HYMANS ROBERTSON

Capital Markets Update

Spring 2024

Markets dramatically scaled back their expectations for the timing and size of interest-rate cuts in 2024. This was down to much stronger US growth than expected, improving global growth momentum and signs that the downtrend in inflation is slowing.

However, optimism about US and global growth, and enthusiasm for all things AI, more than offset any concerns about slower rate cuts. Equities recorded their best first quarter in five years and credit spreads fell, despite a significant rise in sovereign bond yields.

Global themes

Data released in the first quarter revealed a US economy still growing more quickly than previously envisaged – at an annualised quarterly pace of 3.4% in the final quarter of 2023 – amid ongoing resilience in consumer spending and an increase in non-residential business investment. Data in other major advanced economies have been weaker. The UK entered a technical recession at the end of last year, while the eurozone and Japanese economies flirted with one, but survey data suggest the worst may already be over in Europe. Flash composite purchasing managers' indices (PMIs) indicate that UK output rose at a solid pace for the fifth consecutive month in March, while the eurozone economy stabilised. At a global level, survey data suggest growth improved at the start of 2024, as the JP Morgan Global Composite PMI rose to an eight-month high in February (Chart 1).

Chart 1: The upturn in global economic activity gathered momentum in February

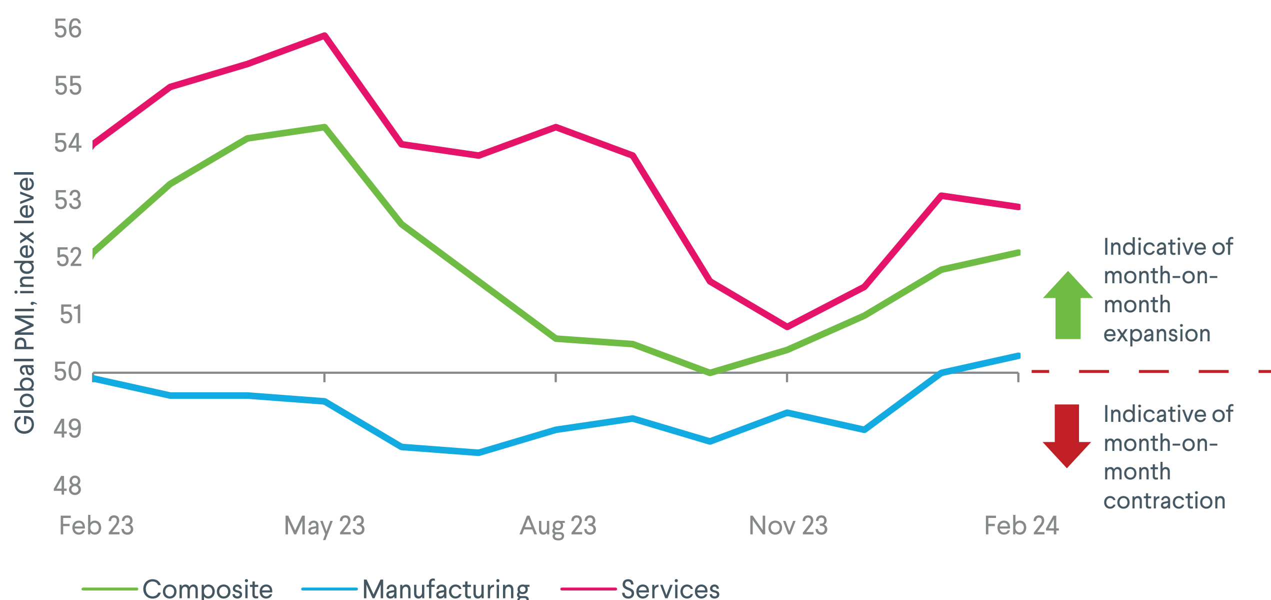


Chart 1: Bloomberg

Notably, Chinese manufacturing activity grew in March, for the first time in six months, amid optimism that policy stimulus focused on high-tech manufacturing might provide further support.

