Signia Invest Insights

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Market Review and Outlook

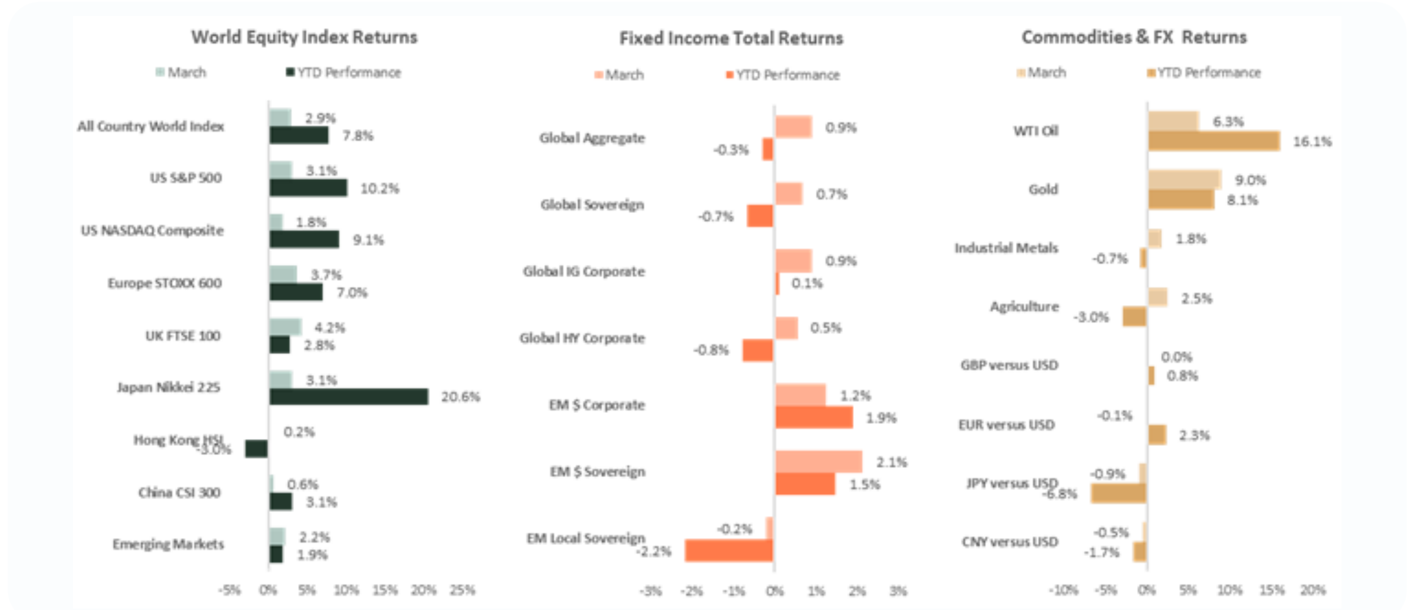
STRONG Q1 A HARBINGER FOR AN EVOLVING OUTLOOK

- March closed out Q1 with another strong performance for risk assets, with several equity indices reaching all-time highs, driven by growing hopes for a soft economic landing along with ongoing optimism around AI. Indeed, the S&P 500 was up more than +10% in the first quarter, remarkably marking the first time in over a decade that it's seen back-to-back double digit quarterly gains. Meanwhile in Japan, the Nikkei saw its strongest performance since Q2 2009, and surpassed its previous record high from 1989. Despite a positive March, bonds saw a weaker performance over the quarter, as more persistent inflation and the strength of the US economy led investors to price in fewer rate cuts from the Fed, leading to a -0.3% decline in the global aggregate bond index year-to-date.

- That backdrop of positive data surprises provided a major boost to risk assets. For equities, it meant the S&P 500 (+10.2%) and the STOXX 600 (+7.0%) both ended the quarter at a record high, with continuous monthly gains throughout January, February and March. Impressively, the S&P 500 managed to post 16 out of 18 weekly gains for the first time since 1971. Nvidia was the top performer in the S&P 500 over the period, leading the Magnificent 7 to a gain of +17.1%. Whilst the equity bull market is starting to show signs of broadening out, performance in Q1 was still driven by a relatively narrow group of stocks, as the equal-weighted S&P 500 was up a smaller +7.9%, and the small-cap Russell 2000 was only up +5.2%. However, the rally in risk assets was broad, with credit spreads tightening notably, oil prices rising substantially, and crypto assets experiencing a very strong quarter.

- There was a significant milestone in Japan, as the Bank of Japan ended their negative interest rate policy in March by increasing its key interest rate from -0.1% to a range of 0%-0.1%. That helped push the 2-year Japanese government bond yield up +14 basis points to 0.18%, its highest quarterly close since 2011. Moreover, the BoJ said they anticipated "that accommodative financial conditions will be maintained for the time being", so perversely, despite the hike, the prospect of low interest rates continuing for some time meant the Japanese Yen was the weakest performing G10 currency over the quarter, falling -6.8% against the US Dollar. On the other side of the G10 currency fence was the Swiss National Bank, who became the first central bank to cut rates in this cycle, with a 25 basis point cut in its policy rate to 1.5%, as Swiss CPI inflation dropped to 1.2% in February with core CPI at 1.1%.

