ROCQ CAPITAL

Third Quarter 2024

The sentiment surrounding US interest rate expectations changed markedly during July with expectations building that the Federal Reserve (Fed) would cut rates by just over 1% through the remainder of this year. There were concerns that the Fed had missed an opportunity to reduce interest rates at the end of July, especially as labour market data and business sentiment surveys were weaker than expected in the early days of August, but the central bank did deliver a 0.50% reduction at its mid-September meeting. This marks the start of an easing cycle which is expected to include further reductions in the policy rate in November, December and into next year. Inflation has continued to trend gradually downwards, remaining stickier in the services sector than in goods prices, but the Fed appears confident that it can now focus on the labour market instead. Recent employment figures indicate a softening in the economy which can be responded to, hopefully without prompting a renewed rise in inflation. Although the European Central Bank and the Bank of England have also embarked on a rate cutting cycle in recent months, including the latter reducing rates at the beginning of August, the Fed's larger move caused the dollar to weaken against peers during Q3 including a fall of around 6% against the pound and 4% against the euro.

Against this backdrop, those asset classes that are sensitive to interest rates outperformed with a notable rotation into small cap stocks in July. More scepticism has developed around potential returns from investment in artificial intelligence tools, resulting in weakness for some of the largest technology stocks which had a strong year until this quarter, and this weighed on overall returns – in GBP terms, the MSCI World equity index was flat, with regional bourses recording small gains or losses. Fixed Income markets fared better, with yields moving lower which helped government and investment grade corporate bonds to appreciate.

August began in dramatic fashion with heavy losses across stock markets. Prompting the sell-off was a decision from the Bank of Japan to raise interest rates from 0.10% to 0.25%. While this is a small move, it indicated a change of tack and tone from the central bank at a time when most other countries are considering reducing rates. As a result, the yen strengthened significantly having been in a weakening trend for most of the last three years, with the currency appreciating by around 8.50% against the dollar over the following three days. Such volatility fed into other markets and asset classes, exacerbated by an unwinding of Japanese investments which rely on low domestic rates and a weak yen (the 'carry trade'), before a recovery occurred over the remainder of the month and into September, which was rather uneventful across global markets until some key announcements from China at the end of the quarter.

The Chinese market has been weak for three years or so, as mentioned in previous commentaries, as the overhang from excesses in the housing market and interference in the private sector by the government have damaged consumption and entrepreneurial activity in various sectors. While policymakers have tinkered around the edges, late September marked a significant step upward in the government's attempt to reignite the economy. The central bank cut key lending rates and bank reserve requirements, freeing up credit capacity, while the Politburo used unusually strong language to indicate its resolve to deal with the property market and suggested that fiscal spending would be increased in various spheres to stimulate economic demand. It remains to be seen whether they will be successful, but it does appear to be a strategic shift in macro policy and consequently the Chinese stock market was exceptionally strong in the final week of the month as the CSI 300 index gained an astonishing 25% and the Hang Seng rose by almost 16%.

Outlook

Expectations of interest rate cuts from the Fed look rather stretched, with a series of reductions in its policy rate forecast over the coming year. These look difficult to justify without a more marked slowdown in economic activity; more likely seems to be a gradual slackening in the US and global economy, counterbalanced by the support that lower rates provide. This represents a reasonably good environment for fixed income investments, as coupon levels remain attractive and there may be scope for capital gains.

The main event in Q4 is the US Presidential election in early November. With polls consistently tight, there has been little pricing in by investors of either candidate's policy agenda, especially given uncertainty over the composition of Congress. Even if measures are watered down, looser fiscal policy is almost certain – whether via Trump's planned tax cuts or Harris' additions to government spending. There appears little consideration of the US's widening fiscal deficit which could result in turbulence in the US Treasury market, a risk that needs to be weighed up in the coming months given we are otherwise positive on bonds within our portfolios. New tariffs, proposed by Trump, could also add inflationary pressure and impact the Fed's plans for further rate cuts.

October has begun with renewed hostilities in the Middle East between Israel and its neighbours, putting upward pressure on oil prices without having large effects on other markets. With the conflict now involving Iran and Lebanon more overtly, the chances of further escalation have risen but are expected to be contained to the region at present. Any indications that this is not the case would arguably cause a spill-over into various asset markets, and while this is not a central scenario our diversified holdings should help portfolios ride out bouts of volatility. Indeed, we are looking to broaden our equity exposure a little via a tilt towards value strategies which may be more resilient in a changing investment environment.

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