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Wealth Management Ltd

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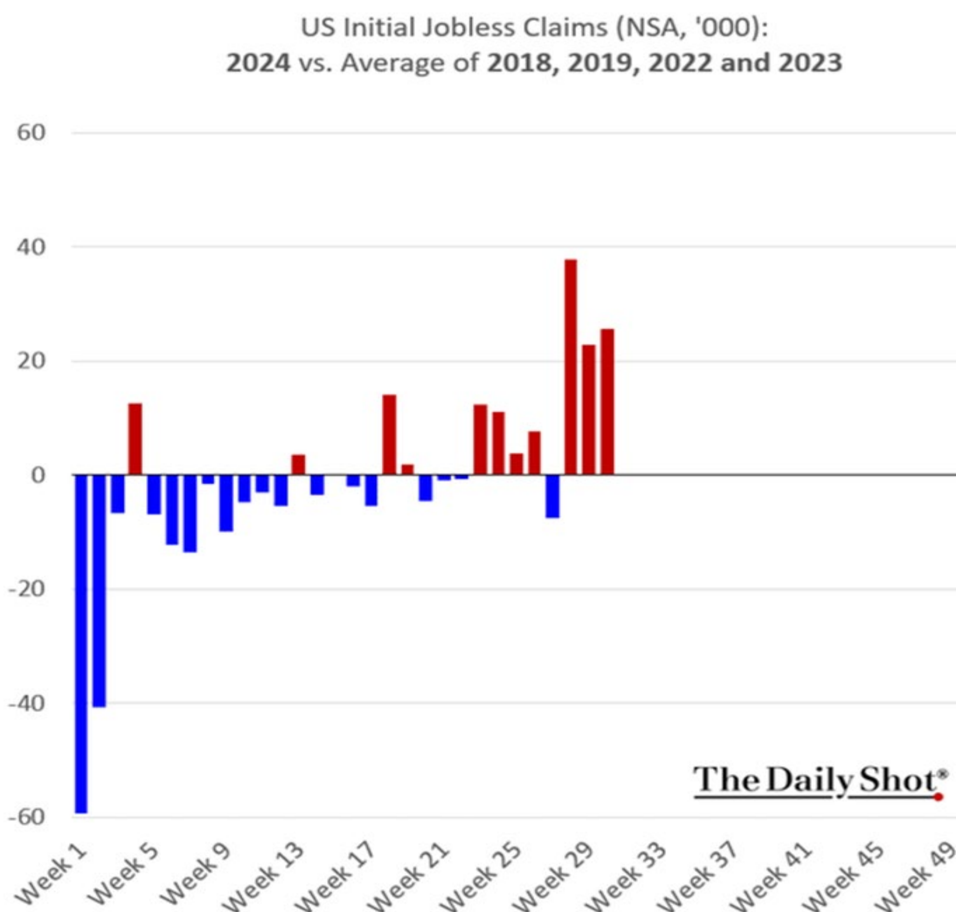
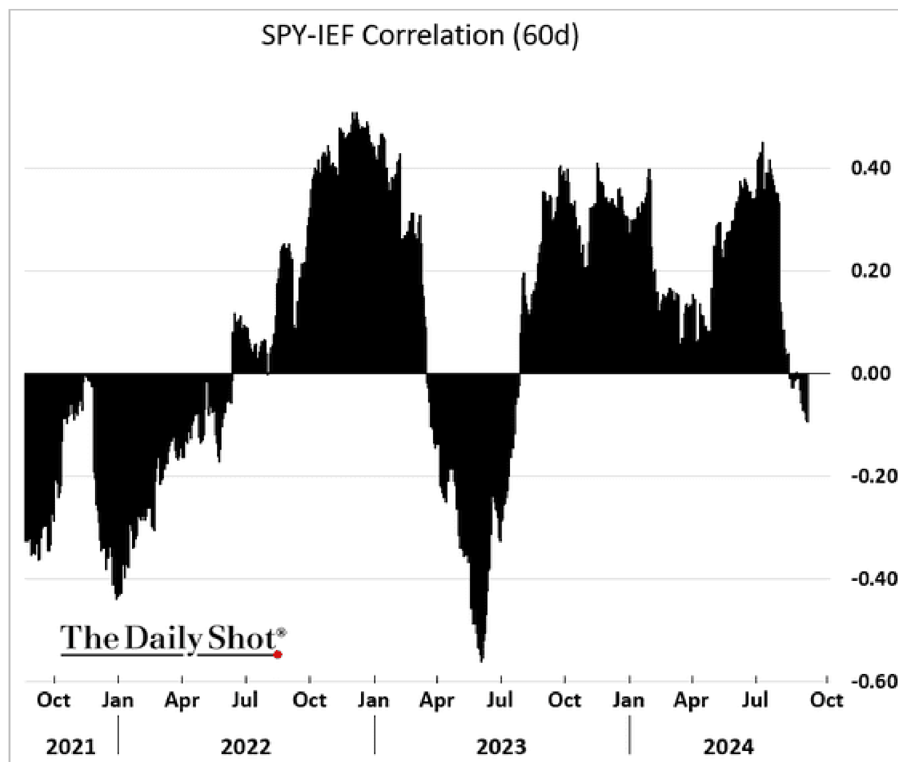
Introduction and Market Overview

