Quarterly review

for the three months to 31 March 2024

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The Federal Reserve, Bank of England (BoE) and European Central Bank (ECB) kept their policy interest rates on hold during the first quarter of 2024, aiming to ensure that inflation returned sustainably to their 2% targets over the medium term. Global equities rose 9.31% in sterling as inflationary pressures eased, albeit more slowly than expected, and investors became increasingly confident rates would be cut during the second half of the year. The gold price rose 8.35% in sterling because falling rates increase the attractions of this nil-yielding asset and central banks have increased gold reserves. Technology stocks led the markets higher in response to strong results and investor enthusiasm for companies supplying the artificial intelligence sector.

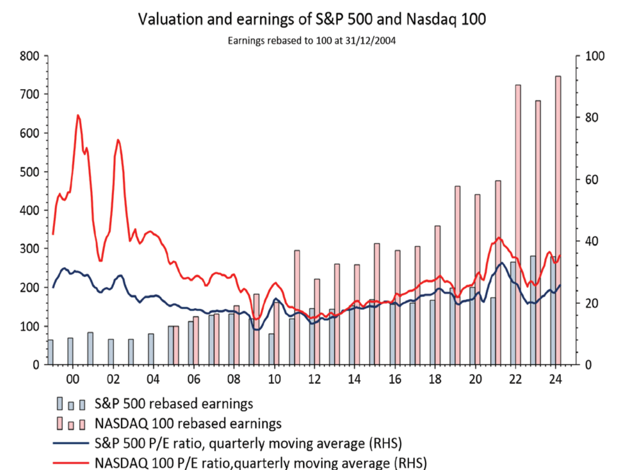
In February, US, UK and eurozone headline inflation figures were 3.2%, 3.4% and 2.6% respectively. Inflation in the US and eurozone is trending down but February's numbers were higher than expected and global bonds fell 1.19% in sterling over the quarter as the likely timing for the first interest rate cuts drifted out. In the US, a disappointing figure for the "shelter" component of inflation data, which covers housing costs, more than offset falling energy prices.

US economic growth was strong despite the absence of an interest rate cut. In the Fed's March summary of economic projections, the 2024 growth forecast rose from December's 1.2-1.7% range to 2-2.4%. The divergence in growth rates between the US and some other industrialised countries, a hallmark of 2023, looks set to continue this year. In March, the ECB reduced its 2024 inflation forecast from December's 2.7% projection to 2.3% despite price pressures from rising wages. Growth, meanwhile, was expected to be just 0.6% this year. UK inflation fell from 4.0% in December and January and, according to the BoE's March monetary policy committee meeting minutes, the figure may fall below 2% in the second quarter of 2024 owing to the freeze on fuel duty in the Budget. After the mild technical recession in late 2023, the BoE expects a return to growth over the first half of 2024.

The reversal of globalisation policies that had left western economies vulnerable to supply chain problems may leave longer-term inflationary pressures higher than in pre-Covid-19 era. President Biden has maintained Donald Trump's "America first" policies in signing the 2022 Inflation Reduction Act (IRA). With its offer of tax breaks to companies that launch clean energy initiatives, this reform aims to increase US manufacturing while combating climate change. In the year following enactment, the private sector announced $110 billion of clean energy investments.

The Bank of Japan (BoJ) raised its policy interest rate for the first time since 2007, taking it from -0.1% to 0-0.1%, and abandoned yield curve control. This brought the era of negative interest rates to a close, with the BoJ now forecasting that inflation would reach its 2% target in a sustainable and stable manner. Despite this significant shift, the yen fell 6% against sterling over the quarter. Yen-weakness has improved Japan's export competitiveness, contributing to gains for Tokyo stocks, which outperformed, rising 11.06% in sterling. Even after this rise, Japan's stockmarket remained lowly valued compared to some other equity markets. Government policies designed to ensure companies focus on improving investor returns has, however, fostered the rise of shareholder activism, which may lead to higher valuations in the future.

US technology stocks rose 14.53% in sterling as big companies such as Nvidia, a semiconductor chip supplier to the artificial intelligence sector, posted strong results. As the chart below shows, technology-heavy Nasdaq 100 Index's price/earnings ratio has been much higher than the ratio for the broader S&P 500 Composite. At the quarter end, the figures were respectively 35.7 and 26.9. This valuation premium may, however, be justified because the shaded bars show how much more rapidly technology sector profits have grown relative to the broader US stockmarket. Current valuations are not, however, as

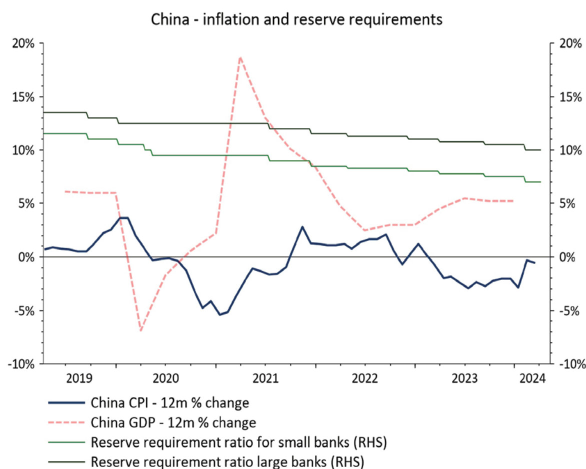


high as they were at the time of the turn-of-the-century dotcom bubble.

The technology sector's increasingly heavy weighting in US market indices means investors face a greater degree of sector and stock-specific risk when investing in tracker funds. Funds that mirror indices become inherently more risky compared to some actively-managed funds when a particular stock or sector becomes dominant because the largest constituents of an index may by definition be amongst the most overvalued companies and fall more in the event of a change in market leadership. At the quarter end, just seven technology stocks including Microsoft, Apple and Nvidia accounted for 33.62% of the S&P 500's market value and 39.77% of the technology-focused Nasdaq 100.

Equities in Asia excluding Japan and emerging markets underperformed, both rising only 3.38% in sterling, partly as a result of the 1.30% fall by Chinese stocks. As the chart below shows, in February the People's Bank of China cut the reserve requirement ratios that control banking system liquidity to support the economy in the face of falling prices, property sector woes and weak consumer spending. Indian stocks did better, rising 7.09% in sterling. India's economy is expected to grow faster than China's in 2024 but the gulf in valuations in favour of Indian stocks may reflect India's superior growth prospects and the political risk weighing on China should November's US presidential election result in more sanctions. The price/earnings ratio for India is 23.55 against only 11.69 for China. There are grounds for optimism about emerging market equities generally but there was, at the quarter end, no catalyst to support a more positive view on Chinese stocks.

Overall, the prospects for interest rate cuts later this year should prove supportive for equities and bonds. The US and emerging markets appear most attractive given their superior economic growth prospects. US technology stocks may continue to lead markets higher but active fund managers may outperform because investor enthusiasm has inflated the value of some stocks to levels that may expose them to profit taking.



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