MONTHLY UPDATE

Latest views from the investment team

Recessions are not all bad news

Using the technical definition of two consecutive quarters of negative growth, the UK and Japan both entered recession in the second half of 2023. While recessions have plenty of negative connotations and can trigger some alarming headlines, the data is backward looking whilst markets tend to focus on what comes next. With many signals of economic optimism and supportive policy, stock markets continued to rally in February with markets in the US, Europe and Japan reaching new all-time highs.

In the UK, the second half of 2023 equated to a very mild recession in the context of history. This coincided with heightened concerns among consumers and businesses regarding the outlook for interest rates which encouraged elevated saving rates and dampened consumer confidence. However, with inflation experiencing a notable decline and anticipated to approach the 2% target by the second quarter – largely attributed to a decrease in the energy price cap – concerns surrounding interest rates have diminished. Additionally, the Bank of England has expressed comfort over investor expectations that interest rates will start to fall over the course of 2024. As a result, consumer confidence and retail sales have started to rebound – creating a better outlook for future company earnings.

Weak consumption in Japan contributed to the contraction recorded in late 2023, despite low unemployment and rising confidence amongst consumers. This complicates the task for the Bank of Japan who have widely been predicted to begin increasing interest rates, which are currently still below 0%. Despite this, Japanese equities rose to record highs in February, surpassing levels last observed in 1989. The Japanese market has continued to benefit from corporate governance reforms and enhanced tax savings incentives for individuals, as well as the weak Yen. Breaking this psychological level could be key to domestic confidence and provides tailwinds for further gains.

Emerging market (EM) equities have significantly underperformed in recent years. However, observing EM returns in aggregate masks huge dispersion between regions – Indian and Mexican markets have delivered annualised double-digit returns over the last three years, while Chinese markets have declined. There are signs of positive momentum in global trade, which may begin to provide a boost to more regions, for example Korean and Taiwanese exports have picked up over the last few months, led by demand for technology products. This is a positive sign for global growth and is likely to bode well for corporate earnings within these regions. Solid domestic growth in India and Latin America is also expected. However, Chinese earnings still seem likely to lag other EM peers due to a sharp slowdown in its housing market alongside a disappointing recovery in consumption after lockdowns. Stark variation between geographies creates good opportunities for active managers in this area.

Bottom Line

While some economies experienced slowdown in 2023, central banks seem to have avoided a deep recession. Looking forward, while we may see some pressure, inflation is likely to remain below highs and should be less critical to markets. Until recently equities relied on declining inflation and the promise of lower rates. With strong company profits and increasing signs of economic resilience, equities are now rising despite higher rates, providing a healthy environment for sustained gains.

Month by numbers

Change in various markets over the month:

Asset		Change / Value
Equities		
UK	↑	0.70%
Europe	↑	2.39%
US	↑	5.32%
Emerging Markets	↑	5.10%
Japan	↑	5.46%
Bonds / Rates (** Absolute change (%)*)		
UK Base Rates	–	0.00% / 5.25%
Fed Funds Rate	–	0.00% / 5.50%
UK 10-Year Yield	↑	0.33% / 4.12%
US 10-Year Yield	↑	0.30% / 4.24%
Currencies		
GBP / USD	↓	-0.63% / $1.27
GBP / EUR	↓	-0.37% / €1.17
DXY (USD Index)	↑	0.85% / 104.16
Commodities		
Gold	↑	0.30% / $2,043.54
Oil (Brent)	↑	2.34% / $83.62
Noteworthy		
St James's Place PLC	↓	-23.10%

Q&A

What's on your mind?

New Record

Nvidia set a record on 22 February for the biggest single-day increase in a company's market valuation after it released its much-anticipated results, with the company increasing in value by $277bn. Nvidia is now the third largest US-listed company, behind only Microsoft and Apple. The company has been directly responsible for approximately one quarter of the year-to-date growth in US indices, highlighting the narrow leadership of recent market gains. This has triggered some concerns amongst market commentators about excessive exuberance and instability in market performance. However, investor enthusiasm for artificial intelligence has been catalysed more broadly and has helped lift stock markets in Japan and Europe, as well as the US, to new record highs. Despite the surge in Nvidia's share price, earnings and revenue forecasts have increased so much that the stock's valuation sits below historical highs.

Why are Commodities Lagging Equities?

With ongoing fighting in the Middle East as well as US military strikes against Houthi targets in Yemen in response to attacks in the Red Sea, it may seem surprising that commodity prices have not risen sharply over recent months. Fundamentally, while the conflicts are close to key oil producers, output has not yet been affected. Additionally, OPEC spare capacity is estimated to have risen substantially over the last year and, therefore, any increase in demand or disruption to supply is expected to be met by current producers. Commodities gained much attention as an asset class in 2022, providing good returns in the aftermath of the Russian invasion of Ukraine, while most asset classes declined. However, over longer time periods commodity returns tend to trail behind equities. While commodities can behave like financial assets in the short-term, investment induces mean-reversion in prices, therefore capping returns.

Why is the UK Stock Market Not Making New Highs Like Several Other Markets?

Many western economies have had similar experiences over the last couple of years with inflation and interest rates. The relief from inflation declining, strong jobs markets, and good corporate earnings has helped to push equity markets in the US and Europe to new highs. However, the UK equity market has far from kept pace - lagging Europe by around 10% in 2023, the US by around 20% and continuing to trail in 2024. On valuation metrics, UK indices are seen as cheap but it's not clear that this is enough to trigger a turnaround. Domestically, UK pension fund ownership of UK-listed shares has been declining for nearly 30 years - a trend that politicians have expressed discomfort with and may take steps to discourage. However, the composition of the index is a significant barrier to global investors. Sectors with high earnings growth, such as technology and communication services, are simply a much lower proportion of the UK index.

For more information, please contact your adviser.