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Investment Management

Window on the world

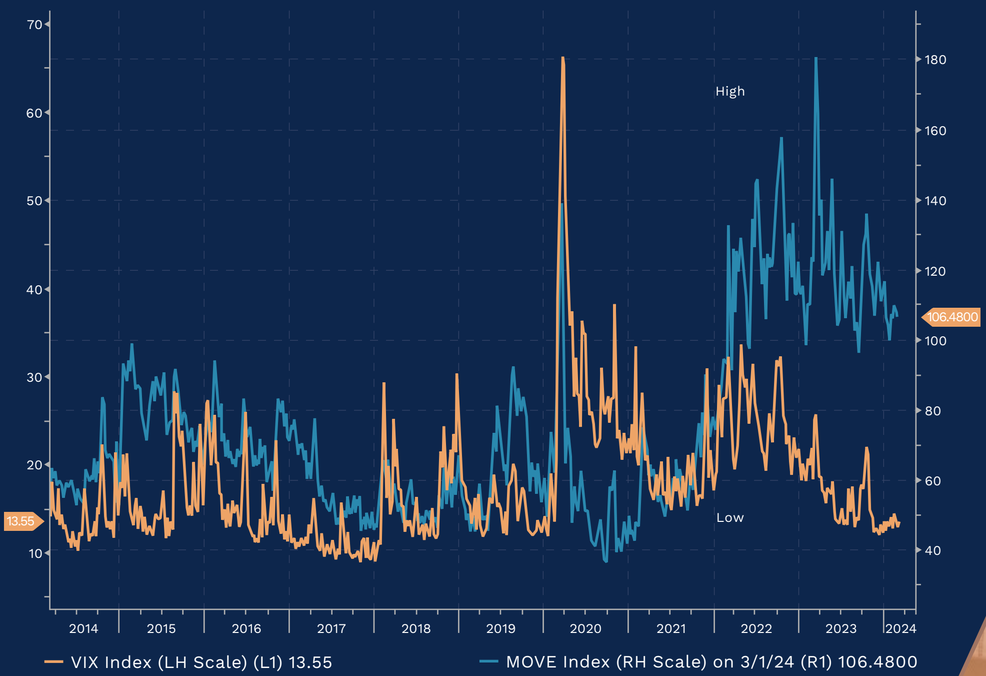
MARCH 2024

Introduction

The shortest month of the year, February, is traditionally an uninspiring one for markets, with data for the US equity market showing that since 2000 US equities have delivered an average return of – 2.1% during the month, some way below the average +0.7% return for non-February months since the turn of the century. As covered later in this piece, February 2024 bucked the trend, thanks in part to ongoing strength in a small handful of US mega caps.

It was also a month in which interest expectations continued to recalibrate from very dovish positioning at the end of 2023. This occurred in a relatively calm fashion, with volatility in both equity and fixed income markets subdued, and below their average over the past 12 months, although volatility in fixed income markets remain elevated when assessed over a longer time frame.

Measures of market volatility have declined over the course of 12 to 18 months, but remains elevated in fixed income relative to the past 10 years (blue line)



Source: Bloomberg. Vix Index (orange line) is a financial benchmark providing a market-based estimate of the expected volatility of the S&P 500 Index. Move Index (blue line) measures US bond market volatility by tracing a basket of derivatives on US interest rate swaps.

Economic Conditions

Attention rightly continues to be focused on economic data as we move through 2024, particularly regarding the resilience of the US economy. At the headline level, with the exception of the UK, economic data in the three core global regions – the US, Europe and China – has been surprising to the upside, indicating a better economic performance than expected.

Citigroup Economic Surprise Indexes for US (blue line), Europe (orange line) and China (purple line) have been on an improving trend since the turn of the year

Source: Bloomberg. Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected, and a negative reading means that data releases have been worse than expected.

Within the US, data has remained resilient for some time, and over the past month both ISM and employment data surprised positively. On the latter, the US economy created 353,000 new jobs in January, and the unemployment rate stayed steady at 3.7%. Revisions to previous month's data also would indicate that the job market was particularly strong in the second half of 2023, explaining the persistent strength in wage growth, which supports real disposable income and consumption, a key pillar to US economic growth.

