Signia Invest Insights

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Market Review and Outlook

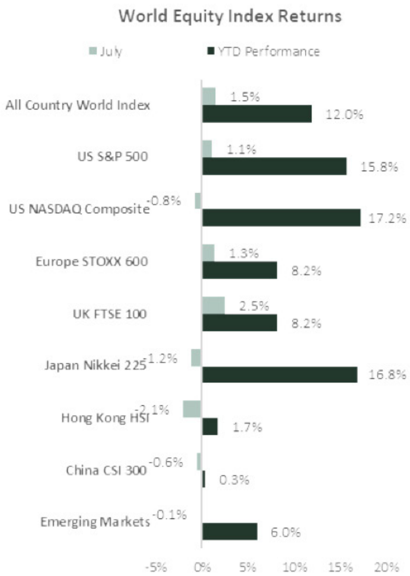
- I have always been amused by the investing adage "sell in May and go away", referring to the historically weaker performance of stocks from May to October compared with the other half the year. Why would anyone want to miss the volatility in markets that opens the door to investment opportunities? Why would any investor who has an iota of interest in markets choose to miss all the action? Well, July and in particular the start of August have indeed been action packed, so for those who have been sitting on a beach somewhere here is what you missed...

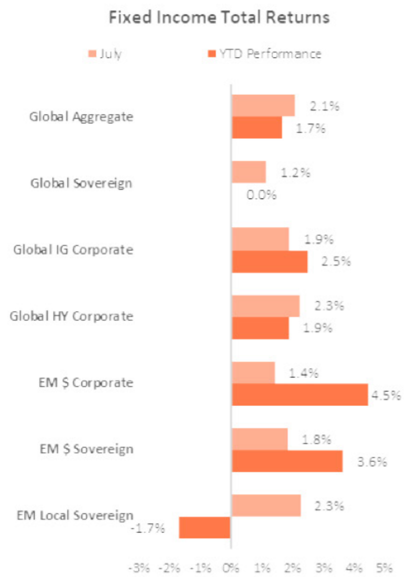
- July was a month of two halves with the first half seeing the S&P 500 hit a further succession of record highs. Bonds also rallied as speculation mounted that the Fed would cut interest rates in September, particularly after a weaker than expected US consumer price inflation report. But risk assets began to turn halfway through the month, with the Magnificent 7 and Nasdaq experiencing significant peak-to-trough drawdowns and entering technical corrections. In addition, commodity prices lost ground across the board, with significant declines among energy prices, industrial metals and agricultural goods.

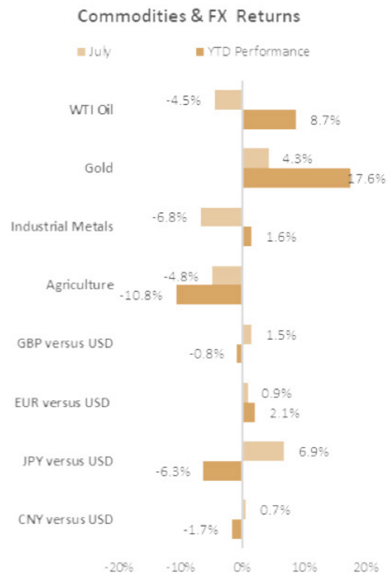
- As noted in last month's commentary, Q3 has seasonally been the weakest quarter for equity markets, so during thin summer market liquidity and after such a protected bull market rally, it is not surprising that markets are weaker and now experiencing elevated price volatility. Overall, world equities still managed to post a positive gain of 1.5% in July, however, these gain were wiped out at the start of August. Fixed income assets from sovereign debt to investment grade and high yield credit performed strongly during the month, with the global aggregate bond index rising 2.1% to bring the asset class into positive territory year-to-date.

- The finger of blame for the market volatility can be pointed at a large list of culprits, but the underlying root cause and fuel to the fire came from the Bank of Japan and US Federal Reserve, which made two perceived hawkish decisions only hours apart on July 31st. The Bank of Japan and subsequent Yen strength is discussed below, but the decision of the Fed to hold interest rates steady in a restrictive 5.25 to 5.50% range whilst concerns over a fast-deteriorating US labour market are rising (albeit from a position of historic strength), and the fact that many central bank peers have already started lowering interest rates to support their respective economies (the BoJ being the major exception), was ultimately what helped spark the early August stock selloff and bond rally. This was the market's warning shot across the Fed's bow to refrain from further delay and promptly begin lowering US rates at its next meeting in September, with over 100 basis points of rate cuts now priced in by year end over the Fed's three remaining meetings.

