

Quarterly Investment Bulletin

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Headlines

- ❖ The ECB were the first of the main central banks to cut interest rates in June.
- ❖ UK inflation fell to 2.0% in June which was slightly lower than anticipated.
- ❖ Equity market returns continued to prosper in the second quarter.
- ❖ Equity returns broadened out in Q2, but volatility continued due to interest rate speculation.
- ❖ UK interest rates remained at 5.25%.
- ❖ European inflation was up to 2.6% from 2.4%.
- ❖ Bond returns have been relatively flat with yields staying higher than expected.
- ❖ The US economy still leads globally, but there are some signs of slowing.
- ❖ A number of stock markets reached all-time highs in the quarter.
- ❖ Geopolitical volatility has risen in Europe with a snap French election announced.
- ❖ Asian markets have delivered more positive results this year after Chinese policies became more supportive.



General Economic Overview – Quarter 2 2024

The momentum in equity markets has continued unabated in the second quarter of the year especially in US, once again led by a concentrated set of stocks, although this has broadened during the quarter.

Since our April review, the growing consensus among managers is that we're in a higher-for-longer interest rate environment. At the beginning of the year markets were pricing in repeated Fed rate cuts in 2024. Instead, the Fed has held its finger on the pause button, including at the last meeting in June. The Fed has gradually been adjusting to the reality that rates will need to stay higher for longer – not only in the short term but also further out, which is illustrated by the gradual upward revision of its own estimate of long-run interest rates. Market pricing has adjusted accordingly. In Europe, with growth improving, inflation still above target and unemployment at a record low, the European Central Bank's rate cut in June did not mark the start of a deep rate-cutting cycle, as noted by Christine Lagarde in her press conference. The same stance is likely from the Fed if it starts to ease later this year.

Central banks describe themselves as data dependent. This means that in theory they have no philosophical bias towards higher or lower rates; they will be what they need to be. Most central banks also have more than one mandate – whilst much of the focus is on inflation, they also can have mandates around employment and financial stability.

These mandates have probably led to a more conservative approach to lowering rates in the US where inflation does not suggest interest rates should be cut just yet. Inflation is above target with some signs it could increase further, and markets seem to be paying attention to this with the volatility in bond yields. The other two mandates, employment and financial stability, do suggest rate cuts may be appropriate. The falling number of job openings indicate that the employment market is weakening. Perhaps more importantly, the scale of deficit spending in the US and the amount of debt that will need to be issued means there could be a dislocation in bond markets and financial markets that could require the Fed to act. Lower interest rates would reduce the probability of this.

Over the quarter, confidence has grown in the ability of the global economy to continue to move forward but there are a number of existing issues that remain. Probably the most significant is the geopolitical balance as nearly half the world's population will vote in elections this year. The recent French election was not expected but symptomatic of a changing political landscape in Europe with more extreme alliances taking place. Trading relations are also strained between the US and China and of course sanctions are in place against Russia. Equity markets have managed to move on for the time being with bond markets relatively flat, but it wouldn't take much to trigger a change in sentiment that could take markets back down from the current highs.

Equity Markets

Equity markets have been the main driver of investor returns in 2024 so far, with the momentum continuing from the first quarter. The focus remains on the tech giants in the US, but this has broadened out a little into a wider set of names including some mid and small cap stocks. The question for many investors is whether this momentum can be maintained with the gains already made this year potentially being the majority of what will be achieved. The US and Japan have been the strongest



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markets with Japan slightly ahead of the US in local currency terms. The UK and Europe are both positive but 7-9% behind the US and Japan (local currency) respectively. The reasons haven't really changed with the US driven by the technology sector and Japan by a changing economic environment, rising inflation, and a more competitive currency which benefits exporters. Asia has lagged for some time, based on the issues in China which have begun to be addressed centrally and this has improved market sentiment and valuations, lifting the returns from emerging market equities overall.

