Quarterly Investment Bulletin

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Headlines

- In December the Federal Reserve reduced interest rates by 0.25% to 4.5-4.75%.
- Global stock markets generally had a strong positive year despite growth concerns.
- In December the Bank of England held interest rates at 4.75%.
- According to the ONS, UK economic growth fell to zero between July and September.
- Japan's inflation rate rose from 2.3 to 2.9%.
- UK inflation was above target at 2.6% in November, driven by energy prices.
- European inflation rose to 2.2% from 2% in November.
- US inflation rose to 2.7% in November from 2.6%.
- Donald Trump won the race to the White House.
- The US market reached several all-time highs during 2024.
- Geopolitical tensions have risen in the Middle East after Syria fell into rebel hands.
- China announced further supportive stimulus measures.
- Both France and Germany have faced political upheaval.

General Economic Overview – Quarter 4 2024

The final quarter of the year continued the previous economic activity trends, with Europe and Asia struggling to improve growth and the US powering ahead as strong consumer spending and employment numbers supported the narrative that we are in a period of US exceptionalism. The UK settled into a new and more stable political regime whilst in the US the election of Donald Trump promises freer spending and a potentially inflationary regime. There was far more uncertainty in Europe as the French Prime Minister had to resign and the German Chancellor hung onto power in a very fragmented political landscape.

In 2023 a quarter of the world's largest economies had slipped into recession and these concerns remained at the start of 2024, but there was a robust recovery in the first half of the year, driven by easing inflation and aggressive monetary policies. The Federal Reserve's decision to cut interest rates by half a percentage point in early 2024 was a pivotal moment, signalling a shift towards supporting economic growth. This move was mirrored by other central banks globally, contributing to a more favourable economic environment.

The global economic growth picture has been varied and disjointed, as a range of countries have had political and economic issues, but equity markets have generally continued to move ahead. The focus has been on the US, led by the technology sector, but a number of developed markets have produced good absolute returns ranging from roughly 8 to 20% with large cap growth stocks providing the strongest returns. As we moved through the year, this broadened out with some recovery in value stocks as high valuations caused concerns, especially in the US.

Inflation has started to rise again in developed markets which has caused some concerns and given central bankers a tricky short-term environment to negotiate. The path of rates still seems to be downwards but there are areas of the world where rates are heading upwards, such as Japan and Brazil. Recent language from the Fed also suggests the pace of rate cuts is likely to slow in 2025 which is giving investors food for thought.

Overall, investors appear broadly more positive as we enter 2025, based on the continued progress of the US economy. The future prosperity of the US economy will no doubt come to a crossroads as the presidency of Donald Trump takes hold, and much of the market sentiment in the early part of the year will be driven by his policies and how they are received by investors.

Equity Markets

2024 was a dynamic and eventful year for the global stock market, marked by significant shifts in economic conditions, investor sentiment, and sector performance. The MSCI World Index, a broad measure of global stock performance, rose nearly 10% in the first half of the year (Charles Swab Global Half Year Outlook) fuelled by improved economic data, including lower inflation rates and stronger employment figures but this performance was not uniform across all sectors and regions.

Equity markets remained positive over the final quarter and held steady towards the end of the year when investor uncertainty increased due to the slowing of US interest rate cuts with strong economic data persisting, alongside a future political regime under Donald Trump, whose policies look to be inflationary. Like many developed markets this year the majority of the returns in the US and UK came from large cap stocks. Whilst investors were more positive as the year developed, they were also defensively minded and saw more protection in these companies. There were periods when mid and small cap stocks outperformed but these periods were short lived and tended to fade away. There has been a large valuation gap between large and small cap stocks for a very long time now and investors are looking for that to close, especially if interest rates continue to fall. This path is not certain however and has been made more complicated by the rise of passive investing, private equity and complex financial instruments, all of which affect the volatility of markets and therefore investor sentiment. This is a theme all investors need to be mindful of in 2025 and beyond. The concentration of markets broadened out a little in the final quarter as investors were encouraged by the potential of lower taxes and higher spending under Trump, but this has been tempered by inflation concerns and waned in December alongside a more hawkish Fed.

