CARTLIDGE MORLAND
INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY

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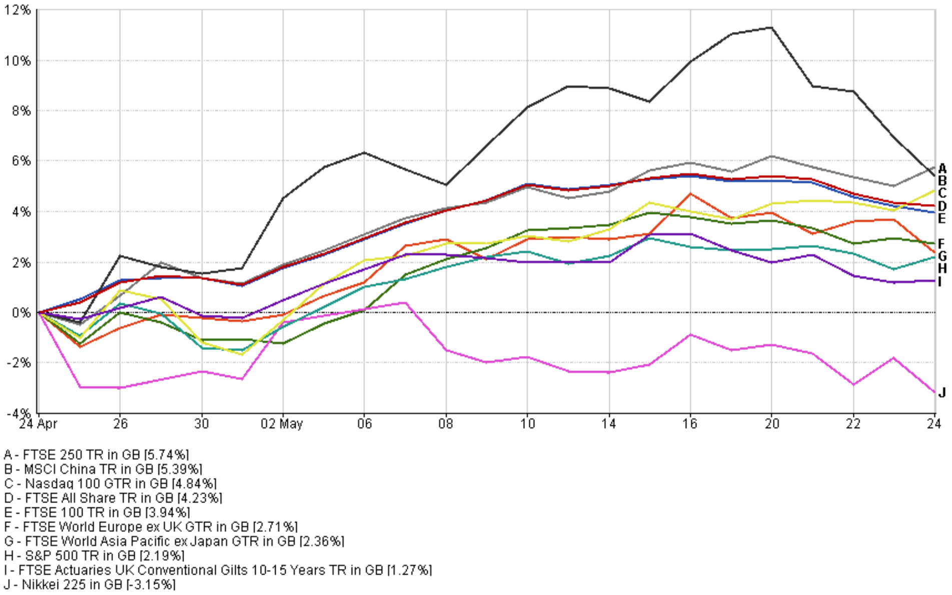
OVERVIEW

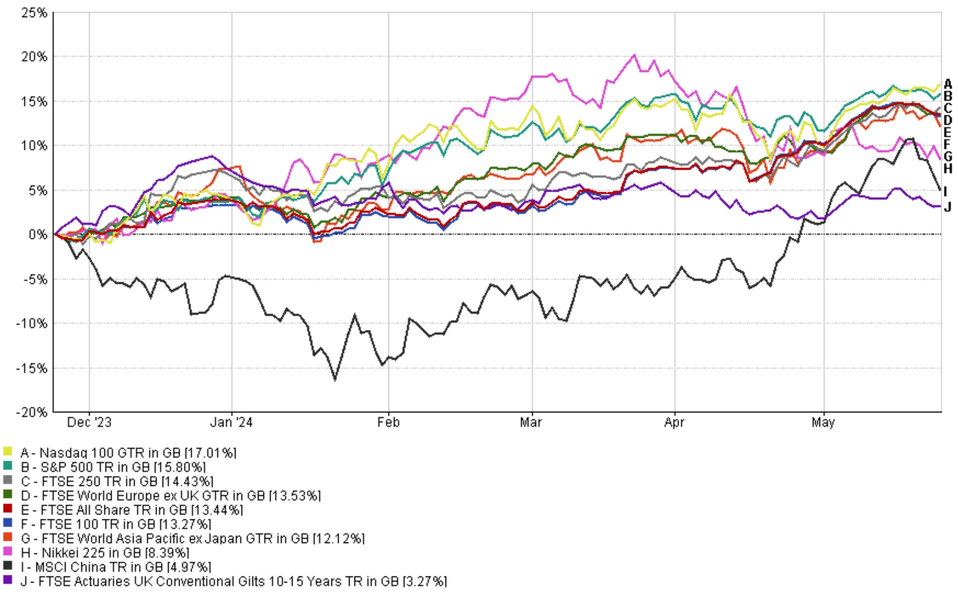
The last month has seen some strong performance from equity markets with investors now expecting interest rate cuts over the summer from the European Central Bank (ECB) and possibly the Bank of England (BoE). Inflation appears to be heading back towards target in Europe and the UK, and economic growth has turned positive after the shallow recessions experienced in the last half of 2023. Another set of inflation data is due before the next Monetary Policy Committee (MPC) meeting of the BoE and therefore before the July General Election. Interest rate cuts are still expected later in the year in the US, but their timing is uncertain whilst inflation remains stubbornly above target. The Chinese equity market has performed well in the last few weeks. Its troubled property market, minimal inflation and weak economic data had weighed on sentiment but latterly, increasingly positive economic activity statistics, cuts in some interest rates and government support of the property market have seen investor sentiment improve.