The third quarter of 2024 was, on the whole, a constructive period for the markets, though it wasn't without its bumps. Volatility picked up toward the end of July, triggered by a surprise rate hike from the Bank of Japan, which led to the largest single-day drop in Japanese equities since 1987. This move, combined with softer economic data, including a spike in jobless claims (see below), from the US called into question the strength of the U.S. economy. The triggering of the Sahm Rule, a common indicator of recession risk, didn't help the mood. The VIX measure of volatility, often referred to as Wall Street's fear gauge, briefly rose to its highest level since October 2020, before stabilising to more normal levels.



Yet, amid the uncertainty, bonds reminded us of their historical role as a refuge. The yield on the 10-year U.S. Treasury, which started the quarter near 4.5%, fell to 3.8% by early August, reflecting renewed demand. This fall in yield meant prices have risen. For much of the past two years, as inflation dominated market concerns both asset classes moved together. But with inflation starting to ease bonds have started to increase in price during periods of equity market stress. In tandem, "bond proxy" sectors like utilities and real estate, which offer steady earnings, also saw strong performance.

Rolling 60-day correlation between US equities (SPY) and bonds (IEF):

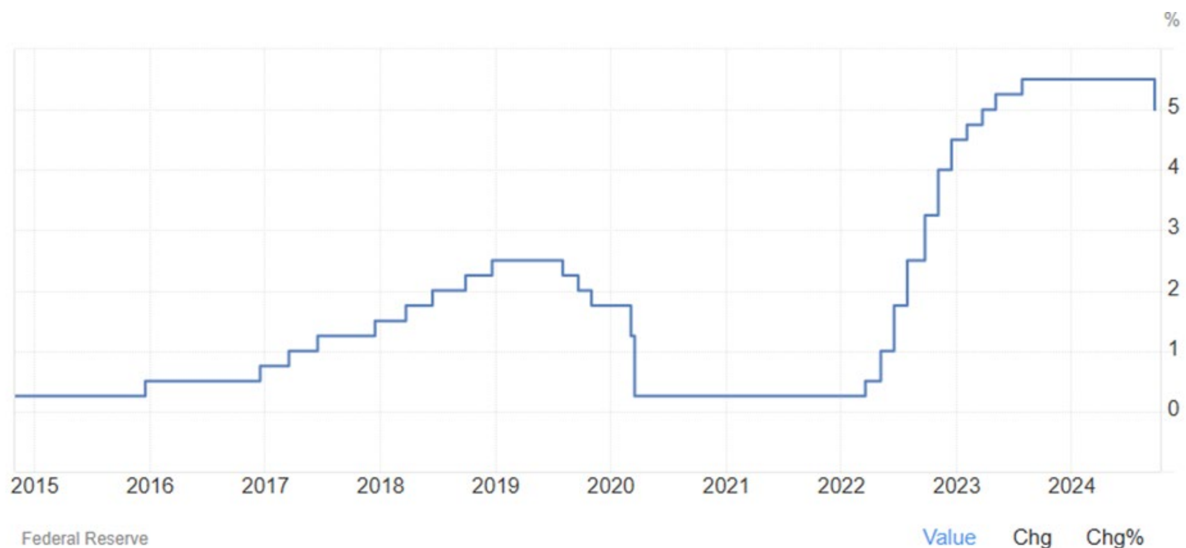


Source: The Daily Shot

On the interest rate policy front, the US Federal Reserve held off on raising interest rates during its July meeting, despite the release of some weak inflation and labour market data. Critics began to argue that the Fed might be behind the curve on cutting rates, much as it was accused of being late to address inflation in 