A repeat of the strong returns in 2024 of over 20% does seem unlikely for 2025, even if we get looser monetary conditions and political support from the US, but if earnings can continue to improve then this may act to consolidate valuations and lead to positive investor sentiment for the second half of 2025 and 2026.

UK

The latest UK GDP growth figures were not very encouraging, with no economic growth predicted in the second half of the year according to the latest ONS figures (which analysed growth between July and September) leaving the economy without much momentum heading into 2025. The strength in the first half of 2024 halted in the second half due to a combination of the drag from higher interest rates, weaker overseas demand, and concerns over the recent budget. The budget was a focus of business concerns as it included £40bn of tax increases including £25bn from the rise in national insurance premiums, and this contributed to a sharp fall in business sentiment and hiring activity. The ONS highlighted a fall in activity in the hospitality sector, legal firms and advertising.

The Bank of England has started to move the core rate of interest downwards but felt it was necessary to halt the trend in December as wages growth remained stronger than expected and inflation had started to move up again, rising to 2.6% in November. This is not good news for a government that has promised to increase investment flows to the UK whilst at the same time balancing the books. The autumn budget increased taxation, particularly at the corporate level with the increase in national

insurance and this will have a significant impact on large employers. A number of fund managers do see encouraging signs in UK stocks, not least because of their low valuations. UK stocks have much lower PE multiples that those in the US for example, and in theory offer greater opportunities. Getting investors to move away from the US will be much harder as the momentum for this trade is very strong at the moment, and a number of high-profile listings are being lost to the US and other markets because of the available capital and higher valuations.

US

At the start of the year, many economists and strategists were braced for a recession, fearing that higher interest rates would choke off growth, corporate earnings would fall, and investors would lose their nerve. Instead, the US economy shrugged off the doubts, consumer spending remained surprisingly strong and corporate earnings outperformed expectations. At the centre of 2024's rally was technology, particularly stocks linked to the AI boom. The likes of Nvidia, Alphabet and Apple became the standard-bearers for this movement, as investors poured money into companies poised to benefit from AI infrastructure and applications. Nvidia was this year's darling, and its valuation soared past $3.6trn at one point. One of the most significant influences on the market was the Fed's decision to cut interest rates by 50 basis points in September and this was followed up by a further quarter point cut in December. Press conference comments by Jerome Powell caused markets to falter at the year-end as he suggested rate cuts would slow in 2025 due to uncertainty as to the effect of the new Republican party's policies on the US economy.

The US stock market achieved solid performance in Q4 2024, with the Morningstar US Market Index rising by 5.31%. This growth was driven by several factors, including easing inflation, favourable economic data, and strategic moves by the Fed. Although large caps dominated over the year, there was a continuation of the rotation from large-cap growth and technology stocks to value stocks and smaller companies in the final quarter. This shift was partly due to the perception that many large-cap tech stocks were overvalued, prompting investors to seek opportunities in undervalued sectors. As a result, sectors such as financials, industrials, and consumer staples performed well whilst tech valuations remain stretched – Nvidia trades at earnings multiples that leave no room for disappointment. The Magnificent Seven (Nvidia, Microsoft, Alphabet, Amazon, Apple, Meta and Tesla) dominated gains in 2024 and by mid-year, their combined weight made up over 30% of the S&P 500, the highest level since the dot-com bubble. Inflation cooled in 2024, leading the Fed to pivot toward rate cuts, but it hasn't disappeared entirely and has edged up recently. Meanwhile, US housing and service sector inflation remain stubborn, and any misstep in monetary policy could throw markets off course. Recent market falls have removed some off the froth from prices, but it shows how markets can be easily spooked. Valuations will remain stretched, unless earnings can catch up.

Looking ahead to 2025, the US stock market is expected to navigate a complex landscape. Key factors to watch include the Fed's monetary policies, economic growth indicators, and geopolitical developments. The rotation from growth to value stocks may persist, as investors seek opportunities in undervalued sectors.