ONE MONTH INVESTMENT MARKETS STERLING TOTAL RETURNS



24/04/2024 - 24/05/2024 Data from FE fundinfo2024

SIX MONTH INVESTMENT MARKETS STERLING TOTAL RETURNS



24/11/2023 - 24/05/2024 Data from FE fundinfo2024

The US equity market appears to be acting positively as and when weaker economic data emerges and conversely generally falls on good economic news. Investors are seeking indicators which may justify the US Federal Reserve (Fed) cutting interest rates. Above target inflation has persisted through 2024 despite the interest rate hikes already made and economic growth remains relatively strong supported by the consumer and the government spending. The recent Consumer Price Index (CPI) reading for April of 0.3% (3.4% pa) was slightly below expectations whilst the core inflation figure (excluding food and energy) rose by 0.3% as expected. Services inflation, especially transport costs, drove these above the target (ie 2% pa) level. However, weaker retail sales figures perhaps indicate that consumers are now moderating their spending as sustained inflationary pressures and high interest rates begin to impact. The cooling jobs market may also be playing its part. Fewer jobs than expected were added to the non-farm payroll in April and average monthly pay increases rose at a slower rate of 0.2% in April. The unemployment rate climbed slightly to 3.9%. Nevertheless, US indicators still point to economic expansion in both the services and manufacturing sectors which lead to ongoing uncertainty as to when the Fed will start to reduce interest rates and impact negatively on investor sentiment.

Against this backdrop, the Fed kept interest rates on hold at a range of 5.25-5.50% at its May meeting. Jerome Powell, Chair of the Fed, commented that the Fed members were still not prepared to cut rates but on the other hand did not see the need to increase them either given the current “sufficiently restrictive” monetary policy.

The UK equity market has made strong gains over the last six months and over the last month in anticipation of an interest rate cut in June or August, although the forthcoming election may perhaps delay a possible decision to cut in June. Sterling has been comparatively weak against the US dollar given the different outlook for interest rates in the two economies. A weak pound is supportive of companies which have substantial overseas earnings. The FTSE 100 index reached a new high partly due to the sterling value of earnings derived abroad supporting valuations of such companies. The recovering UK economy was also more positive for sentiment with first quarter GDP growing by 0.6% so coming out of the shallow recession experienced in the second half of 2023.The BoE again kept Bank Rate at 5.25% at its May meeting. Andrew Bailey, Governor of the BoE, commented that any change in the Bank Rate would be data dependent, especially on the inflation rate returning towards 2% target. He said that the MPC would likely need to cut Bank Rate over the coming months and “possibly more so than currently priced into market rates.” Such guidance has been positive for markets as lower rates mean greater housing market activity – a key driver for the economy – and lower costs for corporates. As predicted, CPI fell substantially from March (3.2% pa) to 2.3% pa in April, its lowest level in almost three years with falling energy prices being reflected in the figure. The April figure was slightly higher than expected but close to the BoE’s 2% pa target. Core inflation (excluding energy, food and tobacco) fell to 3.9% pa in April from 4.2% pa in March. Services inflation, running at 5.9% pa in April, still remains high and is closely watched by the BoE. Monthly wage increases, which impact services inflation significantly, remain above inflation at around 6.0% pa. The BoE expects inflation to rise to around 2.6% pa over the second half of 2024 and then fall through 2025, to reach target in early 2026.

The news of the snap UK General Election was met by relatively muted market reaction given the current sense that the result is a foregone conclusion. Whichever party wins, the financial constraints for government spending will remain and the fiscal plans of the two main parties are not that far apart – neither party wishes to spook the bond markets. In some sectors there may be some political risk, for example, water utilities.

European equity markets also performed well over the past six months supported by the prospect of interest rate cuts in June or July. The eurozone economy has pulled out of its second half 2023 recession, growing by 0.3% in the first quarter of 2024. Economic indicators underline economic recovery as activity in the services increased and manufacturing activity, although negative, is no longer declining sharply. CPI in the eurozone remained at 2.4% pa in April whilst core inflation slowed to 2.7% pa from 2.9% pa. The unemployment rate stood at 6.5% in March 2024, as expected, the same level as in the previous three months. Across the major euro area economies, Spain has the highest jobless rate at 11.7% whilst Germany has the lowest rate of 3.2%. Various ECB policymakers are pointing to a reduction in interest rates in June against this backdrop, with inflation returning to its 2% target next year.

The Bank of Japan (BoJ) kept interest rates unchanged at 0.1% at its April meeting so maintaining its loose monetary policy. Japanese GDP contracted in the first quarter of 2024 although partly due to the negative impact of the Noto earthquake. However, the services sector remains relatively strong, whilst the manufacturing sector - although still contracting - is doing so at a slower pace. It seems that interest rates are likely to increase again this year if inflationary pressures persist. Wage inflation is a prerequisite of further monetary normalisation. The Nikkei 225 has reached a new high with the majority of Japan’s largest companies reporting higher profits as a result of the weak currency, coupled with rising prices and a rebound in tourism. Improving corporate fundamentals and standards of governance, together with increasing demand from foreign investors have all contributed to decent equity market performance over the past year.

