October 2024

INVESTMENT MATTERS

Scottish Widows Platform

ECONOMIC AND POLITICAL BACKDROP

The global economic picture was centre stage. Concerns about a US recession triggered bouts of risk aversion, with investors worried that rate cuts would be insufficient to arrest weakening economic momentum. The mood lifted as markets gained confidence that an interest rate cut from the Federal Reserve would be forthcoming. Global equities advanced, but markets suffered high volatility along the way, with the sudden strengthening of the Japanese yen also reverberating through the financial system. A raft of stimulus measures, announced by the Chinese authorities just before the quarter end, triggered a surge in Chinese/China-exposed equities. Meanwhile, global bond yields fell on the back of softer economic data and interest rate cuts.

UK economy

Recent data releases confirmed a picture of fading economic momentum. Second quarter GDP rose by 0.5%, less than anticipated. GfK's consumer confidence index slumped during September, with commentators concluding that people and businesses were responding to the government's warnings about the dire state of the country's finances and the prospect of painful decisions at the upcoming budget. On the inflation front, prices rose by 2.2% in the 12 months to August. Services inflation remained sticky, making it more challenging for core inflation to fall back to the 2% target. On the jobs front, while the unemployment rate ticked down to 4.1%, and wage growth was steady, anecdotal evidence pointed to receding employer confidence, resulting in a slowdown in hiring.

Countering this weakening picture, the OECD upgraded its expectation for UK growth following relatively robust growth earlier in the year, when the UK was among the fastest growing economies in the G7. The organisation noted that real wage growth is supporting household incomes and spending. The Halifax reported that its house price index increased by 4.3% year-on-year (to August), with prices moving higher over the summer as mortgage rates softened. >>

ECONOMIC AND POLITICAL BACKDROP (CONTINUED)

UK politics

Labour won a decisive victory in the general election, although the party won with just 35% of the national vote amid a low turn-out and broad disaffection for the political class. However, it has been an inauspicious start for Prime Minister Starmer, with notable missteps including the winter fuel payment debacle and the row about "freebies" provided by a Labour donor. With her feet barely under the desk, Chancellor Rachel Reeves was put under pressure to loosen the purse strings to raise pay for public sector workers. At the same time, claiming that she had inherited a fiscal "mess", she prepared the way for a tax-raising budget in the autumn just as UK government debt reached 100% of GDP for the first time since 1961. Indeed, the new government was accused of doom-mongering and talking the country down, forcing them into a swift change of tone at the Labour conference. Meanwhile, the Conservative Party was distracted by its extended leadership contest.

Global economies

Data from the US was mixed, leading to worries that the economy may be heading for a recession. There were clear signs of weaker trends within the manufacturing sector, indicating higher interest rates had taken effect. The closely watched labour market showed signs of softening, adding to concerns that the economy might be faltering. On the other hand, inflation dropped to 2.5% in August, supporting the case for further cuts to interest rates and the economy grew by 3% (annualised) during the second quarter.

Weakness in the French and Germany economies continued to depress readings from the eurozone, despite better growth from southern Europe. German industrial production remained under pressure, dragged down by the auto sector and electrical equipment manufacturing.

In Japan, inflation remained above 2% and data showed that wages were growing in real terms, which helped to build expectations of further interest rate rises before the year end.

Amid persistent weakness in the Chinese economy, a slew of measures was announced, aimed at reviving growth and restoring market confidence. The central bank cut key interest rates and freed up cash for banks to boost lending, while Beijing pledged to support fiscal spending and bolster the struggling property sector. There was even a promise to provide one-off handouts to people in extreme poverty. These announcements came as new data showed that manufacturing activity fell into contraction, while the rate of services expansion also disappointed. >>

ECONOMIC AND POLITICAL BACKDROP (CONTINUED)

Global monetary policies

The Bank of England reduced the base rate by 0.25%, to 5.00%. Later, Governor Bailey suggested that further interest rate cuts could be in the pipeline, noting that inflation is falling more quickly than expected.