MARKET PERFORMANCE AS OF 31 JULY 2024







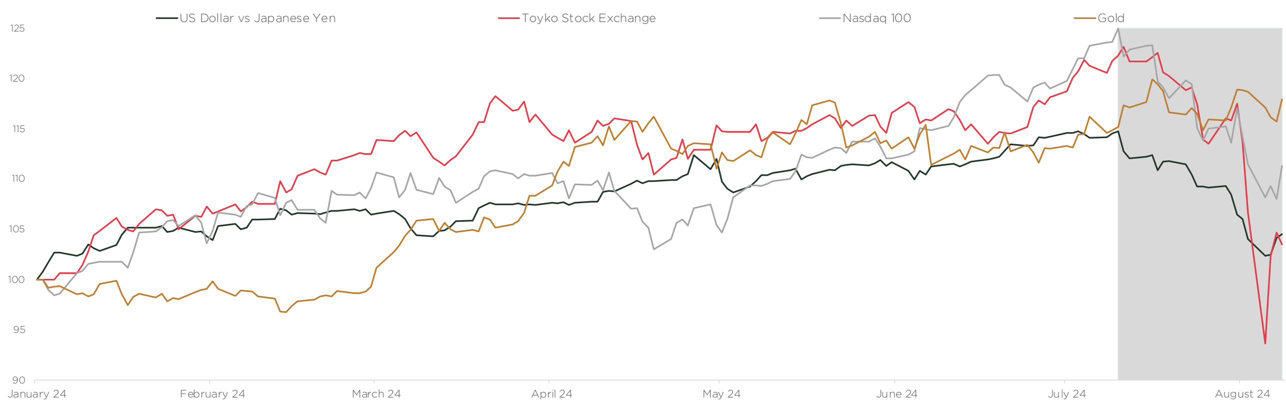
Source: Bloomberg L.P., Arbion Ltd.

YEN'S SURGE TRIGGERS DELEVERAGING ACROSS THE FINANCIAL SYSTEM

- Monday 5th August was the worst day for the Japanese TOPIX (-12.2%) since the 1987 stock market crash and the second worst day since data began in 1949, which covers nearly 20,000 days! It was also the culmination of its worst 3-day move (-20.3%) over the same 75 year plus period. As shown in the chart below, a swift and significant short squeeze causing a 10% strengthening of the Yen against the US Dollar from 161 Yen to 144 Yen effectively triggered a global liquidation and deleveraging event across financial markets, as investors that borrowed in cheap Yen to buy popular assets this year such as Nasdaq stocks and gold, known as the global carry trade, were forced to unwind their positions. Gold's performance during this period was particularly disappointing as a safe haven asset that did not perform well during the volatility, but such was the widespread ferocity of the deleveraging move.

- Sitting behind this volatility was the Bank of Japan, which arguably signalled its strongest intent in decades to normalise monetary policy, raising its policy rate from 0.1% to 0.25%. More importantly, it promised to halve monthly Japanese government bond purchases by 2026. Markets were caught off-guard given how prominent and colossal the central bank's quantitative easing program has been since 2013, especially relative to the size of Japan's economy and to how cautious the BoJ has been under Governor Ueda in the past. In his press conference, Ueda kept all options open going forward, pushing back against any limit as to how high rates could potentially rise.

2024 PERFORMANCE OF DOLLAR/YEN AND SELECTED MARKETS LINKED TO THE GLOBAL CARRY TRADE



Source: Arbion Ltd, Bloomberg L.P.