2022. However, Fed chair Jerome Powell did indicate that he expected the Fed to start cutting rates soon. Powell noted that recent data shows substantial progress toward the Fed's target of reducing inflation to 2%. However, he stressed that officials would need even “greater confidence” before moving to cut rates. His comments provided the clearest signal yet that the central bank was gearing up for a policy shift, more than two years after it began its aggressive campaign to tackle inflation. By contrast, the Bank of England took a more proactive stance, cutting rates by 25 basis points in August, marking its first rate cut in over four years.

By September, with further evidence of inflation nearing the Fed's target, the central bank decided to take action and cut rates by 50 basis points (0.5%), bringing the federal funds rate down to 4.75%. Signs of a cooling labour market likely influenced this pre-emptive move to avoid more serious disruptions.

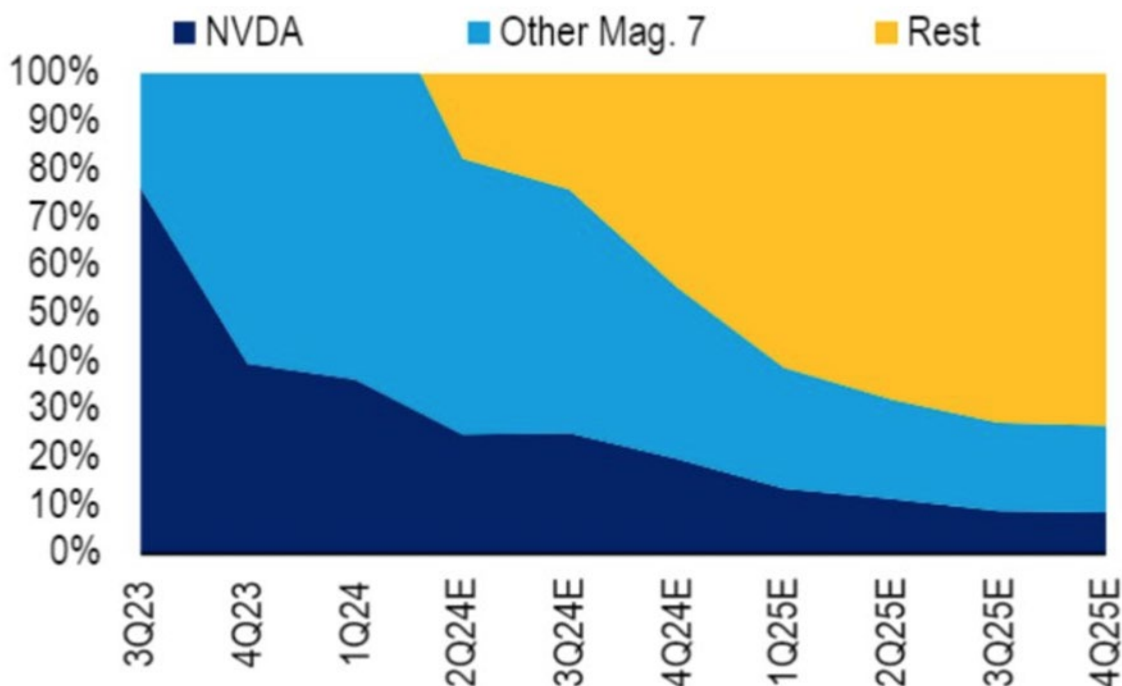
US Federal Reserve Rate:



On the political front, former US president and Republican presidential candidate Donald Trump survived an attempted assassination. The current president Joe Biden announced that he would end his re-election campaign, with Kamala Harris becoming the Democratic nominee. Polls and betting markets have Harris and Trump effectively neck and neck in the race to become the next US President. Closer to home, the UK Labour Party won a landslide parliamentary victory. The Israel-Hezbollah conflict escalated during the quarter, adding to geopolitical risks, but markets absorbed the volatility relatively well. We continue to watch events closely as they could affect global markets, particularly in commodities such as oil and gas, which could feed through to a return of inflation.

