Parmenion
Investment Management

Macro Outlook

Q2 2024

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Summary

Broadening market opportunities

Despite various challenges, markets showed positive returns in Q1 across multiple regions. This diversity indicates widening opportunities for investment, driven by fundamentals and scope for active alpha potential.

Gradual disinflation and monetary policy easing

Disinflation is expected to continue but at a slower pace, keeping central banks cautious about rate cuts. Anticipated uptick in GDP growth alongside interest rate reductions represent a favorable environment for both growth and defensive assets.

Indications of cooling US labour market

The US labour market has been resilient, however there are signs of cooling as wage growth eases, resignations fall and part time roles increase at the expense of full time positions. Careful analysis and selectivity are key especially given elevated expectations and valuations in some markets.

Cyclical growth and manufacturing rebound

Improvements in manufacturing indices suggest a bottoming in cyclical activity. This recovery is being supported by easing financial conditions and less restrictive bank lending, which could lead to positive investor returns if maintained.

Attractive investment opportunities

The UK's expected lower inflation and undervalued market offers potential for positive economic surprises, drawing global investor attention. Emerging Markets are attractive due to monetary easing by their central banks and improved growth prospects, potentially leading to a pick up in investor sentiment towards the region.

What's the outlook?

Widening market dispersion means broader opportunities for investors

Despite stalling disinflation, mounting government debt, equity market concentration risk, extended valuations of the Magnificent 7, and on-going geopolitical risk, markets delivered positive real returns for investors in the first quarter.

And not just in the US – Japan and EU rose over 11% and 6% respectively and the UK and Emerging Markets were up over 3% in sterling terms.

Greater breadth provides a more solid foundation for markets to build on and allows fundamentals such as valuations and quality of earnings to drive returns. It supports diversified multi asset portfolios and gives good active managers scope for alpha generation as we look towards 2025.

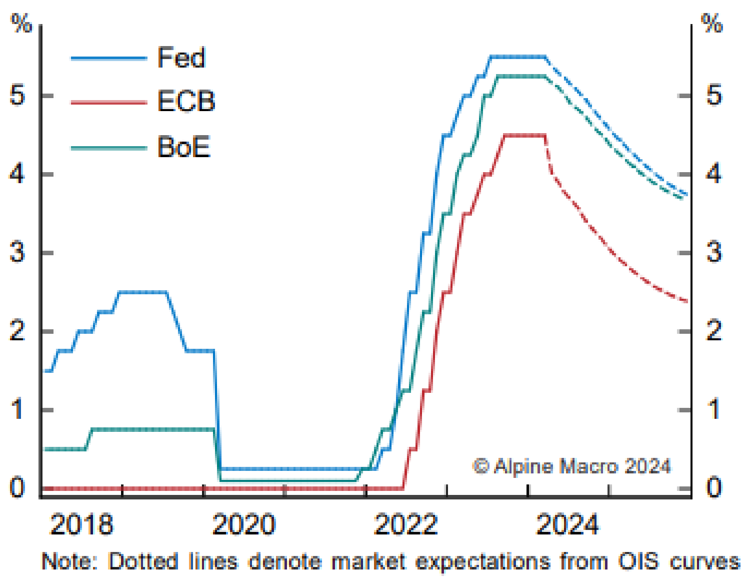
Disinflation continues, but slowly

The pace of disinflation slowed during the first quarter, increasing central bankers' hesitancy to cut interest rates, but investors are still anticipating an improvement in GDP growth into 2025.

A 'soft landing' is now the consensus, and an easing of interest rates expected. Markets assume rates in the US and UK will be cut in both 2024 and 2025 and at a faster pace in the EU, as you can see in the chart below. This would make for a favourable backdrop for growth and defensive assets.

However, after the buoyant returns in markets since the end of October 2023, a 'Goldilocks' hope for 'just right' growth could lead to disappointment. Care, discipline, and selectivity is essential to navigate our way through.

Expected interest rate cuts



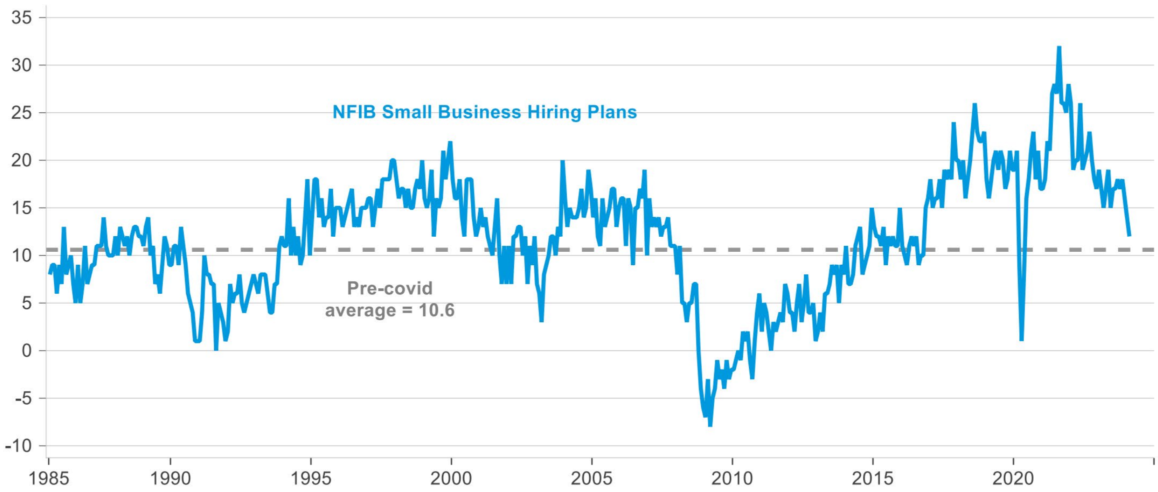
Source: Alpine Macro 2024 as of 29th March 2024