Europe

Geopolitical developments continued to influence the European economy. Trade tensions, particularly between the EU and major global economies such as the US and China, added to market uncertainties. The ongoing adjustments related to Brexit had a mixed impact on trade and economic relations between the UK and the EU. By contrast unemployment rates in Europe reached historic lows, with the EU's unemployment rate at 6.1% (source Autumn Economic Forecast EU Commission). The labour market remained robust, supported by steady job creation and improving economic conditions. Real wages also recovered, and household disposable income expanded at a healthy pace.

Interestingly, stock market growth in certain sections of the European economy has been as positive as in the US. The German economy has been struggling, mainly because of the drop in domestic manufacturing, exports within Europe and competition with China in autos, but it has seen a very strong stock market performance. Frankfurt's Dax, an index of 40 blue chip companies, rose over 18% in 2024 (source FT December 2024), far outstripping the broader Euro Stoxx 600 index. This comes at a time of political turmoil in Germany with the coalition collapsing in November and a new election scheduled for February. The economy is expected to expand by just 0.6% in 2025 according to a poll by Consensus Economics. As with other markets, the performance of the DAX has been mainly achieved by just seven companies including SAP (technology), Siemens (industrials) and Rheinmetall (defence), as well as Allianz and Munich Re (financials). SAP has benefitted from the focus on AI technology and is now Europe's largest technology company, outpacing ASML. This set of companies is more diverse than in the US and so offers a broader opportunity set to investors. France is also struggling on the political front with the far right gaining strength and a new prime minister in office.

The ECB continued to lower interest rates in the quarter with a further 25 basis points cut to 3.0%, marking the fourth cut in 2024. The battle with inflation remains as the inflation rate rose above target in November to 2.2%. The EU has to balance a number of different regional issues but is pressing ahead with cuts to encourage investment.

Asia & Emerging Markets

Asian markets performed better in the second half of 2024 as China issued a series of stimulus measures for their economy. China remains the key economy in the region, but India is now seen as a driving force as its economy is growing at a faster rate and it continues to have an expanding workforce and a positive population demographic.

The Chinese economy grew at 4.8% in the third quarter year on year, slightly lower than in 2023, which is a result of weaker domestic demand and contracted production, and low industrial capacity utilisation. Consumption has picked up since the new measures were introduced, which included a trade in programme for durable goods, a reduction in mortgage rates and additional allowances for target groups. The government also delivered a new bond issuance programme which boosted infrastructure investment, but real estate investment continued to fall in the third quarter. New policy stimuli introduced in September/October to stabilise housing and financial market prices started to have an effect in the final quarter of the year. Manufacturing PMI returned to expansionary territory in October after five months of contraction. It is hoped that these policies will help inflation to pick up, to avoid a deflationary environment developing as happened in Japan in the 1980s. Chinese exports have had a strong year but will face a headwind of tariffs from the US in 2025. Exports of high-tech products including cars, batteries and solar cells were pockets of significant growth. Whilst China managed to

achieve steady economic growth and a strong stock market performance in certain sectors, it also faced significant challenges, particularly in the real estate market and consumer demand.

US President Elect Donald Trump has proposed new tariffs on the region and China specifically. The effects of the proposed tariffs will depend on whether trade patterns will shift as a result. Approximately two-thirds of China's exports to the US already face additional tariffs, and this appears to have accelerated the diversion of trade to other regions. China's exports to the US, as a percentage of its total exports, fell from 21% in 2018 to 14% in 2023, while its exports to other regions such as the Association of Southeast Asian Nations and the European Union have expanded.