For Europe and China, data is beating what are relatively downbeat forecasts, and the former is clearly not exhibiting the same resilient characteristics of the US economy. Nevertheless, the apparent turn in Europe's manufacturing industry from the lows in July, are encouraging, particularly if they persist into the first half of 2024, and is an area of focus for us currently.

In China, which celebrated the Lunar New Year during the month, purchasing manager indices provided a brighter picture for most parts of the economy over the month, and targeted interest cuts towards the end of the month may offer some additional support in the coming months. Possibly of more concern was the 0.8% year-on-year decline in consumer price inflation, the fourth consecutive monthly negative inflation print, signalling that the country finds itself in a very different dynamic to other countries in the battle with inflation.

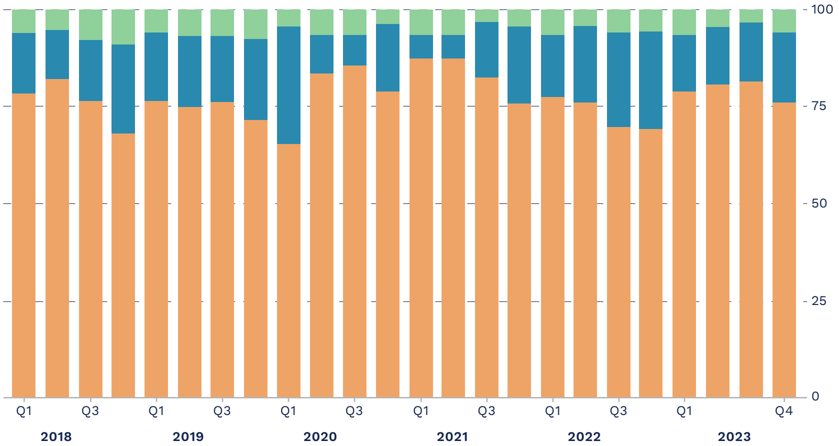
Elsewhere, Gross Domestic Product (GDP) data releases confirmed that both the UK and Japan were in technical recession (described as two consecutive quarters of contracting GDP) at the end of 2023. In the case of Japan, weak spending by households and businesses contributed to the contraction, with individuals in particular suffering from a decline in real wages, with inflation rising faster than wages. In the UK, broad weakness across most areas of the economy and weak retail sales in December was the main culprit behind its contraction. More forward-looking indicators such as purchasing manager indices were more encouraging, and we are optimistic that an improvement in real incomes, lower energy costs, possible fiscal support, and likely easing in financial conditions lays the foundations for UK growth to pick up during 2024.

Corporate Earnings

February saw a large slew of companies report earnings for the quarter ending December 2023, and provided an insight into current performance and the outlook for 2024. In the US, stand out performances came out from two of the biggest companies globally – Nvidia and Meta (previously named Facebook). Both companies reported much stronger earnings than forecasted and saw their share prices record strong double-digit gains off the back of this.

More broadly, US earnings for the fourth quarter of 2023 looked at face value strong, growing at nearly 8% and above expectations of 1.2%. Closer analysis tells a slightly different story, with the "Magnificent Seven" reporting a 59% rise in profits; stripping these out from the aggregate numbers and other US corporates saw a slight drop in earnings. It was a more mixed picture in Europe and the UK, where an absence of large technology stocks and an underwhelming recovery in China weighed on areas such as miners, automakers, and other exporters.

In the US, 76% of companies surprised to the upside when reporting fourth quarter earnings, above the 10 year average of 74%



Source: Bloomberg

"Magnificent Seven" reporting a rise in profits of

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US earnings growing at nearly

