MID-YEAR INVESTMENT OUTLOOK 2024

Coutts

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THE YEAR SO FAR

As we approach the midpoint of 2024, global financial markets have shown remarkable resilience – continuing the positive momentum experienced at the end of 2023. While fears of a recession are a distant memory now, these concerns have been replaced with how long we'll remain in a higher-for-longer interest rate environment.

Six months into the year, the situation remains positive. By anticipating this return to growth narrative, our positioning in risk assets has contributed to material outperformance.

SECTION ONE

STRONG US DATA

US equities have been the standout performers so far in 2024. Major indices have reached record highs, underpinned by robust consumer demand and steady job growth. We've seen the rare Goldilocks phenomenon of inflation and wage pressures falling, in tandem with the economy posting strong economic growth – the ideal soft landing.

A STRONG AND STABLE PICTURE

Retail sales have also remained strong and consumer confidence is high, reflecting a stable economic environment that supports the market expansion. Fears of high interest rates weighing on the consumer have proved misplaced. When interest rates are raised to tackle inflation, higher mortgage payments typically mean people have less money to spend. However, many US households took advantage of pandemic-era interest rates by locking in 30-year mortgages, making them largely insulated from the effects of monetary policy.

GLOBAL RESILIENCE

The story of economic resilience isn't confined to the US, however. We've seen the same trend across many developed economies as falling inflation has steadied consumer confidence, and many companies/regions have surprised with robust earnings growth.

FALLING ENERGY COSTS

Let's look at the European manufacturing sector, for example. It's benefited from falling energy costs (now lower than before the Russian invasion of Ukraine) and a significant decouple away from traditional energy sources to renewable alternatives, according to Wood Mackenzie. Similar improvements have been seen across other services sectors.

Looking at the energy sector specifically, it's expected $3 trillion will be invested globally into the industry. However, according to IEA's recent World Energy Investment report, two-thirds of this investment in energy will be directed to clean energy technologies.

THE YEAR SO FAR

RISING PRICES

Global inflation continued its downward trend as many post-pandemic price shocks and labour shortages worked their way out of the system. History tells us the downward pathway is often bumpy, but the overarching trend is still disinflation – where inflation is positive but falling month on month – just at a slower rate.

INTEREST RATE CUT ON THE HORIZON?

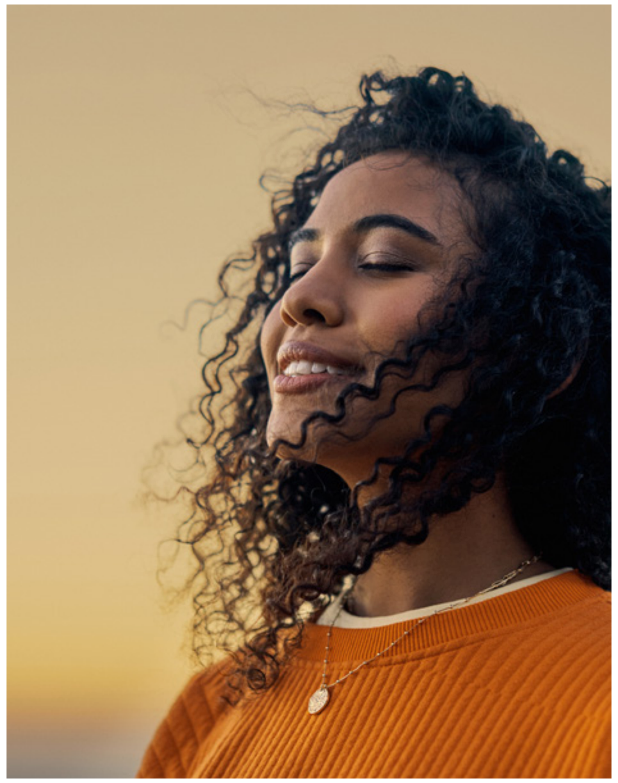
Inflation is now in the zone that gives central bankers some leeway to start thinking about easing, should conditions warrant it. US core inflation – price changes of products excluding volatile goods such as food and energy – fell to 3.6% for the year to April, according to the Bureau of Labor Statistics, down from its recent peak of 6.6% in September 2022.

As a result, the US Federal Reserve (the Fed) has kept interest rates unchanged since its last hike in January. However, markets are optimistic a rate cut will come later this year as inflationary pressures continue to ease, both in the US and other leading economies.

MOVING FORWARD

Global financial markets have maintained a positive trajectory so far in 2024, albeit with some volatility as a result of ongoing geopolitical risks.

As we move forward, we remain committed to monitoring market developments closely and adjusting our strategies to ensure sustained performance and effective risk management.



MANAGING OUR FUNDS AND PORTFOLIOS FOR THE REST OF 2024

Given how financial markets have performed up to this point, we're pleased that our portfolios have been well-positioned to capture the upside, being risk-on from the very beginning of this current rally (which began in autumn 2023). Over the course of the first six months of 2024 – often contrary to consensus – our process was guiding us to take risks as it was suggestive that recession fears were overblown, and global economic conditions had not only stabilised but were improving.

