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Mid Year

Global Market Outlook 2024

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INTERNATIONAL FUNDS

The inflation story is (almost) over - what's next?

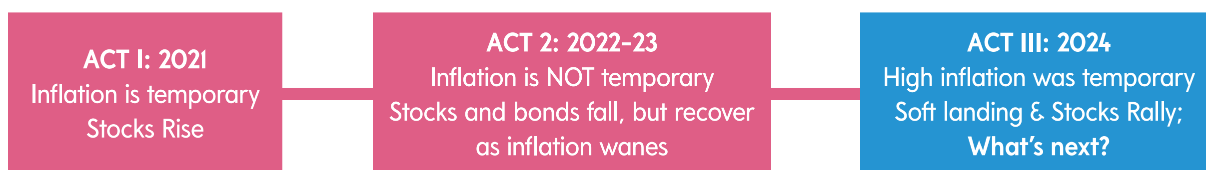
In our January Outlook, we said that 2024 would probably bring us the final act of the inflation story that has dominated global financial markets since 2020. Half year later, global inflation has indeed abated and, also as we expected, market forecasts of rate cuts have proved too optimistic because economies have stayed strong. So far this year, this has fuelled an equity rally and a weak start, life has begun to emerge in bond markets as central banks get ready to cut interest rates. (Figure 1).

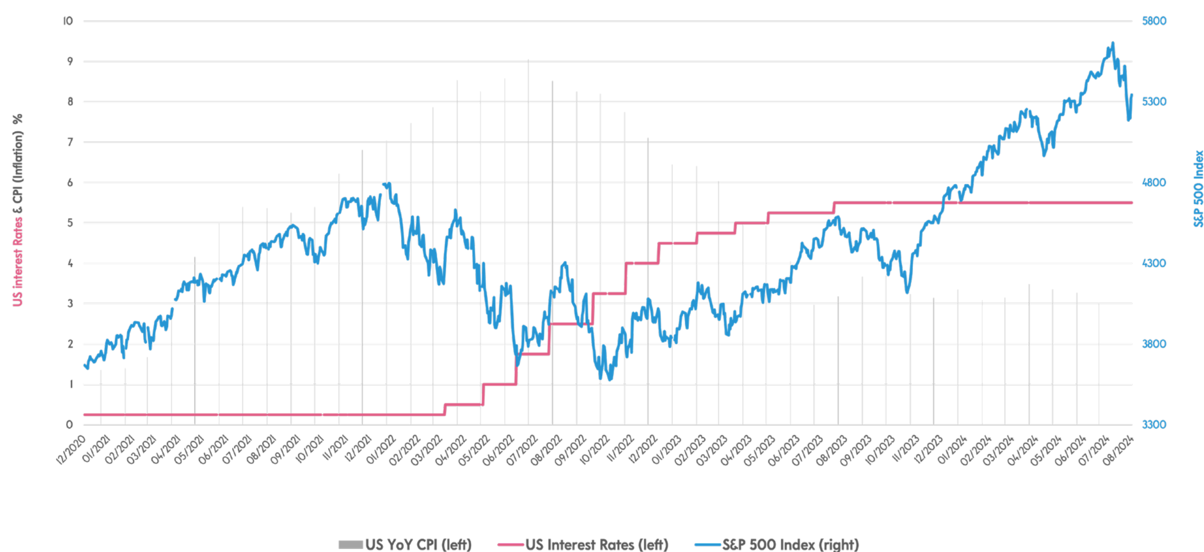
But now that the last act of the inflation story seems to have finally closed - how will markets react, and with what investment consequences?

Overall we think the direction of the global economy and markets will largely come down to 3 main factors - or the 3 P's as we call them - Prices, Profits, and Politics.