Backward-looking GDP data and coincident survey data pointed to an economy with much stronger momentum than previously anticipated: consensus forecasts for year-on-year US GDP growth in 2024 jumped from 1.4% in January to 2.2% in March. At the same time, global growth forecasts for 2024 have been revised up to 2.4%. While this would be a slowdown from the 2.6% expansion in 2023 and is slightly subdued, even by the standards of the 2010s, it would be consistent with a 'soft landing' for the global economy. That is, inflation would have come down alongside sharp increases in interest rates over 2022 and 2023, without tipping the major economies into severe recessions.

But while slowdown fears have eased, inflation remains a concern. Not only was US inflation above expectations in January and February, but survey data also highlight a reacceleration in output prices and prices charged in the manufacturing and services sectors. While the headline rate of inflation looks likely to cool in the months ahead, stubbornly sticky services and wage inflation highlight elevated underlying price pressures (Chart 2).

Chart 2: UK headline CPI is falling, but underlying price pressures may give central bankers pause for thought

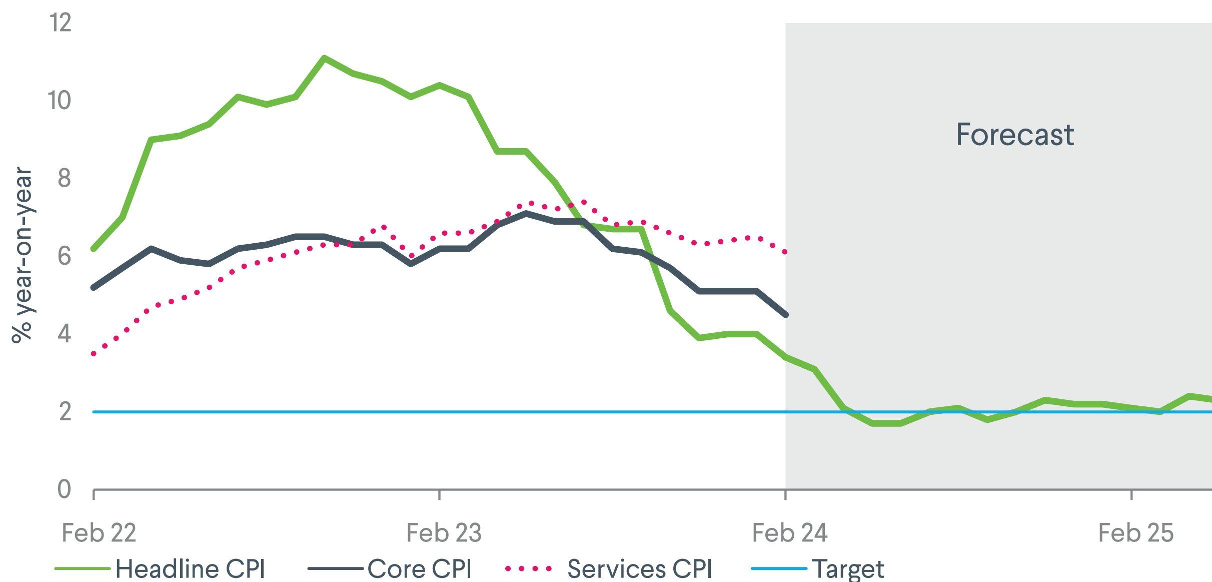
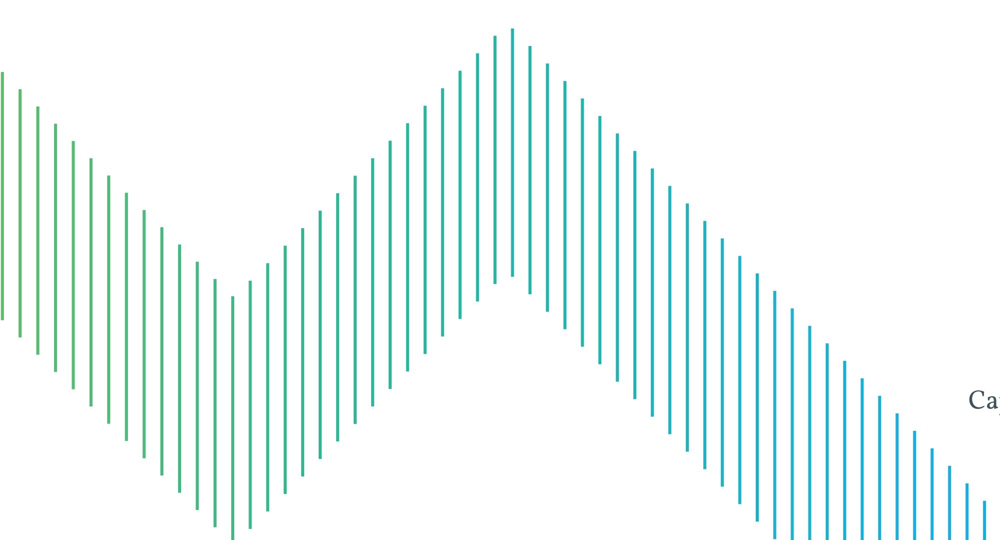


