INVESTMENT UPDATE

MAY 2024

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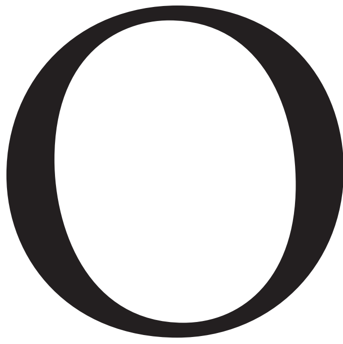
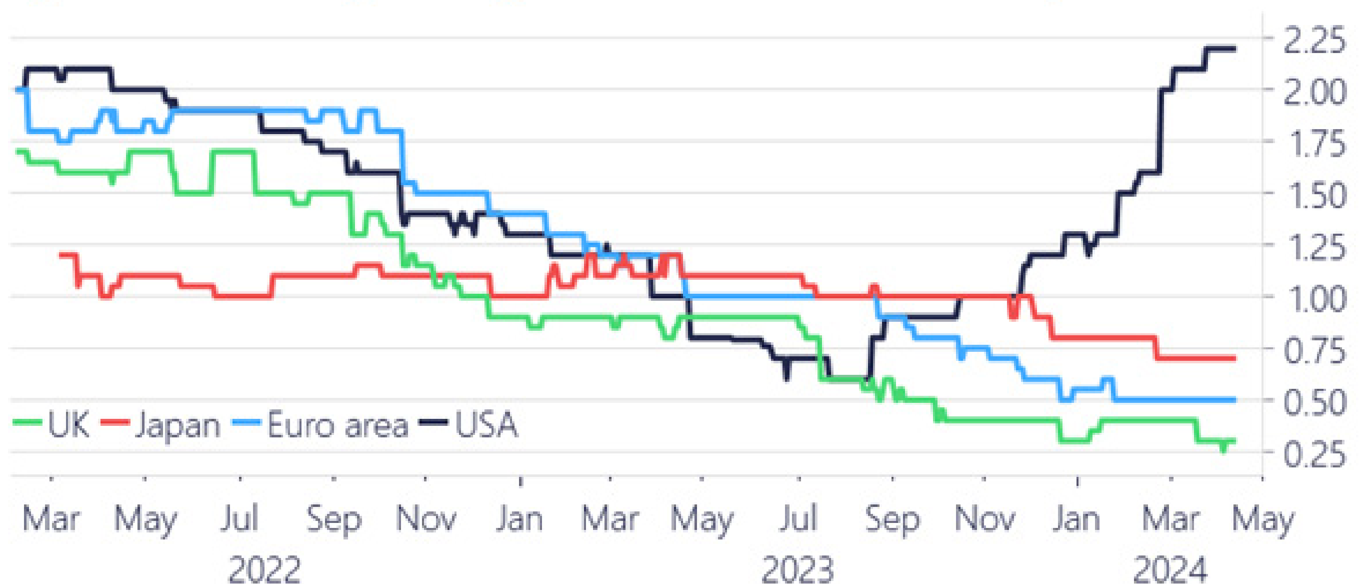


verall, April marked further progress at portfolio level, although it must be noted that volatility made an unwelcome return. In a battle akin to a Marvel inspired movie, our superheroes spar with an unwelcome return of inflationary pressure and higher bond yields. Which way next for markets? We set out our views in the update that follows.

The US still stands head and shoulders above other developed economies.

Reported United States GDP surprised on the low side during the month, although it should be noted this estimate (as ever) is subject to later adjustment. Nevertheless, and assuming the figure is correct, the US still stands head and shoulders above other developed economies.



Source: Steno Research, Bloomberg and Macrobond

National debt levels continue to rise and of course servicing costs are uncomfortably high with interest rates at 5 - 5.25%, equating to an interest bill of $1 trillion per year, and growing. During the month bond yields spiked higher too, increasing the pain.

The 10-year US Treasury yield closed the month around 4.6%, up from 3.4% last year and above the long run average 4.25%. There is every incentive to push interest rates lower, however the fight against inflation should be won first. The Federal Reserve cannot yet announce victory.

