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Capital Markets Update

Summer 2024

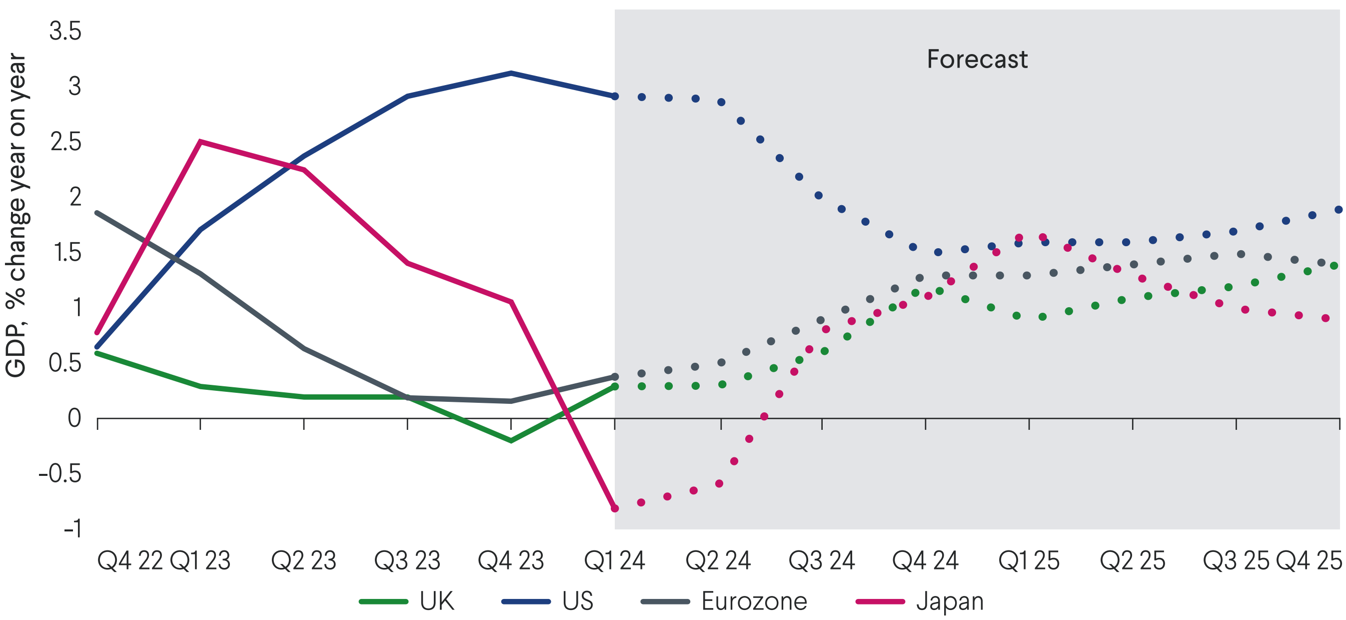
Global growth forecasts rose as the relative resilience of the US economy shone through in survey data. Solid, if unspectacular, growth and signs of stubbornness in underlying inflation suggest that policymakers will ease monetary policy gradually.

Government bond yields rose in Q2 on decent growth and sticky inflation data, while credit spreads stayed near record lows. Resilient growth and AI optimism helped global equities deliver another quarter of positive returns.

Global themes

While the US economy slowed more than expected in Q1 from the blistering pace set at the end of 2023, the slowdown was mainly due to volatile inventories and higher imports – the data still pointed to an economy with decent underlying domestic demand. At the same time, growth rose more than expected in the eurozone and the UK, which grew at the fastest quarterly pace since 2021, with both regions exiting technical recessions in Q1. Furthermore, China's 1.6% quarter-on-quarter expansion was larger than most economists expected as Chinese authorities provided more support to the real estate sector. Indeed, while forecasters expect the US economy's year-on-year pace to ease in the second half of 2024, growth elsewhere is expected to converge towards the US (Chart 1).