We believe that lower prices and a less inflationary backdrop, coupled with a lower interest rate environment, are supportive of more stable growth - and ultimately, positive financial asset returns. Less inflation volatility will allow central banks to cut interest rates and in turn this will let the underlying forces of change growth develop at a steady pace, shaping financial markets and offering investors both opportunity and risk. Here are the four forces of change, or themes, that we believe will determine equity and bond markets in the months ahead:

Figure 1





Source: Bloomberg, August 2024

Four themes for 2024-2025

1) Lower interest rates:

Inflation is near central bank targets, but still somewhat above them. This has led many countries, including Britain and the US, to delay their first rate cut in years, disappointing bond investors. This "higher-for-longer" narrative has significant consequences in major asset classes:

Equities: Growth companies, or those in an earlier stage, tend to have more debt as they need funds to invest in human and capital resources; this makes them more sensitive to higher interest rates than so-called Value businesses, or those that trade at a cheaper price because they are more mature, already grown, so their pace is usually slower. Less need to raise funds makes them more resilient when rates rise or stay high. However, investors should beware that this does not always apply. Some infrastructure-intensive Energy Transition firms, for instance, have suffered from this so far this year, even if not all firms in the industry have high levels of debt.

Bonds: With the currently high levels of yield and peak rates hopefully behind, the bond market offers good perspectives over the next few months - following a bumpy first half: Bonds with longer maturities have suffered so far this year, as this longer time-to-maturity makes bonds more sensitive to yield movements. We have a preference for longer-dated bonds due to our expectation for rate cuts. However, in order to diversify one's portfolio, investors might consider other areas of the bond market, including:

Liquidity Funds: Short-term bonds currently offer attractive yields and substantial liquidity, as they tend to have maturities of less than one year.

Emerging Markets (EM): First to hike interest rates during the Covid pandemic, some EMs such as Mexico and Brazil have already started to cut them. Improved transparency, governance, and the ongoing closing gap with developed markets makes this asset class compelling, especially given the high level of yields available.

High Yield (HY): This higher-risk part of Fixed Income markets drives most of its returns from the income generated by coupons, rather than price gains (or losses) derived from interest rate moves. This happens as bond maturities tend to be between 2 or 3 years, well below the 5, 10 or 20 years of some sovereign bonds. Often in High Yield the income generated is such that it more than offsets the price loss from defaults, ultimately generating a strong return for investors over the long term. HY, or non-Investment Grade (IG), companies tend to pay higher coupons to compensate investors for the higher risk taken.

Real Estate: Many retail investors in countries with less financial market experience tend to accumulate their wealth in bricks and mortar - in Spain, for instance, 75% of families' wealth is in real estate, leaving only 25% in financial assets. Apart from substantial concentration risk, such exposure might be challenging at present, given the potential for higher interest rates. A diversified portfolio would help such investors mitigate risk.

2) Improved Global Growth:

Despite the rate-rising cycle of 2023, global growth forecasts remain robust: according to the World Bank, the global economy will keep its 2023 growth rate of 2.6% this year, improving to 2.7% in 2025 and by the same amount in 2026. This is positive news especially for equity investors, as ultimately equity returns are highly correlated to economic growth over the long term. Let's now look in more detail where exactly investors could capture such growth.

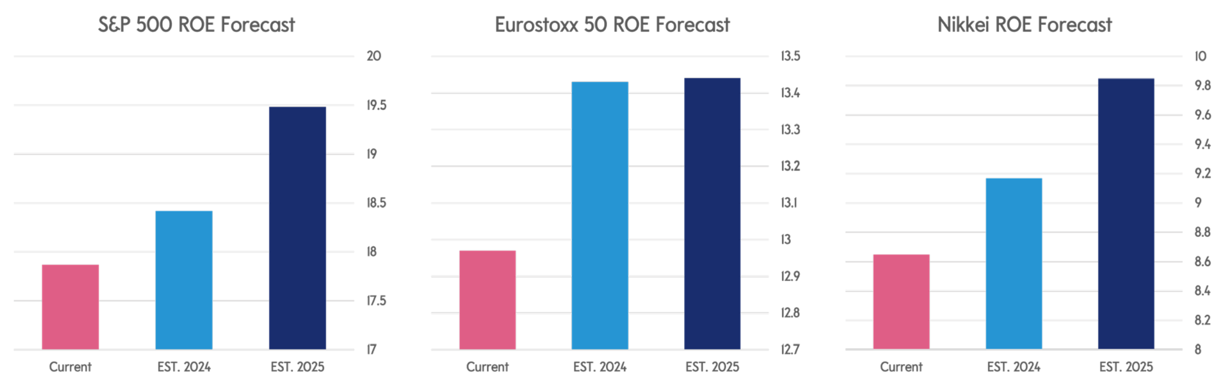
Countries: Emerging Markets (EMs) are expected to lead global growth, expanding by 4.0% this year, well above the expected 1.5% rate for Advanced Economies. Within EMs, India tops the list, with an estimated growth rate of 6.6%, closely followed by China's 4.8% forecast. At MIFL, we believe the two countries present attractive opportunities to investors, especially in the Equity space, given their significant investments in technology (China) and Infrastructure (India).

