Hymans Robertson Investment Services (HRIS)

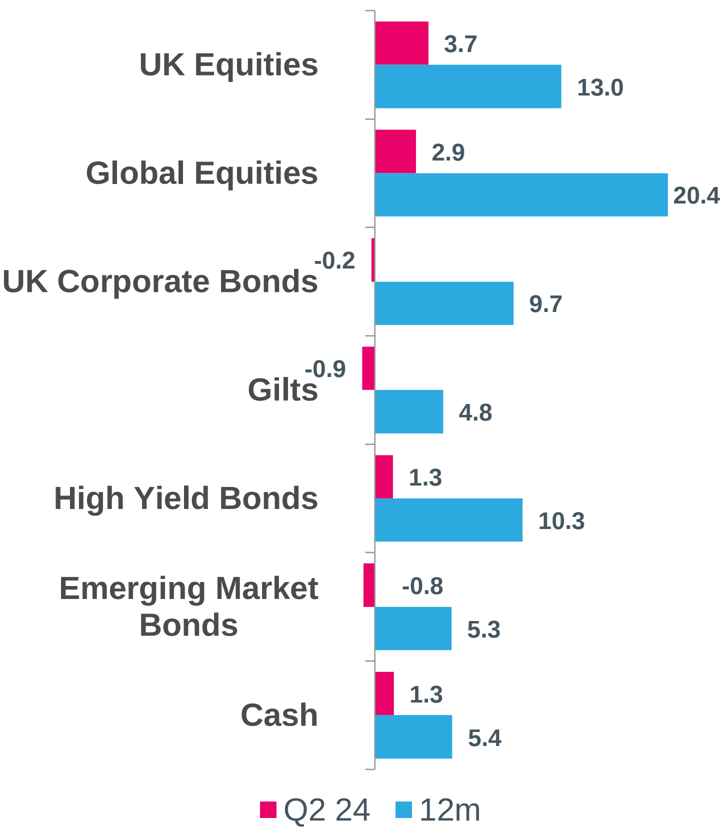
Market Digest

Q2 2024

Quarterly highlights

- Equities provided positive returns over the quarter, while bonds were more mixed.
- A UK general election was called for July to little market impact. Uncertainty over France's election outcome led to market jitters in Europe.
- UK inflation fell 1.4% to 2.0% (i.e. the Bank of England's target) over the quarter, but high services inflation meant no interest rate cut from the Bank of England.
- On page 3 of this document, we provide market commentary to cover the past year to 30th June 2024.

Asset class returns (%)



Source: Morningstar. Figures to 30 June 2024. Returns in sterling terms except High Yield Bonds which are hedged. EM bonds are 50% local currency denominated and 50% US dollar denominated bonds.

Market summary

- Our model portfolios typically invest in a combination of the asset classes shown in the left-hand chart.
- Inflation fell sharply to 2.0% in the UK over the quarter. Even so, the Bank of England decided to keep interest rates level, as other measures of underlying inflation, such as services and core inflation (which excludes volatile items such as food and energy), remain high. Data also showed the UK economy emerged from recession in Q1, growing by 0.7% over the quarter.
- Unexpected elections were called in both the UK and France. Labour's substantial lead in the poll meant there was little uncertainty around the result and hence market impact was muted. The prospect of the National Rally making strong gains in France means we have seen more volatility there.
- Equity markets continued to generate positive returns, as the themes from Q1, namely strong US growth and AI, continued to support asset prices. Emerging markets and the US were particularly strong.
- Bond returns were more mixed. High-yield bonds generated a small positive return. However, other bonds, such as gilts, experienced small losses, as bond yields nudged higher after investors priced in fewer rate cuts for the year (bond prices fall as yields rise).
- At a portfolio level, equities generated stronger returns than bonds, meaning higher risk portfolios outperformed lower risk portfolios over the quarter.

Outlook and topical market themes

- The UK general election took place with little impact on UK asset prices.
- High-yield (HY) bond spreads are now below 2%. Strategically, we continue to like HY, given the income and diversfication benefits it brings, but it currently looks less appealing and therefore we trimmed our HY allocations at our most recent strategic review.