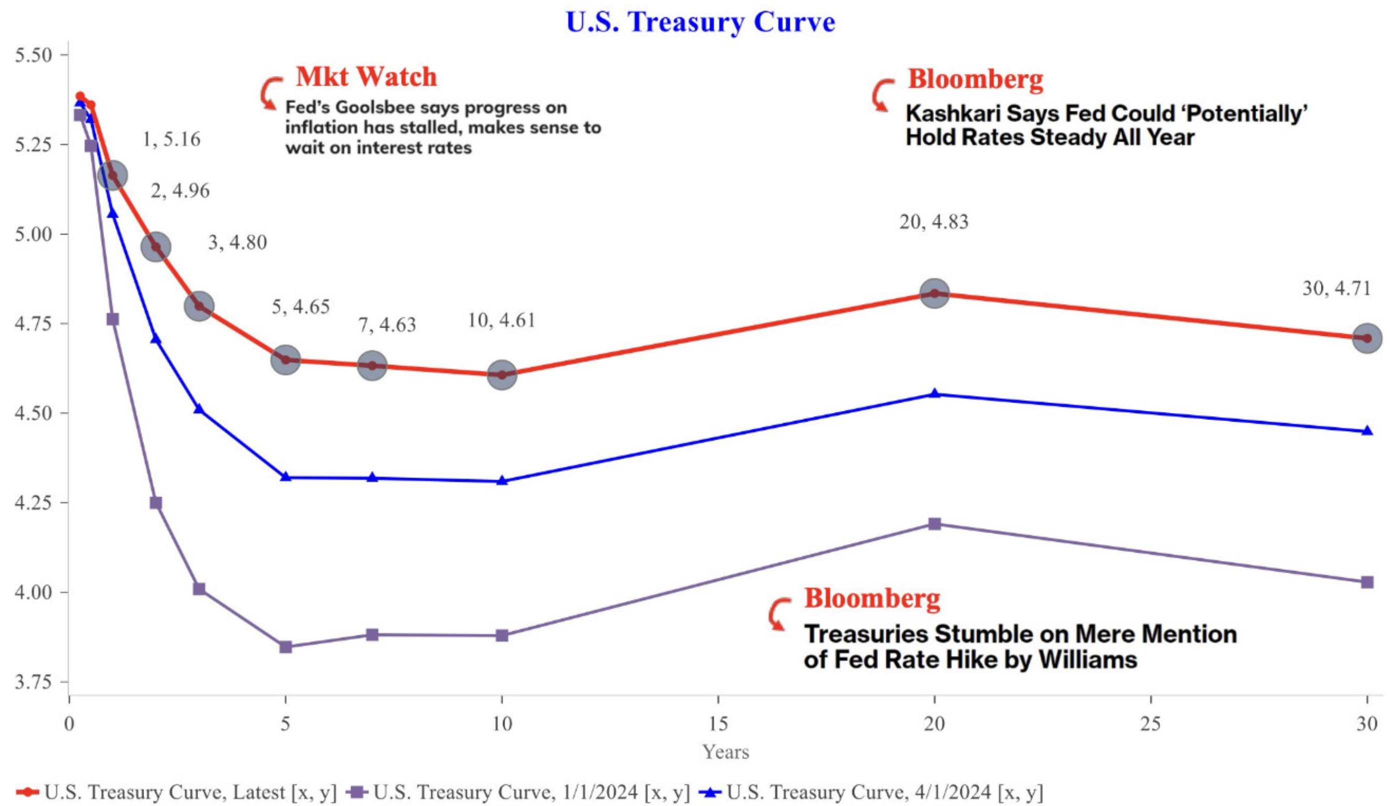
US CPI inflation data plateaued during the month and PCE inflation, the Federal Reserve's preferred measure, nudged annoyingly higher to 2.8% versus the 2.2% expected. This uptick in inflation resulted in a reduced expectation for rate cuts. Rate cut expectations in the year ahead have fallen away from an unrealistic 6 to a far more sober 1 or 2.

The labour market remains tight with close to full employment despite a surge in migration through the US southern border measured in millions of people. Likewise, the US business cycle remains robust with Purchasing Managers indices and other key indicators in positive territory whilst robust corporate earnings are being reported.

So, we have a strong, accelerating economy which is generating modest inflation, albeit structurally lower inflation than a year ago. The Federal Reserve may well cut rates nominally but clearly rates at current levels are no strong impediment to economic expansion. Borrowing costs are an issue as stated earlier and we would anticipate some sort of yield curve control intervention by the Fed to effectively ease the pain.

Yield curve control is not a new phenomenon and has been deployed successfully in Japan for a decade or more. The United States previously capped borrowing costs in the post-World War 2 environment to help facilitate a robust recovery and to ensure success from the outcome of the Breton Woods agreement in July 1945, which effectively handed the US global economic leadership in the years ahead.

The chart shows Treasury yield curve reaction to likely changing monetary policy.



Source: Bloomberg

As we know, ample financial liquidity drives asset prices higher and simultaneously reduces the real value of debt via a form of financial repression. We similarly anticipate the provision of liquidity – delivered in multiple forms. The issuance of Bills rather than Bonds on the instruction of Mrs Janet Yellen, Chief Secretary to the Treasury is one form and we anticipate an uptick during May at the Quarterly Refunding Announcement. Ongoing draining of the Reverse Repo facility, tapering back of the Quantitative Tightening programme, before stopping the process altogether. Spending from the Treasury General Account, effectively the countries current chequing account is likely to add further support.