Both countries, of course, contain significant risks: China's heavily directed economy has not always been investor-friendly, while India's April & May elections left president Modi with the need to form a coalition government in order to stay in power, potentially diminishing his ability to implement reforms. Although these are indeed significant challenges, both countries continue be the home of interesting, market-leading companies with strong growth potential ahead.

Within Developed Markets, economists highlight the fact that "ailing" Europe is earlier in the economic cycle than the US, which has enjoyed strong growth over the past year and might be beginning to show signs of tiredness - the country recently posted weak housing and retail sales data. While only expected to grow by 0.7% this year (vs 2.5% in the US), Europe is forecast to expand by 1.4% next year, according to the World Bank, bringing its pace closer to the US', which is expected to slow down to 1.8% in 2025.

Stock markets: Some investors are worried that valuations are still high, even after the recent sell-off, and that growth prospects are challenged. They have a point: the world reference Standard & Poor's Index trades at 22 times earnings, above its long-term average of 17.4 times, while the Technology-heavy Nasdaq trades above 25 times. While this may bring vertigo to some investors, those valuations also reflect an expected strong earnings outlook, as well as increasing Return on Equity ('ROE') rates, as seen in Figure 2. For sure we expect a more volatile period for equities in the second half of the year, as investors digest the prospect for growth, inflation and lower interest rates, but if Central Banks can engineer a 'soft landing' then it sets investors up for better opportunities in the years ahead.

Figure 2: Return on Equity forecasts: Do they justify present valuations?



Source: Bloomberg August 2024

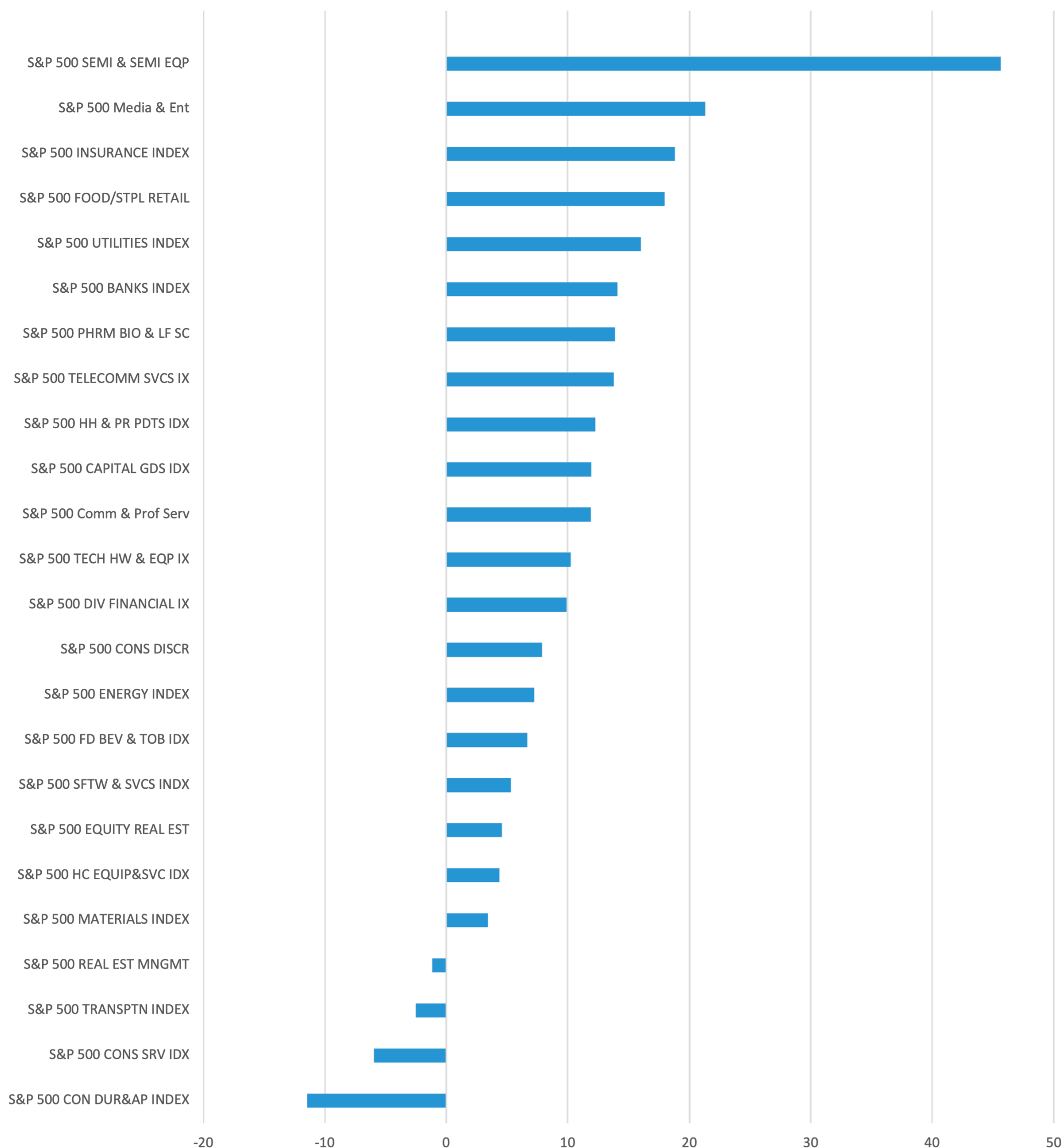
As ever, active management will be crucial to separate the wheat from the chaff, selecting those companies or industries in which growth prospects and valuations are in synch.