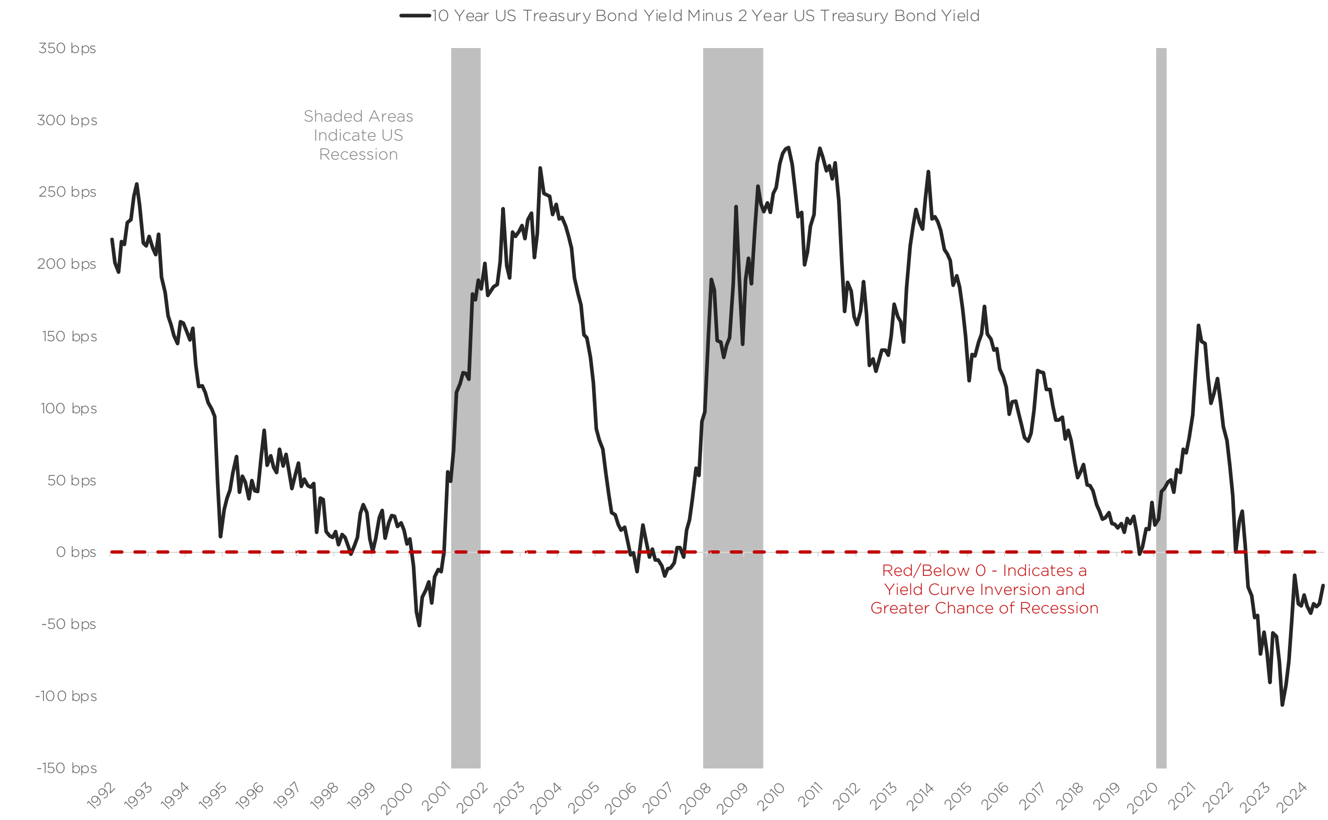
There were multiple warning signs...

- Whilst the Fed and BoJ shoulder the majority of the blame for the market rout, there were many smaller issues evident in the lead up to the sell-off. At the top of the list were a number of weakening US economic indicators in July, in particular the increase in the US unemployment rate from 4.1% to 4.3%, which contributed to fears of a policy error by the Fed by holding interest rates at current restrictive levels. The US unemployment rate has now risen by 0.6% this year from 3.7% at the start of 2024. Whilst this is not an immediate cause for concern as the overall picture of the US jobs market is still relatively healthy and balanced, when the three-month moving average of the unemployment rate rises by half a percentage point or more from its lowest level over the past 12 months, the US economy has historically been in the beginning of a recession, otherwise known as the Sahm Rule.

- Adding to recession fears was the steepening of the US 2s10s yield curve, which has also historically preceded a US economic recession, as can be seen on the chart below. In previous market cycles when the difference between the 10-year US Treasury bond and its 2-year equivalent has been unusually negative or 'inverted' (i.e. the 10-year yield has been lower than the 2-year yield), and has subsequently steepened or 'normalised' back above zero, then an economic recession has usually followed. Again, this is not something to be imminently concerned about, rather another market development to keep an eye on as the chorus warning of a US recession will likely grow in the second half of this year.

- Together with some mega-cap tech earnings disappointments (Amazon, Intel and others), Warren Buffett halving Berkshire Hathaway's stake in Apple stock, Bill Ackman's complete failure to raise any assets for a new $25 billion fund, lower odds of a 'market-friendly' Trump presidency (even after the failed assignation attempt) now that Kamala Harris has entered the race as the likely Democratic candidate, an expanding Middle East conflict, and lower seasonal trading volumes as well as record low implied volatility, this all created a perfect setup for a steep risk-off move that we have witnessed in markets.

