PERSPECTIVE
PRIVATE WEALTH

Q3 2024 Market Update

The 3rd quarter was a period of consolidation following a strong first half of the year. Equity market returns were found more broadly in financial markets following the technology stock rally during H1. Indeed fundamentally (value) driven stocks outperformed growth stocks over the quarter. Bond markets continued to perform well in GBP terms.

The PERSPECTIVE investment strategies followed the trend, posting neutral to marginally positive returns over the quarter, following strong performance over the first half of the year.

Asset Class Returns (GBP)

EQUITIES	Performance
MSCI World (ACWI)	0.54%
FTSE 100	2.83%
S&P 500	-0.84%
Eurostoxx 50	1.28%
Nikkei 225	8.04%
MSCI Emerging Markets	2.86%

BONDS	Performance
UK Gilts	3.26%
UK Index Linked Gilts	2.83%
UK Corporate Bonds	2.72%
Emerging Market Debt	-3.21%

PROPERTY/ COMMODITIES	Performance
Global Property	10.19%
GOLD	13.13%
OIL	-16.52%

In the coming quarters, equities are expected to perform the best among major asset classes through the end of 2025, as the AI bubble reinflates. Government and corporate bonds are likely to underperform, even with monetary easing, though they are still anticipated to deliver positive returns. In contrast, most commodities are projected to face challenges due to weak demand and abundant supply.

Equities generally delivered good returns overall in Q3. The best performing equity market in GBP terms was the Nikkei 225 (up 8.05% on the quarter), and the poorest performing equity market was the S&P 500 (down 0.84% on the quarter).

UK Bond markets performed strongly this quarter, reversing the losses from the previous quarter. Returns were primarily driven by government bonds, which benefited from declining yields as investors reduced their expectations for the level at which policy rates will stabilise.

Global property prices rose 10.19% on the quarter, outperforming ordinary equities after a sustained period of underperformance. The return has probably been aided by lower bond yields.

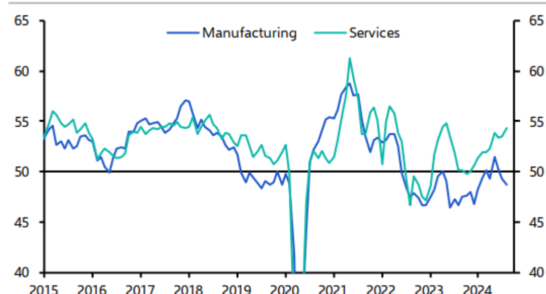
Brent crude oil prices dropped significantly over the quarter, ending at $71.95 per barrel, a 16.52% decline, as concerns over weakening global demand continued to weigh on investors.

Economic Outlook – A soft patch

Global – The recent slowdown in global economic activity is expected to continue for several more months. However, the likelihood of a hard landing remains relatively low, as lower inflation is bolstering real incomes. Monetary policy normalisation should generate a modest economic revival in most areas in 2025, although risks are skewed to the downside.

While most of the hard data suggest that global economic activity has remained resilient, the recent downturn in surveys of manufacturing activity is somewhat worrying. (See Chart 1.) This sector tends to be more sensitive to higher interest rates as households cut back purchases of big ticket items like cars and appliances and firms delay spending on capital goods. So it is possible that previous monetary policy tightening has begun to take a heavier toll.

Chart 1: Global Manufacturing & Services Sector PMIs



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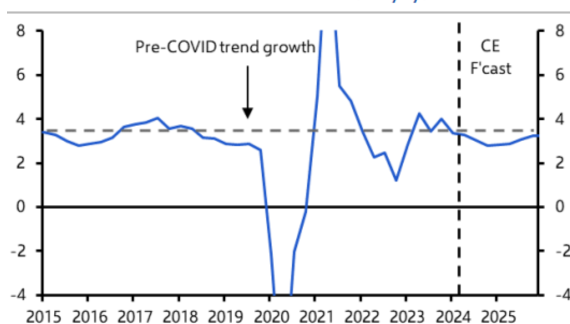
The recent slowdown in employment growth and uptick in unemployment across several major economies has also sparked some concern. Meanwhile, sentiment towards China has continued to weaken.