At the much-anticipated meeting of the Federal Reserve, the committee opted for an interest rate cut of 0.50% (falling to a new range of 4.75% - 5%), a larger move than many had expected. This was the first reduction in borrowing costs since March 2020, with the Bank highlighting the softening inflation picture and a potential slowdown in the labour market. Officials also projected that rates could decrease by another half percentage point by the end of the year.

The European Central Bank also cut the deposit facility rate by 0.25%, to 3.5%, reflecting the Bank's confidence that inflation will fall to the 2% target. Marking an important moment, the Bank of Japan raised the short-term interest rate into positive territory, from around 0% to around 0.25%, the highest level since 2008. As part of a raft of stimulus measures, the People's Bank of China cut a key policy rate and reserve requirements for banks, and announced support measures for the property sector and the stock market.

Global politics and events

There was plenty of drama on the US political scene as November's general election drew nearer. Under intense scrutiny concerning his fitness to stand in the election, President Biden finally announced that he would not run. Vice President Kamala Harris was then confirmed as the Democratic nominee and she chose Tim Walz as her running mate. At the Republican National Convention, JD Vance accepted the invitation to be Donald Trump's running mate. Mr Trump suffered to two assassination attempts, the first of which very nearly succeeded. As things stand, the election race remains too close to call and the outcome will likely be a function of turnout rates and marginal voters.

In France's general election, none of the three main political blocs achieved an overall majority, leaving France in a political and legislative vacuum. President Macron appointed Michel Barnier as the new Prime Minister, hoping that he would be able to end the political impasse. In Germany, Chancellor Olaf Scholz managed to fend off the far-right party, AfD, by a small margin in the state of Brandenburg, while in Austria, the far-right Freedom Party gained the largest share of the vote in the general election.

Japan's prime minister, Fumio Kishida, resigned amid public scandals and internal conflicts. New party leader, Shigeru Ishiba, wasted no time in calling a snap election in October, saying that the new administration should be judged by the people as soon as possible.

Middle Eastern tensions ratcheted higher, with Israel fighting a war on three fronts - Hamas in Gaza, Hezbollah in Lebanon and the Houthis in Yemen. All eyes turned to Iran to see how it would retaliate, particularly in light of the killing of Hassan Nasrallah, secretary-general of Hezbollah, in an Israeli airstrike.

Ukraine launched a surprise incursion across the Russian border, but exhaustion and a lack of manpower and weaponry weakened their ability to fight on a new front whilst still fending off Russian forces in the east.

MARKET REVIEW

Equity markets

Positive returns at the headline level masked high drama below the surface as investors responded to fears of a US recession, the sudden change in the direction of the Japanese yen (leading to the unwinding of the so-called "carry trade", whereby investors borrow in yen to invest in higher-yielding assets elsewhere) and doubts about valuations within the technology sector. Indeed, a measure of volatility reached its highest intra-day level since March 2020, at the height of the pandemic fears. However, the turmoil was short-lived as the Federal Reserve cut interest rates, US economic data improved and latterly, China unleashed a whirlwind of stimulus measures.

US equities enjoyed another robust quarter although, alongside bouts of elevated volatility, there was also a change of market leadership. The mega-cap technology stocks, which had performed so strongly, stumbled after some disappointing earnings results which called into question companies' ability to turn huge capital expenditure on AI-related products and services into future profitability. Indeed, this was the first quarter for some time that the broad market had outperformed the "Magnificent 7" grouping. Instead, the best performing sectors included the likes of utilities and real estate. Mid and smaller-cap indices also performed very strongly.

