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Investment review - End Q1 2024

For Arena Investment Management clients

March 2024

After their dress-rehearsal in the final weeks of 2023, and a modest reality check in January, global stockmarkets have been buoyed again by the near certainty of interest rate cuts coming for many key economies before the middle of this year. Outperformance by 'big tech' and 'growth' companies, especially those leveraged to secular growth themes such as the proliferation of artificial intelligence ('AI'), has also supported the market mood, contributing to some healthy investment returns right across the portfolio risk spectrum during the first quarter of 2024.

The global economy is generally performing well and better than many forecasters had expected: the US economy has been particularly resilient and only mild recessionary conditions have been felt in the UK and parts of the eurozone. Although the lag effects from the 2022-23 period of monetary tightening are still working their way through various economies, and some near-term weakness in activity can be expected, a soft, rather than hard, economic landing is now looking much more likely this year. This should allow market confidence to be maintained. Overall, forecasts for global GDP of around 3% for both 2024 and 2025, which is close to pre-pandemic levels, seem quite realistic.

We expect the US economy to remain the dominant force in the developed world, followed by a reinvigorated Japan, whilst the UK and eurozone remain in the economic slow lane. In Germany, for example, weak consumption and poor industrial demand have continued to push its recovery further into the future.

China's more subdued economic performance has been a drag on money flows and sentiment within the wider Asian region in the past year. But there are now tentative signs of improvement that should benefit all of Asia, where some of the highest economic growth rates and lowest stockmarket valuations in the world can be found. China's central bank has hinted at some flexibility for additional easing of monetary conditions, fuelling hopes of stimulus that will support struggling parts of its economy, such as the property market, help household confidence return and allow China to achieve its goal of growing its economy by 5% this year.

Limbering up to cut interest rates

The general inflationary backdrop has improved markedly in the past few months, with higher interest rate policy bringing inflation within striking distance of key central bank targets. Labour conditions also now support the case for rate cuts: wage growth is slowing as job markets begin to loosen and the impact of tighter policy becomes more apparent. The last mile will not necessarily be even or easy, but inflation should be back to target in most G20 countries by the end of this year or early next. Key central banks are therefore limbering up to cut interest rates before mid-year.

In the UK, however, there is a growing feeling that the Bank of England ('BoE') could reduce interest rates a little sooner than expected, perhaps in May, especially since there is a real possibility that inflation will have dipped below the BoE's 2% target by then.

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The Bank's Governor has been quite upbeat in his recent comments, noting that rate cuts are now 'in play' and acknowledging that the technical recession in late 2023 was quite brief. Acutely aware that a general election is not far off, the Prime Minister has also weighed in with supportive comments, but whilst he may be quite hopeful that the UK economy 'bounces back' this year (and lower rates may help achieve that), the economy it still coming from an exceptionally low base: it will still need to compete on the global stage with economies that are growing at an even faster pace and continue to have higher rates of productivity growth.

In Europe, the European Central Bank ('ECB') has previous form on being somewhat indecisive with regards to changes in interest rate policy. ECB President Christine Lagarde's recent 'wait and see' comments have done little to persuade markets (so far) that the ECB will be first out of the blocks, despite recent weak data, particularly from Germany, showing that it is probably time to take action.

Across the pond is a slightly different picture from a few months ago, with reductions in inflation stalling slightly of late, largely down to persistent elevated price pressures in the housing sector and the economy generally performing better at this point in the cycle than expected. It is therefore possible that the ECB and BoE may now usurp the US Federal Reserve ('Fed'), potentially moving earlier with rate reductions and needing greater shifts in monetary policy. Overall, rate cuts of between 0.75% (USA) and 1.5% (UK/eurozone) are currently being priced in by the end of 2024, with the potential for another percentage point haircut by the end of 2025.

Land of the rising yen?

Japan is on a different page of the inflation playbook. Latest figures show annual inflation at 2.8% and heading in a different direction to other developed world economies. Japan's largest trade union, Rengō, has helped secure a 5.2% pay rise for workers at the country's largest firms, the biggest spike in over 30 years. The ultra-cautious Bank of Japan has now called time on an era of negative interest rates, raising interest rates for the first time in 17 years, showing that the country is finally putting behind it the years of deflationary forces that have held its economy back for so long. Interest rates still remain at zero, a sign that Japan wishes to play it safe with what is still quite a fragile recovery, but there is now a change in psychology and marked improvement in sentiment towards investment in Japan. Our increased allocation to the region last year has already made good progress and we are hopeful of further market gains that could additionally be boosted by currency strength as appetite for the yen improves too amidst a broad reflationary environment.

