Eden Park | HRIS

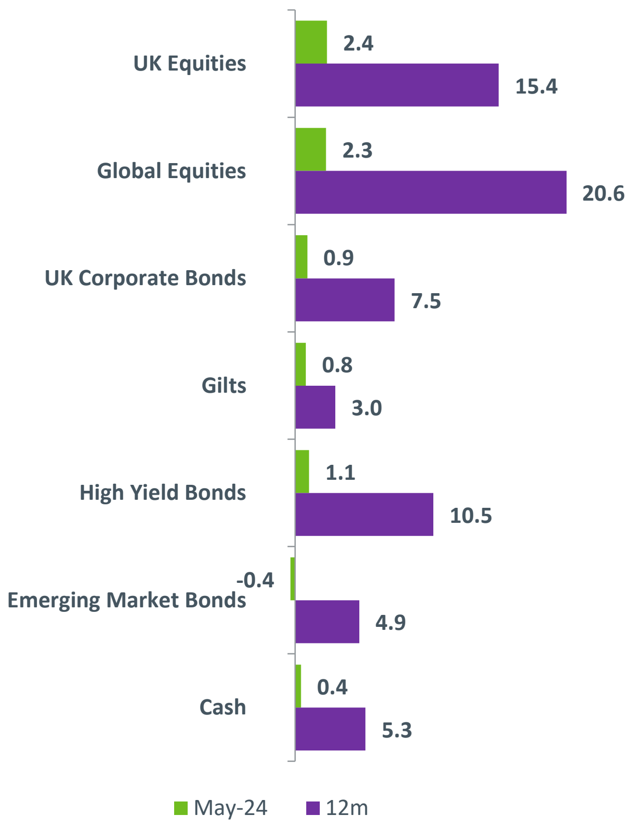
Market Digest

May 2024

Monthly Highlights

- Most asset classes generated positive performance over May.
- A UK general election was called for July to little market impact.
- UK inflation fell 0.9% to 2.3% but US inflation looks stickier around the 3-3.5% mark.
- Equities performed well, especially the UK which benefitted from improving economic data and returned 2.4%.
- On page 3 of this document, we provide market commentary to cover the past year to 31st March 2024.

Asset class returns (%)



Source: Morningstar. Figures to 31 May 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.
- Most asset classes delivered good returns over May.
- Inflation fell sharply to 2.3% in the UK, albeit the drop was less than expected and services inflation remains high, meaning the prospects of a Bank of England interest rate cut in June have reduced.
- Rishi Sunak called a general election for 4th July. Given that Labour's lead in the poll is substantial, there was little market impact from the announcement (more on this below).
- Equity markets were boosted by strong corporate earnings in the US and improving economic data in the UK and Europe. After a strong start to the year, Japan underperformed in May as the yen weakened further.
- Bond returns were supported from comments by Federal Reserve Chairman Powell who dismissed the option of further interest rate hikes. Global bond yields fell, boosting prices. However, a stronger pound hurt Emerging Market (EM) bond returns.
- Corporate and High-Yield bonds both outperformed gilts (UK government bonds), driven by stronger corporate earnings.
- At a portfolio level, equities generated stronger than bonds, meaning higher risk portfolios outperformed lower risk portfolios over the month.

Outlook and topical market themes

- Barring an unlikely tightening of the polling data, we envisage little market impact for the upcoming UK general election.
- Despite a significant drop in headline CPI in April, other measures of underlying inflation slowed by less than was forecast. The likelihood of a June interest rate cut from the Bank of England reduced as a result.

UK general election called for 4th July

The Prime Minister's announcement on 22nd May that an election will take place on 4th July had little impact on UK asset prices. This is because the Labour party currently enjoys a strong lead in the polls meaning investors have already mostly 'priced in' an incoming Labour government. Although a close election looks unlikely at this stage, any tightening of the polls which implies a Labour minority or even hung parliament could increase UK asset volatility. This is not because investors favour the Labour party, but because markets hate the uncertainty and political instability that this would potentially bring.

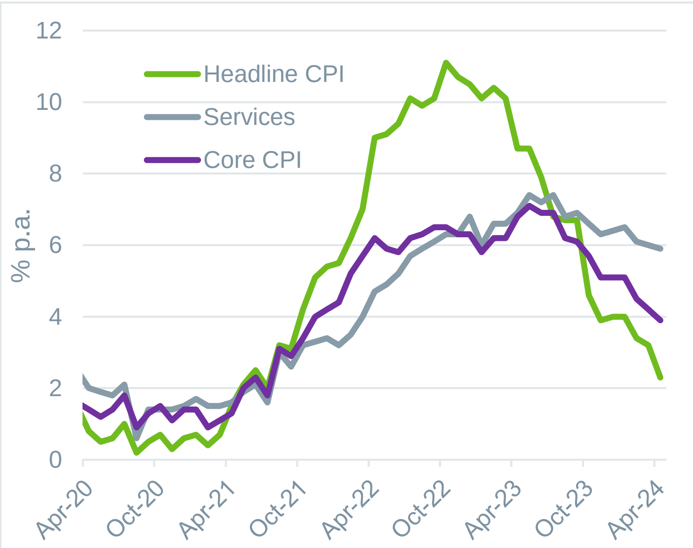
Ultimately, over the long term, global macro-economic trends have a much larger impact on markets than elections. There may be short-term volatility where elections are tight, but Labour's comfortable lead means this is unlikely to be the case. Instead, investors are likely to remain more focused on inflation and the prospect of central bank interest rate cuts.

