CAMBRIDGE
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5th February 2024

Central banks challenge Goldilocks assumptions

The first month of the year is behind us and, despite what many expected, returns were positive for most investors (see January's returns review in a separate article below). Following the initial hangover from last year's tremendous Santa Rally, risk asset markets continued on their upward trajectory. That was until the last day of the month, when the US central bank (Fed) dampened the mood by repeating the message that rate cuts will begin later than markets anticipate.

It was slightly surprising that this reiteration led to a short, sharp stock market sell-off. Surprising, because over the course of the month it appeared that market participants had already grudgingly accepted that rate cuts would be coming through later than they hoped in late 2023, when central bank interest rate pivot euphoria peaked. Surprisingly resilient Q4 growth – especially in the US – made those previous hopes unrealistic. The argument why markets had continued their upward trend had been that, as a consequence, earnings growth could outweigh the headwinds from continued high rates.

It is therefore reasonable to assume that last week's temporary cooling of stock markets, and decline in long bond yields, was driven by more than just central bank press conferences. In particular, bond yields had started to fall from their recent rebound levels much earlier in the week. The usual suspects are therefore China, fears over banks and uninspiring company outlook statements in the current quarterly earnings season.

In China, the long faltering property giant Evergrande was finally forced into liquidation by a Hong Kong court. This could spell further short-term trouble for the property-heavy Chinese economy, even if it may spur the Chinese regime to properly address the property crisis. To deflate the bubble, leaders need to create an environment that allows prices to clear. This will inevitably lead to some painful losses from the supply overhang, but will eventually reallocate capital towards gainful purposes. This is the remedy prescribed by historic precedence and academia, but not necessarily always followed by those in charge (It was applied successfully to remedy the US Savings and Loan Crisis of the 80s and 90s, but Japan in the 90s and the US in 2008/2009 waited with forcing clearing prices for far too long).

If China's procrastination on its property issue is a medium-term issue to watch, the return of banking concerns in the US are of far more immediate market concern. We all remember last March's crisis amongst US regional banks, and last week's sudden 40% share price collapse of the New York Community Bancorp (NYCB, which took over one of last year's falling banks, Signature Bank) on funding pressures arising from its commercial property loan portfolio, certainly made headlines in the financial media.

The downbeat earnings outlook statements of US companies from the start of last week, seemed quickly forgotten, when some of the major US Mega Tech companies reported much stronger Q4 results than anticipated and much better than expected figures were also reported by global oil majors like Shell and Exxon. This was topped on Friday when the number of newly created US jobs for January came in at 353,000, more than double what was expected.

That markets initially traded sideways, rather than rallied on the news, takes us back to what we discussed at the top. The US economy remains so strong that a tight labour market is almost inevitable and the wage pressures this brings will quite possibly re-ignite second round inflation dynamics later in the year. Central banks' incentive to lower rates in the near term may therefore be quite limited, as they do not want to be caught out by inflation again. For more, please refer to this week's focus article on central bank policy.

With signs of renewed pressure in the US banking and commercial real estate sector, January's narrative – that resilient economic growth will overcome and counterbalance the re-financing pressure headwinds of high interest rates and loan yields – may well be tested. We expect that the US banking authorities will once again deal swiftly to squash any bank sector weakness – possibly through another shotgun bank marriage and this time with one of the national champions. However, the continuation of plateauing rates is likely to exert both renewed valuation pressures on risk assets as well as cost of (re-)financing pressures on businesses.

For investors this is likely to mean less vibrant markets and a longer wait for interest rate normalisation. When that comes, it should bring a widening of investment opportunities, as positive growth dynamics trickle down to mid- and small cap companies, while previously unloved sectors have the potential to rebound. We got a glimpse of this late last year, when stock market positivity broadened in the hope of a cyclical rebound. But until there is more clarity around the actual timing of rate cuts, we have to expect more of the same: China is out, US powers ahead, with its Mega Tech market darlings in focus, while the rest of the economy is hoping for more sympathetic central bank rates sooner rather than later.