UK

The UK economy continues to improve slowly as we move through the year. GDP growth is positive again and overall inflation, based on the May data, has fallen to the target level of 2%. The annual average inflation was 4.6% in May (5.1% in April) reflecting the downward trend, and core inflation fell to 3.5% in May from April's 3.8%. More data is required for the BoE to lower interest rates, but the pattern looks good, and inflation is now lower than in the US and Europe. There has also been a rebound in retail sales as goods bought increased by 2.9% (ONS) between April and May marking the fastest growth since January. This suggests that economic growth might be stronger in the second quarter than the ONS forecast of 0.4%. During the first quarter the economy expanded by 0.6%, which lifted the UK out of recession and backed the belief that consumer confidence was improving. Public sector borrowing also came in lower than expected at £33.5bn (OBR) but there remains a huge fiscal challenge for the ruling party according to Capital Economics, given the size of the deficit. The stock market continues to ride high with the strongest growth in valuations coming from the FTSE 100, but this has broadened out a little in recent months. Returns this year from mid and small cap companies have been better but are only half that of their larger cap alternatives.

US

US stocks have hit record highs and are up about 14% this year and US 10-year Treasury yields fell roughly 20 basis points to near 4.20%. The US CPI for May came in below expectations thanks to core services inflation broadly moderating. The Fed held rates steady as expected and now predicts only one rate cut this year.

Annual retail sales grew 2.3% in May, which was below April's 2.7% expansion whilst annual average growth of retail sales was 2.9% in May, mirroring April's figure (source Focus Economics June 2024). Taken together, consumption of goods and services data for April and retail sales data for May suggest a still-solid private spending outturn in Q2, in line with Focus Economics' forecasts. There are however indications of the beginnings of a slowdown as retailers are starting to lower prices to encourage spending – Target and Walmart are both already discounting. This is encouraging news for those hoping for rate cuts after a period when most data pointed to few if any cuts in interest rates this year.

The US continues to be the strongest western equity market, after the recent falls in Japan, based on a stronger than anticipated economy. There are signs that some of the data is now weakening as employment and savings data have begun to deteriorate, albeit from strong positions. One obvious risk is in the concentration of the companies that are driving the market forward. The AI theme has certainly kept the momentum going this year, but the fall for Nvidia at the end of June illustrates how that momentum could change quite quickly, although it has now recovered. The revenues for the fab five tech stocks (Alphabet, Amazon, Apple, Microsoft and Meta) are still strong but if they started trimming their investment budgets then this would have a knock-on effect for Nvidia as these five form 40% of



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Nvidia's revenue. The expected growth for these companies, based on analyst forecasts, does appear realistic – even Nvidia has come down from 50% pa in recent years to an expected 23% over the next 12 months, and this lowering of expectations is similar for the other stocks mentioned. Earnings estimates for the group remain in single digits which is also reasonable, but the valuations have changed and Nvidia, Apple and Broadcom have all seen a 20% upward move in their price earnings ratio in the past three months. This could reflect current momentum, which will eventually subside, but it emphasises that the industry is in the hands of only a few players, and it is difficult to see this changing in the short term with the AI impetus continuing.

The government deficit continues to rise, and it doesn't appear that a change in leader will make much difference as both potential presidential candidates have a similar spending ethic. A deficit of this level would also suggest that whoever ends up as President later this year will not have much fiscal room to manoeuvre. 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. There will no doubt be an inflection point when the parties debate the next set of budget approvals between October 2024 and March 2025.

Europe

Probably the most surprising event to occur in Europe in recent weeks was not the lowering of interest rates by the ECB but the snap election instigated by President Macron. It was the result of a poor showing in the European elections when the far right took a greater share of the vote. The decision focused investors' thoughts and resulted in a rapid fall in French shares and also pushed up government borrowing costs. Things settled down the following week, but it highlighted the growing strength of the right wing and raised concerns about geopolitical stability in Europe. European shares have all suffered from the effects of the announcement and it will be interesting to see if the Le Pen led far right gains enough seats to rule alone or can form a coalition. Business activity in France has fallen back for the time being as uncertainty prevails, with a fear that a far-right regime will bring in unfunded tax cuts and anti-immigration policies. France is the second biggest economy in Europe, hence the concern for global investors that this could cause contagion.