OUR POSITIONING

Our investment process guided us to three primary convictions that have driven our strong year-to-date performance:

- Overweight global equities, funded by our government bond allocation
- We favoured high-yield corporate bonds over investment-grade bonds
- We've diversified our bond allocation further through holding gold

While the first two of these convictions are expressions of a risk-on stance, it's important to recognise our conviction was based on different drivers.

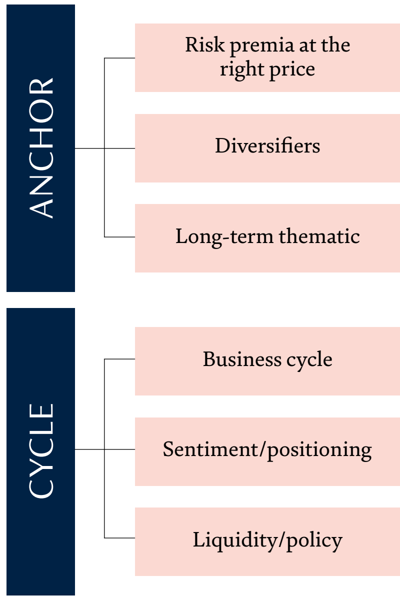
ANCHOR AND CYCLE

The philosophy behind our investment decision takes the form of two strategies: *Anchor* and *Cycle*.

Anchor is about the long term, ensuring our overarching positioning is right for that time frame. While short-term shifts in asset prices are important, it's good to stay focused on long-term goals.

Cycle, on the other hand, focuses more on the now. This takes into consideration where we are in the business cycle, how the macroeconomic environment is faring and what governments or central banks are doing. From this, we consider how we can make the most of those conditions.

As always within this investment process, we look at a wide range of financial and non-financial risks and opportunities, such as the climate transition.



EQUITIES

The case for our equity exposure was largely based on our Cycle strategy. There was an indication that an expansionary economic regime would be supportive of broader, improving earnings. Many market participants were focused on unattractive valuations for some equity markets, even as valuations tend to be a poor indicator of returns over medium-term time horizons.

FIXED INCOME

We invested in high-yield corporate bonds as part of our Anchor process, as it showed an attractive premium being paid for the risk taken from the asset class (versus its history). In a year when standard fixed-income assets – both government and investment-grade corporate bonds – have performed negatively as yields have surged upwards (as yields go up, prices go down), high-yield bonds have held their value, far outperforming their "safer" counterparts.

GOLD AT AN ALL-TIME HIGH IN 2024

Our allocation to gold is slightly more complex. We hold it within our portfolios as an additional source of diversification in an environment where government bonds are subject to higher than historical volatility. To the surprise of many, the price of gold has shot up to all-time highs in 2024. While it's a volatile commodity, it continues to provide us with a distinct source of safety and return.

OPTIMISTIC OUTLOOK

Looking at the rest of the year, we continue to be optimistic. The economic cycle continues to be expansionary and we see earnings growth – a critical metric – staying in an uptrend. As a result, we continue to have conviction on global equities. We also continue to hold high-yield bonds and gold – but took some profits on both of those positions earlier this year, given their strong recent returns.

ALTERNATIVE INVESTMENT STRATEGIES

Part of those profits have been placed into a mixture of alternative investment strategies, providing yet another differentiated source of returns compared with traditional equity and fixed-income markets. Indeed, the nature of the risks we are facing has made us actively seek this additional diversification. Geopolitical tensions are one, uncertain electoral results are another. There's also the uncertain path of inflation. Downward momentum in general price pressures has slowed, and that may well result in higher-for-longer global interest rates. A tail risk scenario would include more rate hikes, which can't be ruled out.

FOCUS ON POSITIVES

Nonetheless, we believe our expectation of earnings growth – supported by an expansionary business cycle – backs our risk-on stance. Indeed, risk is a perpetual reality in markets, but the biggest realised risk is often putting too much emphasis on what might go wrong and not enough on what's going right. Many in the market have been reminded of this so far in 2024.

GEOPOLITICAL RISKS

Among the numerous elections taking place globally this year, the US presidential election stands out as the most consequential. While India holds the title of the world's largest democracy, the US election's significance lies in its potential to redefine America's relationship with global norms and established institutions such as the United Nations, NATO and the International Monetary Fund. As the architect of the post-Second World War economic order, the US's leadership choice is pivotal for market participants worldwide.

ELECTIONS VERSUS INVESTING

What implications does the US election hold for investors? Looking at the annual returns of the S&P 500 calendar from 1928 to 2023 shows that average returns during election years (11.0%) closely mirror those of non-election years (11.5%). Interestingly, positive returns were more frequent in election years, occurring 83% of the time compared with 73% in other years.