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January 2024 asset returns review

The hangover from an exceptional Christmas rally led to some downdraft at the start of the month, but after these teething problems, January turned into a half-decent month for investors. Previous optimism was based on expectations for the coveted 'soft landing', where central banks can ease financial conditions without causing outright recession and its associated damage to growth and company earnings. Coming into the new year, capital markets were anxious that they had got ahead of themselves, and that interest rates or inflation might indeed remain 'higher for longer' as central bankers had suggested in the autumn. These fears dissipated somewhat as the month went on and major central bank meetings coupled with the latest inflation figures seemed to vindicate market confidence. In the end, global stocks gained 0.7% in sterling terms. The table below shows January returns for key assets and indices.

Asset Class	Index	January	3 Months	12 months	2023	3-yr rolling annualised
Equities	UK Large Cap	-1.3	4.9	2.1	7.9	10.0
	UK Ethical Large Cap	-0.9	4.4	-2.0	3.7	5.9
	Europe ex-UK	0.3	11.3	7.9	14.8	9.7
	US Large Cap	1.8	10.5	16.8	19.2	13.8
	US Technology Large Cap	1.2	12.7	27.6	36.5	5.9
	Japan	4.7	12.9	14.6	13.5	14.6
	Global Stocks	0.7	9.7	10.9	15.3	6.1
	Emerging Markets	-4.5	2.0	-6.2	3.6	-7.5
Bonds	UK Gilts All Stocks	-2.2	6.1	-1.1	3.7	-9.3
	£-Sterling Corporate Bond Index	-0.9	7.4	4.6	9.7	-4.6
	Global Aggregate Bond Index	-0.2	6.3	3.7	6.2	-2.7
Commodities	Commodity Index	4.6	-7.3	-3.2	-9.7	19.0
	Brent Crude Oil Price	4.7	-9.7	-8.9	-15.4	13.5
	Spot Gold Price	-1.1	-2.3	3.9	7.4	3.2
Inflation	UK Consumer Price Index (% Chg for period)*	0.1	0.1	4.5	4.0	-
Cash rates	SONIA 3-Month	0.4	1.3	4.8	4.6	2.0
Property	Global REITs	-3.9	10.8	-6.5	4.0	4.3

Source: Morningstar Direct as at 31/01/24. * to end of previous month (31/12/23). All returns in GBP.

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The 0.7% return may appear meagre, but is actually quite impressive when considering the rally that came before it. December brought plenty of gifts for investors, meaning that equity markets started the year from an elevated base. Crucially, they started with higher valuations, in terms of price-to-earnings ratios. This was particularly so for the US, whose assets have been preferred by investors for years, to the point where its equity market looks comparatively expensive.

The S&P 500 nevertheless gained 1.8% in sterling terms, making it the month's second-best regional performer after an even more impressive 4.7% from Japan, as this month's leader. Again, better than expected growth and expectations of forthcoming looser Federal Reserve (Fed) policy were the key factors. Figures released last month show that the US economy grew 3.1% year-on-year in the last quarter of 2023, an increase on the previous quarter that showed the impressive resilience of US consumers and businesses. The Fed, meanwhile, had been happy to guide interest rate expectations down – with markets pricing a near 50% likelihood of a March cut – until the final day of the month, when the latest central bank meeting communications poured cold water on such early timing expectations. We write about the Fed and other major central banks in a separate article.

For investors, these signals came together for a proverbial goldilocks' environment. Enduring US strength means that earnings will remain strong, but the steady decline in price pressures means that monetary policy can ease and hence support growth and valuations. The S&P accordingly broke to new all-time highs toward the end of January, almost touching the 5000 points level at the start of last week. However, as we have written extensively, investors might be overly excited about the prospect of Fed easing and continued US outperformance. The reasons for US equity strength are genuine, but some valuation aspects of current US stocks are a little nerve-wracking.