Previous sharp falls in inflation related mainly to food and energy costs are supporting real incomes growth. Early interest rate cuts and expectations of more to come have already reduced borrowing costs and bolstered bank lending. While employment growth has softened, major job cuts have not taken place. Indeed, wider measures of labour market conditions such as vacancy rates suggest that conditions are simply normalising after a period of tightness.

The disinflation process has slowed due to persistent price pressures in the services sector. Policy rates are still anticipated to be cut to more neutral levels next year as declining wage growth alleviates price pressures. This is expected to stimulate economic activity, though to a limited extent, as market interest rates have already decreased in anticipation of these rate cuts. Additionally, the pace of policy easing is likely to disappoint in Europe, Emerging Europe, and Latin America next year because of ongoing wage pressures in those regions.

In all, global GDP growth is expected to fall below its long-run average pace in the near term. (See Chart 7.) Activity should recover next year, but with significant variation by economy. The US will benefit from relatively aggressive interest rate cuts given its benign inflation picture. But growth in the euro-zone will be weighed down by fiscal tightening and structural issues in industry. And while India and China will benefit from fiscal policy support, several other emerging markets will suffer from tight policy and stubborn price pressures.

Chart 7: World GDP (% y/y)

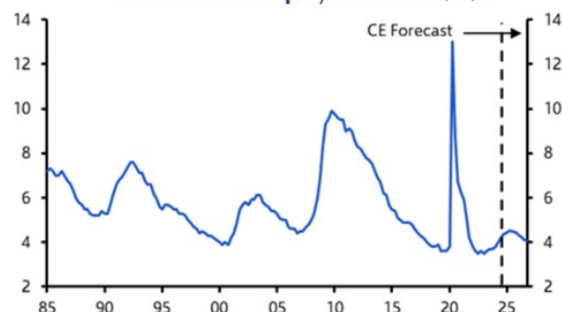


US – With inflation normalising due to improved supply, the Fed finds itself in a fortuitous position to lower interest rates even as economic growth remains robust and the unemployment rate stays relatively low. Despite a slowdown in employment growth, GDP is expected to remain strong over the next couple of years, as monetary policy shifts rapidly from being a headwind to a tailwind.

Third-quarter GDP growth is projected to be 2.5% annualised, primarily driven by strong consumption growth. Households continue to benefit from low fixed-rate mortgages from the pandemic era, keeping debt servicing costs low. Additionally, higher-income households are experiencing gains in wealth due to the stock market boom. Finally, the recent decline in energy prices is expected to offer some relief.

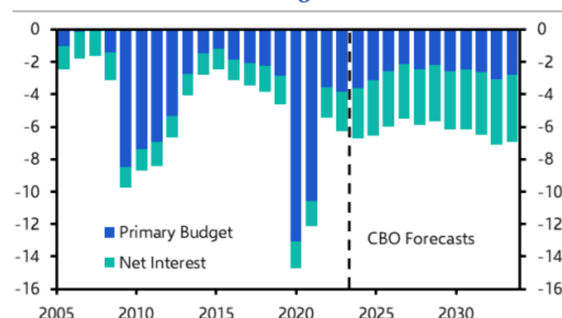
The pace of employment growth has slowed, but monthly gains are expected to stabilise at around 100,000. Assuming the recent sharp decline in unauthorised immigration continues, this slower pace of employment growth may not lead to a rising unemployment rate, which is projected to peak at 4.5%. (See Chart 12.)

Chart 12: Unemployment Rate (%)



Concerning the presidential election, regardless of the outcome, significant fiscal stimulus is not expected, particularly given that the federal deficit is already above 6% of GDP and the debt burden is approaching 100% of GDP. (See Chart 16.)

Chart 16: Federal Budget Balance (% of GDP)



Euro-zone – The economy looks set to continue growing only slowly. Headline inflation is expected to drop below 2% next year, while the core rate will decline more gradually. As a result, the ECB is likely to cut interest rates

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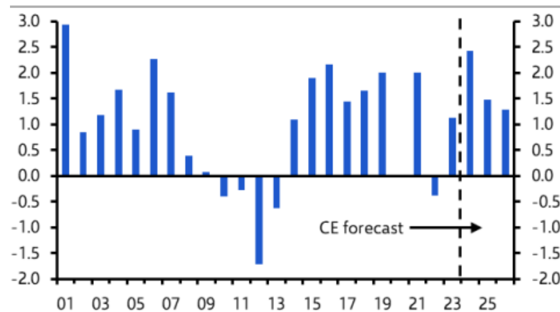
steadily, lowering the deposit rate from the current 3.5% to 2.5% by late next year.