Meanwhile, equities posted broad gains, supported by robust earnings reports, especially in cyclical sectors and smaller companies. The broadening of results beyond large tech stocks, signals a healthier market environment.

For some time, we have been concerned that equity markets in the US, like the S&P 500 index, have been extremely reliant on these tech companies for almost all of their returns. The financial term for this is “concentration risk”. With extreme increases in share prices in such a short space of time, too much of what is supposed to be a broad and diversified market index becomes overly exposed to just a few large companies. This could be a larger issue when these companies are on expensive valuations and expectations for earnings growth are sky high. An encouraging sign is that corporate earnings for many of the more reasonably valued companies outside of the concentrated tech sector are now starting to show meaningful growth. As illustrated in the chart below, the Mag 7’s contribution to the earnings growth of the S&P 500 is expected to continue falling sharply over the coming year.

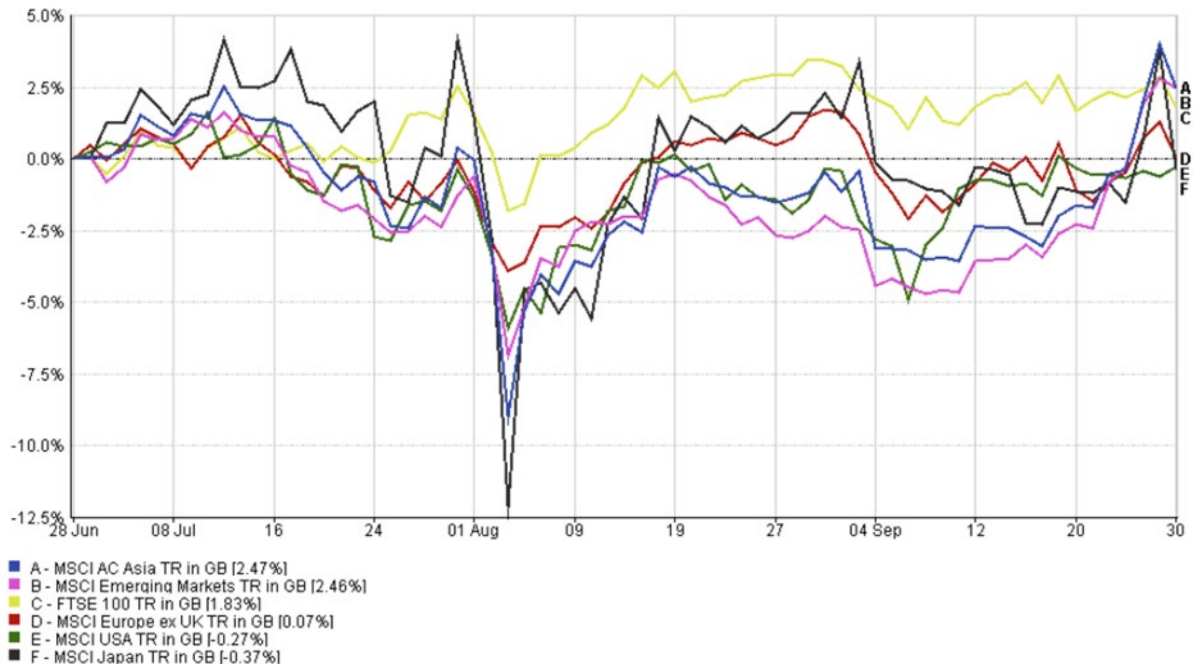


Source: BofA Global Research, FactSet

China's announcement of a 3% GDP stimulus package added further support to equity markets, though concerns linger about its structural issues. Still, markets remain focused on the near term, with stimulus measures sparking a significant surge in Chinese equities and helping pull up other Asian markets.