10 YEAR US TREASURY BOND YIELD MINUS 2 YEAR US TREASURY BOND YIELD

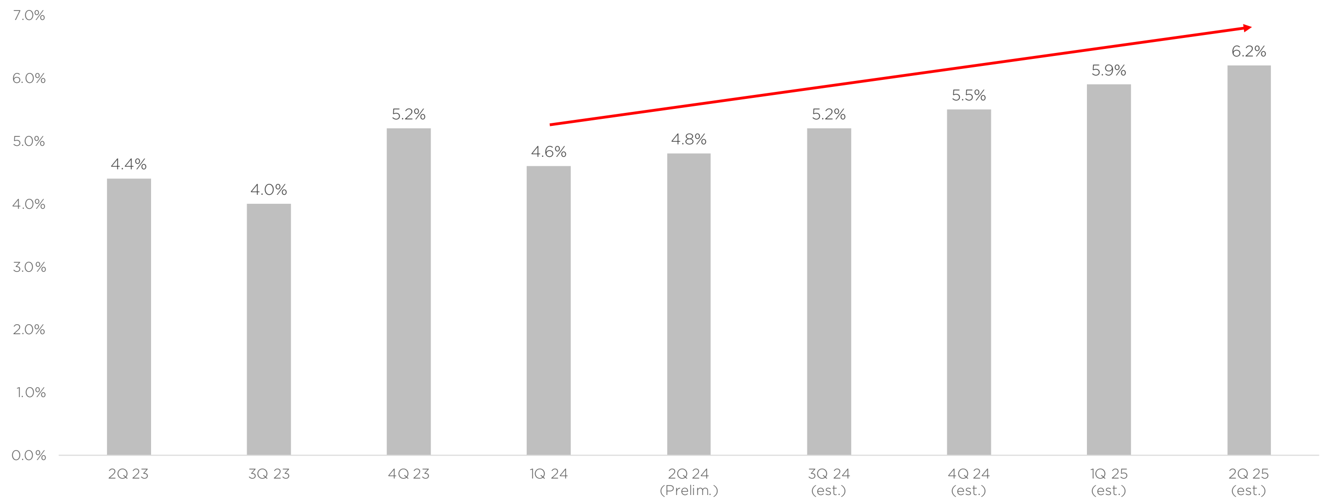


Source: Arbion Ltd, Bloomberg L.P.

A VERY HIGH BAR HAS BEEN SET FOR US CORPORATE REVENUE GROWTH

- One area of debate is whether the glass is half full or half empty for corporate America's earnings and revenues outlook. Over the next four quarters the Wall Street consensus believes that revenue growth will be very solid between 5.2% and 6.2%. This in itself is positive, but potentially too positive in a world where the lagged effects of restrictive interest rates is largely still to bite US households and the consumer. We are already beginning to see some companies lose some pricing power, the consumer is arguably now in a more fragile position having depleted pandemic savings and taken on more credit card debt, and AI enthusiasm is beginning to waver. It is thus fair to say that the path to achieving these estimates is somewhat unclear at the moment and potentially a lower bar needs to be re-priced into markets.

S&P 500 QUARTERLY REVENUE GROWTH ESTIMATES



Source: Arbion Ltd, Strategas

OTHER NOTABLE ECONOMIC AND MARKET DEVELOPMENTS

- **IMF:** The International Monetary Fund updated their growth forecasts, which painted a broadly similar picture for the global economy relative to three months ago. For 2024, global growth is still seen at 3.2%, but 2025 growth was revised up one-tenth to 3.3%. Indeed, there were some bigger moves at the country level, with several emerging markets seeing notable upgrades. That included China, where growth in both 2024 and 2025 was revised up four-tenths to 5.0% and 4.5%, respectively. India's growth was also revised up two-tenths this year to 7.0%. The IMF warned of slowing momentum on global disinflation, raising the prospect of "higher-for-even-longer interest rates".

- **US:** Real GDP rose more than expected in the second quarter at an annualised rate of 2.8% in the second quarter but there were some weak spots. Housing data have continued to weaken in the US, with existing home sales down -5.4% in June and new home sales declining -0.6%, whilst real disposable incomes have risen only modestly over the past year and the household saving rate now stands at a 16-month low.