Taking the lead from the US on the last day of the month was Japan, whose stock market gained an impressive 4.7% through January in sterling terms. Japanese stocks were boosted last month by the Bank of Japan's decision to maintain negative interest rates. Easier financial conditions buoyed the stock market, and a weakening of the yen bolstered expectations of export-led growth. Whether Japanese optimism can continue is hard to say – the country's financial assets have had many false dawns over the years – but we note the continued improvements in its economic and corporate structures. Given how unloved Japanese stocks have been by global investors over the years, there is plenty more room to grow.

Closer to home, UK market returns turned negative for the month on the last day. The UK Large Cap index lost 1.3% for the month in the end, while Eurozone equities gained a mild 0.3%. As we discuss in our separate central bank article, investors have little to get excited about with domestically exposed UK assets at the moment, thanks to a weak economy and a Bank of England still apparently committed to keeping interest rates 'higher for longer'. That being said, international large caps dominate the FTSE 100, most notable in Energy, materials, consumer discretionary and finance. What the market lacks is a strong big tech player as in the US. In any case, the fact returns were only mildly negative means that UK stocks mostly held onto the gains seen in November and December. The UK Large Cap index is still up 4.9% over the last three months, a decent base as we head into a new global growth cycle.

This is arguably even more so for Europe, whose mild equity upswing in January comes off the back of impressive full year returns in 2023. The European economy is undeniably weak, backed up by the most recent growth and inflation data, providing higher conviction for investors that the European Central Bank will have to cut interest rates in spring. If global demand starts to pick up just as that happens, Europe's exporters – who make up a sizeable chunk of the economy – could stand to benefit. Moreover, the fact that European equities' valuations are comparatively cheap versus their American peers mean that further growth – based just on this metric – could be on the horizon.

Lagging behind the other major regions are emerging markets (EM). The MSCI EM index lost 4.5% in sterling terms through January, despite the fact that EM currencies have stabilised. The biggest drag on EM assets remains China, making up around 27% of the wider Index. Disappointment in Beijing's lack of willingness or ability to arrest its economy's decline is still being felt. As we commented elsewhere recently, the support measures being pursued now are significant, but the lack of private sector confidence runs deep. For wider EMs, they should at least be able to look forward to looser Fed policy and, eventually, a pickup in global demand.

All in all, January turned out much better for globally diversified investors than could have been hoped for after the very strong year end rally and poor initial start. Gains from November and December were not just solidified, but in most instances extended. The current monetary policy backdrop bodes well for asset values and growth from here.

Central banks confirm 'lower, slower'

Central banks are holding steady. The US Federal Reserve and the Bank of England (BoE) held meetings last week, following the European Central Bank's (ECB) monetary policy meeting last week. All three left interest rates unchanged, as was widely expected by capital markets. With current policy a near-certainty, investors are more interested in hints at how the future might look.

Inflation and monetary policy expectations are probably the biggest market movers right now. We find ourselves – after years of supply chain congestion and the sharpest cost of capital hike in a generation – at the turn of a new growth cycle. However, the green shoots of global growth can be fostered by easier policy or crushed by overly restrictive financial conditions – and behind all of this is central bankers' fear that easing too soon would bring back the inflation spectre they worked so hard to excise. The memory of being so recently 'behind the curve' – allowing inflation to run rampant while interest rates remained historically low – only heightens the anxiety.

Not so surprisingly, the US Federal Reserve (Fed) seems to be oscillating exactly between these two aspects of its future impact of monetary policy. Earlier this month, Christopher Waller, a governor on the Fed's board, said the central bank was within "striking distance" of its 2% inflation mandate. This came after dovish messages from the bank's last meeting in December, and seemed to vindicate implied market expectations of multiple interest rate cuts in 2024. Then, at its meeting last week, Fed chair Powell poured cold water on the idea of a rate cut as early as March, while at the same time confirming the view that rates are unlikely to go up from here and will eventually fall. As a result, market expectation still sees rates 0.5% lower by

June. This is not a significant change from before the Fed meeting, though market implied timing probabilities have now moved more firmly backwards from a March cut.