Elsewhere, the lowering of interest rates by the ECB was a good sign for investors as it lowers borrowing costs for individuals and companies and shows that inflation has trended down enough to warrant a cut, although the May inflation figure came in higher than April's which wasn't expected. The ECB made it clear that data will now need to support this consistently before any further cuts can be made. The issues facing Germany, the other key European economy, are less political (although the coalition is not very strongly aligned) and more associated with competition in key markets such as autos and some structural issues such as onshoring and a reduction in globalisation. 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.

Germany is going through a difficult period and is only expected to grow by around 1.4% in 2024 (source FT March 2024) as a tough environment for the auto industry and slowing exports to China have caused problems for the industrial sectors.



Asia & Emerging Markets

The strength in the US economy has provided a challenging backdrop for some emerging market currencies in the first six months of 2024. As a result of stronger than expected US growth and the continued resilience despite higher interest rates, the prospects of rapid easing by the Fed have dissipated, and consequently expected rate cuts in much of the developing world have also been put on hold. This has affected many emerging market currencies in Latin America and Asia which are on track for their worst first half of the year since 2020. JP Morgan's Emerging Markets Foreign Exchange Index has fallen around 4.5% this year versus the US\$. Countries such as Chile, Hungary and Brazil which have cut rates have seen currency weakness, and Indonesia has been forced to raise interest rates to defend the rupiah.

Geopolitics remain problematic, and tensions between the US and China show no signs of easing with both Presidential candidates finding China a useful scapegoat in the run up to the election. Trump, if elected, may be more extreme in the imposition of further tariffs on China. Many Americans believe if China gains economic supremacy, it will look to leverage this into military supremacy, challenging the right of the US to be the world's pre-eminent superpower. China continues to operate in a way that its smaller Asian neighbours argue is threatening in the South China Sea, and reunification with Taiwan remains a long-term goal of President Xi.

Chinese equities, both in the mainland and those listed in Hong Kong, had enjoyed a significant rally in the second half of Q1, recovering from oversold positions as the economy showed tentative signs of stabilisation. The authorities in China seem to have realised they need to put a floor under growth and in May announced plans to help support the property market where falling prices have badly affected consumer confidence. Savings rates in China have increased, and the authorities now realise that without a stabilisation of property prices this is unlikely to change. The first measures announced were a reduction in first time buyer deposits from 20% to 15% and a relaxation in most major cities of rules concerning the purchase of second or third homes. There has also been some lowering of mortgage rates. This alone is not enough to persuade buyers to come into the market if they believe that prices will be lower in 12 months' time, and the authorities have announced plans to underpin property prices by local authorities (with central government support) purchasing empty or unfinished apartments to provide better social housing. This would also boost confidence at the lower end of the income range in China as it would reduce insecurity over where to live in old age. The market is now waiting to see how these policies are implemented and there is a focus on the economic forum in July where significant economic reforms have been announced in the past. The authorities in China now seem to have recognised that falling property prices will lead to continued economic weakness.

The election in India produced a surprise, not that Modi has remained as Prime Minister, but that the BJP Party did not record an overall majority. As a result, Modi has had to rely on coalition partners to form a government. The market had rallied when exit polls were released, predicting a Modi majority, but these proved incorrect and the market initially sold off on the announcement of the official results, with companies believed to be closely aligned with Modi, such as the Adani Group of companies, hard hit. The broader market has since rallied significantly as investors believe that the broad package of reforms in India will continue, although further sweeping reforms of the land and labour markets will likely be put on hold. Investors now accept that nationalistic pro-Hindu policies will be watered down,



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but the development of the country's manufacturing base, which continues to receive attractive incentives and has brought in considerable FDI, will continue.

