PAPAMARKOU WELLNER PERKIN

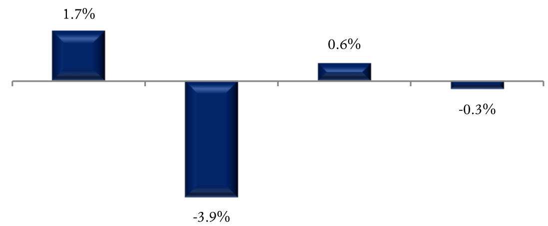
January - February 2024 Issue # 249

Markets

Following an exuberant end to 2023, January ushered more moderate results for investors. Strong economic data increased conviction of a "soft economic landing." However, it also led the US Federal Reserve to strike a less dovish tone, indicating that a March interest rate cut is unlikely. For equity investors, the S&P 500 index started the year strongly, ascending +1.7% in January, reaching record highs. Large capitalization growth stocks returned +2.1%, again outperforming their value counterparts which delivered +0.3%. Shares of smaller capitalization companies in the Russell 2000 index underperformed, declining -3.9%. Overseas stocks produced positive returns in January, amid a wide range. The MSCI EAFE index added a modest +0.6%, while the European Stoxx 600 (+1.5%) and Japan's Nikkei 225 (+8.4%) led the way higher. To the downside, Shanghai equities declined -6.3%, despite newly announced stimulus from the People's Bank of China (PBOC).

Fixed income markets reversed some of last year's gains, as markets digested stronger than expected economic data, which led to a pushing-out and reduction in the number of rate cuts expected in 2024. Futures markets ended January handicapping a 35% chance of a March Fed Funds rate cut. As a result, the Barclays US Aggregate index declined -0.3% during the month.

Commodities rose +4.5% in January, with the energy complex powering higher. Tensions in the Middle East escalated, disrupting certain regional shipping lanes and reducing traffic through the Suez Canal, while Russian energy infrastructure was targeted by Ukrainian drone attacks. As a result, crude oil rebounded from a three-month decline, with the WTI benchmark rising +5.9%. Conversely, non-energy commodity prices eased -0.7%. The US Dollar also broke a three month losing streak, with the DXY index advancing +2.3%.



Source: Bloomberg Markets

With regard to digital assets, 2024 began with the much anticipated SEC approval of a spot Bitcoin ETF (exchange-traded fund) which saw nearly $1.5 billion in initial net inflows, driving the cryptocurrency higher by +0.4% in January. This is an important milestone in the institutionalization of the asset class. The spotlight next turns to Ethereum, the second largest digital asset, whose proposed ETF is slated for approval in the spring.

Geopolitics

In 2024, an estimated 76 countries are scheduled to hold elections, representing over 50% of the global population. Most notably, India in April, the EU Parliament in June, the US in November and the UK and Israel around year-end. This increases the potential for geopolitical volatility as election campaigns will take precedence over policy implementation and political attention will turn inward. Ongoing conflicts include US-China strategic competition involving Taiwan, technological advances, as well as trade. The latter may be exacerbated if China leans on exports to drive economic growth, driving down prices and putting pressure on higher cost producers. The Middle East is also edging toward regional conflict as Iran and its proxies in Syria, Iraq, Lebanon (Hezbollah), Yemen (Houthis) and the Palestinian Territories (Hamas) are pitted against Israel, the US, and their European allies. This dynamic has implications for continued oil and gas price volatility as well as potential disruption of critical trade routes through the Suez Canal and Persian Gulf. The Russia-Ukraine conflict also continues to pose a significant geopolitical risk. It has initiated a humanitarian crisis and given rise to greater risk exposures in capital flows, trade and commodity markets worldwide. With neither side seemingly able to produce a conclusive victory in the near term, and a ceasefire or settlement looking improbable, the war persists, increasing the risk of escalation.

United States

US GDP grew at an above average annualized rate of 3.3% in Q4 2023, leading to full-year figure of 3.1%. Meanwhile, annual inflation (as measured by the consumer price index) ticked up to 3.4% from 3.1%. Labor market data remained strong with non-farm payrolls showing 353,000 jobs added in January and the unemployment rate remaining steady at 3.7%. The ISM manufacturing (PMI) moved higher to 49.1% from 47.1% in December (approaching the expansionary level of 50).

The Fed held a policy-setting meeting at the end of the month where interest rates were kept on hold, as expected, at 5.25-5.50%. Comments from Fed chair Jerome Powell indicated that based on the strength of the economy and labor markets as well as the still elevated level of inflation, investors should temper their expectations for rate cuts. Futures markets are handicapping that an initial rate cut will be announced post the May 1 FOMC meeting.

Europe

The eurozone economy registered zero GDP growth in Q4 2023. This followed a -0.1% contraction in Q3, resulting in an annual GDP growth for the single currency bloc of 0.5% in 2023. The German economy was the main drag on output, shrinking -0.3% in Q4.

Inflation in the region has been volatile of late, as seen by the December CPI which was confirmed at 2.9%, up from 2.4% in November. However, the rate of increase eased once again in January with the initial estimate coming in at 2.8%.