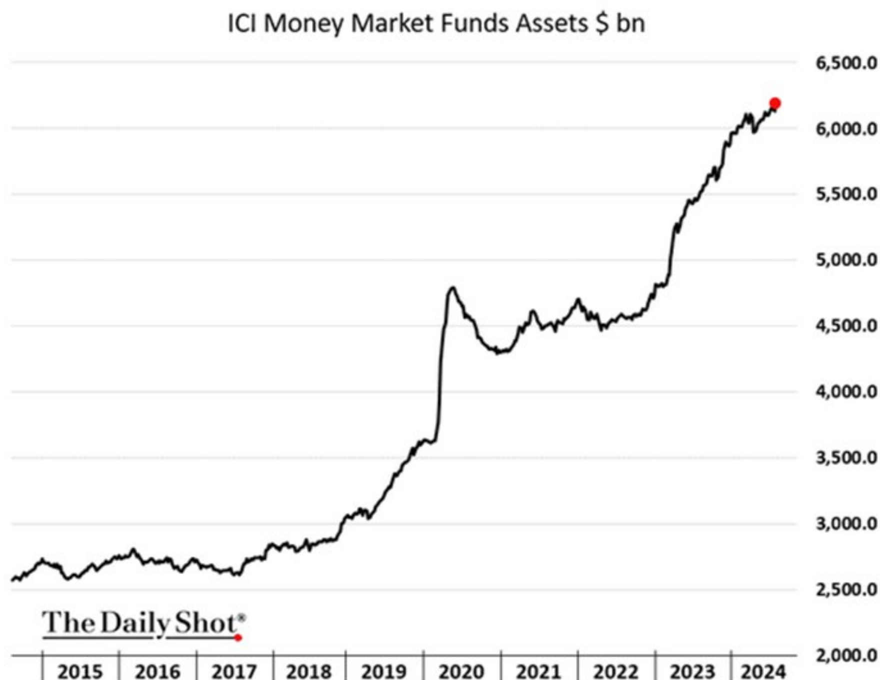
UK equities broadly produced solid returns over the quarter. UK equities appear attractively valued and well-positioned to benefit from lower interest rates and increased political stability. The economic recovery is gaining momentum, with improving consumer and business confidence. Additionally, robust M&A activity, driven by these low valuations, should support market performance in our opinion.

Performance of regional equity markets during Q3:



As we move into the final quarter of 2024, it's clear the market's concern over inflation is now fading into the background. The focus has shifted to the overall health of the economy. In our view, the most likely scenario remains a soft landing, an economy that's slowing but still continues to grow. Inflation is coming down, and while the unemployment rate has ticked up, we see this as more a reflection of an expanding labour force than a sign of trouble. In fact, we should see it as part of a normalisation process, rather than a reason for alarm.

Even if the economy weakens more than anticipated, central banks are well-positioned to provide additional support. With interest rates at relatively elevated levels, they have room to lower rates if necessary. Such a move could encourage some of the capital currently sitting on the sidelines to flow into equities. At present, more than $6 trillion is held in money market funds, which offer low-risk, cash-like returns. The key question remains how much interest rates will need to fall to draw some of this capital back into the equity markets.



Looking at corporate earnings, reports covering the third quarter will be closely watched. Expectations have been tempered, but it is curious that while Q3 estimates have been revised lower, full-year 2025 estimates remain strong. We will likely hear more about this as we listen to management commentary during results season. We have also seen a notable broadening of market participation beyond the largest tech stocks particularly as the Fed eases and China's stimulus kicks in.

The upcoming US Presidential election in November may trigger market volatility, which we will aim to capitalise on. A split Congress is typically seen as beneficial for US equities. The Labour Budget, set for October 30th, could have a notable impact on UK markets, and we are closely following this development.

As ever, there are plenty of potential sources of volatility in the months ahead, from geopolitical tensions to Fed decisions and the US election. Overall, we think the positive momentum in economic data, lower interest rates and support from China should keep markets on solid footing, even in the face of potential headwinds. Also, historically, the fourth quarter tends to be a strong one for equity market returns. Our current analysis is that the fundamentals for growth remain solid.