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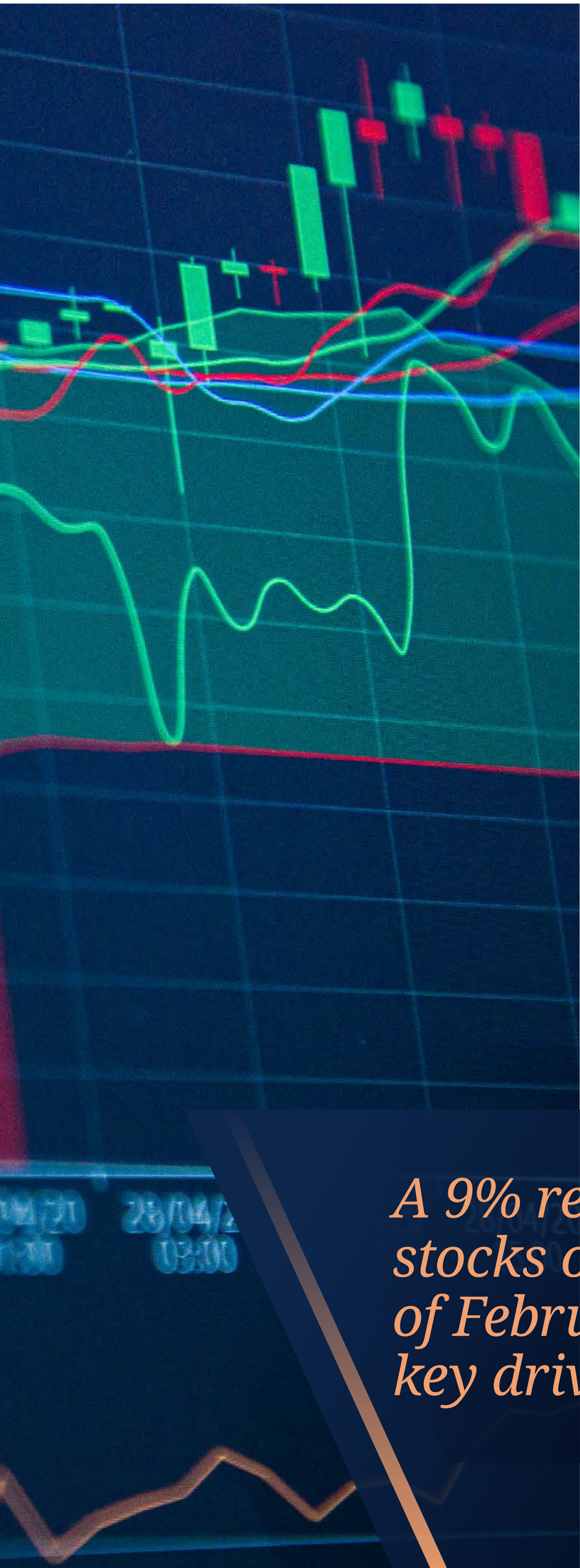

Markets

Equity markets were higher across the board in February, with US, European, Japanese, and emerging markets appreciating by around 5% in local currency terms. The technology sector remained a key contributor to returns in US equity markets, led by Nvidia and Meta. Chip manufacturer Arm Holding, incorporated in the UK but listed in the US, also saw its share price double on the back of its results. It is a rare phenomenon for a $70billion market capitalisation company to double in value in such a short time frame, outside of corporate activity, and indicative of the latent enthusiasm for US technology stocks.

A 9% rebound in Chinese stocks over the course of February was the key driver for returns in the emerging market space. This follows additional intervention taken by the authorities to stabilise the market, including a ban on short-selling, stock buying by state-owned enterprises, and a targeted cut in mortgage rates. The UK market lagged international peers, rising by just half a percent, driven by lacklustre earnings and the weak fourth quarter GDP data.

Bond markets declined over the month, with yield continuing the ascent which started in January. In the UK, the yield on the UK 10 Year Government Bond rose from 3.8% to 4.1%, resulting in gilts falling by just over a percent over the month. There was a similar magnitude of move in US treasuries. Investment grade credit suffered similar declines. Short duration fixed income assets outperformed longer duration bonds.

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Positioning

The recent back-up in Government bond yields has increased the attraction of fixed income, and this asset class continues to appeal on valuation grounds. Into this move higher in bond yields we have rotated into longer duration fixed income investments, given the improvement in valuations and the likely role they can play as a hedge during weaker economic conditions. This increase in duration is primarily via our UK government bond exposure and we continue to maintain good exposure to short-duration credit, which offers good yields of around 5%.

Short-duration credit, which offers good yields of around

5%

Within equities, the strong run over the past three to four months leads us to retain a reasonably defensive stance in the near-term. Valuations in part of the US stock market look stretched, and we have been trimming exposure here in certain strategies. Both the UK and emerging market equity space remain attractive on valuation and fundamental grounds, and we have been adding to the former more recently. Looking forward, we believe the prospect of a narrowing in growth differentials between developed market economies and likely cuts in interest rates will allow equity market breadth to broaden out, driving a better performance from those areas which lagged in 2023.

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