Hymans Robertson Investment Services (HRIS)

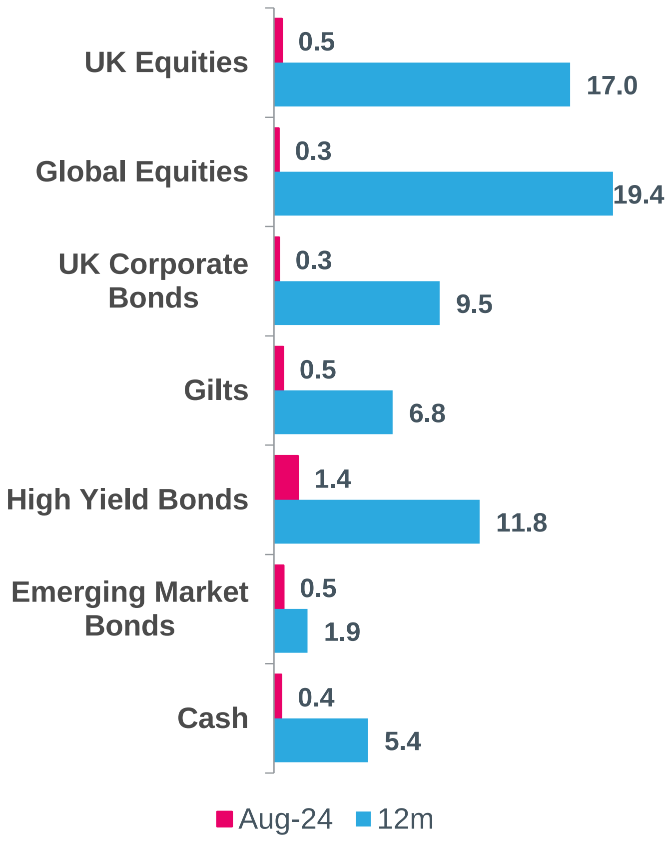
Market Digest

August 2024

Monthly highlights

- Equities and bond markets both generated positive returns to portfolio performance. However, this masks what was a period of intra-month volatility (most notably in early August). We wrote more about the period of volatility here.
- The Federal Reserve continued to signal strongly that an interest rate cut will come in September. This helped to drive positive bond performance over the month.
- On page 3 of this document, we provide market commentary to cover the past year to 30 June 2024.

Asset class returns (%)



Source: Morningstar. Figures to 31 August 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.
- A combination of events at the beginning of August led to a significant increase in short-term market volatility. A few data points indicated a slowdown in the US economy and a weaker labour market. A few days earlier, the Bank of Japan had raised interest rates leading to a sharp rally in the Japanese yen. In addition, earnings from big tech companies like Amazon and Alphabet were below expectations. Beyond the first week of August the volatility subsided, and markets recovered.
- The chairman of the Federal Reserve (Fed), Jerome Powell, effectively gave the green light to September interest rate cuts in a speech at Jackson Hole.
- Global equity markets recovered from losses over the first week of August to eke out a small gain for the month. Japanese equities (which form a small proportion of portfolios) were at the centre of the volatility, falling by as much as 12% in one day (in local currency terms). However, a sharp snapback and a strong yen meant the region ended the month down just 1.8%.
- Bonds performed well over the month. First, during the period of volatility, investors favoured the safety of government bonds. Secondly, as the month progressed, the inevitability of incoming interest rate cuts from the Fed helped push down bond yields (bond prices rise as yields fall).

Outlook and topical market themes

- A Manufacturing PMI and unemployment data was one of the drivers of the early August volatility. We think this was an overreaction, with other data points still showing decent economic growth in the US.
- The Federal Reserve looks set to cut interest rates in September. The growth and employment story will be just as key as the disinflationary one in determining the pace of cuts in the future.

Assessing the signs of a slowing US economy

One of the triggers for the short-lived period of heightened volatility was concerns over a couple of data points indicating that the US economy was rapidly slowing, perhaps even entering recession. Specifically, a Manufacturing PMI on 1 August and a jobs data report the following day. PMIs are business surveys, with this one being relevant to the Manufacturing sector. A reading above 50 indicates growth, below means contraction. The data came in at 46.8, a larger contraction than forecast. The jobs data showed the US economy had only added 114k jobs over July, far less than the 175k estimate. Unemployment unexpectedly rose by 0.2% to 4.3%.

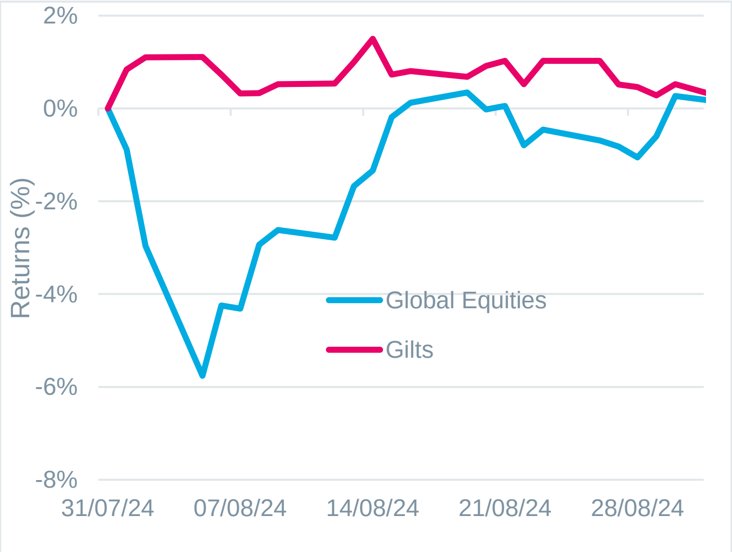
It's important not to get carried away with just a couple of data points (as investors did in early August). The US PMI for the Services sector, released the following week, was stronger than expected which brought calm to markets. Services is a far larger part of the US economy than manufacturing. Recession fears deriving from the unemployment data may be overblown too. The labour market is certainly loosening but from a very tight position. The data suggests some of the rise in unemployment is due to higher immigration, as opposed to people losing their jobs. The Federal Reserve Bank of Atlanta's, GDPNow, which estimates GDP based on real-time date, still forecasts the US economy to be growing by an annualised rate of over 2% in Q3 – a slowdown but still a healthy rate of growth.