Despite this, elections – including those in the US – typically have minimal impact on long-term investment returns. Over the past 75 years, the primary economic drivers – interest rates, inflation and corporate earnings – have consistently overshadowed electoral results.

DIVIDED GOVERNMENT

There's no clear evidence to say markets perform better whether Republicans or Democrats control the White House and Congress. Our research indicates that markets tend to perform better with a divided government, where power is shared between both parties. This arrangement mitigates the risk of sweeping or radical political change and tends to minimise the risk of market volatility.

MINIMAL REACTION FROM MARKETS

As the election approaches, we should anticipate normal market volatility – especially given the heightened political stakes this year. However, such volatility (if present) is usually short-lived – and can be mitigated by portfolio diversifiers such as gold. Ultimately, markets typically react only briefly to election-related uncertainties, before turning attention back to the fundamentals.

THE EVOLUTION OF ESG

In the US, while there's been a political divide on the term ESG (environmental, social and governance), green investment has continued to increase. This growth has been led by the Inflation Reduction Act, which pledges to direct nearly $400 billion in federal funding towards clean energy and mitigating climate change, according to the White House. This has support from both US political parties, and Republican-held states are the largest beneficiaries. While there are still disputes over semantics, we can still see ESG active in practice.

FUNDAMENTALS ARE KEY

Looking ahead to the rest of 2024, we believe macroeconomic factors will predominantly drive investment performance, not the outcome of elections or other geopolitical factors. This will include potential interest rate cuts by the Fed, the trajectory of inflation and corporate earnings growth. Currently, indicators in these areas are supportive of our overarching growth narrative and positioning.

POTENTIAL OPPORTUNITIES FOR INVESTORS

Additionally, these factors collectively suggest a positive outlook for investors. We maintain a positive stance towards the US economy and equities, positioning ourselves overweight in both US and broader risk assets.

Regardless of the election outcome, a robust economy and positive market outlook position the US as a compelling opportunity for global investors this year.

US EARNINGS

As previously mentioned, corporate earnings play a pivotal role in investment decisions. On a quarterly basis, companies announce how their businesses have performed over the previous period and provide insight as to how they, and their respective sectors, could perform in the future.

RETURN TO GROWTH

After a flat 2023, this year marks a return to earnings growth for US companies. Growth is expected to reach 9% in 2024, according to Bloomberg. This can be attributed to just a handful of technology giants, which are expected to grow earnings in 2024 by almost 40% compared with a paltry 1% from the rest of the S&P 500's constituents, according to Ned Davis Research.

The industry has recognised a small group of mega-cap technology stocks for their size and outperformance so far this year, naming them the Magnificent 7 – made up of Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla. The group outperformed the rest of the US market by roughly 14% between January and June.

The graph below shows the performance of the Magnificent 7 compared to the S&P 500 for the first five months of the year.

YEAR-TO-DATE PERFORMANCE OF MAGNIFICENT 7 VERSUS S&P 500

Source: S&P, Refinitiv, as at 30 May 2024.

SECTION FOUR

It isn't just the average consumer who felt the squeeze from rising interest rates – most companies did too. Businesses can finance growth by using loans, but this becomes more expensive with higher interest rates. The aforementioned Magnificent 7, on the other hand, held massive cash positions that they could rely on for growth rather than using expensive loans.

ARTIFICIAL INTELLIGENCE

The biggest theme of the year so far is artificial intelligence (AI). As more and more companies adopt the technology into their businesses and services, those first and effectively implementing attracted the most attention from investors.

This is being highlighted by technology giants with the financial strength to outspend their smaller rivals on the "picks and shovels" of the AI revolution – computer chips and data centres – along with the software development to fully exploit this new technology's potential.

MOMENTUM SHIFT

As the year progresses, current analyst estimates suggest earnings growth from the wider constituents of the US market might improve. This could be a catalyst for the market's narrow leadership to widen, but there are already some signs that other areas of the market are participating in AI euphoria.

UTILITIES PERFORMING STRONGLY

Looking at the current list of the top performing S&P 500 stocks, it's perhaps surprising that three of the top five spots are occupied by utility companies believed to be beneficiaries from an expected increase in power prices from enlarged data centre capacity across the US. Indeed, aside from the Magnificent 7-dominated technology and communication services sectors, utilities has been the only other sector to outperform so far in 2024 in the US.

S&P SECTOR RETURNS

SECTOR	RETURNS
Comm SVC	21.3%
Info tech	19.8%
Utilities	12.5%
Financials	9.6%
Energy	8.9%
Industrials	8.3%
Consumer staples	7.3%
Materials	6.3%
Healthcare	4.4%
Consumer discretionary	0.7%
Real estate	-6.7%

Source: S&P as at May 2024.

IMPORTANT INFORMATION

Past performance should not be taken as a guide to future performance. The value of investments and the income from them can fall as well as rise, and you may not get back what you put in. You should continue to hold cash for your short-term needs.