That would nevertheless still be extraordinary, considering the enduring strength of the US economy. US GDP grew at an annualised rate of 3.3% in the last quarter of 2023, well above forecasts of 2%. This came after a remarkable 4.9% annualised return in Q3, and means that the US economy expanded 2.5% for the whole of 2023. That's an acceleration from the previous year and, considering many thought recession could be on the cards, shows the incredible resilience of American consumers and businesses. The flip side of the current and likely longer plateauing of rates at a high level comes in the form of signs of stress in the regional banking sector with exposure to the real estate sector – as illustrated by New York Community Bancorp's 40% stock price fall last week, after loan provisions were made for commercial property lending turned sour.

More pertinently for the Fed, the general resilience of the US economy is clearly creating some inflation pressures. Core US inflation (removing volatile elements like food and energy) has eased but is still around 4%. Core PCE inflation – the measure watched most closely by the Fed – did fall to 2.9% in December, but headline inflation increased, and the jobs market remains extremely strong. The US economy added 333,000 jobs in December, up from the 173,000 in November and beat that number again with 353,000 in January – when only 170,000 had been widely expected.

So, overall, the Fed currently sees little reason to cut as early as its March meeting. The bank has made clear its intentions to loosen policy this year, but continued US economic strength – particularly in terms of employment, the Fed's other key mandate – means there is no need for immediate support. This is true for overeager rate expectations and for the outlook for the ongoing quantitative easing reversal through quantitative tightening. Some observers thought that the Fed's balance sheet reduction would slow in the near term, allowing greater liquidity and boosting asset valuations. For now, the Fed has stayed clear of giving precise indications. However, the bank's recent increase in its repo rate for the extraordinary liquidity facility (which was set up in March last year to facilitate and ease regional bank funding pressures) is signalling the opposite. This facility is set to expire in March, as confirmed by the Fed in January, which means that the funding situation in money markets could become tighter for some participants.

If the Fed is a dove among the bulls, the Bank of England (BoE) was a hawk among the bears – but after last Thursday's meeting it is well in the middle of the road, with its Monetary Policy Committee being split three ways for a hike, on hold, and a cut. The BoE effectively joined the current Central Bank chorus of the question being not when, not if, rate cuts can be delivered. However, compared to the US, this positioning stands against the backdrop of a much weaker UK economy. Nevertheless, given the still higher rate of UK inflation, markets appear to agree and do not price in a UK rate cut until June, even though growth has been close to zero for over a year.

The BoE's dilemma continues to be that wage rises are too high to expect secondary inflationary pressures to abate any time soon – and this is backed up by stubbornly high core inflation figures (core CPI came in at 5.1% for December, unchanged from the previous month). Structural supply-side problems, emanating from both Brexit adjustments and workers trying to make good on years of real income losses, are pushing up prices – a dynamic that may persist a bit. On the other hand, consumer confidence is extremely low and mortgage approvals have stabilised at a low level. In many ways, Britain's economy is calling out for support,

but the BoE is unwilling to give it – for fear of stoking price pressures that have already proved hard to shake.

Though not to the same extent, the European Central Bank (ECB) has shown similar caution recently. The Eurozone economy is stagnant and contracting in some areas – most notably its German powerhouse – while core inflation has slowed dramatically, and high financing costs are holding back demand for loans. But recently the ECB left rates unchanged and urged for patience in cutting rates, despite declaring the inflation battle won. Policymakers' reasoning is the same in Europe as elsewhere: the labour market is much too tight for its liking, and they are anxious not to underestimate price pressures again. While Eurozone unemployment is much higher than in the US or UK, we have written before about the specific labour market pressure Europe faces from cross-regional flows.