Mexico has benefitted from its proximity to the US and from multi-nationals reducing supply chain dependency on China, but the recent Presidential election result has resulted in a short term setback to the currency and stock market. Challenges include a worsening budget deficit due to expanded welfare programmes and the cost of new infrastructure projects. Mexico remains well placed as long as it doesn't go down an anti-business route. Brazil's financial markets have been under pressure this year as concerns have grown about the spending plans of left-wing President Lula, and the currency (versus the dollar) and stock market are both down close to 10% so far in 2024. Expectations for economic growth have been pared back, and inflation forecasts have edged up. The stock market will need reassurance that economic policy will not emulate Lula's second presidential term for it to stage a significant rally. With the right policies, Brazil continues to have strong long-term potential.

The issues in the Middle East continue to have the potential to escalate but to date have had negligible impact on the oil price, which is a positive for the future path of inflation. The conflict in Gaza has demonstrated how the market differentiates between a humanitarian and economic tragedy and as long as the conflict remains well contained it is unlikely to be the driver of global market performance. So far, the oil price has been remarkably well behaved, and the US has increased the supply of shale which has countered certain production cuts within the OPEC+ group.

Emerging markets continue to wait for a US economic slowdown, and this has resulted in upward pressure on the US currency which is never an easy backdrop for this asset class. So far this year, the currency has taken most of the strain, and any sign of US economic weakness would likely be viewed positively by the market, so long as it did not presage a more significant downturn.

Japan

The Japanese economy has seen a resurgence of positivity in the last nine months, backed by a weaker yen, higher inflation, and a relaxation of the yield curve policy from the Bank of Japan. There have also been structural changes to encourage retail investment as well as changes that encourage greater share ownership and the adoption of shareholder friendly policies by companies. These factors have led the main market on an upward path for a number of quarters until June, when sentiment changed leading to falls in the Topix. The main reasons for this change have been concerns over a downturn in the US economy, and an exchange rate that has possibly weakened too far and could require Bank of Japan intervention. A weaker currency is good for exports, but Japan has limited natural resources and imports have become more expensive leading to a rising cost of living for consumers. Higher interest rates in the US and Europe are attracting assets to those countries which potentially leads to further yen weakness.

Longer term, the backdrop for the economy remains challenged by structural issues. There may be some resolution in technological advances but in the meantime an aging population, sluggish consumption, high public debt, and low growth rates all continue to be problematic. The short-term outlook for Japan looks positive for equity investors and could benefit from any recovery in Asia and China.



Fixed Interest

Shifting expectations around interest rate cuts have led to yields rising and falling throughout the year but this quarter investors seemed to accept that the number of expected rate cuts in the US have reduced, possibly to zero. There were times during the quarter when suggestions were made that rates may well go up if inflation were to stay higher for longer. As always, the main focus was on the positioning of the Fed which moved from being dovish at the beginning of the year to more hawkish as the year has progressed. At the end of this quarter most economic forecasts expect there to be some kind of rate cut in the US before the end of the year, but the likelihood is that there will only be one or possibly two cuts this year.

Government bond yields have fluctuated around the 4% mark for 10 year bonds in the UK and around 4.5% in the US. This is still a good level of return, even if capital returns have remained flat this year so far. This has led to significant buying by investors wishing to lock in yields at relatively high levels in anticipation of them falling during the rest of the year. Spreads have remained very tight in US corporate debt with maturities around 10 years now some 1.5 percentage points more in yield than the equivalent government debt (it is typically closer to 2 percentage points). Counter intuitively in Europe and the US, the longer the maturity the less relative reward you receive, prompting the argument that investors are not being properly compensated for the risk, with little obvious value around at the moment. The question for investors is why take on any company risk when the US government are offering a risk free rate of 4.5%? In reality, investors have continued to support the corporate bond market because of the lack of distress, which gives them confidence. With company fundamentals in decent shape, the focus has moved from spreads to yields as there are similar but safer returns available from bonds compared to equities. This is particularly relevant to the pensions industry which prefers greater certainty in its returns to meet set liabilities. High yield bonds have performed better this year with defaults limited and stable.

