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Introduction and Market Overview

Equity markets ended 2023 on a high note following Fed Chairman Jerome Powell's dovish 'pivot' in December, which raised hopes of significant interest rate cuts. The rally for equities has continued into 2024, despite the likelihood of fewer cuts than were expected at the start of the year. The explanation for this is the strong global economy, particularly in the US. Investors are translating this into better prospects for corporate earnings growth. This is already being seen in the robust earnings reports delivered by companies during the first quarter.

The global economy continues to evade the recession that many analysts were predicting. US economic growth remains particularly resilient, helped by unusually high Government spending. Despite this, the purchasing manager indexes compiled by S&P Global show that the global economy has recently moved back into expansion mode. Both the US and Chinese manufacturing sectors are contributing to the strength, although Europe continues to lag. The UK joined the list of advanced economies experiencing a technical recession during the second half of 2023.

Coming into 2024 the bond market was pricing in a high likelihood of a first rate cut by the Fed in March. This did not materialise but Powell said during the quarter that the Fed is "not far" from cutting interest rates. Equity markets responded positively to his comments later in the quarter indicating a continued expectation from the Fed to lower interest rates by three-quarters of a point over the year. These developments suggest that despite recent mixed economic data, including recent hotter readings on inflation, the Fed is positioning itself to commence rate cuts soon, with Wall Street now betting that the first-rate cut will come in the summer. All other major developed central banks held off cutting interest rates, apart from the Swiss National Bank, which unexpectedly cut by 0.25% as inflation fell close to 1%.

The Bank of Japan bucked the trend and raised interest rates, for the first time in 17 years. This ended the world's only remaining negative rates regime. This major shift signals a return to traditional monetary strategies and demonstrates a renewed confidence in Japan's path to recovery from years of deflation and economic stagnation. In addition to this, the BoJ announced several other monetary policy adjustments aimed to stimulate the economy by encouraging spending and investment, while also keeping inflation in check.

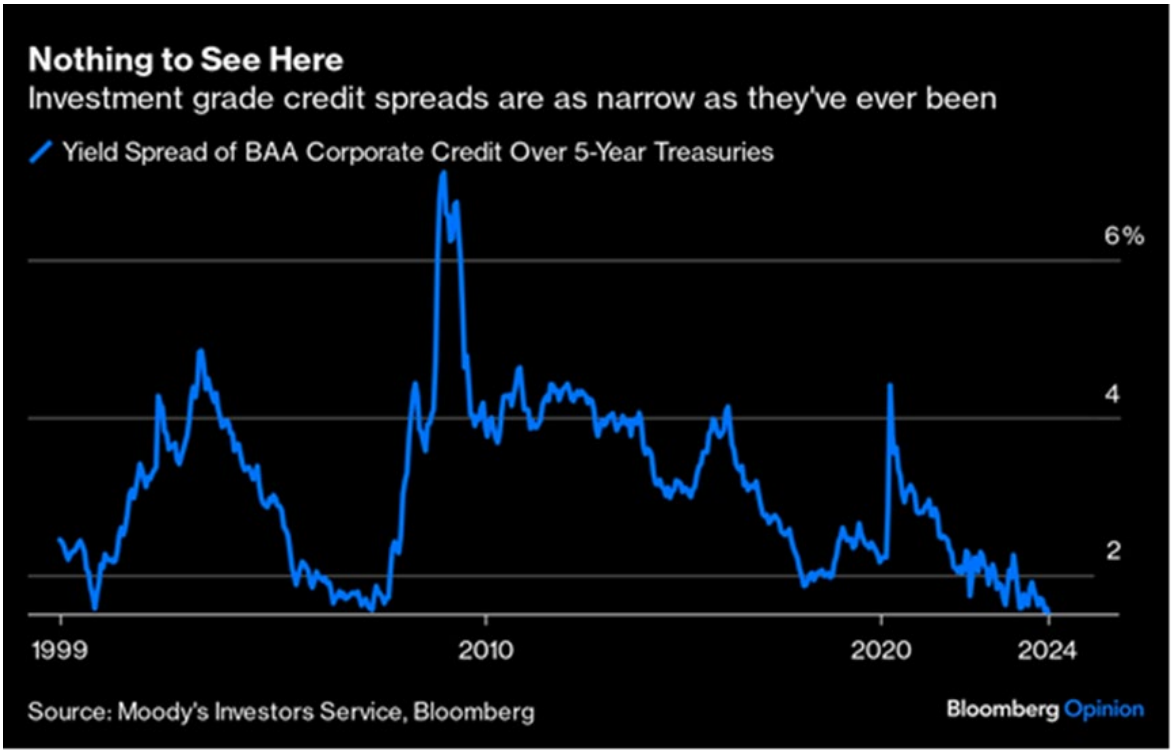
The absence of a rate cut in the US means that the treasury bond yield curve remains inverted. This is a condition where longer-term bonds yield less than short-term ones, reflecting the market's continued expectation of a recession. However, according to a recent Bank of America survey, most investors do not agree. The percentage of respondents believing that a recession is "unlikely" over the next 12 months has spiked sharply higher.