Chart 1: Solid but unspectacular growth expected in the major advanced economies



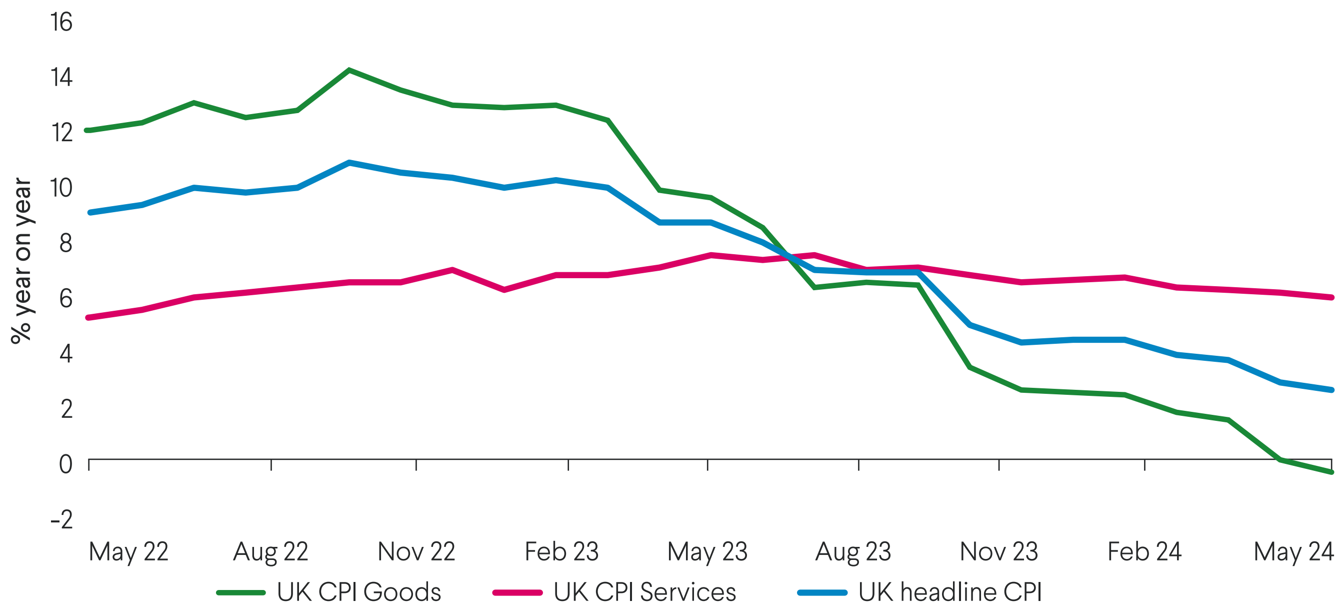
Source: Datastream and Consensus Economics

However, June's Purchasing Managers' Index (PMI) data are indicative of robust US growth at the end of Q2, across both the manufacturing and services sectors, suggesting US 'leadership' may persist for a little while yet. Although the global composite PMI, which aggregates global service and manufacturing activity, suggests the pace of expansion slowed across sectors and regions outside the US (including the UK and eurozone), the index is still consistent with a solid pace of expansion in global GDP. Indeed, a further increase in global employment PMI suggests the underlying fundamentals are resilient. Crucially, the J.P. Morgan Global manufacturing PMI held close to a two-and-a-half-year high in June, signalling better operating conditions in the sector for the past five months.

Inflation falls to the Bank of England's target

UK CPI fell to the Bank of England's (BoE) 2% target for the first time in almost three years in May. However, this was largely due to declines in energy prices and their interaction with the Ofgem energy price cap. Core CPI, which strips out volatile components like energy and food prices, also slowed, but at 3.5% year on year, highlights stubborn underlying inflationary pressures. This is further illustrated by services CPI, which, though slowing, remained at 5.7% year on year (Chart 2). Indeed, UK business surveys highlighted wage increases, higher shipping costs and rising raw material prices contributing to increasing costs. This suggests that services inflation is likely to remain sticky, while goods price disinflation has largely run its course.