The composite purchasing managers' index (PMI) rose

January 2024 Economic Statistics

	Jan-24	Dec-22	Dec-21
Federal Funds Target Rate	*5.25 - 5.50%*	*4.25 - 4.50%*	0 - 0.25%
Consumer Confidence Index	*114.8*	*108.3*	115.8
Manufacturing PMI Index	*49.1%*	*48.4%*	58.7%
Unemployment Rate	*3.7%*	*3.5%*	3.9%
JPY/USD	*146.88*	*131.11*	115.08
USD/EUR	*1.0816*	*1.0702*	1.1368
Gold/oz.	*$2,037.19*	*$1,824.40*	$1,828.39
Oil (WTI)/bbl	*$75.85*	*$80.26*	$75.21

Sources: see disclosure *

0.3% to a preliminary 47.9% in January, its highest level since July, but still in contractionary territory. Concurrently, the manufacturing specific measure resoundingly beat expectations, rising 2.2% to 46.6%, reaffirming that activity in the sector bottomed out in the third quarter.

Taking all this data into account, the European Central Bank (ECB) kept rates on hold at its January meeting and re-iterated its commitment to remain data-dependent. Rate cuts, expected later in the year, were affirmed by ECB president Christine Lagarde who commented that "the disinflation process is at work."

The UK saw signs of accelerating growth, with the composite PMI increasing 0.8% to 52.9%, and consumer confidence hitting a two-year high in January. This optimism was tempered by the latest retail sales print, which fell by a sharp 3.2% sequentially, sparking some concerns of a slowdown. Similar to the EU, UK inflation is on a decelerating path but ticked up to 4.0% in December. Meanwhile, wage growth was revealed to have slowed in the three months through November. In an effort to jump-start the economy, Chancellor of the Exchequer Jeremy Hunt hinted he would announce major tax cuts in the upcoming spring budget.

Asia

In China, the domestic economy continued to struggle, with disappointing retail sales and further deterioration in housing activity. Fourth quarter GDP grew 5.2% year-on-year, in line with expectations, but below historical trends. Although the PBOC announced a number of stimulus measures, they were less potent than markets were hoping for to re-ignite economic activity. As a result, investors remain concerned that the world's second largest economy could face a prolonged period of slow economic growth, as illustrated by factory output which contracted for the fourth consecutive month in January. The crisis in China's property market, once an engine of economic growth, also continued to deepen with Evergrande facing liquidation.

In Japan, the Tokyo Stock Exchange released a list of companies which have volunteered to take "action to implement management that is conscious of cost of capital and stock price." Market participants saw this as an important step in Japan's corporate governance reforms. It provides a clearer picture of the policy's development as well as further pressure on managements, given that the list will be updated every month. According to the TSE, circa 40% of listed companies have disclosed plans thus far.

Outlook

It has been a mixed start to the year for financial markets. Large capitalization US equities have performed well with hopes of impending rate cuts pushing the S&P 500 index to record highs, with valuations following. Conversely, small-cap companies remain in the doldrums given their weaker balance sheets and economic sensitivity. Overseas stock markets have been lagging. Notably, China is in the midst of an economic hangover, after years of mal-investment in manufacturing and infrastructure, which has resulted in sub-standard economic growth. The central planners have been hesitant to artificially stimulate via fiscal and monetary policy. This introduces the potential risk that the country's low cost manufacturers increase production and open the export spigots, to increase profits via volumes. This would have a significant global deflationary effect. These cross-currents, along with soured relations with the US have left Chinese equities trading at bargain-basement valuations. On the other hand, the shining star overseas has been Japan, whose stock market has rallied strongly over the past decade (+430%), on its way to exceeding its 1990 high (the Nikkei 225's boom/bust cycle between 1980 and 2003 is considered to be one of the greatest in global financial history). What is perhaps more relevant is that recent gains have come amid shareholder friendly actions that could unlock a fair amount of additional value after decades of poor management and inefficient capital allocation. The upshot for investors is that select international equity markets offer interesting opportunities at relatively low valuations.

From a macroeconomic perspective, the Fed has telegraphed it is awaiting soft-enough data to justify relaxing monetary policy, to the detriment of the Federal Government and other heavily indebted entities. Inflation has indeed come off (but remains elevated), but the economy is humming along and the job market is red-hot. While the timing of interest rate cuts has been pushed out, with a less than a one-in-four chance of a 25bps cut in March, futures markets are pricing 130bps lower overnight rates by the end of 2024. This leads us to believe that the most salient dilemma for investors is whether a strong economy trumps lower interest rates, or not?

Despite the current uncertainty regarding the direction of interest rates, credit markets remain compelling. If the resilience of the economy does fade, bonds will play the role of diversifier while producing robust income, with longer dated bonds poised to produce strong returns due to interest rate sensitivity. In the event of a 'soft landing' which is the consensus view of economists, investors stand to make solid total returns across the fixed income spectrum, with higher yielding bonds leading the way.

Alternative assets such as liquid hedge funds and commodities can also be employed to reduce correlation and maximize risk-adjusted portfolio returns. Natural resources and precious metals stand to benefit from cyclical tailwinds stemming from underinvestment and the potential for scarcity and supply shortages, amid geopolitical instability. Hedged strategies should also benefit as liquidity ceases to be the main driver of financial markets. For longer-term, growth-oriented, investors, we are seeing opportunities to invest in disruptive technologies in the healthcare, defense, edu-tech and cybersecurity sectors.

*Sources: Reuters, Bloomberg, Bureau of Labor Statistics, Conference Board, Federal Reserve, Institute for Supply Management, MSCI, Russell, Standard & Poor's, Financial Times and the Wall Street Journal.