The performance of major Indian stock market indices in 2024 differed greatly across segments. The Nifty 50 and Sensex delivered around 10% returns, showcasing the steady performance of blue chip stocks. Conversely, the small and mid-cap indices significantly outperformed their large-cap counterparts. Indian economic growth continued to power ahead and is over 8% (Trading Economics November 2024) year on year which makes it one of the strongest emerging economies, and the outlook for 2025 is very encouraging. Brazil and Mexico have had fluctuating fortunes in 2024 with interest rates rising in Brazil as the year progressed due to fears of a worsening environment for prices and core goods. Fiscal conditions are favourable and GDP growth of over 2% is predicted for the medium term, but if developed market conditions deteriorate or there is a slowdown in China then this could limit investment and export growth and exacerbate currency and inflation pressures.

Following a sharp decline throughout 2021 and 2022, earnings growth expectations have moved higher for emerging markets (EM) compared to developed markets (DM) over 2024 and 2025. Consensus earnings growth for EM in 2024 is over 15% and nearly 16% in 2025, compared to just 7% and 11% for DM and 11% and 14% for the US (source JP Morgan Sept 2024). An acceleration in EM earnings momentum along with US rate cuts (historically, EM has been more sensitive to rate moves than US equities) could be tailwinds for relative performance even when absolute valuations are expensive. Geopolitical factors, such as escalation in the Middle East, the ongoing conflict in Russia and Ukraine, and tensions in the South China Sea, could act as headwinds.

Japan

As was expected, the Bank of Japan held interest rates in December at 0.25%, the lowest of the developed nations. Economists forecast that there might be a signal of a rise in January, but when this didn't appear, the currency weakened significantly against the dollar. The inflation rate in Japan is now 2.9% which has been seen as positive after long periods of very low or negative rates. Further rate hikes are expected in the coming months as the BOJ doesn't want the yen to continue depreciating

In quarter three, volatility in the Japanese stock market was much higher as currency fluctuations and worries over US Growth meant stocks fluctuated significantly. Whilst this has settled, the sensitivity to domestic and global sentiment changes remains acute. The stock market finished the year as one of the strongest in local currency terms with the main index reaching above its 1989 highs for the first time in decades. Perhaps less surprising is the fact that this has been led by the exporting companies as the yen has weakened against other currencies. As we have seen in other developed economies, technology companies have fared well, but some areas remain under pressure, such as the automotive market with

several large manufacturers including Nissan, Toyota and Mitsubishi engaging in discussions about mergers.

Japan's engine of economic growth is already switching from exports to consumer spending. A rapid rise in wages has finally given households the purchasing power they need to spend more. A stronger yen should also help alleviate some inflationary pressures, which will further bolster consumer spending. However, inflation is likely to remain elevated in the near term, which could keep the pace of spending relatively modest. A more hawkish monetary policy stance in the US as well as a reversal of wage gains are risks that could further hinder Japan's nascent recovery.

Fixed Interest

The movement in fixed interest yields over the quarter has been surprising, with similar volatility to equities. The changing sentiment around the rate cutting cycle has been at the centre of the increased level of movement and yields have risen far more often than expected in a falling interest rate environment. Investors poured over $600bn into global bond funds in 2024 (source: EFPR) as they bet on a shift towards easier monetary policy with the sense that slowing inflation would be a turning point for global fixed income. This was despite it being a patchy year for bonds which rallied over the summer before giving up their gains by the end of the year on rising concerns that the pace of global rate cuts would be slower than previously expected. More recently the language from the Fed after the December interest rate cut suggested a slower pace of cuts in 2025, which sent US government bond prices lower and the dollar to a two year high. This led to significant outflows in December and the 10 year US Treasury yield was back up to 4.5% in Christmas week, having started the year below 4%. The positive flows have been a reflection of a fear of recession earlier in the year as investors became more defensive along with concern that US equities became very expensive as the year progressed.

Corporate credit has been more resilient, and US and European spreads reached their lowest levels in decades which led to a surge in bond issuance as companies sought to take advantage of easy money conditions. Corporate debt sales hit a record $8tn this year (source FT December 2024) as companies took advantage of investor interest to accelerate borrowing plans. This issuance is up over one third from 2023 as borrowing costs relative to government debt were at the lowest level for decades. The outlook for 2025 looks to be very steady as companies seek to refinance the debt they secured in during the pandemic.