Real household incomes are growing rapidly. (See Chart 17.) But this is not translating into rapid spending growth because high interest

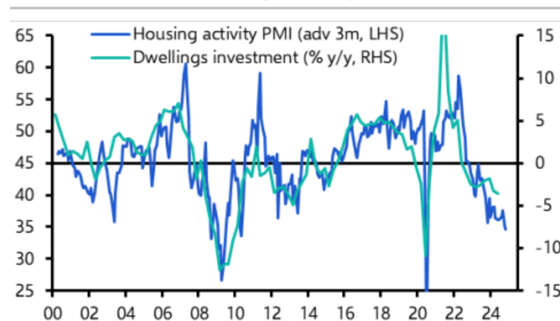
Chart 17: Euro-zone Real Household Disposable Income (% y/y)



rates and low confidence have deterred consumption and pushed the saving rate up to a record high outside the pandemic. A substantial decline in saving appears unlikely, and looser monetary policy is expected to have minimal impact on boosting borrowing and spending.

Investment fell sharply in Q2. Housing investment has now declined in eight of the past nine quarters and the latest surveys suggest this will continue. (See Chart 19.) With corporate profits declining and industrial capacity utilisation low, business investment is likely to remain weak too.

Chart 19: Dwellings Investment & Housing Activity PMI

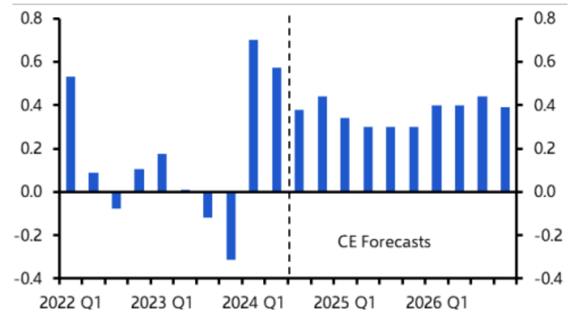


Headline inflation is expected to rise slightly in Q4 due to base effects but will then return to a downward trend. If oil and gas prices decrease as forecasted, headline inflation could reach around 1% by the end of next year before gradually rebounding. The core rate is anticipated to decline more slowly.

UK – While the recent stagnation in GDP shows that most of the recovery from the weakness of the previous two years is now in the past, a modest easing in growth rather than a slump or a recession is the most likely outcome. (See Chart 34.) After all, GDP growth will be supported by the fading of the drags from the previous rises in inflation and interest rates.

Admittedly, the government's plans to raise public spending by around £16bn a year have caused concerns that a big rise in taxes will be

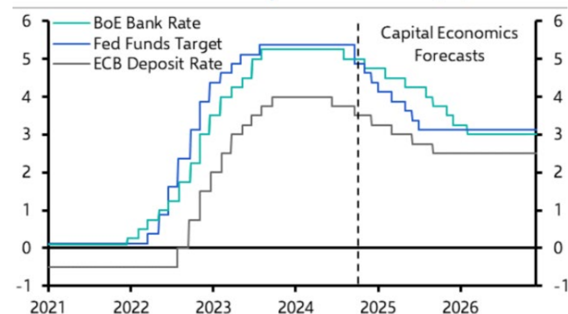
Chart 34: Real Quarterly GDP (%q/q)



announced in the Budget, which could weaken GDP growth. It's assumed that taxes will be raised in line with spending (i.e. by £16bn or 0.6% of GDP). That would mean the overall stance of fiscal policy would be similar to the previous government's plan to reduce the budget deficit.