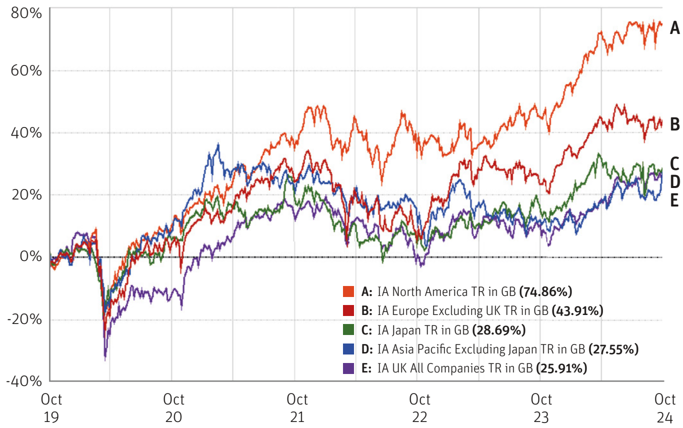
In China, assertive and wide-ranging policy changes designed to prop up asset markets and the economy spurred a blockbuster stockmarket rally, with investors from all quarters rushing to get involved in the previously unloved market. On the last day of the quarter, the Chinese market rose by over 8%. The Hong Kong market also sprang into life, enjoying its best quarter since 2009. These moves contributed to stellar returns from Asian and emerging market indices.

European indices advanced, but underperformed the US, Asian and emerging market indices. Core European markets struggled to make progress, with political upheaval in France and the lacklustre German economy weighing upon sentiment. Earlier in the quarter, the share prices of China-exposed companies, such as luxury goods and car makers, were impacted because of flagging demand and disappointing revenues, although the dramatic stimulus announcements provided some relief.

Compared to the excitement seen elsewhere, the UK market struggled to gain traction. The strength of sterling dampened sentiment towards larger companies with overseas earnings. Indeed, on this note, it is important to highlight that, in an investment portfolio context, the returns from non-UK sterling assets were dampened because of the currency's strength. Mid and smaller-cap indices fared well, with a resurgence in bid activity brightening the mood and helping to attract investors.

The Japanese market peaked in early July, in tandem with the turning point in the Japanese yen, which had reached a position of extreme weakness. The weak currency had supported the market, boosting the profit outlook for export-heavy industries. The rapid change in the currency's fortunes represented a major turning point for the Japanese market and, in a broader context, for those using the yen as a cheap funding currency. Amid these rapidly shifting sands, in July, the market dropped by 12% in a day, the worst sell-off since "Black Monday" in 1987 (although it reclaimed much of the lost ground in short order). Weakness in US technology stocks also weighed upon the Japanese technology sector. >>

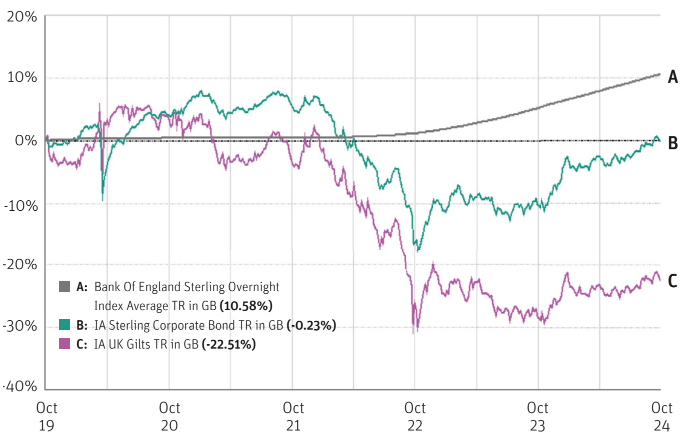
Average total returns of funds in IA equity sectors over 5 years to October 2024 (in UK sterling terms)



Source: FE fundinfo. Please note that the value of investments and the income from them can fall as well as rise.*

MARKET REVIEW (CONTINUED)

Average total returns of funds in IA bond sectors over 5 years to October 2024 (in UK sterling terms)



Source: FE fundinfo. Please note that the value of investments and the income from them can fall as well as rise.*

Bond markets

Against the backdrop of loosening monetary policy, global bond yields declined over the quarter (prices rose), with the Federal Reserve's decision to cut rates by half a percentage point bolstering the case for a more rapid cycle of easing. The UK gilt market followed this trend and delivered a positive return, but it underperformed other core government bonds because of the Bank of England's relatively hawkish stance.