With the dollar trading at higher levels and an interest rate setting meeting due where the tone from Federal Reserve Chairman, Jerome Powell, is likely to remain hawkish, we would anticipate some further volatility before prices can move upwards again.

China is mustering for an aggressive expansion in manufacturing-led exports. Significant debts and bankruptcies in the real estate sector have stymied post pandemic recovery.

Consequently, a move to undercut western rivals in the production of battery electric vehicles and the production of infrastructure and key components in the drive for zero carbon emissions is the ambition. China's modern automated factories and cheap labour will be supported by a likely currency devaluation making prices to market even more appealing.

The purchase of essential commodities supporting the move, including copper and lithium, have seen a very notable pick up in the past month. Likewise, China's purchase of large sums of gold offers a leading indicator for a Yuan devaluation. We note Chinese equities have nudged higher later during April, although as yet we have not witnessed a notable breakout.

Japan remains in good shape with more recent economic expansion finding a firmer and broader footing. Yen weakness is certainly a stimulant to export growth (and one to be copied by China as stated above) fuelled further by the significant gap between US and Japanese interest rates. We would anticipate some further modest tightening of Japanese rates in due course, but we know already the Ministry of Finance and Bank of Japan move in small, incrementally controlled steps.

In Europe, Germany posted improving data in their Purchasing Managers' report for services sectors and ongoing gloom in the manufacturing equivalent, particularly the automotive subset. Having trained and shaped the Chinese equivalent, the teacher is now being set upon by its pupil. Inflation across the Eurozone has fallen steeply and appears benign despite slowing to a plateau modestly above the European Central Bank's 2% target. We do expect Mrs Lagarde, Head of the ECB to announce rate cuts potentially ahead of the US Fed. Failure to do so would provide further impediments to areas of the economy which need support.

At home, the UK has seen pleasing reports that inflation is falling towards the Bank of England target with added momentum. The Consumer Prices Index (CPI) rose by 3.2% in the 12 months to March 2024, down from 3.4% to February and well below its recent peak of 11.1% in October 2022. The leading UK equity index, FTSE 100 has surpassed an all-time high and we note the smaller company FTSE 250 has crossed over into an expansionary phase – long overdue but pleasing all the same. Likewise, we expect Mr Andrew Bailey, Governor at the Bank of England to move rates lower in coming months.

A reflating world is increasing its demand for essential commodities. Consequently, we have seen a surge in prices across leading industrial raw materials. This will add to manufacturing costs and has potential to push inflation upwards if the trend escalates, particularly to energy.

Geopolitics remains impossible to model. Of course, the month gave rise to a sudden escalation in Middle Eastern tensions with a tit-for-tat exchange between Israel and Iran. The Gaza war grinds on with scenes of horror a daily occurrence. Likewise in Ukraine, although the US Congress did finally agree a funding package which might assist against Russia who appear to be gaining momentum. Despite the cost in human life and destruction on a large scale, market impact has remained muted overall, unless it is anticipated a wider conflict is the near-term outcome.

At portfolio level, progress remains steady with a decent year in prospect, although volatility has certainly resumed. US Treasury yields anywhere near 5% are synonymous with the VIX volatility index posting higher readings. That said, we do anticipate a resumption of liquidity and forms of yield curve control in the United States. Despite high valuations for technology behemoths earnings are currently supportive and a robust economy helps to underpin corporate performance. A bullish position is the current mindset in North America. We are less convinced in China where the post-Covid recovery remains frustratingly out of reach for now. We watch the latest export drive with interest.

Our overweight allocation in Japan has been well rewarded. We remain a believer in the economic rising sun although we are considering top slicing some profits for good order whilst remaining fully invested to harvest further potential upside. We have been well served by European equities despite recessionary conditions in the major economies. Prices reflect the potential ECB rate cuts which have been a long time coming.

We are considering reducing our European weighting as rate cuts are inbound and in line with “buy the rumour sell the news”. We remain content with the UK allocation sitting above the global equity benchmark weighting as we see improving conditions at home whilst valuations are attractive.

We are considering our fixed income duration, typically around the 6.5 years mark, and the potential to subtly shorten tenor such that portfolios benefit from short term rate reductions but avoid the inevitable steepening of the curve for longer durations as markets realise deep rate cuts, particularly in the US, are less likely.

Importantly, volatility has been anchored at appropriate levels per portfolio and we are pleased to report no risk corridor breaches during the past month, or indeed at any time since inception, despite some trying market conditions.

As ever, we thank clients for the solid support and warm feedback year-to-date. We look forward to updating you further next month and appropriately if we elect to trade mid-month.

Written by the Alpha Beta Partners Investment Team.

All sources Bloomberg unless otherwise stated.

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