The delay in the interest rate cutting cycle has meant the demand for so termed junk loans and collateralised loan obligations (CLOs) has been very strong and has allowed over \$400bn of loans to be refinanced at lower rates. Borrowers have tended to roll over loans rather than issue new debt meaning the demand has been higher for a limited pool of loans, especially from CLOs. This has been a boost for high debt companies that have faced higher interest rates in recent years as rates have now come down.

If interest rates start to fall in 2024/25 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. A higher for longer environment would be less beneficial for the bond market with continuing volatility created by the 'will they won't they' debate by investors over interest rate cuts in the US. In the meantime, investors have been buying bonds to secure higher yields before rate cuts happen, with the longer-term possibility of capital appreciation which has kept the market supported even with central banks gradually reducing liquidity.



Alternatives

The pushing out of interest rate cuts has naturally affected those interest rate sensitive asset classes, such as property and infrastructure, and has meant that any momentum created in Q4 2023 and Q1 2024 has slowed.

In property, the warehousing and logistics sectors have proven remarkably resilient whilst offices have struggled in a sector that has yet to recover from the change in working practices. 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. Any lowering of interest rates would be a boost for the property and infrastructure sectors and could lead to a decent recovery.

Commodities made a decent recovery in the previous quarter led by industrial metals such as copper which benefitted from hoarding and continued expansion in emerging markets. Copper has recently fallen due to the declining market for EVs and a lowering of construction related demand in China. The low carbon economy is important for many of these metals and the need to supply this transition should keep prices at competitive levels as it's an unavoidable structural change. Inventories are low and in many of these commodities building new supply takes a significant amount of time. Gold has continued to be strong, helped by central banks buying this asset.

Oil has been discussed less recently, but it is clearly hugely important for the global economy. Prices have been relatively stable this year, with some company consolidation taking place and production levels declining as assets deplete. 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

Markets have persevered rather than shot forward this quarter, as expectations of rate cuts by the Fed have been pushed further into the year and possibly 2025. As expected, the ECB was the first major western bank to cut rates but in doing so identified that data needs to show more consistency before the next cut can be made. This data dependency is the overall theme coming from central banks and even if inflation has been trending in the right direction there are still elements that remain higher than they would like, especially in the service sectors of the global economy. The sentiment around interest rates and the timing of cuts still dominates much of the volatility in markets and this will continue to be the case until a Fed cut happens.

Economic growth has shown signs of improvement across the globe, and the UK has moved out of its technical recession after what looks like two quarters of positive growth. The pattern across Europe is



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more mixed but is heading in the right direction. The US continues to be a bellwether for positivity, and data this year has shown it to be the strongest of the western economies with high employment and wage growth. The concerns are that this may be tapering as consumers run out of pandemic savings and inflationary pressures hit home in lower income households. How far this penetrates consumer demand is difficult to predict but if it starts to appear in consumer data then it may encourage the Fed to lower rates as early as September 2024. So far, we have avoided any major recession across the globe, but this has come at a cost with debt to GDP ratios higher than they have been for many decades and higher for longer interest rates mean the debt repayments stay higher than is comfortable. Dealing with this debt overhang will restrict the fiscal capability of heavily indebted administrations.

A number of geopolitical changes in Europe look to be taking place as we conclude this review, which may have far reaching consequences, especially in mainland Europe as political alliances change. The US will face its election in November, and although both candidates seem to be backing similar themes, the result of this is clearly important on the global stage. Equity market momentum continues to focus on technology and large and mega cap stocks in the US, and in the short term this looks likely to continue, but this could change and the need to maintain a diversified portfolio is as relevant as it has ever been.

Ken Rayner, CEO, RSMR
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