Chart 2: **Goods disinflation has largely run its course, while services inflation remains elevated**



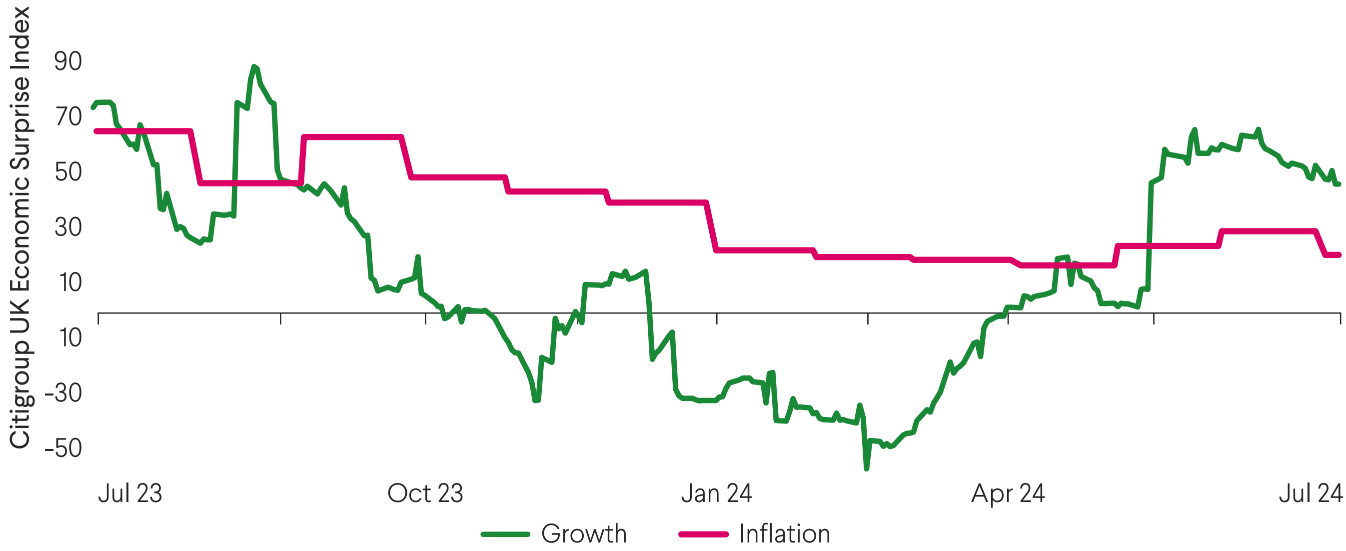
Source: Datastream and Bloomberg

We still expect the other major central banks to follow the European Central Bank (ECB). It reduced rates 0.25% pa, to 3.75% pa, in June. However, stubborn core inflation and solid growth suggest the easing of monetary policy will be gradual.

Government bonds

June's fall in UK business activity data is expected to be temporary, stemming from the uncertainty we saw ahead of the general election. Some commentators suggest the decisive result and large majority will allow for a more stable policy platform, lending modest upside risk to potential growth. This, alongside stronger-than-expected growth and activity data (Chart 3), ongoing upwards revisions to near-term growth forecasts and a slowing disinflation process, modestly reduces the fundamental attraction of gilts.

Chart 3: UK growth and inflation data have been exceeding economists' expectations