Chart 2: Datastream and Bloomberg

Therefore, while we still expect weaker headline inflation and, consequently, higher real interest rates to open the door for two or three interest-rate cuts by the major central banks in 2024, we think the balance of inflation risks weighs in favour of the banks doing less than markets currently anticipate.



Government bonds

Despite this, and short-term yields that look, at best, fairly valued, we still think longer-term nominal yields are attractive relative to long-term real growth and inflation forecasts (Chart 3). That is, we think the Bank of England (BoE) will ultimately reduce rates more than long-term forward nominal yields imply. We expect an eventual easing of currently negative technical headwinds (high net issuance and BoE asset sales) to lead to a decline in the additional yield investors require to invest in long-term bonds rather than rolling shorter-term debt.

Chart 3: UK forward nominal yields look attractive relative to potential long-term real growth and inflation

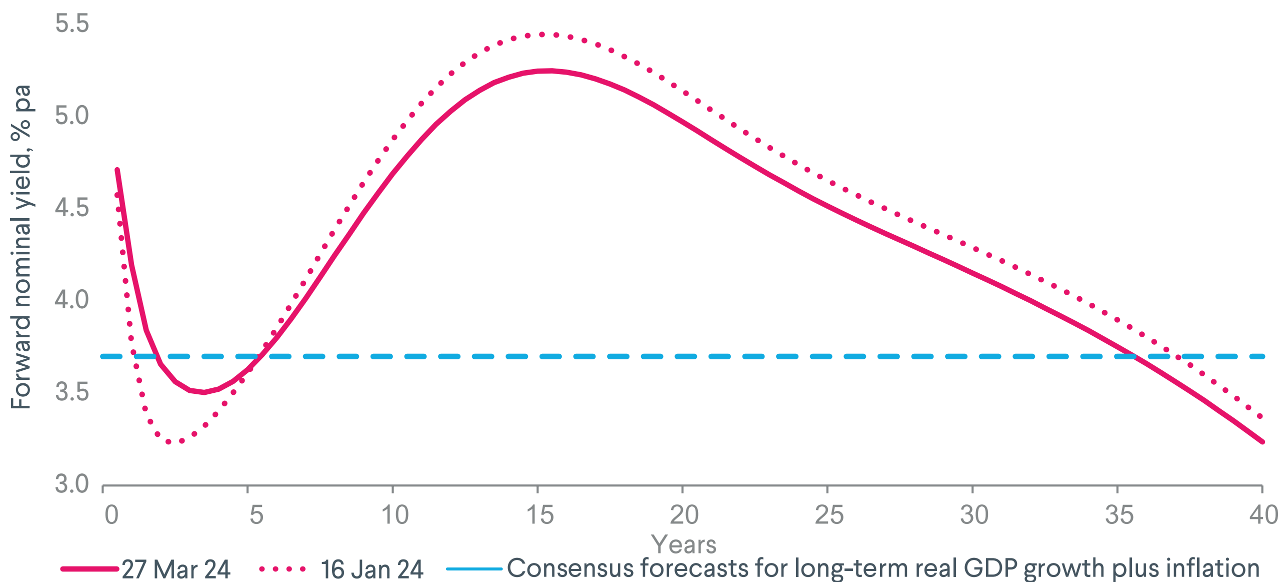


Chart 3: Bank of England and Consensus Economics

Following recent declines, we now think long-term real yields are broadly similar to our assessment of long-term fair value, which is set in line with long-term real growth forecasts minus an inflation risk premium (IRP). We assume a fair value for implied inflation according to consensus long-term forecast inflation of 2.2% pa, plus a term-dependent IRP, resulting in a 'neutral' implied-inflation rate of 2.7% pa. Given that implied inflation is somewhat above this assessment, buying inflation protection looks expensive on this measure. This is also true at shorter terms, even allowing for currently elevated levels of inflation and indexation to RPI, which is typically 1% pa higher than CPI, until 2030.

Credit

Corporate credit spreads fell further in the first quarter of 2024. This, in part, reflects improvements to the economic outlook. Moody's predicts the current 12-month speculative-grade default rate of 5.0% will mark this cycle's peak. With global growth expected to stabilise at only modestly lower levels in 2024, and the prospect of interest-rate cuts on the horizon, it forecasts that the default rate will decline to 3.5% by the end of the year. This is below long-term averages. However, strong institutional demand for corporate credit, which potentially says more about underlying yields than it does about the pricing of credit risk, has most likely played a part.