As far as other currencies are concerned, greater resilience in the US economy and pared back forecasts for the scale of the Fed's rate cuts this year has removed several US dollar 'bears' from the market and we believe that the currency will retain good support. In contrast, the struggling eurozone and UK economies, and the prospect of them needing earlier and potentially greater policy relaxation, suggests the euro and pound will remain relatively weak.

Geopolitical tensions remain a risk to both activity and inflation, particularly if the Middle East conflict were to impact energy prices. Red Sea shipping disruptions have not, so far, led to any material upside threat to inflation. Elections later this year will soon come more into sharper focus, but politics alone are unlikely to cause economies or financial markets to stray from their expected paths.

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Technology and AI themes to remain in vogue

We feel well placed, with the strategies at the upper end of their corresponding Dynamic Planner risk profile, to participate in further market momentum as monetary policy and inflation conditions become more favourable for risk assets. The gulf between 'growth' and 'value' companies has widened again since the start of the year as another leg of the technology and AI-fuelled rally has led global markets higher. But signs that markets are broadening out and increased merger and acquisition activity is reflective of the attractive value that can be found elsewhere, including lower down the market capitalisation scale. Corporate profit margins generally remain healthy and should improve as the cost of capital reduces and sensible pricing power returns.

It has become quite a crowded trade, but we expect the appetite for the global leaders in broad technology sectors and the associated beneficiaries of AI adoption to continue, driven by strong profits momentum. We are maintaining good exposure to this longer-term opportunity though a dedicated thematic investment, as well as via a range of funds, not just US focused, that can seek out future growth opportunities outside the universe of more well-known mega-cap names.

Opportunities across the world, including in mid- and small-caps

The US and Asia, now including Japan, remain our favoured regions for stockmarket exposure – in our view these markets offer the best combination of plentiful and superior growth opportunities (notably the USA), attractive valuations and access to longer-term beneficiaries of domestic demand and structural recovery trends. Exposure to European markets, including the UK, is also merited based on cheap valuations and future recovery potential.

Overall, we are maintaining a balanced, yet flexible, approach to general stockmarket positioning in each region, recognising the combination of value and opportunity across both the market-cap spectrum and investment styles, all of which should ultimately benefit as elevated inflation and interest rates are brought more under control. It is also worth noting that the post-pandemic restoration of dividends and increased pressure from shareholders has improved the position for those stockmarket investors seeking income.

Fixed interest markets taking their time

Bond markets have yet to be fully convinced that inflation has been tamed in all areas and hence the sharp end-2023 recovery in this asset class has stalled a little, but only temporarily we believe. More solid data-backed evidence on the safety of, and need for, lower monetary policy together with the conversion of central bank words into deeds should be sufficient to raise investor appeal for both corporate and sovereign debt in the coming months. Having already made a meaningful reallocation back into bond markets in the past year for medium and lower risk investors, including lengthening the maturity profile of exposures, it is now a question of waiting patiently for the slower and perhaps less exciting release of return from this asset class to materialise. But we do believe that acceptable real returns will be made as the year unfolds.

Exposure to alternative investments has been reduced in the past year to fund increased allocations to bond markets, but they have not lost their fundamental appeal as valuable diversifiers and sources of return in times of market stress. Increased stock dispersion should provide good opportunities for 'market neutral' investment funds in particular, allowing this asset class to compete with more traditional investments, yet with less volatility.

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Entering more of a sweet spot

Generally speaking, the post-pandemic supply and demand imbalances, along with conflict-induced energy spikes, which pushed inflation higher, have now largely disappeared. As a result, we seem to be entering more of a sweet spot where acceptable economic activity and the levers which can control it are becoming more balanced and supportive for a range of investments. Zero interest rates were unsustainable as are those rates currently above 5%. We are now heading towards the equilibrium between both extremes – a period of modest inflation that allows more modest interest rate policy – that should hopefully allow the global economy to remain more in balance.

The coming period should also reintroduce some sensible awareness of the cost of capital and provide a backdrop where a range of asset classes revert to more of their traditional longer-term behaviours. Greater investor confidence should also return as real (inflation-adjusted) returns become more achievable.

In conclusion, various tailwinds, including further moderations in inflation, meaningful cuts to interest rates and positive economic and corporate earnings growth should continue to be supportive for both financial markets and investor confidence in the coming months. Having made various alterations to positioning during 2023 and the early part of this year we feel well prepared for what lies ahead.

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