- **UK:** The Bank of England delivered on its first rate cut of this cycle reducing its base rate by 25 basis points to 5.0%. However, it is not clear there was a strong imperative, nor a necessity to cut rates at this juncture, so the scope for more cuts over the coming months will likely be limited, something Governor Bailey himself acknowledged. Headline inflation is trending higher again into year-end, as positive energy base effects drop out of the annual comparisons, while services inflation and pay growth are still far above where you would associate with inflation returning back to 2% on a sustainable basis. Meanwhile, UK GDP prospects appear a little firmer, house prices are edging up and consumer confidence is improving. In that respect, the five out of nine MPC members who voted for a cut this month may have acted too hastily, acting to help the mortgage market rather than concrete economic data to support the decision.

- **Eurozone:** The European Central Bank held its main interest rate at 3.75% at its policy meeting, however ECB President Christine Lagarde stated the possibility of a cut in September was "wide open". Eurozone annual inflation was confirmed at 2.5% in June from 2.6% in the previous month, easing in line with expectations, as services inflation, as in the US and UK, remained stubbornly high.

- **France:** Although the electoral rules of the Fifth Republic were designed to avoid gridlock, France is facing the same political fragmentation that has seen parliaments across Europe plunge into extensive and complex negotiations in order to form majorities. The country is heading into an extended period of political gridlock after a shock defeat for Marine Le Pen's far right party in elections produced a divided parliament with no clear majority. A left-wing alliance including the far-left group France Unbowed will be the biggest group with 178 out of 577 seats in the lower house, but still way short of the 289 required for an absolute majority. President Emmanuel Macron's group was second with Le Pen's National Rally trailing in third place. The leftist alliance, known as the New Popular Front, struck a deal with Macron's centrists ahead of the second round of voting in order to prevent Le Pen from clinching a majority. Her National Rally party won the biggest share of the vote in the first round but wound up with only 143 seats, while Macron's group took 156 seats. So it seems that Macron's gamble to avert the political extremes in France has paid off but at the expense of his own party, or any party for that matter, being able to govern the country.

- **China:** The third plenum pledged to implement comprehensive reforms over the next five years. Three areas warrant closer attention, as they have the potential to shape China's longer-term economic structure: support for high-tech sectors, fiscal reforms, and the steps to enhance social welfare. The People's Bank of China unexpectedly trimmed the seven-day reverse repo rate for the first time in almost a year, lowering it by 10 basis points to 1.7% to reinvigorate the economy. Consequently, Chinese banks have lowered one and five-year loan prime rates by 10 basis points each to 3.35% and 3.85%, respectively, bringing the rates further into record-low territory. Onshore local currency China bonds hedged into US Dollars have provided one of the best risk-adjusted returns in the fixed income markets this year.

Although a picture of dissipating inflationary pressures and weaker growth emerges with risks of a consumer-driven recession rising, it is harder to make a case for an imminent and deep recession. However, considering prevailing lower growth and inflation, we know that global interest rates are too high at the moment and particularly in the US. The only question is how much lower should they go?

The market shock in early August was a welcome warning shot that equity markets are not a one-way street. As mentioned in last month's commentary, during the month of June we started hedging a substantial part of our equity allocation via equity put options. This was not in anticipation of an imminent sell off but because the cost of hedging was extraordinarily low, and we received more and more indications that we reached a point where dispersion of market prices from perceived reality was probably too wide and required some course correction in the third quarter. Whether the recent volatility has flushed out excess speculation and brought various prices back into line with assumed fair values can be debated at length. However, we feel that for the time being a more cautious stance is warranted as a secondary wave of market volatility is quite possible. Fundamentally, we are somewhat less concerned as the ongoing earnings season has not indicated a substantial decline in earnings yet, and the broader economy is not weakening as fast as implied by some stock price corrections. Furthermore, G10 policy rates are expected to continue their decline over the rest of the year which is somewhat supportive for markets, especially with the Fed joining the easing cycle after the market's shot across its bow!

ROBERT LEE

CO-HEAD OF MULTI-ASSET INVESTMENTS, HEAD OF RATES

Robert has been managing the wealth of private clients since 2006 as a portfolio manager and fixed income specialist. He is jointly responsible for the multi-asset investment team, global fixed income strategies, and Arbion's retail funds business. Previously, he worked for Lehman Brothers on the European Capital Markets team, and then Coutts & Co where he was a member of the fixed income and foreign exchange selection committees, responsible for managing the advisory and discretionary portfolios for private clients and institutions.

Robert is a Chartered Financial Analyst and a member of the Chartered Institute for Securities & Investment.

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