The Chinese equity market has performed strongly in recent weeks after a prolonged period mired in negative sentiment. The weakness of the property market, deflationary pressures and economic growth below 5% pa have all contributed to investor caution. Recent CPI figures have turned positive with inflation increasing by 0.3% pa in April. Various initiatives have been announced to try to improve property demand including reductions in minimum deposits for property purchases, scrapping the floor on mortgage rates and increasing funding to some state-owned banks to increase lending to other state entities to purchase unsold homes. Economic indicators point to ongoing expansion of the services and manufacturing sectors as well as an increase in exports to Asia Pacific countries. Imports increased although this is likely to be due to higher shipments of raw materials rather than recovering consumer demand. The Chinese Politburo said at its April meeting that it would use monetary and fiscal policy to encourage economic growth.

OUR VIEW

Compiled by Angela Cooper, MD - Investment Services.

Angela runs Cartlidge Morland's Investment Management team, with over 30 years' experience in investment research working for investment companies, leading UK national IFAs and wealth managers. Angela graduated from the London School of Economics and is a Chartered Insurance Practitioner.

Markets have entered a new 'risk-on' environment as the major central banks prepare to shift tempo and to orchestrate a fresh phase of economic growth, supported by lower interest rates. Undoubtedly, the data flows will not always contain all the central bankers would wish – and the Federal Reserve will need to tread particularly carefully, against a background of apparently unchecked Federal fiscal expansion. Neither the Democratic nor the Republican Party wish to grasp the nettle in terms of reining in a burgeoning Federal deficit, whether through spending cuts or increased taxes. The situation threatens a problem for the world at some point in the future.

The US situation remains divergent from that in UK/ Europe. Without the safety net of proprietorship of the world's reserve currency, the UK and the EU economies have no choice but to control spending, in order to reduce public sector deficits. A dose of non-inflationary economic growth would undoubtedly assist in this.

It now appears that interest rates cuts in Europe are very likely over the summer with perhaps the ECB cutting first at its June meeting. The prospect of the BoE reducing interest rates in June is perhaps less likely if services inflation and wage increases remain elevated. Additionally, the imminent General Election may call into question the independence of the Bank of England if rates are cut in June – although equally it could prove its independence! The Fed faces a similar political dilemma with the Presidential Election in November. It appears that the Fed may now only cut interest rates at the end of the year given the relative strength of the US economy and stubbornly above target inflation. The concern is that the Fed may be too slow in starting to cut rates.

Although we have reduced our UK equity position over the last twenty-five years it has not been to the same extent as UK pension funds moving from around 50% to 4% - reflecting the UK's position in a global index. It seems that some institutional investors are considering increasing their exposure to UK equities from historically low levels. The UK equity market is still a good income generator currently yielding around 3.7%. We hold UK equity funds for this income which forms an important component of total return and indeed for our clients who are relying on portfolios for income. The past six months has seen good performance from UK equities with its energy and banking sectors making strong returns which in turn is reflected in the performance of our portfolios. Good stock picking funds have proved their worth. The UK equity market is undervalued compared to its international peers evidenced by the increasing number of takeovers of UK companies seen this year. The forthcoming election does bring with it uncertainty to the UK over the next six weeks. However, inflation falling back towards its 2% pa target coupled with interest rate cuts at some point in 2024 should continue to provide support for investor confidence.

Electoral outcomes whether in US, Europe or the UK tend to be taken in their stride by financial markets. In the US, neither party is promising to raise taxes, nor to reduce Federal spending and markets should prosper against that background for the time being. Europe and the UK are largely involved in controlled government spending – with no dramatic squeeze anticipated. Essentially, we have a group of economies committed to high public spending, lower deficits and higher taxes with implications for future rates of economic growth. Europe and the UK remain home to some strong companies; both domestically focussed ones and some world-beating multi -nationals. The exceptional performance of the US ‘Magnificent Seven’ in recent years, sometimes serves to obscure the excellent opportunities available globally.

Strong sterling, dollar and euro bond yields are serving to provide investors with good income streams from the lower risk elements of their portfolios. Expectation of interest rate reductions has also driven up sterling/euro bond prices to some extent too, especially investment grade corporate bonds. In this normalised monetary environment, we regard bonds as providing attractive and reliable income streams, alongside stable capital values. Investment grade debt, including gilts, remain attractively priced. In general, the climate of anticipated falling interest rates is supportive of global bond markets.

Global infrastructure is also providing a stable yield of around 5% pa. Pricing remains attractive with recovery coming through as interest rates look set to decrease which should be of benefit for shareholders in infrastructure orientated companies.

As always, the utterly unexpected has capacity to disturb markets for a while and such possibilities are ever present. It is however unusual for markets to be unresponsive to the monetary, fiscal and growth levers for any length of time meaning these are far more important. Sometimes, the latter elements can be re-orientated for a pronounced period by the unexpected but that is comparatively rare. As a private investor one always needs protection against downside risks. This usually means holding part of ones holding in bonds, but most importantly it means diversification amongst investment sectors to capture opportunities, whilst reducing risks.

If you have any queries please do not hesitate to contact your Cartlidge Morland consultant.

CARTLIDGE MORLAND

83-85 Mansell Street London E1 8AN **t:** +44 (0)20 7709 5560 **e:** enquiries@cartlidgemorland.com **www.cartlidgemorland.com**