Powell gives green light for interest rate cuts

For over a year now, the Fed has held US interest rates flat at a range of 5.25-5.5%. A September interest rate cut was mostly expected, even prior to Chairman Powell's speech at Jackson Hole where he stated "*the time has come for policy to adjust*". The Fed is now behind other central banks. The Bank of England cut rates in August while the European Central Bank did the same in June, but what the Fed does matters far more to global markets than the others. The economic strength and stickiness of inflation seen in the US may have justified a delay but the market gyrations, seen in early August, indicates there are fears they might be a bit late to the party. At one point, as the panic was setting in, investors fully priced in a 0.5% cut in September, instead of a standard 0.25% move.

As calmness returned, a 0.25% cut is now back to being the base case, but a larger cut cannot be ruled out if the economic data turns south. The Fed is still data dependent, but this is no longer a one-sided inflation story. The committee is, in their own words, now attentive to the risks to both sides of their dual mandate (stable prices and maximum employment) meaning data points such as unemployment will be just as important to the pace of interest rate cuts as the disinflationary process.

Chart of the month – Global equities have recovered any losses experienced in early August



Source: Morningstar

The chart shows the returns for global equities and UK government bonds (gilts) over August.

The equity market experienced losses in early August. However, there was a rapid snapback, and any losses were fully recovered by the middle of the month.

Meanwhile, gilts helped to dampen losses over the period of market volatility by increasing in value, just as equities were falling.

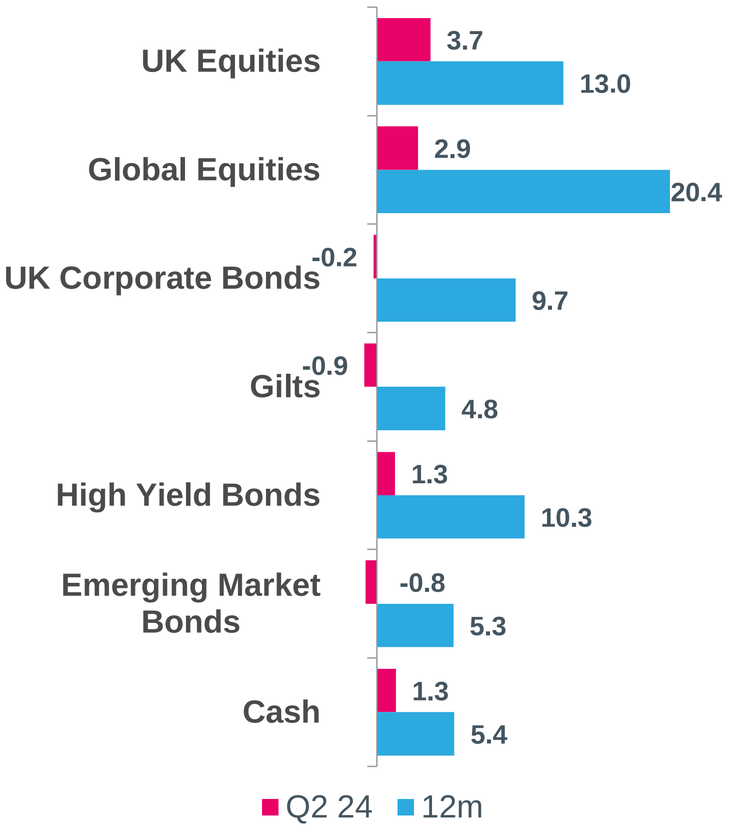
Jack Richards
Investment Manager

Annual market summary – covering the 12 months to 30 June 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.

Central banks mostly kept interest rates level. The Bank of England made one final hike to 5.25% in August 2023, before holding for the remainder of the 12m period. Pretty quickly, investors looked ahead to the prospect of rate cuts in 2024. During Q4 23, expectations were raised for several rate cuts over the next 12 months, boosting both equity and bond prices significantly. However, the disinflation story stalled in the US. In the UK, despite headline CPI falling back to 2%, services inflation remained too high, 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 7.9% to 2.0%, while interest rates rose from 4.25% to 5.25%.

Asset class returns (%)



Source: Morningstar. Figures to 30 June 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.

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 performed 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. This was enough to offset small losses from the other quarters over the period. Equity markets fared much better, as the US economic strength, the prospect of lower interest rates and excitement over Artificial Intelligence ("AI") technologies boosted sentiment and corporate earnings. The US market was the best performing region, benefitting from a heavy tech exposure and several companies that gained from the AI excitement, such as chipmaker Nvidia. Emerging Markets and the UK both lagged after weaker Chinese and UK growth prospects hurt both regions. Although in the case of the UK, the second half of the period provided a more positive economic picture.