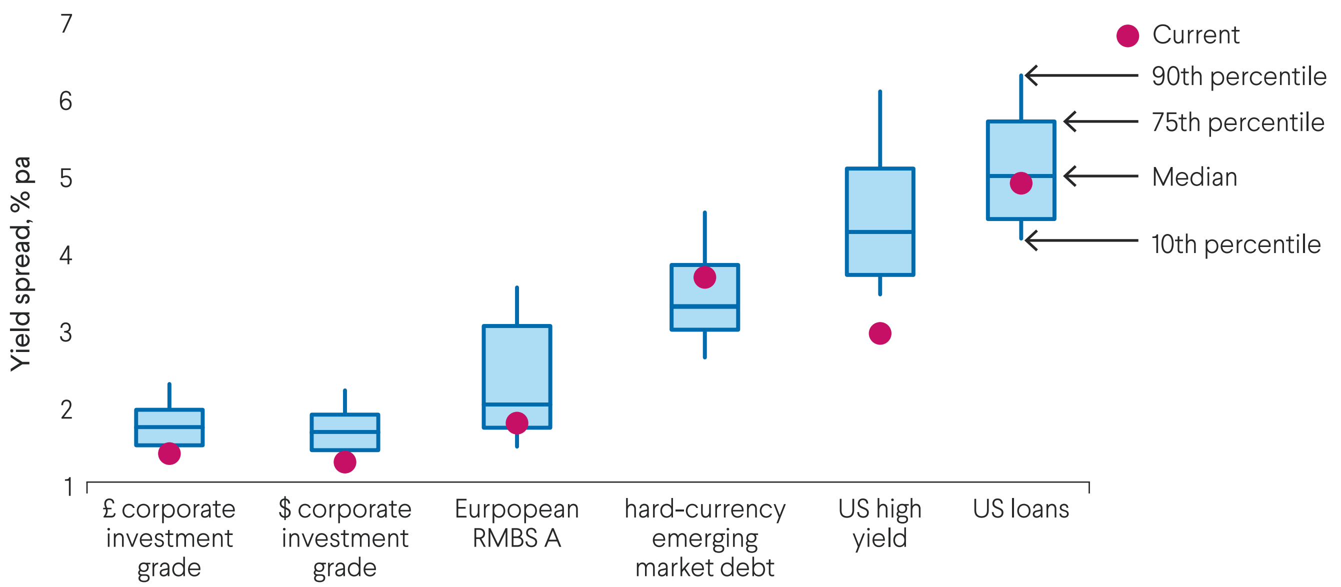
Source: Bloomberg

Having said that, we continue to see longer-term value in UK gilt yields, particularly nominal gilts, where forward yields remain well above our assessment of fair value based on long-term growth and inflation forecasts. Expectations of rate cuts should help anchor yields, but the technical backdrop of high issuance and BoE asset sales is fragile. It looks likely that the incoming government may have to borrow more than is currently budgeted for in the near term, which might delay rate cuts and place upwards pressure on the additional yield investors require to invest in long-term bonds rather than rolling shorter-term debt.

Credit

Credit spreads were little changed over the quarter as resurgent new issuance, on the back of improved business confidence and low lending margins, was met by ongoing strong demand for high headline yields . Overall corporate funding costs continue to rise in fixed interest markets as companies refinance existing debt at higher yields, but debt affordability metrics remain in decent shape. Robust growth, an upswing in corporate earnings and supportive financial conditions are all factors that could keep credit spreads at current levels for a while yet.

Chart 4: Credit spreads are generally very low by historical standards



Source: ICE Index Platfrom, Datastream, Citivelocity, Barings

However, while we acknowledge the decent yields on offer, it's difficult to get too excited by credit spreads, which look very low versus history (Chart 4). Buy-and-hold investors may be able to look through potential spread volatility in investment-grade markets, on the basis that spreads, even at current levels, would still provide some cushion against a reasonable level of loss due to defaults and downgrades.

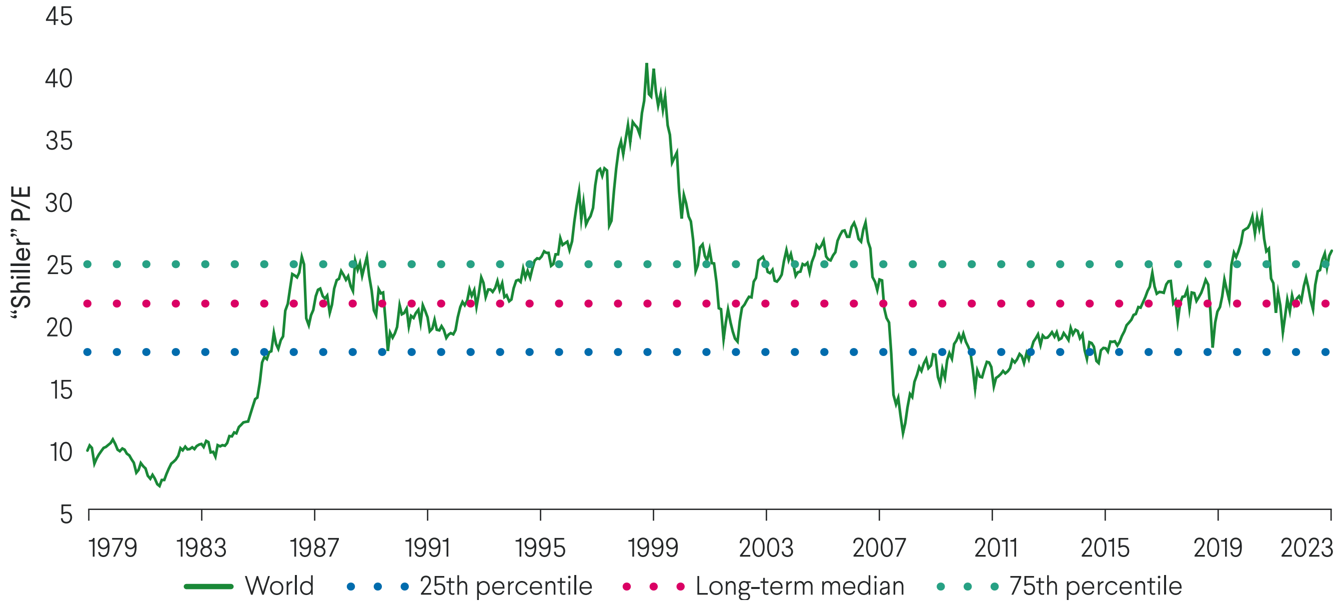
But for investors with shorter investment horizons, or those investing in speculative-grade markets (where average credit losses tend to be materially higher), the message from attractive yields and unattractive spreads may be that the underlying sovereign currently offers better risk-adjusted returns. That said, there are still some areas that don't look particularly expensive, such as traded loans and hard-currency emerging market debt.

