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Second Quarter 2024

It was a reasonable quarter for equity markets, despite declines in April, as corporate earnings and disinflation trends underpinned sentiment in stock markets. The MSCI Emerging Markets index gained 5%, with the biggest contribution coming from Asian stocks, while developed markets were rather mixed. The US S&P 500 added another 4% or so, driven again by large technology stocks. Some of the leading US companies experienced large price moves immediately following the release of their Q1 results in April: positive to the tune of 10-12% for the likes of Tesla and Alphabet, thanks to forward guidance and an initiation of a dividend respectively, and negative with a similar magnitude for Meta as it forecast high R&D spending. This illustrates the degree to which these stocks can move the market despite being analysed and followed heavily.

Returns in continental Europe were flat, hindered by a sell-off in June centred around France. President Macron surprisingly called a snap parliamentary election in response to a weak showing in European elections early in June and in the hope that a campaign would solidify support for his centrist Ensemble alliance. With the right wing Rassemblement National (RN) polling well, French government bonds sold off and the national stock market, CAC 40 (-6.4%), fell sharply as investors feared a move away from the centre ground. with risks to fiscal stability possible and a more confrontational approach to the EU likely. While RN did well in the first round of the vote on 30th June, a left-leaning alliance became the largest bloc in the second round a week later. There is uncertainty over how a government may be formed by disparate interests within this group while also requiring support from others such as Ensemble. It looks likely that some of Macron's reforms may be reversed, including pressure to lower the retirement age which is an important tenet of the left's programme.

The UK election campaign was less eventful, with a Labour majority confirmed after polling day on 4th July. Leading figures in the party have been at pains to stress their credibility and prudence in economic management, which is likely to mean considerable continuity in the UK investment landscape in the short term. UK assets had a good quarter, with the FTSE All Share index gaining 3.7%.

In June, the European Central Bank reduced interest rates by 0.25%, its first move in a cutting cycle. While it is likely to tread slowly, recent inflation and growth data was deemed sufficiently weak to allow scope for a cut. In the UK, the Bank of England did not follow suit, keeping rates on hold while it awaits more evidence of services inflation slowing down – should more confidence about this be gained, then a cut in August is a possibility. The Bank may also have been unwilling to adjust policy so close to an election.

In the US, economic data continues to be strong which encouraged a further push-back of expectations for interest rate cuts; only two are now deemed likely over the remainder of the year. Federal Reserve Governor Jerome Powell's comments at the start of May indicated that further rate rises would be unlikely. While rate cuts have not occurred so far this year – contrary to expectations at the end of 2023 – the robustness of US economic data and limited success in bringing inflation towards target had caused some market participants to opine that the next move in interest rates might be up, rather than down. With such a move now "unlikely", according to Powell, we are in a situation where rates remain steady or decline from here and this can be supportive for equities and bonds. There has been little to move the dial in terms of inflation itself, with downward pressure from goods prices but services inflation remaining sticky as labour markets are tight across various economies.

Outlook

Our views remain consistent with those expressed at the end of the first quarter, reflected in no significant changes being made to portfolios during the past three months. With little change in core government bond yields, fixed income investments remain attractive with most of the expected return likely to come from coupons. There remains the possibility that economic conditions may weaken during the second half of the year, which would be likely to add capital gains to this income as yields fall, but this does not need to be the base case for bonds to appear an attractive asset class while running yields are at solid levels.

The strength of equity markets, led again by the largest US technology stocks, has been a slight surprise this year and we would reiterate our previous view that some caution may be merited alongside continued exposure to such themes in prudent sizes. The earnings of the likes of NVIDIA and Microsoft remain highly impressive, with both companies well-positioned and able to achieve revenue and margin expansion despite their large size. Market sentiment is likely to be highly sensitive to any change in this picture, but all evidence so far points to positive momentum and share valuations which have risen but are not extreme.

UK assets' relatively good performance in Q2 may suggest that sentiment has bottomed and has begun to recover. Valuations are certainly attractive after years of outflows from international investors, and a change of government is unlikely to have a significant impact on sentiment. Share buybacks and merger and acquisition activity, particularly in the small-cap sector, have accelerated and may be reflective of the good value on offer; we expect to retain exposure to this area.

The third quarter will see campaigning in the US Presidential election step up, yet July has started with uncertainty over Biden's candidacy and even his tenure as President during the next few months. Thus far, financial markets have been unaffected by the election despite polling being close and the candidates differing in important ways. Under either a Democrat or a Republican President, the US fiscal situation is likely to deteriorate whether through higher spending or lower taxes. There could well be implications for the US Treasury market, so this must be monitored closely.

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