MARKET PERFORMANCE AS OF 29 MARCH 2024:



Source: Bloomberg L.P., Arbion Ltd.

- For markets, the most important story in Q1 was how global economic data kept surprising on the upside, which raised hopes that a soft economic landing was still on the horizon. For instance, the latest data showed the US economy grew at an annualised rate of +3.4% in Q4, whilst nonfarm payrolls were unexpectedly up by +303k in March versus consensus expectation of 214k with strong contributions from most underlying sectors. The unemployment rate fell by -0.1% to 3.8% but was in-line with expectations, driven by an increase in labour participation, which rose from 62.5% to 62.7%. Moreover, average hourly earnings growth came in at the consensus figure of 4.1% year-on-year, down from 4.3% a month earlier.

- Meanwhile, the Fed remained unfazed by three hotter-than-expected inflation readings in the first quarter. Indeed, despite these readings and an increase in the Fed's own inflation projection for 2024, Chair Jerome Powell remarked that the inflation story remained "essentially unchanged." This gave comfort to markets on the prospect of continued Fed support despite the growing unease of an unfolding 'higher for longer' interest rate environment. Indeed, this has been our scenario for some time alongside the risk of normalising bond market term premiums that still remain artificially depressed.

- Zooming out to a more global perspective, the picture does not change. In the Euro Area, growth in Q4 again lagged and was unchanged, however, Purchasing Managers' Index surveys have continued to rise with the March flash composite PMI up to a 9-month high of 49.9, indicating a trend towards >50 which is seen as expansionary economic readings for an economy. Furthermore, manufacturing PMIs for China came in above 50 with a similar double beat of forecasts and prior figures. All of this points to a cyclical global economic upswing on the cards for 2024.

- The obvious negative implication of this development is that the probability and magnitude of rate cuts this year must be trimmed back by a meaningful amount. Currently, markets are expecting around three cuts this year from the Fed, down dramatically from almost seven cuts in January. Considering the resurgent inflationary pressures, it would probably be unwise for the Fed to ease at all, but it still conceivable to see one or two 'mid-cycle' cuts in the summer before the window closes for the elections.

MARKET-IMPLIED FED RATE CUT EXPECTATIONS FOR 2024:

Source: Bloomberg L.P., Arbion Ltd.

- Further evidence of improving activity and the emergence of a reflation theme can be seen in the performance of the commodity complex. Crude oil is up 27% since its December low, copper is up 21% from its October low, and several agricultural commodities (coffee and cocoa) have been rising substantially on the back of poorer-than-expected harvests.

- All of this increases the spectre of a secondary inflation wave later this year and into 2025. During almost all historic inflationary episodes we have observed a secondary rebound between one and two years after the peak of the first inflation wave. Looking at the various input factors that constitute inflation indices, it seems we are very close to a cyclical bottom across most consumer price indices from which one should expect a rebound higher. This can be tentatively seen in the swaps markets, where 1-year zero coupon inflation swaps have begun moving higher again, to levels that I suspect are causing some unease at the Fed.

INFLATION SWAPS MOVING HIGHER PERHAPS ALLUDING TO A SECOND WAVE:

Source: Bloomberg Finance L.P., Arbion Ltd

- So far, equity markets are reflecting this outlook via stable forward earnings estimates for this year and even an anticipated increase in corporate profit margins. The most notable, and potentially consequential observation from recent market dynamics is an ongoing sector rotation out of technology and into energy and industrials. On an equal-weighted basis, technology was only the fifth best-performing sector in Q1 in the US. Energy, industrials, financials and materials, all performed better. Certain sectors within tech, especially semiconductors looked stretched in technical terms and are overdue a consolidation. The broadening sector rotation and strength of other sectors is encouraging as it speaks to the healthy state of markets overall and is likely to ensure that headline indices won't suffer too much in the event we experience a deeper drawdown in mega-cap growth stocks this year.

- The S&P 500 enters Q2 with a 12-month percentage change just about in the top decile historically, along with 12-month equity ETF flows pushing +$500B. Both these metrics are certainly stronger than at the start of prior quarters but remain well short of the early 2021 euphoric investor environment. Momentum isn't something to fear, but we would at least consider that the -1.7% max drawdown through Q1 would score as the least intense annual correction over the last 80 years of S&P 500 data. Said another way, US equities have posted a smaller drawdown than US Treasuries through 3-months of 2024. Indeed, it has now been 44 months without a new all-time high for the Bloomberg Aggregate Bond Index and this is approaching 3x the prior record of 16 months!

- This underlying fundamental momentum is diffusing into the consumer: US consumer sentiment hit the highest since 2021 driven in part by rising financial markets and the wealth effect lifting household balance sheets and with it household sentiment. This is ultimately bullish for risk assets even though one should expect more moderate returns over the summer as recent strong market momentum hits near-term fatigue. In fact, a moderate bull market correction at these levels would be longer-term healthy for risk assets. Indeed, despite the strong election year seasonality factors discussed over recent months, markets appear to be increasingly running into technical resistance levels. Very low implied volatility levels and a sense of complacency amongst investors are also notable observations in this context. As a result, we expect performance to moderate somewhat in Q2 and, once these overbought conditions are dealt with in the near-term, markets can continue to move higher.

ROBERT LEE

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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.

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