ROCQ CAPITAL

First Quarter 2024

Equity markets performed well in the first three months of 2024. The release of strong corporate earnings from several key US stocks, such as NVIDIA, Microsoft and Meta, was influential in buoying sentiment and pushing up global markets. At the same time, economic data was largely as expected with little sign of weakness. The MSCI World index rose by almost +10% in GBP terms, led by American names, while the Japanese market also performed well, adding over +13%. Once again there was generally subdued performance from companies which look more attractively valued, such as many in the UK and parts of the emerging markets; the FTSE 100 and the MSCI Emerging Market indices only rose by around +3% during the quarter.

The fall in inflation seen in the second half of 2023 has stalled somewhat, throwing doubt on projections for central banks to reduce interest rates. With goods price inflation down to tolerable levels, and showing deflation in some cases, it has been the service sector entirely responsible for slightly above-expectations price data. Labour costs are the key element of this, and with unemployment staying low there has been little sign of further disinflation in this area. The UK picture is illustrative of this; the February CPI figures showed a slowdown to 3.4% in headline inflation, led by food prices, and this is likely to drop further in Q2 due to falling energy costs, but service inflation fell more modestly and sits at 6.1%.

While this points to a healthier global economy, notably in the US, than might have been expected a few months ago, it has implications for central bank policy. Coming into 2024, the US Federal Reserve was expected to cut rates in six 0.25% increments this year; while this always looked a lot, current pricing indicates this has been reduced to fewer than three such moves, starting around the middle of the year. Such a shift has been good for equities, as it reflects benign economic conditions, but government bond markets have seen yields rise (prices fall) given rates are likely to be higher for longer. During the quarter, the US 10-year yield moved from 3.92% to 4.20% while the UK equivalent rose by a similar magnitude from 3.62% to 3.93%. Credit markets have performed solidly, as corporate earnings have been strong which has encouraged a tightening of spreads to largely offset the rise in bond yields. The Barclays Global Aggregate index, which includes government and investment grade corporate bonds, had slightly negative performance in Q1.

Expectations of other central banks have also been pared back, with the European Central Bank and the Bank of England now forecast to deliver 2-3 cuts, starting in Q3. Bucking this trend, the Bank of Japan raised rates in March, from negative to zero, while also abandoning several other long-running policy measures. This shows how out of kilter Japanese policy has been with the rest of the world, but its exit from negative rates is significant and reflects higher confidence in the domestic economy.

Outlook

Our view on markets has not changed greatly over the past three months. We remain well-disposed to fixed income investments, which continue to look attractive, and expect them to perform solidly in most scenarios over the coming months. While there has been a significant re-pricing of central bank rate rises for the remainder of the year, and inflation is not as low as we would like, the yields that can be secured in bond markets are worth locking in and in many cases represent a low-risk way to generate positive real returns.

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Equity markets feel more difficult to call at present. Company earnings and share price performance of many of the world's largest stocks has been impressive, helping to drive stock markets upwards, and at present most indicators suggest that the global economy has been able to weather the rise in interest rates experienced during 2022. However, we remain vigilant on this point given that monetary policy operates with long and variable lags and that a weakening of the labour market (synonymous with a recession) may be tolerated by central banks if it enables inflation to fall back to their target levels.

The strength of mega-cap US stocks, particularly those in the technology sector, has been a notable feature of the past year or so and has been responsible for a large share of market performance. This is another area where some caution is warranted, as a wobble from one or two key stocks would ripple through global stock markets. Where appropriate, we have added Japanese equity exposure to provide some diversification from this in two aspects – Japanese stocks generally have cheaper valuations than US ones, and the yen can be expected to strengthen from its undervalued position in a range of scenarios including a flight to safety. We have also retained exposure to emerging markets and the UK, as generally valuations are attractive and certainly less stretched than in the US. Towards the end of the quarter, the Chinese market showed signs of life after a torrid couple of years – the protracted weakening of the property market is ongoing, but we may be reaching a point where sentiment and investment flows can recover.