UK general election has little immediate impact on markets

Last month, we wrote about the likely impact of the UK election announcement on markets. As expected, the response to the results on 5th July was mild, such was the expectation of a large Labour majority. The FTSE 100 fell 0.3% on the 5th, as markets focused more on US jobs data than the outcome of the election. The more domestically focused FTSE 250, which one would expect to be influenced more by UK events, rose 0.9% - a decent gain, but nothing out of the ordinary. Gilts and the pound were relatively flat.

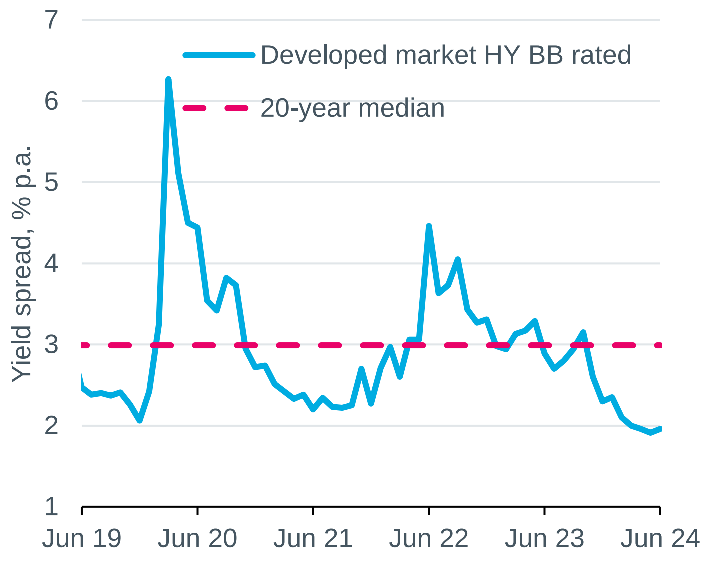
Looking ahead, a period of political stability for the UK may mean UK assets, like gilts, are more attractive to overseas investors, especially when viewed in the context of the political uncertainty in places like France and the US. However, the fiscal position in the UK remains challenging. Labour's plan is to encourage stronger economic growth by loosening planning regulations and investing in infrastructure, but these policies will take time to have an impact meaning tough decisions will still need to be made over the short term.

High-yield corporate bond spreads tighten

High-yield, or sub-investment grade bonds, are issued by companies that aren't able to achieve an investment grade credit rating i.e. they are rated as BB+ or below. As these borrowers are perceived to be riskier, with a higher chance of default, investors normally demand a yield substantially higher than that offered by less risky lenders, such as the US government. This additional yield is called the credit spread and has historically been around 3% for companies with a credit rating of BB. However, despite higher defaults, this credit spread has been falling considerably (boosting returns for holders of such bonds) over the last two years, from around 4.5% in 2022 to under 2% now.

A large part of this is a supply story. Companies issued a lot of debt over the pandemic when interest rates were low, meaning less issuance was required recently. The US economy has also remained surprisingly strong, which has increased risk appetite. Another potential driver is more investors are holding HY as an alternative to equity – total yield on HY bonds is 7-8% p.a. Pretty handy for investors with a total return target. However, we prefer to measure the attractiveness of bonds on a spread basis. Strategically, we continue to like HY, given the income and diversfication benefits it brings, but the asset class looks less appealing once an investor considers they can get 4-4.5% holding a US Treasury bond with no default risk, and therefore we trimmed our HY postions at our most recent strategic review.

Chart of the month – The spreads on HY bonds are historically low



Source: ICE

The chart shows the additional yield, or spread, received on high-yield bonds on top of the government bond yield.

The pink line shows the 20-year average, and the blue line indicates that current levels are well below this. A lower spread means that investors are being compensated less for taking on credit risk, which makes high-yield bonds a less attractive asset class.