Source: BofA Global Fund Manager Survey

Cyclical stocks, which tend to do well in an economic growth cycle, outperformed defensive stocks in Q1. The S&P 500, which is the bellwether for US equities, enjoyed a strong quarter. Its current run without a pullback of even as little as 2% now stretches to five months. It is notable that the performance continues to broaden out and is less focused on the "Magnificent Seven" large technology names. Notably, Tesla and Apple suffered sharp share price falls during the quarter.

Japanese equities continue to do well, with the Nikkei 225 Index posting its first all-time high for nearly 30 years. UK equities lagged behind but finished with a strong March performance. An index of 100 leading UK stocks ended the quarter up with a close to 4% total return.

The strong global economy and jobs market, as well as relatively sticky inflation prints, did cause a weaker performance for government bonds. With fewer rate cuts being expected, the relative attractiveness of bonds has reduced in the short term. Credit spreads, which measure the extra yield that investors require to take the extra risk of lending to a company rather than the government are as low as they have been in a quarter of a century. This meant that bonds issued by companies did a little better, a further sign of risk appetite during the quarter.



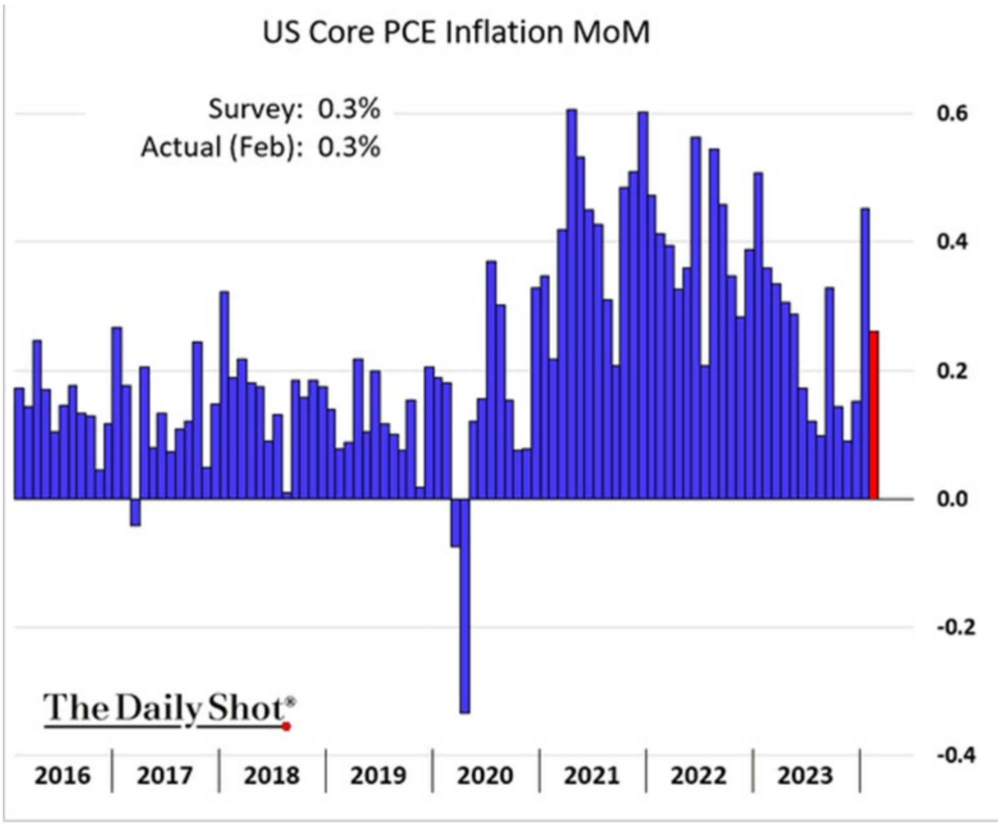
Elsewhere, commodity prices were broadly strong. US crude oil futures surged to $85 a barrel for the first time since October. Cocoa prices rose above $10,000 per tonne for the first time ever, more than doubling in two months, due to poor harvests in Africa. Despite generally being regarded as a safe haven asset, the price of gold also continued to climb higher, exceeding $2,200 per troy ounce for the first time.

During March, Chancellor Jeremy Hunt announced his Spring Budget. The centrepiece of the Chancellor's speech was the announcement of a 2% cut to National Insurance, ignoring calls from some Conservative MPs to slash income tax instead. Hunt went on to state that this cut, combined with that announced last November, will benefit the average worker by around £900 a year.