While we recognise the trend of disinflation will help positive real rates work their way through the system, we expect central banks to tread cautiously. They'll want to ensure inflation doesn't resurface and reassert their inflation fighting credibility. This suggests rates will stay 'higher for longer', but with bond yields at their current elevated levels, it looks like a favourable environment for investors to pick up attractive income in fixed interest - with scope for capital appreciation as and when rates start to come down.

Cooling labour markets

Buoyed by labour market strength, extended social security payments and pandemic-related excess savings, the consumer has been a core engine to US GDP growth. Unemployment rate remains low at 3.8%, but there are early signs of fragility. Resignations have fallen sharply, permanent employment has slipped as part time roles have risen, wage growth has eased, and small business hiring (which make up over half of private sector employment) has slumped, as you can see in the chart below. These are all signs of initial nervousness around economic conditions.

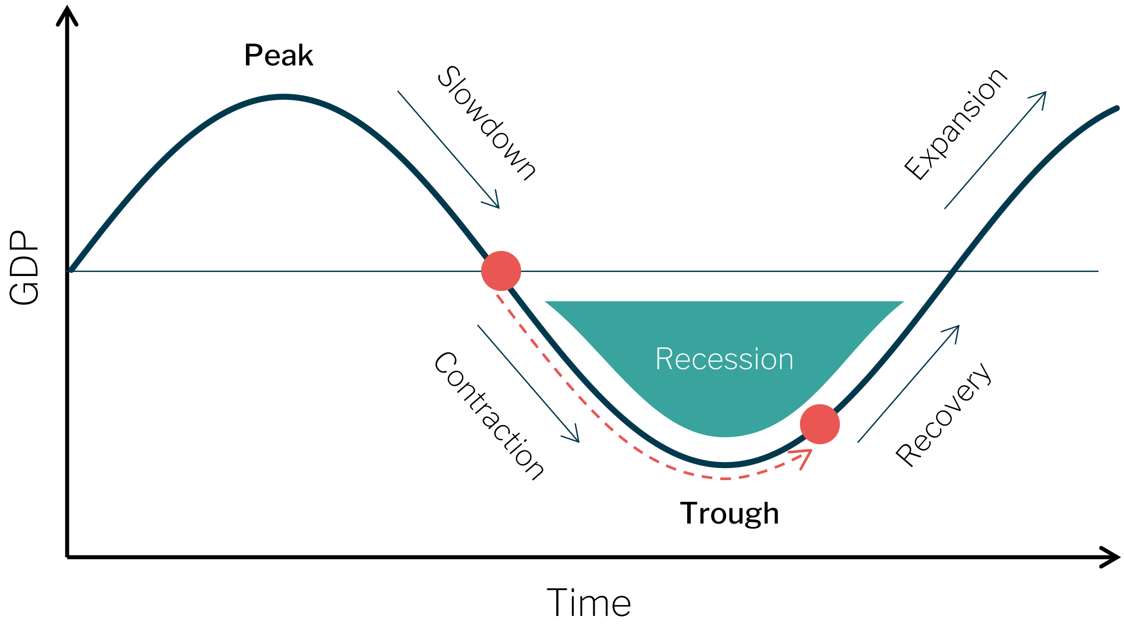
NFIB hiring plans



Source: Columbia Threadneedle Investments, Bloomberg & Macrobond as of 19/03/2024

This may simply reflect the uneven path back to normalisation after the extraordinary Covid years, but given where current US equity valuations are, the range of possible upside/downside needs careful consideration.

Where are we in the economic cycle?



Cyclical growth outlook is picking up

Encouraging signs are emerging that the downturn in global manufacturing is starting to reverse. PMI manufacturing indices in the US, UK and EU all improved in March with new orders, inventories and deliveries ticking up.

The easing of financial conditions, combined with less restrictive lending criteria in anticipation of lower interest rates, is helping to support a pick-up in business and consumer confidence. If sustained, as markets are anticipating, the position in the economic cycle is likely to roll forward from slowdown to recovery. Typically, this environment will support positive returns for investors.

After the global turmoil following Covid, this would be an incredible achievement, and the trends in the data appear encouraging.

