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Market Commentary – April 2024

The light at the end of the tunnel may be brighter, but we are not out of the woods yet

The first quarter of 2023 has come and gone. As we wait for Spring, the prevailing gloom in markets has given way to a renewed sense of optimism.

Central bankers, for all their dithering, finally delivered on “whatever it takes”. Interest rates rises, have been at their fastest pace in 30 years, to tackle inflation. Their efforts have slowed the post-Covid economic boom which fuelled price rises.

Whilst the path down for inflation is unlikely to be entirely smooth, we believe the Central Banks have done enough to prevent a repeat of the 1970s. US inflation has fallen steadily in recent months, and even in the UK and Europe, things are slowly improving. While investors and markets are likely to be jittery around the exact pace of improvement, a decline in inflation numbers through the summer months looks highly likely given the annual rate of inflation will no longer be including the rapid price rises of a year ago.

Banking tumult and peak policy rates

Higher interest rates impose stress on the financial system. We wondered what would break first, something in the real economy, or the central bankers’ resolve to continue to tighten policy.

As it turned out, we saw some failures amongst small US banks and a forced merger for Credit Suisse, but the central bankers held their nerve.

However, these events have made it more likely that inflation will fall faster as banks opt to reduce the amount of lending they are carrying out in the real economy to reduce risk. For this reason, the market has become convinced that we are very close, and possibly at, the peak for interest rates. The bond market is signalling a belief that US interest rates will be 1% lower than today in two years’ time.

We believe that the US Central Bank will need to cut rates as early as the fourth quarter. Ultimately this is the mechanism by which the world begins to move out of economic crisis. However, it may mean that we may have to pass through a recession first.

Some of course will worry that the banking issues will persist. However, we do not believe the collapse of Silicon Valley bank and the demise of Credit Suisse in the subsequent week, speak to a broader fragility in the financial system. These institutions suffered a lack of confidence in their management, which caused a liquidity crisis as they were unable to find sources of capital to replace fleeing deposits.

While all banking institutions are susceptible to bank runs, deposit guarantees, and timely regulatory action can help limit financial contagion. The Federal Reserve and US Treasury have been swift and direct in their response, which mitigates spill over effects.

Duration – welcome back dear friend

The last few months have seen a recovery in portfolios, with positive returns ranging from 2-3%. While we are pleased to see portfolios deliver during a recovery in risk sentiment, it was even more pleasing to see the relative outperformance of portfolios (versus IA equivalent benchmarks) during the mid-March pullback in equity markets. We neutralised the duration of our fixed income allocations during the final quarter of 2022. These steps, though uncomfortable at the time, were taken to provide downside protection in the event of a deflationary shock. Bank failures either side of the Atlantic showed the efficacy of this decision and speak to our forward-looking approach to investing. While bonds have rallied sharply in recent weeks, they remain attractive sources of diversification and return during a period of economic uncertainty.

Factor diversification

The shift in the financial landscape over the last few weeks has caught many investors by surprise. The risk of a severe recession has increased which has pressured economically sensitive stocks, ranging from banks to commodity suppliers. We were concerned about a recession in 2023 and positioned portfolios accordingly.

We have retained exposure to a wide variety of factors but have understood the factor biases in geographical allocations. The UK large cap market was a standout performer in 2022. The value bias in the index, as well as its large dividend yield helped placate investor nerves as they sought sanctuary from the implosion of growth stock valuations.

Having passed the peak in rates, we understood the benefit of owning some growth through our US equity positions. Again, just like duration, growth and quality stocks can provide stability to portfolios during periods of economic risk. These subtle and timely decisions have helped portfolios weather high risk scenarios without the need to change tack.

Conclusion

The events of the last few weeks have increased the risk of a deeper recession as banks tighten lending standards. Bond markets have started to rally in anticipation of a pause in monetary tightening and are likely to benefit from a continued decline in inflation. While the economy has so far been resilient, earnings could fall sharply if a deeper recession materialises. Quality and growth stocks have been beneficiaries of falling yields and a rotation away from cyclical sectors. We see value building in parts of the fixed income and equity market and will be disciplined in adding risk exposures.

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