HYMANS ROBERTSON
INVESTMENT SERVICES

Hymans Robertson Investment Services (HRIS)

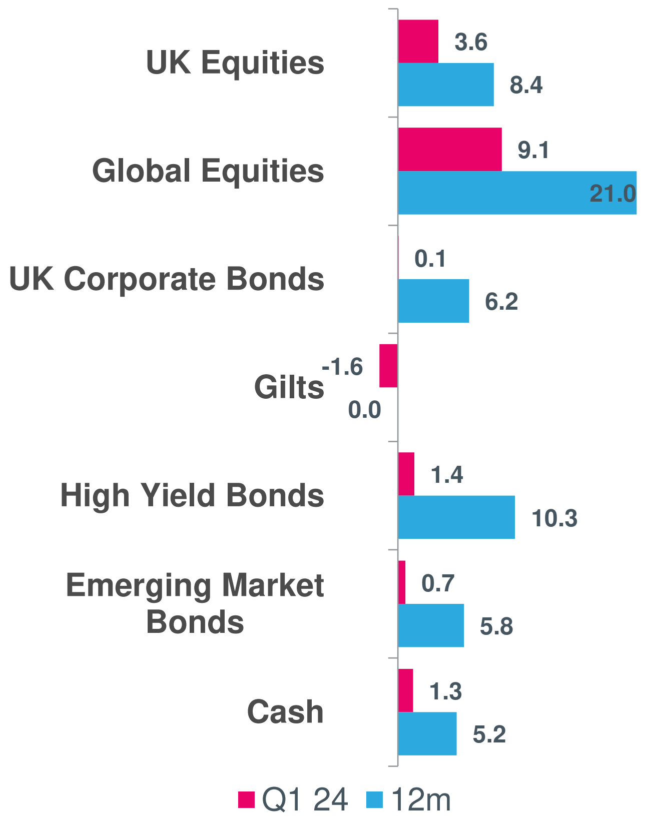
Market Digest

Q1 2024

Quarterly highlights

- Q1 saw a divergence in equity and bond performance, as US economic strength pushed expectations for interest rate cuts to later in the year. Meanwhile, the UK officially entered recession (we discuss this further in our article "Supporting your clients through a UK recession").
- Strong corporate earnings from the likes of Nvidia helped global equities record their best Q1 performance in 5 years, while bonds struggled on the prospect of fewer rate cuts. Given these markets, portfolios typically generated a positive return over the quarter, with higher risk ones outperforming lower risk ones over the period.
- Equities have also performed strongly over the past 12 months. On page 3 of this document, we provide market commentary to cover the past year.

Asset class returns (%)



Source: Morningstar. Figures to 31 March 2024. Returns in sterling terms except High Yield Bonds which are hedged. EM bonds are 50% local currency denominated and 50% US dollar denominated bonds.

Market summary

- Our model portfolios typically invest in a combination of the asset classes shown in the left-hand chart.
- Q1 saw mixed results for investors, as the equity market rallied strongly whereas bonds were mostly flat.
- The US economy continued to generate strong GDP growth, recording an annualised growth rate of 3.4% for Q4. The same cannot be said for the UK, which officially entered recession.
- Equity markets focused on the upbeat picture from the US, as global markets had one of its strongest quarters in years. Strong corporate earnings growth, especially from the tech sector, as well as excitement over AI, helped to boost equity prices higher.
- Japanese and US markets both generated returns of over 11%. However, Emerging Markets and the UK lagged, albeit still with a return of over 3%.
- Bond markets were driven by the expected path of interest rates. In the US, the optimistic view coming into 2024 was for around 1.5% worth of cuts this year. This has moderated over the quarter to around 0.75% worth of cuts, as the slowdown in inflation has stalled over the last few months. As a result, bond yields have increased, hurting bond returns.
- Longer dated bonds with a greater interest rate sensitivity, generated a small loss, whereas high-yield bonds still made a small positive return.
- At a portfolio level, equities outperformed bonds, meaning higher risk portfolios outperformed lower risk ones over the quarter.

Outlook and topical market themes

- January and February Gross Domestic Product ("GDP") data for the UK looks positive (0.3% and 0.1% respectively). The economy seems to have turned a corner going into 2024.
- Despite falling expectations of interest rate cuts, equity markets have shifted attention to strong US economic growth and excitement over AI.

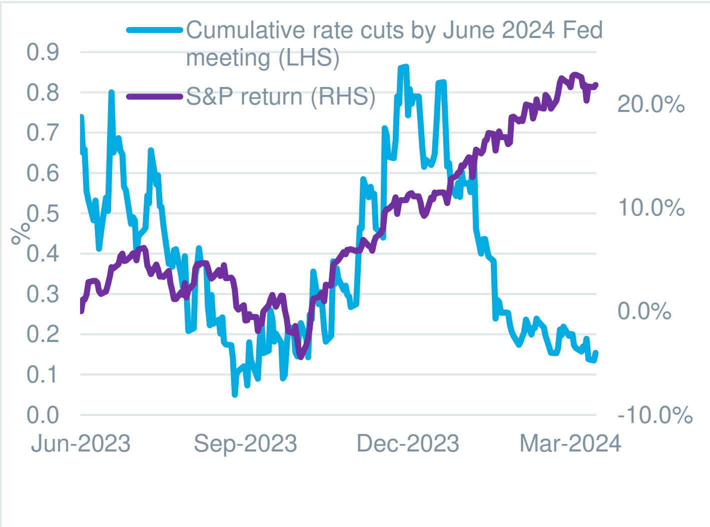
Is the UK already out of recession?