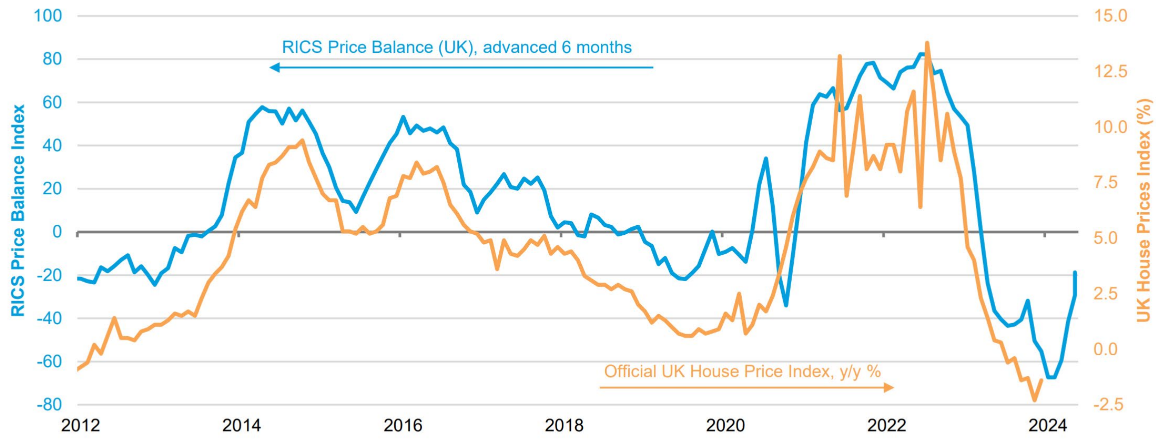
History shows that it takes, on average, 19-23 months from the start of monetary tightening for the full effects to come through. Allowing for a slight lag with corporates and households locked into longer term low fixed rate debt, that happens to be right now. We believe we're still in the 'danger zone' and are applying careful management and monitoring to be on the lookout for unexpected downside surprise.

Where are the opportunities for investors?

Given how unloved, under owned and undervalued the UK is, we're increasingly seeing scope for positive surprise. After suffering the highest inflation in 2022/23 amongst the G7, the UK is now expected to see inflation fall to one of the lowest in 2024. This will ease pressure on the Bank of England to keep rates at their current levels.

With lower inflation and a solid labour market, real incomes are expected to rise meaningfully. Alongside an above average savings rate of 10% this is expected to boost consumption and lift GDP growth above consensus expectations of 0.7-1.0%. Rising consumer confidence combined with falling mortgage rates could also lead to a revival in the property market, with increasing transactions and prices acting as a positive stimulus to the wealth effect, which has been so absent for the past few years.

UK housing market



Source: Columbia Threadneedle Investments and Bloomberg as of 19 March 2024. RICS = Royal Institute of Chartered Surveyors

From an index construction point of view, the UK also offers investors attractive diversification characteristics. Meaningful weightings in cyclicals like energy, industrials, financials, and mining, at a time when global growth prospects into 2025 and 2026 appear to be improving, are an interesting prospect. If inflationary pressures resurface from rising commodity prices, the FTSE All Share would be expected to benefit in that environment too.

However, it's critically important that the UK improves its productivity to compete on the global stage. This requires proactive, decisive, and bold long-term policies, something a new government ought to have the vision and fortitude to deliver.

We'll see – politics is all too often a short-term game at the expense of the long-term benefit of the country.

Emerging Markets is another asset class offering compelling value over the medium term. Monetary easing is well underway, supporting domestic economic activity. Global cyclical growth is expected to improve, so upside surprise to modest growth and earnings expectations looks probable.

While Japan has reached new all-time highs, we believe the positive momentum from the revival of inflation, plus accelerating wage growth and structural change in corporate governance, has further room to run. As foreign investors remain underweight and valuations undemanding, we believe there is upside to come.

Money markets – a source of funds

As interest rates fall from their peaks, investors who sought safety in money market funds in 2022 and 2023 are expected to rotate into fixed interest and equities. Increasing reinvestment risk, combined with the rising opportunity of missing out on potential capital appreciation in fixed interest should kickstart this shift. With over $9 trillion invested in money market funds globally, this is a considerable source of potential demand for defensive and growth assets.

Change is coming

Markets have come a long way since the October lows, and a pause for profit taking feels overdue. However, signs of a cyclical recovery in global manufacturing alongside resilience in the service sector are leading to an improved growth outlook for 2025 and 2026. Consensus earnings expectations are expected to incrementally improve, and with interest rates likely to ease, the medium-term outlook appears to be on the turn for the better.

However, the path towards recovery is unlikely to be smooth. Volatility is to be expected. As a result, maintaining a disciplined and diversified approach is important in delivering consistency of risk adjusted returns, while offering scope for tactical positioning when risk/reward is appropriate.

Avoiding complacency and exercising care is key, but don't forget that to earn a return you do need to take some risk. Just make sure the level of risk aligns with your clients' attitude to risk and capacity for loss.

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