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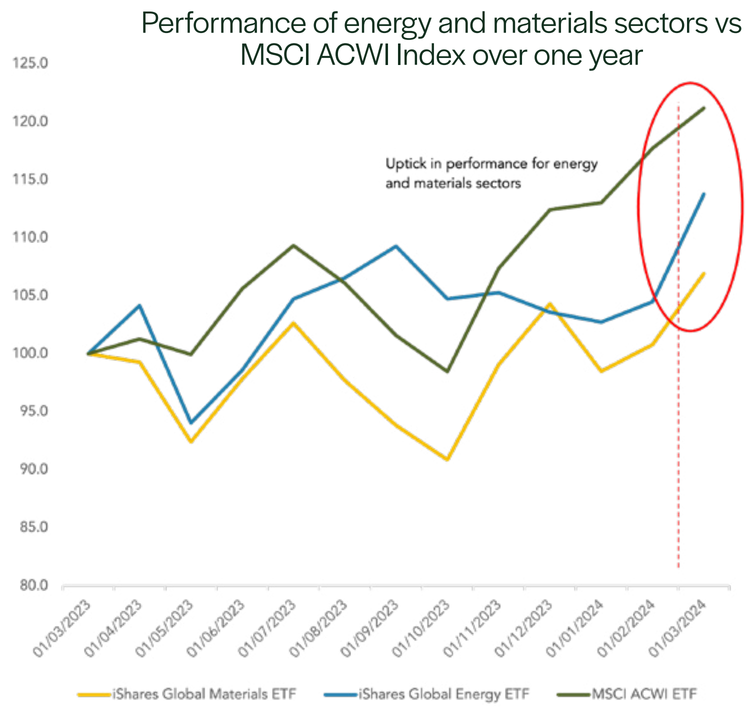
Quarterly Market Commentary

For clients of Atomos Investments Ltd April 2024

What moved markets over the quarter?

One of the standout themes in financial markets between January and March was the first evidence of an equity market rotation. By this we mean different sectors may be finally starting to lead overall market performance after a long run of strong returns from US tech names.

The energy and materials sectors were the best performing of the MSCI World equity sectors in March, returning 8.8% and 5.9% respectively.



Returns in USD. Source: Bloomberg
The MSCI ACWI is a stock index which captures large and mid cap representation across 23 developed market and 24 emerging market countries. Past performance is not a reliable indicator of future returns.

On a geographical basis, March also showed better relative performance from non-US stocks, including those in Europe.

Could this signal a departure from the seemingly unbreakable winning streak we've seen from US technology stocks over many months, notably the 'Magnificent Seven'?

Between January and March, communication services and information technology continued to perform strongly, with Microsoft, Apple, Nvidia, Meta, and Alphabet doing well, although Apple lagged over the quarter. We will be watching with interest to see whether other market sectors can finally overtake these tech leaders in the second quarter and beyond.

Inflation pressures subside

Elsewhere, inflation was still an important story and global central banks continued to make headlines with their interest rate decisions. We are seeing more economic differences between countries emerge as the unifying inflation pressure we've seen over the past year or so subsides.

For example, as many developed market economies including the US hold rates steady or even signal rate cuts later this year, Japan has recently raised its policy rate from -0.1% to 0.1%, marking the end of its negative interest rate policy.

In January, the Federal Reserve announced it would maintain the policy rate in the range of 5.25% to 5.50%. This decision marked the fourth meeting in a row that it had opted to keep interest rates steady. The Federal Reserve System is the central banking system in the US, responsible for setting interest rates and regulating financial markets.

Over the quarter, US inflation slowed and markets reacted positively to stronger-than-expected GDP growth, decreasing the probability of an economic recession.

The US primary presidential election results on 'Super Tuesday' at the beginning of March were as expected, with big wins for both President Biden and former President Trump. It's almost certain they will be the Democratic and Republican candidates for the US election in November this year.