Why the recent sharp drop in inflation was disappointing for the Bank of England

In May, the Office for National Statistics reported inflation had fallen 0.9% to 2.3% in April. On the face of it, this looks like a great result (and it may have even convinced the Prime Minister into calling an early election) but the Bank of England (BoE) would have been disappointed with the underling data and it has reduced investors' expectations for an interest rate cut in June.

Although the drop in the headline rate of inflation was significant, this was already expected owing to the fall in the energy price cap. Other measures of inflation, like Core and Services inflation, can give a better indication of domestic price pressure. Core inflation, which excludes volatile items like food and energy, only fell 0.3% to 3.9% when a 0.6% fall was expected. Meanwhile, Services inflation barely fell 0.1% to 5.9%. Before this data release the June meeting was a 50/50 call on whether the BoE would vote for an interest rate cut but this looks off the table now. However, we don't think it will delay a cut for too long, with the August meeting possible if data goes the right way. The BoE won't necessarily wait until Core and/or Services inflation is back at 2%, but they will want to see more evidence that it is on a sustainable path down to 2%.

Chart of the month – Headline CPI is nearing target, but Services and Core CPI remains high



Source: ONS

The chart shows three measures of inflation: CPI, Services and Core CPI.

The chart shows that, although headline CPI is approaching the Bank of England's 2% target, other measures, which give a better indication of underlying inflation, are still elevated and will take longer to get back towards the BoE's target.

Jack Richards
Investment Manager, HRIS

Annual market summary – covering the 12 months to 31 March 2024

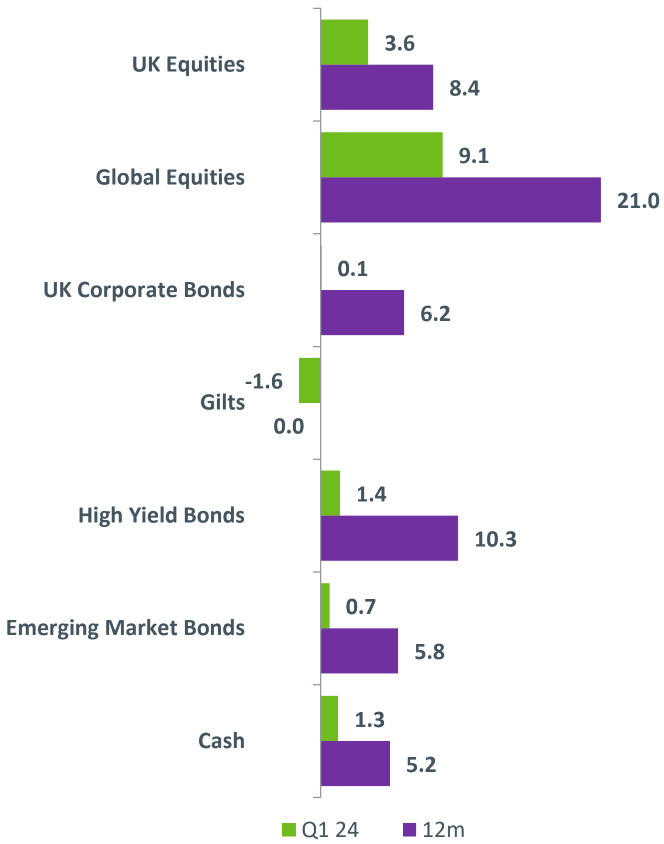
Throughout this 12-month period, the US economic story was one of consistently beating expectations. The consensus for a recession at the start of the period slowly but surely shifted towards a 'soft landing', where inflation falls back to target without the higher interest rates causing a significant 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.

Investors were initially heavily focused on how high interest rates would need to get, to bring inflation sustainably back to target. The Bank of England eventually paused after raising rates to 5.25% in August 23. Pretty quickly, investors looked ahead to the prospect of rate cuts in 2024. During Q4 23, expectations were raised of several rate cuts over the next 12 months, boosting both equity and bond prices significantly. However, inflation stopped falling over Q1 24 in the US, 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 10.1% to 3.4%, 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.

For most of the period, bonds continued to perform 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, offsetting losses from the past few quarters. 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. US and Japanese markets were the best performing regions, benefitting from a heavy tech exposure and corporate governance reforms respectively. Emerging Markets and the UK both lagged after weaker Chinese and UK growth prospects hurt both regions.

Asset class returns (%)



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