Even so, the ECB has been happy to go along with markets in expecting rate cuts this year. Traders expect the first to come this spring, and for ECB rates to be 1.5% lower by the end of 2024. This outlook has been boosted by the latest inflation figures from France and Germany, which once again came in below expectations and show a definite slowing. Unfortunately, the biggest inflation pressures remain in services prices, heavily influenced by wages. The fact that the ECB's biggest area of concern is not improving as hoped could mean the bank continues its cautious path.

Economic realities should mean European rate cuts come sooner than American ones, but policymakers seem to have different preferences either side of the Atlantic. The Fed's dual mandate for price stability and maximum sustainable employment allows it to not worry too much about inflation as long as growth makes it worth it, but here and in Europe the sole focus on prices means the opposite. For global investors, an easier Fed should be a comforting sign (it has already helped stabilise emerging market currencies, for example) but we cannot overestimate its dovishness.

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Global Equity Markets	02-Feb			Technical	Valuations			
Market	much	% 1 Week	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7637	-0.1	-0.1	→ →	4.0	10.9	10.8	13.2
UK FTSE 250	19210	-0.5	-0.5	↗ →	3.6	11.5	11.0	14.4
UK FTSE All-Share	4171	-0.2	-0.2	⬀ →	4.0	10.9	10.7	13.4
UK FTSE Small	6283	-0.4	-0.4	↗ →	6.1	8.0	6.9	12.4
France CAC 40	7611	-0.3	-0.3	↗ →	3.0	12.7	12.6	14.0
Germany DAX 40	16958	+0.1	+0.1	↗ →	3.2	11.7	11.6	12.9
US Dow	38439	+1.1	+1.7	↗ ⬀	1.9	18.3	18.0	16.6
US S&P 500	4915	+0.5	+1.0	↗ ⬀	1.4	20.7	20.3	17.8
US NASDAQ comp	15396	-0.6	-0.0	↗ ⬀	0.7	27.9	27.1	23.4
Japan Nikkei 225	36179	+1.2	+1.9	↗ ⬀	1.7	22.0	19.4	16.8
World Bloomberg	1712	+0.3	+0.9	↗ ⬀	2.1	14.9	14.2	13.8
China mainland	3166	-5.4	-5.2	↗ ⬀	1.9	18.1	17.7	16.5
Emerging Bloomberg	1099	-0.3	+0.3	↘ ↘	3.0	10.0	9.8	12.1

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%	Company	%	Govt bond	%Yield	1 wk chg
Diageo	+4.7	SSE	-67.3	UK Govt 10yr Gilt	+3.87	-0.10
GSK	+3.7	Ocado	-11.4	UK Govt 15yr Gilt	+4.23	-0.10
Phoenix Holdings	+3.3	BT	-9.1	US Govt 10yr Treasury	+4.00	-0.14
United Utilities	+2.6	Mondi	-7.9	France Govt 10yr OAT	+2.72	-0.07
IMI	+2.5	DS Smith	-5.7	Germany Govt 10yr Bund	+2.22	-0.08
St James's Place	+2.4	International Consolidated Airlin	-5.6	Japan Govt 20yr JGB	+1.46	-0.06

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%, no fee)	02-Feb	03-Jan
USD per GBP	1.266	-0.6	Oil Brent $:bl	77.6	-5.8	UK BoE base rate	5.25	5.25
GBP per EUR	0.853	+0.0	Gold $:oz	2030.1	+0.5	2yr fixed	4.82	5.03
USD per EUR	1.080	-0.6	Silver $:oz	22.5	-1.1	3yr fixed	4.52	5.06
JPY per USD	147.85	-0.0	Copper $:lb	382.2	-1.2	5yr fixed	4.25	4.68
CNY per USD	7.189	+0.2	Alumnm $:mt	2217.5	+0.0	10yr fixed	4.39	4.72
USD per Bitcoin	42,733	+3.9	S&P soft crops	246.6	-0.5	Standard variable	7.96	7.96

02/02/2024
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
Bloomberg equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
Mortgage estimates are derived from sterling swaps markets

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The value of your investments can go down as well as up and you may get back less than you originally invested.

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