Chart 4: Speculative-grade bond spreads have rarely been below current levels

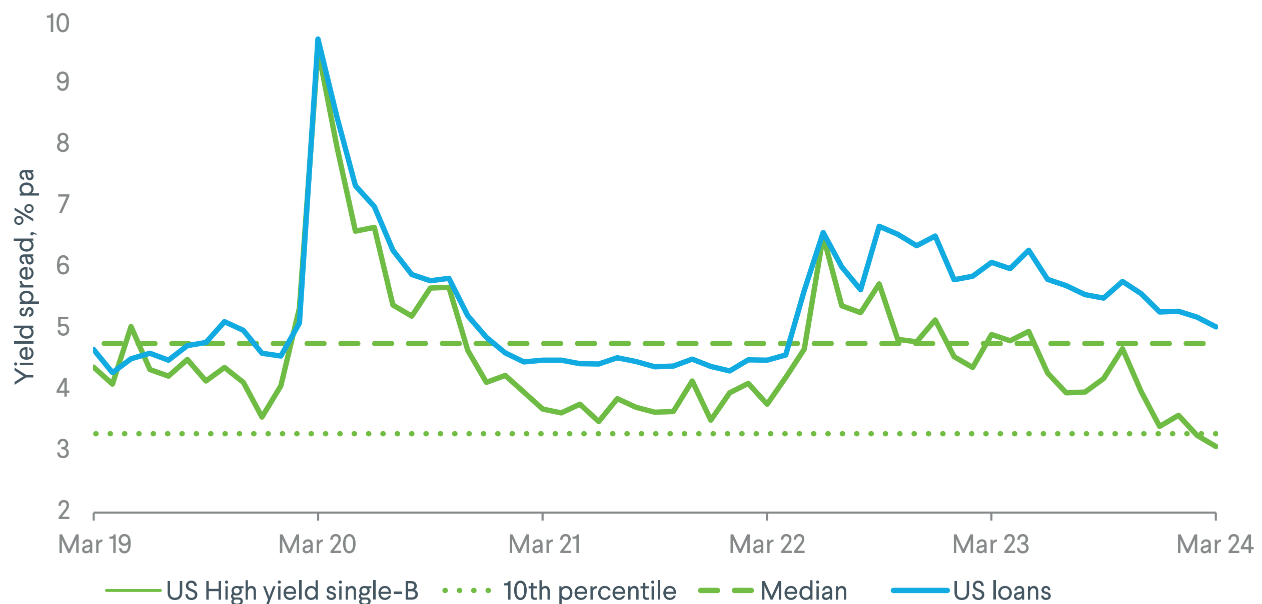


Chart 4: ICE Index Platform and Barings Investment Management

Of course, demand can keep spreads low for a while, and long-term investment-grade credit investors would still expect to harvest a reasonable premium over gilts. However, credit spreads are at levels that do not represent an attractive entry point, particularly in speculative-grade bond markets (Chart 4), where even long-term investors can still suffer material credit losses. Speculative-grade loan spreads, which are in line with long-term medians, offer better value relative to similarly rated bonds, and a more modest pace of interest-rate cuts points to a potentially attractive income-based return over the medium term. While default rates are currently higher and debt affordability metrics weaker in the traded-loan market, credit analysts note that private debt provides an alternative source to refinance debt, potentially reducing default risk in the traded-loan market.

Equities