Jack Richards
Investment Manager

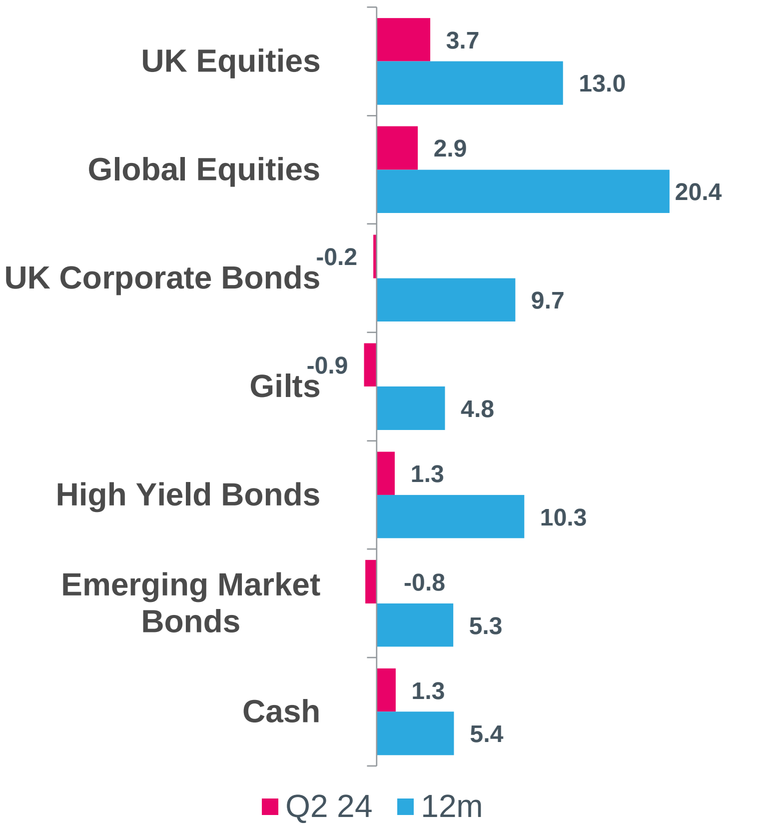
Annual market summary – covering the 12 months to 30 June 2024

Throughout this 12-month period, the US economic story was one of consistently beating expectations. The consensus for a recession at the start of the period, slowly but surely, shifted towards a 'soft landing', where inflation falls back to target without the higher interest rates causing a significant economic slowdown. The story on this side of the pond was quite different. Economic stagnation finally led to recession, as the UK economy shrunk in Q3 and Q4 2023.

Central banks mostly kept interest rates level. The Bank of England made one final hike to 5.25% in August 2023, before holding for the remainder of the 12m period. Pretty quickly, investors looked ahead to the prospect of rate cuts in 2024. During Q4 23, expectations were raised for several rate cuts over the next 12 months, boosting both equity and bond prices significantly. However, the disinflation story stalled in the US. In the UK, despite headline CPI falling back to 2%, services inflation remained too high, quickly dampening hopes of imminent rate cuts. This reversal hurt bond prices, but equity markets continued to ride the waves of strong US economic growth. Over the period, UK inflation fell from 7.9% to 2.0%, while interest rates rose from 4.25% to 5.25%.

Geopolitical risk was once more highlighted in Q4 23, as conflict in Israel and Palestine threatened to escalate. The region's importance to global trade and energy markets meant the price of oil increased towards the end of the period. This threatened to undo some of the disinflationary process experienced over the last 12 months and contributed to inflation flatlining in the US in Q1 24.

Asset class returns (%)



Source: Morningstar. Figures to 30 June 2024. Returns in sterling terms except High Yield Bonds which are hedged. EM bonds are 50% local currency denominated and 50% US dollar denominated bonds.

For most of the period, bonds performed poorly, as uncertainty over inflation and interest rates kept bond yields high. Q4 23 was the exception to this, as the exuberance over potential rate cuts drove significant returns for bonds. This was enough to offset small losses from the other quarters over the period. Equity markets fared much better, as the US economic strength, the prospect of lower interest rates and excitement over Artificial Intelligence ("AI") technologies boosted sentiment and corporate earnings. The US market was the best performing region, benefitting from a heavy tech exposure and several companies that gained from the AI excitement, such as chipmaker Nvidia. Emerging Markets and the UK both lagged after weaker Chinese and UK growth prospects hurt both regions, although in the case of the UK the second half of the period provided a more positive economic picture.