due to a rise in demand for these assets from non-logistics operators, who have wanted to hold increased volumes of stock, replacing the 'just in time' supply chain management strategy with a 'just in case' approach. The growth in e-commerce has also been important to the logistics market, and it is expected that demand from retailers will start to creep up in 2024 once the warehouse spaces they acquired during the pandemic become fully absorbed and online sales continue to increase. Office space in Europe still looks resilient compared to the US. Workspace in the US underperformed compared to much of the rest of the world in 2023, and the market's correction started later than elsewhere. There's a risk that the European market could be affected by the US, but the problems stateside seem to be structural rather than driven by sentiment. The lowering of interest rates will be a boost for the property and infrastructure sectors and could lead to a decent recovery, but the focus may change – the capital value cycle is finely poised as at the moment. While there are plenty of areas where caution should be exercised, such as secondary stock in the office and industrials sectors, we are in the early stages of positive growth in new sectors that could generate very attractive long-term returns.

The first part of the year saw a high level of uncertainty in the commodity market due to geopolitical risks and a soft economic outlook. Consumers and businesses grappled with lingering cost pressures and high interest rates, leading to subdued global economic activity and softer commodity demand. The Red Sea security crisis and mounting geopolitical tensions threatened to disrupt commodity supply chains, raise shipping costs, and intensify commodity price volatility. This gradually subsided as the quarter wore on with the overall sector proving to be one of the strongest performing areas as the oil price increased on reduced supply but also certain food sectors such as cocoa beans accelerated in value due to poor harvests. One of the commodities that has performed extremely well this year is gold which has reached all-time highs probably on the back of its protection against rising US debt and a possible escalation of the war in the middle east. Gold is also seen as a hedge against inflation should price increases persist when interest rates start to fall.

The energy market's trajectory was shaped by diverse factors. Weaker global demand capped energy price growth, but uncertainties surrounding global output, supply stability, and geopolitical tensions tilted risks to the upside. China's persistent headwinds, including a property crisis and deflationary pressures, added to concerns over global energy consumption. Meanwhile, the rapid expansion of renewables and low demand for heating due to a warm winter helped to slash natural gas usage in North America and Europe, lowering prices as supply was less constrained. Oil may well be a barometer for commodity growth in 2024 as will weaker GDP data from China, which generally acts as a lead indicator to industrial metal prices such as copper, aluminium and nickel. One encouraging long-term factor for commodities outside of oil is the transition to net zero that has to take place to meet climate change goals. Renewable energy infrastructure will need huge amounts of these commodities to create enough alternative energy supply to reach these goals.



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The energy transition, adverse weather events, inflation, central bank policies, and the direction of the US dollar will be key themes to watch for commodities in 2024.

Summary

The end of the first quarter of the year usually indicates the mood of investors after they have had the chance to evaluate current trends and consider various data points. The language of central banks has been key to this in recent years, and the more dovish approach many banks have taken in recent weeks suggests that the optimism of equity markets has some foundation. Interest rates have been the key focus of many market watchers over the last twelve months and the speculation over when rates will be cut has dominated the movement of asset classes. Whilst this continues to be a key factor in how markets will behave, there are some important changes in how investors are reacting to information. Core to this is the move back to recognising the fundamental reason for investing in companies, and that is their earnings capabilities. Earnings have reasserted themselves as an important factor in valuing companies and this has become evident as macro influences linked to interest rates movements have subsided.

There are always a number of headwinds to the momentum in markets and currently that includes valuation levels, especially in the US. A broadening out of markets from a focus on certain stocks and sectors would provide investors with a stronger signal that improving global economic growth could be sustained, and that inflation was under control. The 'Magnificent Seven' and in Europe the so termed 'Granolas' have been grabbing the headlines as they have represented the lion's share of equity market upside but as investors become more confident investment should broaden out into the mid and small cap stocks that have struggled in recent years. There are some regions that have struggled, the most prominent of which has been China, although economic growth is still higher than the developed world. China has structural issues that will take time to resolve but they should not be ignored, even if just on valuation grounds.

The focus should not just be on equities, as the forecasted rate cuts also suggest a positive future for bond investors. Year to date this has not materialised as bond yields have steadily crept upwards due to the acceptance by markets, based on central bank rhetoric, of the need for patience with more durable data needed to indicate inflation is on a clear downward path. One potential benefit of this for multi asset investors has been the lowering of the correlation between equities and bonds.

There are lots of positives to take from the quarter – global economic growth is improving, and higher interest rates have helped to stem the post pandemic inflationary surge without creating a deep or even mild recession so far. We may have to accept that this results in the equilibrium rate of inflation being above the target rate of 2% in the next cycle as economies adjust to a different world with supply constraints and less globalisation. There is a divergence in economic growth between the US and the rest of the world but there are also signs that growth is returning to other regions, with Japan a beneficiary of a higher inflation world.

There are many unresolved issues that seem to be being ignored by investors, the problems in Ukraine and Gaza, the fragility of various supply chains, and the possibility of inflation returning if strong growth continues. For the time being the positive start to the year is good news for portfolios, but we need to remain diversified and not be drawn into the latest theme or an over concentrated investment strategy.



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