Global equities recorded their best first quarter in five years, with the FTSE All World Total Return Index rising 9.5% in local-currency terms, as optimism about the US economy and AI enthusiasm offset expectations of slower rate cuts. Earnings per share (EPS) growth forecasts for the MSCI All-Country World Index have stabilised at around 9% and 13% for 2024 and 2025, respectively. EPS momentum, or the extent to which analysts' upgrades outnumber downgrades, has sharply improved since the beginning of 2024. A more favourable fundamental outlook to some extent justifies positive performance, but recent price moves leave cyclically adjusted global equity valuations looking stretched (Chart 5). This owes a lot to US valuations,

Chart 5: Global equity valuations look elevated, but regional dispersion persists

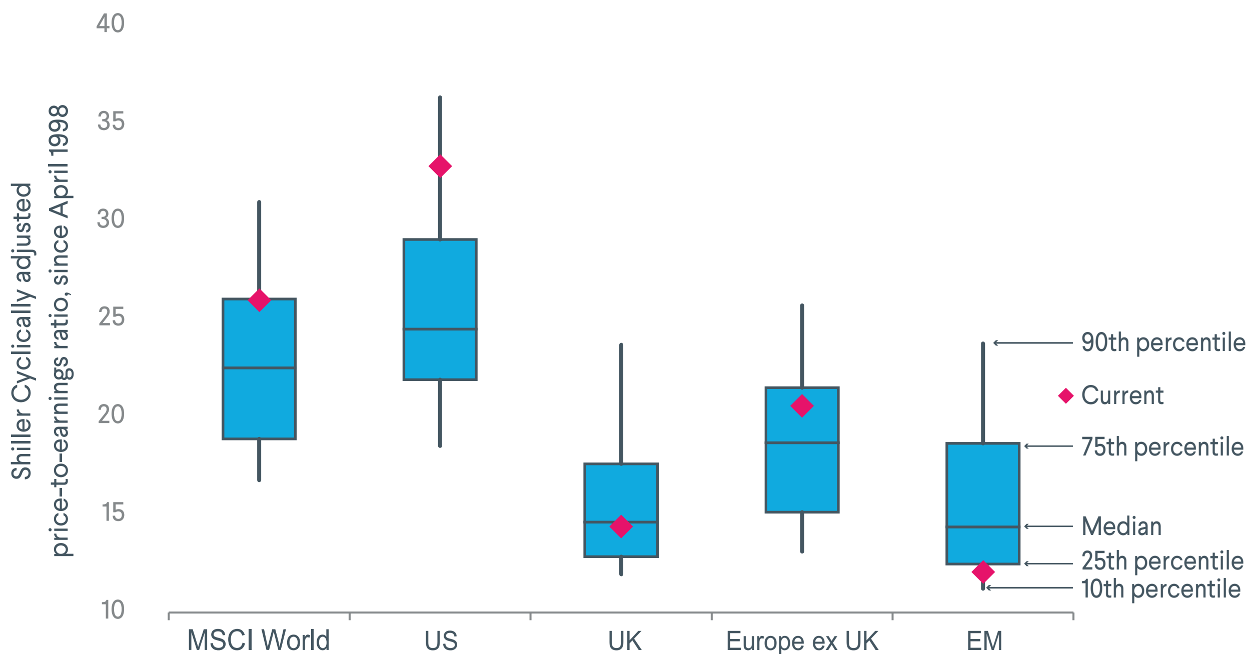


Chart 5: Datastream and Hymans Robertson

which are elevated, even relative to their usual premium. However, strong relative EPS growth and momentum suggest being underweight the US could be a costly strategy. The same measures indicate a degree of caution towards European and UK equities is still warranted, despite less demanding valuations. Past extremes in Japanese equity valuations mean comparison with their own history is less helpful, but they still trade at a modest discount to global benchmarks, despite continued outperformance.