But since rises in public spending tend to boost GDP by more than increases in taxes to reduce it, fiscal policy is set to support GDP growth. One risk however is that taxes are raised by more than public spending, which would mean fiscal policy is a bigger drag on overall GDP. Nonetheless, monetary policy is likely to be loosened, albeit slowly, over the coming months, perhaps by 25bps every other meeting. Initially, the Bank will move slower than the Fed. (See Chart 38.)

Chart 38: Policy Interest Rates (%)



In the second half of 2025, though, CPI inflation is likely to fall below the 2.0% target as the support to wage growth from the spike in inflation in 2021/22 fades. This will prompt the Bank to cut rates more quickly from June next year, and perhaps to 3.00% by early 2026.

Japan – The economy is on the mend and underlying inflation seems to be levelling off

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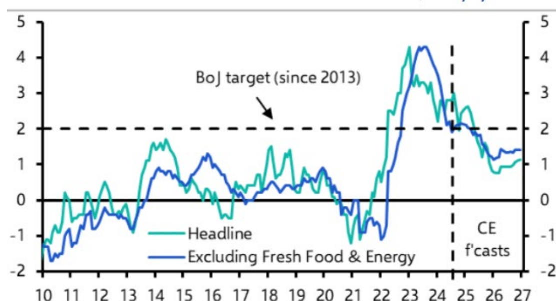
around the Bank of Japan's 2% target. Accordingly, a final rate hike in December is expected. But as inflation falls below target next year and the spring wage negotiations result in a smaller pay hike, more tightening in 2025 is unlikely.

Following a fall in Q1 this year, GDP bounced back in Q2, driven by the first rise in consumer spending since Q1 2023. It mostly reflected a rebound in car registrations as major carmakers had to shut down production in Q1 due to scandals.

The backdrop for consumer spending is improving. Real household incomes have stopped falling as wage growth has accelerated and inflation has softened. And with households benefitting from income tax cuts from June this year, real income growth should be quite strong over the coming quarters.

Inflation excluding fresh food and energy should remain around 2% until the end of the year which should prompt the Bank of Japan to hike rates once more in December. But it is expected to fall to around 1.5% by the end of next year as the impact of the previous import cost shock fades. (See Chart 27.)

Chart 27: Consumer Prices (Excl. tax, % y/y)



What's more, the case for tighter policy will became much weaker if the upcoming Shunto results in smaller pay hikes as anticipated. The main driver of trade unions' Shunto pay requests is inflation over the previous year. It is now all but certain that inflation this year will be well below last year's level, which should result in lower pay hikes.

The Bank of Japan is still describing financial markets as unstable and has indicated that it will not tighten policy in those circumstances. Policymakers have also voiced concern about the stronger yen, which has appreciated further since the Bank's July meeting. The analyst consensus is that the Bank will hike rates to 0.75% by the end of 2025.

China – A pivot towards fiscal and monetary stimulus should support China's growth in the near term. But the economy continues to be propped up by investment, ongoing high levels of construction, and the willingness of trading partners to allow China's producers to expand their market share. None of this is sustainable.

The China Activity Proxy (CAP) suggests that the economy has been holding up better than many headlines suggest, though it has lost some momentum since the start of the year. (See Chart 57.) The CAP breakdown suggests this has mainly been driven by a slowdown in services activity.

Chart 57: Official GDP & CE China Activity Proxy (% y/y)

Of particular concern is the outlook for consumer spending. The labour market has softened again recently, which is likely to translate into slower wage growth. And with house price declines accelerating, confidence is likely to weaken further. By contrast, investment growth has been strong in real terms and will probably remain the main engine of domestic demand.

But there are limits to how quickly the supply-side of the economy can expand. Overcapacity is already resulting in deflation and growing financial strains for manufacturers. Even generous subsidies won't prevent firms from paring back investment.

The big picture is that China has only been able to sustain growth of close to 5% by leaning heavily on investment and exports. As that strategy runs into diminishing returns growth will almost certainly slow further, and probably by more than most anticipate.

Asset Allocation Views

Bonds - DM bond indices have fared well so far in the third quarter of this year, with positive returns across the board. The best performers have been government bonds outside of the US, helped in large part by stronger currencies there. Indeed, about half of the return from DM

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government bonds in aggregate has come on the back of a weaker dollar. In particular, Japanese, UK and euro-zone bonds have been the biggest outperformers, reversing their losses from the previous quarter.