High yield debt performed well in 2024 as the default landscape remained very low and spreads tightened. The robustness of the default rate surprised many investors as rates rose, but 2025 may see defaults rise as low rates are refinanced from the pre Covid era.

Alternatives

As interest rates have come down, the market has supported real estate and infrastructure assets which have made good progress over the year. Further interest rates cuts will be supportive, however both asset classes are also benefitting from larger investment themes surrounding the increasing

commitment to renewable energy (infrastructure), and artificial intelligence via data centres (property). The energy transition is also important across a range of sectors as it has forced structural changes and, along with Covid and the Russian invasion of Ukraine, has heightened resource protectionism across the globe which has impacted prices as countries seek security of supply.

Commodities are important in the range of alternatives, and the oil price is a key factor in the global economy. The price of oil has been very stable this year as demand has dictated prices rather than supply. Countries in OPEC have been limiting supply for some time but the gradual move to energy transition, the production of oil from other sources such as fracking in the US, and slowing demand from China has offset this capacity reduction. The energy transition is important as it heralds a structural change in the global economy. The sale of EVs in China for example far outstrips other economies with close to 50% of new sales now electric or hybrid which reduces the demand for oil.

Precious metals responded positively to the Fed's cuts in interest rates with gold trading to record highs in dollar terms into the quarter end. Wider commodities, including iron ore, copper and steel, reacted positively to the stimulus measures announced in China as increased demand is anticipated.

Summary

The path for global growth and stock market returns was not immediately clear as we started 2024. There were lingering concerns about inflation and the actions of central banks, particularly the US Fed. Early in the year, inflationary pressures were still a major concern, prompting central banks to maintain a cautious stance on interest rates but as the year progressed, inflation began to show signs of easing, leading to a shift in monetary policy. This shift was the catalyst for investors to regain confidence in the momentum being shown in the US stock market, driven by a select number of large cap stocks in the technology sector. Whilst this theme ebbed at times during the year it never went away, and at the end of the year we can see that the strongest returns came from the same narrow band of stocks, although this has begun to broaden out as a much wider set of companies have shown improved earnings. Mid and small cap stocks have struggled in the US and Europe (including the UK) but in emerging markets such as India they have performed extremely well.

The global economy has been robust but dominated by the strength of the US, which has led to a wider debate about American exceptionalism in an era when several economies have suffered from the result of a downturn in the Chinese economy and the political instability that has plagued many developed and emerging economies. Regime changes and elections have been a major theme over the year with more countries going to the ballot box than has ever been seen before. Wars in Ukraine and in the Middle East added to the uncertainty over supply of goods and resources which led to a greater level of global protectionism and a move away from globalisation of goods and services. These factors have meant that global GDP has lagged the US, but despite this, global stock markets have performed reasonably well, even in Asia and Europe which have both seen a fall in GDP growth. China is still growing faster than many areas of the world but faces structural problems with its property market and changing demographic picture. Europe has been a casualty of this but has also had political problems in key

economies such as France and Germany and has suffered from its energy and general supply side issues created by the Russian invasion of Ukraine which rumbles on.

Looking ahead there is a sense of optimism from a range of investment managers. There is belief that the momentum in earnings growth can continue into 2025, helping to justify some of the extended valuations we have seen. 2024 returns in developed markets have ranged from low single digits to over 30% (US Nasdaq) but we have generally seen positive returns from risk assets led by equities. Can this be repeated in 2025? It seems unlikely unless earnings can maintain their momentum, which looks to be a stretch in European and Asian economies. The US and India may prove to be exceptions, although new polices may be inflationary which could stall further growth if interest rates have to remain higher than expected.

In summary, 2024 has been a year of significant change and adaptation for global stock markets. The broadening of markets, the impact of central bank policies, and the resilience of various sectors have all played crucial roles in shaping the market landscape. As we look ahead, the ability to navigate these dynamic conditions will be key for investors seeking to capitalize on emerging opportunities.

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