Sectors: After hefty first-half gains, many doubt whether the Tech sector will be able to keep pace. Figure 3 shows the great dispersion in returns within the S&P 500, with the Semiconductor industry taking most gains.

This has led to increased concentration: The top 5 sectors, by weight, in the S&P 500 are Technology-related, representing over 30% of the index. This is something never seen before and a reason to diversify exposure if one aims to reduce risk. Adding Value and Quality factors to a Growth-oriented portfolio would give exposure to securities that may do well in case of a Tech sell-off, while international exposure to countries in a different part of the economic cycle may also help create a more balanced portfolio.

Figure 3: Return on Equity Forecasts: Do they justify present valuations?

S&P 500 Sector Returns YTD to August 2024



Source: Bloomberg as August 2024

Forward looking estimates may not come to pass. Future performance is not guaranteed and may fluctuate in accordance with market conditions. Markets could develop differently in the future.

3) The sustainability transition:

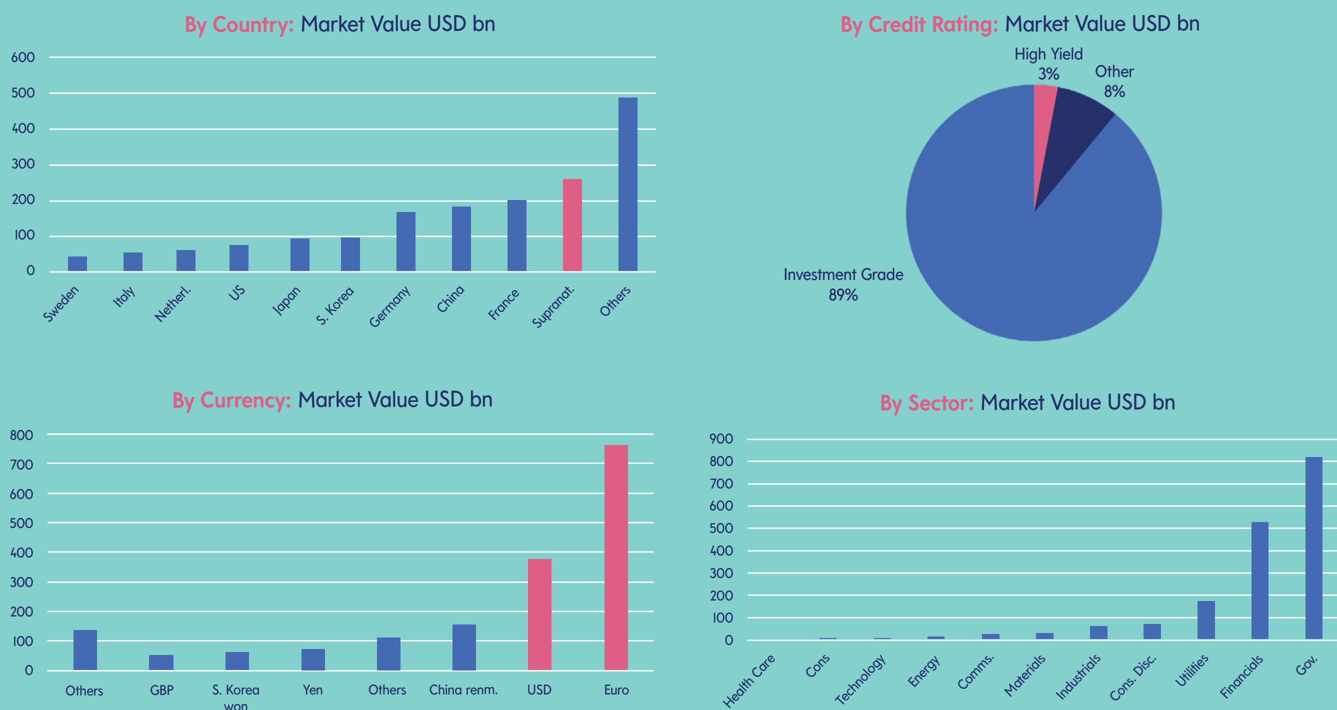
Draughts, ghast winds, wild fires, unexpected storms and heat waves remind us every day about the pernicious effects of climate change. Governments and companies are investing billions of euros, dollars and yen to create and build solutions that make the world economy more sustainable, now and in the future. The EU Commission, for instance has committed to mobilise 200-300bln euros per annum as part of its Green Deal. In the US, The Inflation Reduction Act will yield cumulative global economic benefits from reduced greenhouse gas pollution of over $5 trillion from the present to 2050. For those investors either willing to benefit from these investment flows, or willing to contribute to a greener future because of their personal values, at MIFL we identify the following areas of opportunity:

Green Building: Real Estate accounts for about 36% of global CO2 emissions, a figure that governments are requiring companies to reduce. In Britain, for example, homes will not be able to be rented unless they have a minimum sustainable rating, while in Europe, the European Union just passed its Energy Performance of Buildings Directive (EPBD), part of a cohort of net zero regulations. This will force many real estate owners to improve their buildings - unless they want to see their value drop or their properties become obsolete assets.