Corporate bonds – Meanwhile, corporate bonds have fared relatively well so far in the third quarter, especially those in ICE BofA's High Yield Index. That has been in large part due to lower underlying Treasury yields. Credit spreads have not changed much on net: they have fallen back after rising earlier this quarter amid fears about a US recession.

Equities – Hype around AI has waned a bit over the summer, reflecting growing doubts about the sustainability of some firms' earnings growth, rising concerns about a recession in the US (or at least a marked economic slowdown), and uncertainty about US monetary policy. This resulted in a big drop in equities in July, led by the so-called "Magnificent 7" which had largely outperformed earlier in the year. Stock markets have largely recovered since then, with both the MSCI USA and S&P 500 indices reaching all-time highs in September. The AI bubble will reinflate before it bursts, with the S&P 500 projected to reach 6,000 by the end of this year and 7,000 by the end of next year.

Emerging market equities – The overall picture of EM equities is quite positive. This is notably the case in Asia – where equities represent nearly 80% of the MSCI EM Index – albeit with some important caveats. If we're right about the AI bubble reflating, equities in Taiwan and Korea, could make strong gains given their tech-heavy compositions. And other stock markets will also benefit, although to a lesser extent. In China, equities have rebounded strongly in September, helped by a coordinated package of stimulus measures from the authorities there.

Commodities – It has been a mixed quarter so far for commodity prices: precious metals prices have continued to surge, but the prices of energy products and industrial metals have sagged. Supply of most major commodities looks set to dominate the near-term outlook, and with OPEC+ output cuts unwinding and LNG production ramping up, energy commodity prices could suffer more than most. And despite the expectation that the global economy will enjoy a fairly soft landing overall, commodity demand, especially for metals, could struggle as China's economy continues to slow. As a result, returns from most commodities are projected to be weak compared to other assets and to their historical performance.

Industrial metals – Industrial metal prices have dropped this past quarter, and this poor performance is likely a sign of what is to come. Most industrial metals prices are expected to decline due to weaker demand, although they will likely remain elevated compared to historical standards, driven by demand from the green transition and AI-related uses throughout the decade. However, this boost may be partially offset by a significant contraction in China's construction sector. Copper is anticipated to fare the best due to its wide range of applications in the green transition, but its price is still projected to drop from around $9,600 currently to $8,000 by the end of 2026.

Precious metals – Prices of precious metals have surged this quarter, with gold faring particularly well. The rise in gold prices so far this year seems to reflect a combination of non-traditional drivers (mainly demand from China) and, more recently, a tailwind from falling US real yields. The medium-term outlook is positive for the precious metal as China's appetite for gold is set to grow as its economy slows down this decade. Prices may also be supported by a fall in short-dated yields as the FOMC cuts interest rates over the next year or so, thereby lowering the opportunity cost of holding precious metals.

Final Word

During 2024, financial markets have continued to shrug off geopolitical risk, focusing instead on the challenge faced by Central Banks in developed markets to tackle inflation. Led by the US, Central Banks seem to be winning the battle with inflation falling to near 2% target rates. There is no room to be complacent, Central Banks must continue to adjust monetary policy appropriately to avoid choking off economic growth.

Financial markets are expected to remain buoyant into 2025 as enthusiasm around AI, and the productivity gains that can be achieved, feed through to corporate earnings. Short term concerns over the outcome of the US election – particularly with a Trump victory – will cast a shadow over financial markets in the coming weeks as volatility will rise. In the medium term, whilst significant opportunities exist across business sectors as AI impacts productivity whilst geopolitical risk will weigh on markets, creating higher levels of volatility in future.

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We are entering a period where financial markets will reward investors for exercising patience and composure, ignore the short term ‘noise’ and remaining committed to their investment strategies. Appropriate levels of diversification will once again prove to protect investors from experiencing uncomfortable levels of volatility as bond markets will provide the safer haven characteristics that investors will crave whilst (at long last!) providing long term attractive yields, supported by interest rates settling at higher levels relative to the last decade.

Scot Laing (Chartered FCSI)(CFP™)
Managing Director
Sources: Capital Economics; Bloomberg; FE Analytics
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