Fears that the reduction of National Insurance could increase consumer spending and potentially fuel inflation, leading to interest rates staying higher for longer, were laid to rest early in the Chancellor's speech. He insisted that the Tory party, under Rishi Sunak, is successfully bringing down inflation. To support these claims, he referenced reports from the Office for Budget Responsibility (OBR), stating that inflation is expected to fall below the 2% target within the next two months—nearly a whole year earlier than previously forecasted at the Autumn statement last November. The Chancellor went on to announce a freeze on fuel duties for a further 12 months, a move likely to further help ease UK headline inflation.

The current narrative in the markets is that inflation is being brought under control without causing an economic slowdown, which has been described in the financial media as a "no landing" scenario. However, historically when inflation reaches the highs that it did in 2022, it is the last mile back to 2% which is the most difficult, and there has been several spikes higher before the target is achieved.

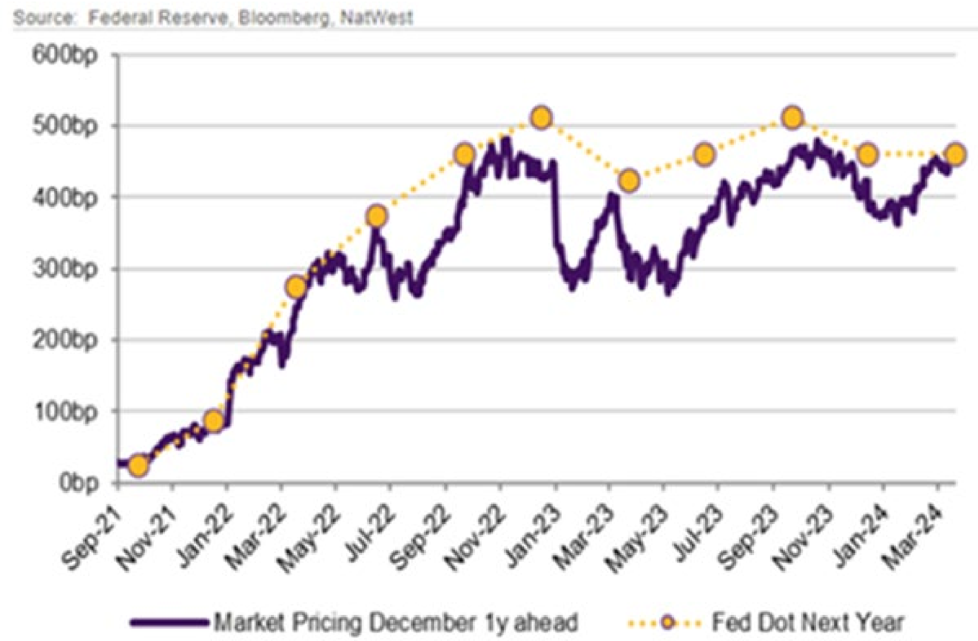
The Fed's preferred inflation indicator is the core personal consumption expenditures price index, which strips out the volatile food and energy components. This jumped higher on a month-over-month basis in January and February. The recent uptrend in many commodity prices is a further reminder that inflation may not yet be completely under control and is something we will be watching closely during the second quarter.



Interest rates are currently appreciably above the rate of inflation. Historically, when real (inflation-adjusted) rates are high, growth eventually slows as it represents a tightening of financial conditions. Part of the reason that growth hasn't slowed so far is due to the strength of the consumer, which is supported by the fact that most people who want a job have one. If unemployment does pick up, it will likely impact on consumer spending.

Coming into 2024, bonds were pricing in more rate cuts than were being indicated by central bankers. The fall in bond prices since then means that the two are now much more closely aligned. We believe if the global economy does show signs of weakening, it would likely be met with more aggressive rate cuts than are currently being priced in. Markets are expecting the US Federal Reserve and Bank of England to start cutting interest rates during the second quarter. We believe this will be key for asset prices going forward.

Market pricing of Fed funds vs the Fed's own forecast



In our view, this should be very positive for the performance of bonds and parts of the equity market that have a bond-like profile, meaning defensive stocks that generate a stable income. We see a potential asymmetric risk/reward profile for these types of assets, given that the market is positioned for the opposite scenario.

We are currently avoiding markets that we view as overvalued, such as large US technology companies, and are positioned for a continued catch-up from more fairly priced equities. We are favouring lower volatility stocks that have an attractive dividend yield. The US quarterly earnings season covering Q4 2023 was positive, and all eyes will be on companies when they start reporting on Q1 2024. Nvidia results will be particularly influential.

As ever, many other situations will need to be monitored during the second quarter, which could have the ability to influence investment markets. Geopolitical risks remain elevated, with conflicts being fought in several geographic regions. The build-up to national elections in many key countries will also be gathering steam.

In general, we have enjoyed a good start to the year. For now, we retain a conservative stance in our portfolios as our expectations that growth stocks will underperform have started to play out.