Autos: The race to produce more and cheaper electric vehicles continues to test the commercial relations between the US, Europe, and China, as the three regions aim to absorb rocketing demand. Apart from car-makers, companies trying to lengthen electric battery life, improve the connectivity of a moving vehicle, among many other fields, also offer opportunity.

Bonds: Issuance of Green debt securities has increased over the past few years, as companies and governments need to finance their projects - for example, the building of solar panel parks, cycling networks, recycling facilities, monitoring technology etc. The Green bond market is largely European-based, and mostly includes Investment Grade-rated companies in traditionally defensive sectors such as Financials and Utilities. Figure 4 shows this market at a glance - an ample universe that gives investors plenty of choice.

Figure 4: Global Sustainable Bond Issuance: European and Quality Focus



Source: Bloomberg as of February 2024

4) Politics Matters

We knew that this year was going to be politically influenced, with as many as 40 countries scheduled to vote in 2024, representing 41% of the world's population.

As expected, the votes have brought surprises in Mexico (where Claudia Sheinbaum won an unexpected landslide majority) and in India (where Modi didn't). We expect the uncertainty to continue, and even increase as we approach the US election in November: a Trump victory may lead to a lower US dollar, which he has advocated for, and increased trade tariffs, which would most likely have inflationary consequences. Pressure on traditional institutions, such as the Federal Reserve, might follow suit. Alternatively if Kamala Harris wins a shift back to renewable energy and other more democrat-friendly parts of the market could benefit.

Conclusion

The next few months may well be more volatile than the first half of the year. At MIFL, we believe that the mixture of conflict, the US late-cycle economy, high valuations, and expected political uncertainty ahead warrant a balanced approach. Whilst economic growth and corporate profitability appear in relative good health, investors are always advised to build their portfolios from a strong core and solid centre, adding risk depending on their personal investment goals and circumstances. Whatever volatility the next six months may bring, it has been proven many times that investors largely benefit from staying in the market, and taking a longer-term view.

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