Meanwhile, relative earnings growth forecasts, and revisions to those forecasts, remain supportive. We are becoming increasingly positive on emerging markets (EM), where relative economic and earnings growth forecasts look at odds with historically cheap valuations. The decline in EM profit margins over the past few years looks well advanced, and a potential recovery in the global manufacturing cycle bodes well for EM equities.

Property

A range of indicators hint at signs of improvement in the outlook for UK commercial property. While the latest Royal Institute of Chartered Surveyors survey highlights ongoing falls in occupier demand and rent expectations, and rising availability and inducements offered to tenants, all indicators were less negative than in the previous survey. At the same time, the pace of decline in the MSCI UK Monthly Property Capital Value Index, which is now almost 26% below its June 2022 peak, has slowed. Additionally, falling inflation, alongside decent nominal rental growth, means real rental growth returned to positive territory in February for the first time since January 2017.

Chart 6: Net initial yields are as high as they've been in almost 10 years

Chart 6: MSCI IPD Monthly

Net initial yields, based on current income, have risen to 5.6% pa, while gross reversionary yields, based on estimated rental value, have risen to 7.3% pa (Chart 6). Transaction yields, which sometimes include secondary-market discounts, have often been higher than those at index level, but some major valuation houses are suggesting that yields are stabilising across many sub-sectors. However, despite these tentative signs of improvement, the technical backdrop remains challenging, as many pooled UK property funds continue to face a substantial level of investor redemptions and need to sell assets while transaction volumes are relatively low.

Conclusion

Global growth momentum improved at the beginning of 2024, and there are tentative signs of a recovery in manufacturing activity, following the global industrial recession of the past 18 months. As a result, global growth is now expected to slow only modestly in 2024, and recession fears have rapidly receded. However, better activity data have been accompanied by a resurfacing of inflation fears, with markets now expecting two to three interest-rate cuts from the major central banks in 2024, down from six to seven at the start of the year.

The fundamental outlook for risk assets has improved, but our concerns are shifting towards valuations, which have baked in a lot of good news. Razor-thin credit spreads are supported by strong demand, but we think attractive yields are mostly a reflection of underlying sovereign bond yields, and credit risk premia look exceptionally low, particularly in fixed-rate bond markets. We do not suggest an imminent reversal of fortunes is likely, but global equity valuations point to a more subdued medium-term return outlook. There are also hints of stabilisation in the UK commercial property market. Valuations are no longer demanding, given the steep declines in capital values over the last couple of years. However, the technical backdrop is still challenging.

While short-term sovereign bond yields, at best, fairly reflect the likely extent of near-term rate cuts, and underlying inflation pressures suggest central banks might cut even less than expected, we still think longer-term bond yields are attractive. A more modest pace of interest-rate cuts would also extend the shelf life of cash, which offers a positive real yield to sit on the sidelines.

Additional notes

This communication has been compiled by Hymans Robertson LLP® (HR) as a general information summary and is based on its understanding of events as at the date of publication, which may be subject to change. It is not to be relied upon for investment or financial decisions and is not a substitute for professional advice (including for legal, investment or tax advice) on specific circumstances.

HR accepts no liability for errors or omissions or reliance on any statement or opinion. Where we have relied upon data provided by third parties, reasonable care has been taken to assess its accuracy; however, we provide no guarantee and accept no liability in respect of any errors made by any third party.

Chris Arcari
Head of Capital Markets
chris.arcari@hymans.co.uk
0141 566 7986

Hymans Robertson LLP is a limited liability partnership registered in England and Wales with registered number OC310282. Authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities.

© Hymans Robertson LLP 2024. All rights reserved.