Last year, the UK economy entered recession, after producing two consecutive quarters of negative GDP growth in Q3 and Q4. We have written previously about how this is not necessarily something that investors should worry about. Over the past few months we have seen data releases showing that the start of the year may have been a turning point. GDP growth figures for January and February showed growth of 0.3% and 0.1% respectively, meaning positive growth for Q1 overall is likely. Encouragingly, the recovery looks reasonably broad. Production, which has been weak for months, was the largest contributor to February's positive growth figure. The UK Purchasing Managers' Index, a survey that tries to capture the state of the UK economy, recorded the first expansion in manufacturing output since July 2022. Retail sales have also exceeded expectations so far this year. The one downside for investors is that a stronger economy gives less reason for the Bank of England to cut interest rates as quickly as planned. The expectation of several rate cuts this year may be fading (markets are now pricing in rates of around 4.75% by this December), but we still expect the BoE to begin cutting, albeit slowly, from Summer.

Equity markets are paying less attention to interest rates, for now

It's said that the equity market struggles to focus on more than one shiny thing at a time. For the past two years it's been high inflation and the accompanying increase in interest rates. Over this period, the equity market has been highly correlated with investors' expectations for the path of interest rates – when interest rates were expected to move higher, the equity market fell. Conversely, when expectations shifted towards a lower peak in interest rates or faster rate cuts, the equity market rallied. This was seen as one of the key drivers for the strong performance observed in Q4 last year. Guidance from the US Federal Reserve (Fed) gave investors the impression that interest rates would be falling rapidly this year. That expectation has since faded (see chart below), but the equity market has continued to power through. Investors seem to be more focused on the continued strength from the US economy and excitement of AI technologies. For bond investors, as yields have risen again, it has re-opened a potentially attractive entry point that looked to be closing late last year.

Chart of the month – The equity market is ignoring the expectation of fewer rate cuts from the Fed



Source: Bloomberg

The chart shows the market's expectations for interest rate cuts from the Federal Reserve by June (blue) against the S&P 500 equity index (purple).

Until last December, the equity market was moving up and down with the expectation of cuts. Since the turn of the year however, this correlation has disappeared. One of two things has happened. Either equity investors are now less concerned about movements in interest rates than previously, or the rally in Q4 wasn't to do with interest rate expectations in the first place.

Jack Richards
Investment Manager

Annual market summary – covering the 12 months to 31 March 2024

Throughout this 12-month period, the US economic story was one of consistently beating expectations. The consensus for a recession at the start of the period slowly but surely shifted towards a 'soft landing', where inflation falls back to target without the higher interest rates causing a significant economic slowdown. The story on this side of the pond was quite different. Economic stagnation finally led to recession, as the UK economy shrunk in Q3 and Q4 2023.

Investors were initially heavily focused on how high interest rates would need to get to bring inflation sustainably back to target. The Bank of England eventually paused after raising rates to 5.25% in August 23. Pretty quickly, investors looked ahead to the prospect of rate cuts in 2024. During Q4 23, expectations were raised of several rate cuts over the next 12 months, boosting both equity and bond prices significantly. However, inflation stopped falling over Q1 24 in the US, quickly dampening hopes of imminent rate cuts. This reversal hurt bond prices, but equity markets continued to ride the waves of strong US economic growth. Over the period, UK inflation fell from 10.1% to 3.4%, while interest rates rose from 4.25% to 5.25%.

Geopolitical risk was once more highlighted in Q4 23, as conflict in Israel and Palestine threatened to escalate. The region's importance to global trade and energy markets meant the price of oil increased towards the end of the period. This threatened to undo some of the disinflationary process experienced over the last 12 months and contributed to inflation flatlining in the US in Q1 24.

For most of the period, bonds continued to perform poorly, as uncertainty over inflation and interest rates kept bond yields high. Q4 23 was the exception to this as the exuberance over potential rate cuts drove significant returns for bonds, offsetting losses from the past few quarters. Equity markets fared much better, as the US economic strength, the prospect of lower interest rates and excitement over AI technologies boosted sentiment and corporate earnings. US and Japanese markets were the best performing regions, benefitting from a heavy tech exposure and corporate governance reforms respectively. Emerging Markets and the UK both lagged after weaker Chinese and UK growth prospects hurt both regions.

Please note, 12-month asset class performance is shown in page 1 of this document.