Broadly, corporate bonds matched the move in their sovereign counterparts. Credit spreads on investment grade bonds (the yield premium available to compensate investors for additional risk) were already narrow, leaving little room for additional price appreciation over and above the move in government bonds. Lower-rated bonds delivered robust positive total returns, benefiting from superior running yields as well as price appreciation.

* These graphs reflect the average performances of funds that feature in different IA (Investment Association) sectors. The performances are in sterling terms, which means that the effects of changes in the value of sterling versus other currencies are incorporated in the performance figures. Performances are calculated on a bid to bid basis, which means that any costs associated with the purchase or sale of shares/units are not included.

Other assets

UK sterling hit its highest level versus the US dollar since March 2022 after the Bank of England kept rates on hold at the September meeting. The Japanese yen strengthened significantly following the Bank of Japan's interest rate hike. This triggered a move by investors to close out their yen borrowings (also known as the unwinding of the yen "carry trade"), the consequences of which rippled through the financial system.

Despite geo-political tensions, the oil price fell, succumbing to persistent concerns about global demand, particularly in the context of China's economic woes and a weakening US economy. The prospect of increased production from OPEC+ later this year also depressed the price.

The gold price rose sharply, reaching a new record high thanks to a weaker US dollar (in which gold is priced) and lower interest rates around the globe (reduced competition from yield-generating assets). Geo-political tensions also reinforced the allure of the safe-haven asset, and ongoing buying from central banks added to the positive price momentum. >>

MARKET REVIEW (CONTINUED)

And finally…China returns to the headlines

Before September's stimulus blitz, investors had been relatively immune from the long-running drip-drip of disappointing economic news from China, preferring instead to concentrate upon the fate of the US economy and the Federal Reserve's next steps.

Commentators have been drawing comparisons between China's malaise and the experience of Japan after its stockmarket slump at the beginning of the 1990s, whereby a period of heady growth was followed by years in the economic doldrums. At the heart of the problem is China's property market, which boomed on the back of speculative activity and a quite staggering level of capital misallocation during the noughties and beyond. In practice, the bubble began to deflate early in the 2010s as Beijing sought to curb activity. Unsurprisingly, China's economic output began to decline at the same time. The default of property giant Evergrande Group in 2021 brought the crisis into the spotlight and raised international awareness of the scale of the problem.

Despite various announcements of support packages in recent months, consumer confidence remains at a low ebb. The recently announced "bazooka" of support measures has provided a boost to Chinese asset markets, but the real issue is that China has a demand problem. People and businesses are choosing not to borrow because sentiment is poor. Mirroring the experience of Japan, it appears that the Chinese are falling into the mode of "paradox of thrift", with more people choosing to save rather than spend and invest, battered as they are by the real estate crisis, the extended Covid-19 experience and the perceived increase in external risks, including trade tensions. Structurally, the economy is also swimming against the tide of population decline.

Given the size of the economy, the repercussions of the situation in China are clearly significant and global in nature. Commodity prices had already been weakened by the diminished demand outlook. In Europe, the luxury goods companies and car manufacturers have been reporting disappointing sales from their Chinese businesses, resulting in slumping share prices. Germany's heavy reliance upon exports to China is a major headwind for its economy.

Some investors have been voting with their feet, opting for Asian products that exclude China. While understandable, this is not a fail-safe strategy given the dominance and connectivity of the Chinese economy within the region. On the other side of the coin, professional investors who do invest in the country are not short of ideas, given low valuations and the ability to access exciting new industries, such as green technology. It will be fascinating to observe the next stage for China's economy as the effects of the recent stimulus policies wash through the system. One thing is for sure – China is too big to ignore.

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