Equities

Amid resilient global growth and ongoing optimism around all things AI, global equities delivered another quarter of positive returns. A large rise in stock prices since the beginning of the year has taken the global equity price-to-earnings ratio above long-term averages, while above-trend earnings mean cyclically adjusted valuations are even higher. However, while elevated valuations are likely to weigh on longer-term returns, the fundamental outlook may support them in the near term.

Despite cautious forward guidance, the Q1 earnings season was strong enough to prompt modest upgrades to full-year global equity earnings estimates for 2024 and 2025, which now stand at 10.0 and 13.4%, respectively.

Chart 5: Cyclically adjusted valuations are elevated, but fundamentals are supportive in the near term



Source: Datastream

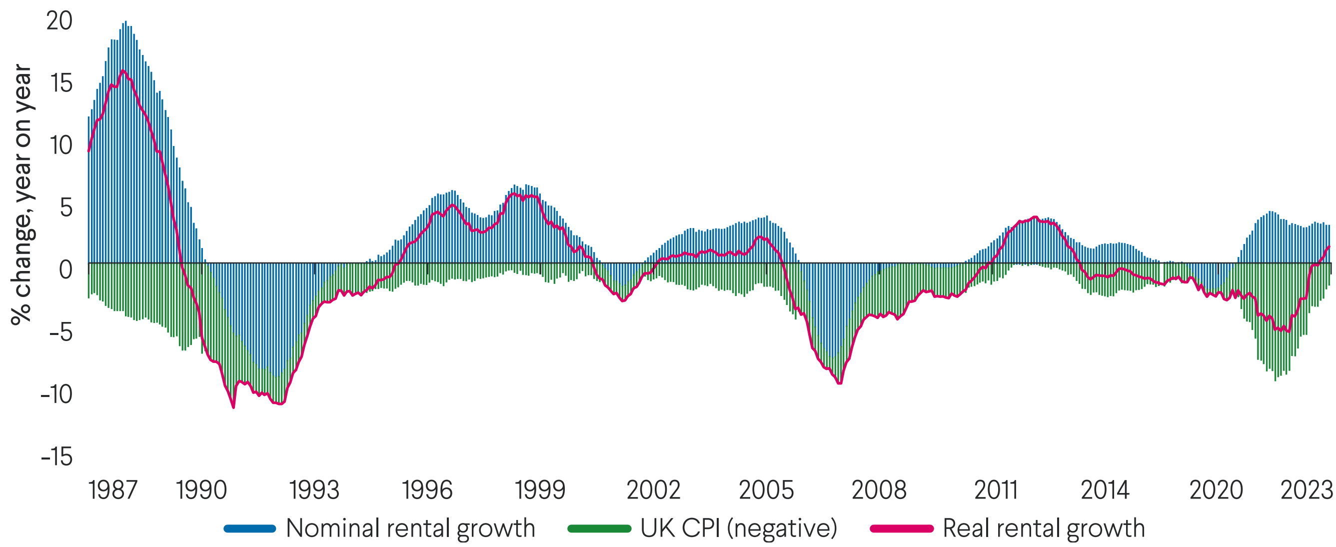
Cyclically adjusted Japanese equity valuations have rapidly approached parity with global benchmarks. Meanwhile, Japanese earnings forecasts for 2025 look relatively weak and earnings momentum is on a rapidly deteriorating trend – this points to reducing our overweight to Japanese equities. While emerging market valuations still look cheap and the region is forecast to enjoy the strongest earnings growth in 2024 and 2025, earnings momentum is negative, tempering our optimism towards the region.

European and UK earnings forecasts remain relatively weak, but earnings momentum has been on an improving trend and both regions look inexpensive, even allowing for their usual level of discount relative to global benchmarks. Furthermore, nascent signs of recovery in the region's domestic economies and in global manufacturing activity might benefit value-oriented markets. The US is largely responsible for elevated global valuations, but the relative strength of the US economy, positive relative earnings growth and positive earnings momentum lend support. As a result, our outlook is neutral across regions, albeit for slightly different reasons in each.

Property

We've seen continued improvement in a number of the fundamental indicators we track for UK commercial property, making us a little less cautious on the asset class. The latest Royal Institute of Chartered Surveyors survey, which provides a quarterly guide to the trends in the commercial property investment and occupier markets, shows tentative signs that the market is shifting towards a recovery phase. The largest share of respondents view the market as either having reached a floor or having entered the early stages of an upturn. In particular, the survey highlighted improvements in occupier demand, rent expectations and capital value expectations. At the same time, real rental growth has continued to rise as inflation has fallen (Chart 6). Indeed, the fundamental picture is generally better for industrials, particularly areas like logistics and life sciences, than it is for other sectors.

Chart 6: Real rental growth continues to rise and is running at a reasonable level relative to history



Source: MSCI IPD

That said, vacancies have continued to rise in the office sector and, at close to 23%, are almost double long-term averages. Furthermore, given shifts in working patterns and office space requirements, the rise in vacancies in the sector looks somewhat structural, with a return to long-term averages perhaps unlikely in the near term. However, yields have risen a lot since the market's peak in June 2022, and capital values, in aggregate, have fallen 25% over the same period. Survey data suggest the recent stabilisation in capital values might signal the market's nadir, but we retain a degree of caution, as selling pressure continues to dominate market dynamics, with transaction yields often above those based on net-asset values found in index data.

Conclusions

Stubborn core inflation and solid growth suggest any easing of monetary policy will be gradual

The economic resilience seen in 2024 remains intact, and global GDP growth, which saw further upwards revisions in Q2, is expected to reach 2.5% in 2024 and 2.6% in 2025. The decent underlying fundamental backdrop is perhaps best illustrated by strong labour markets, with global employment continuing to expand in Q2. Furthermore, ongoing signs of a recovery in manufacturing activity are a positive development. The cost of resilient growth has been a slowing of disinflation in the major advanced economies. Data pointing to slowing, but still elevated, underlying inflationary pressures and solid, but unspectacular, growth is consistent with a gradual shift towards less restrictive monetary policy. We continue to expect the US Federal Reserve and BoE to follow the ECB in lowering rates this year, but we expect them to tread cautiously.

Equity valuations are high, but near-term fundamentals are supportive

The underlying growth backdrop, forecast earnings, and ongoing upwards revisions to both, provide a positive backdrop for risk assets like credit, equity and property. However, elevated valuations give us pause for thought. While we acknowledge that elevated equity valuations tend to augur a period of more subdued long-term returns, the near-term fundamentals remain supportive. At the same time, we still see decent value in government bond yields, while very low credit spreads make for a much more asymmetric return profile in credit markets, given limited upside risk.

We've pared our overweight to government bonds and cash, and we've become warmer towards global stocks and property

As result, we reduced our overweight to government bonds and cash, and reduced underweights to global equity and property, while retaining an underweight to credit assets. Equity and property markets look well supported by the current fundamental outlook, while government bonds would be expected to provide ballast if a more negative growth, and lower inflation environment, took hold. The overweight to cash may be interpreted as a nod to high equity valuations and lingering inflation risks, which have scope to undermine fixed rate government bonds, even in a more negative growth environment.

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