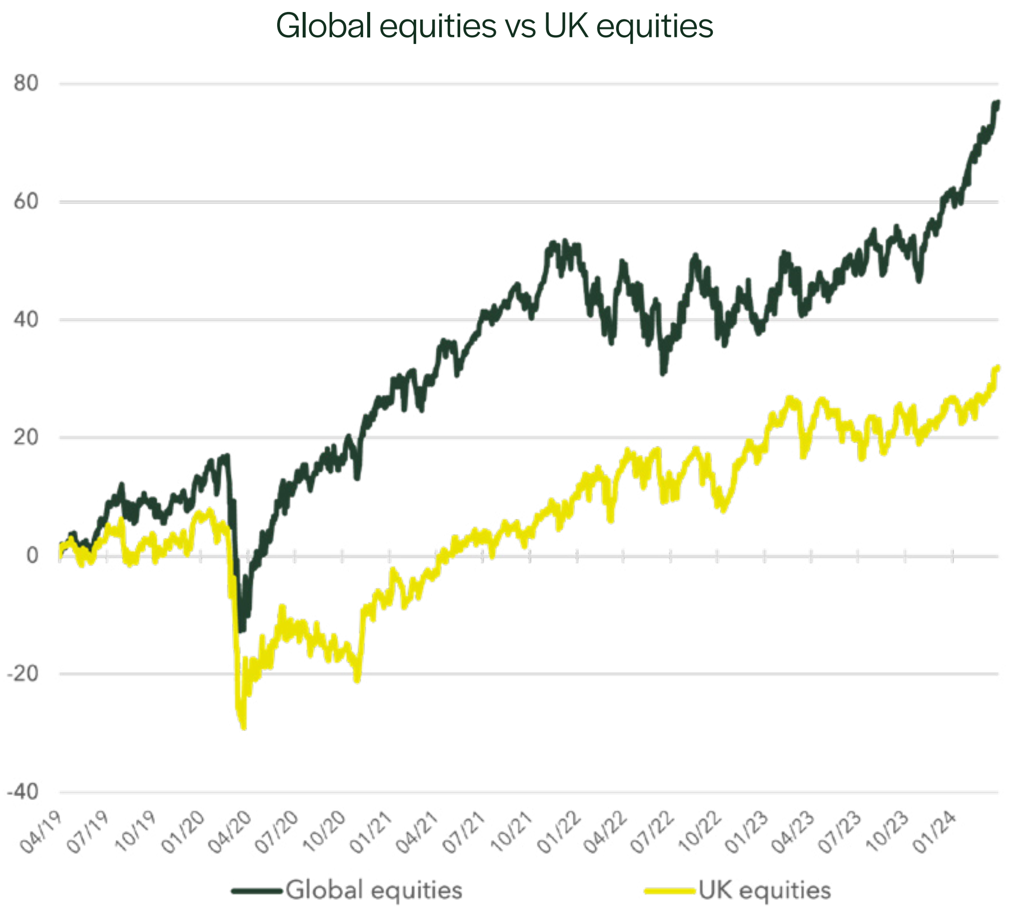
In the UK, 12-month Consumer Prices Index (CPI) inflation continued to fall over the quarter, from 4% in January to 3.4% towards the end of Q1. The Bank of England's Monetary Policy Committee voted to hold the base rate of interest at 5.25% in its March meeting. Does falling inflation in the UK signal the end of the cost of living crisis?

Also in March, Chancellor Jeremy Hunt delivered his Spring Budget with a theme of long-term growth. The key policy announced was a 2% cut to National Insurance Contributions. Most policies were flagged in advance of the Budget announcement so there was little market reaction.

How different assets performed in Q1

Global equities had a strong first quarter, with performance driven largely by US stocks after a robust reporting season for companies and resilient economic data.

In contrast, UK stocks lagged in Q1 as fourth-quarter GDP tipped the UK into a technical recession in February (defined as two quarters of negative economic growth in a row). However, the news that CPI inflation is still falling helped boost returns from UK stocks during March.



Source: MSCI
Past performance is not a reliable indicator of future returns. Global equities are represented by MSCI ACWI Gross Return, while UK equities are represented by MSCI UK Gross Return. All returns are in GBP. Performance is from 01.04.2019 to 31.03.2024.

Emerging market stocks from developing economies such as China, India and Brazil delivered a mixed performance over the quarter. At the start of the year, trouble in the Chinese property sector dragged down returns, but industrial production data from China came in stronger than expected and state intervention in the stock market supported an emerging market equity rally towards the end of the quarter.

Japanese stocks performed well in Q1, with the Nikkei 225 Index (the stock market index for the Tokyo Stock Exchange) reaching a new all-time high after 35 years after currency depreciation boosted exports. The Bank of Japan also raised interest rates from -0.1% to 0.1%, marking the end of its negative interest rate policy.

Investment grade bonds are a type of corporate bond which are considered the highest quality because the issuing company is creditworthy and unlikely to default on repaying bondholders.

Investment grade bonds fared marginally better as credit spreads continued to tighten as investors pinned their hopes on an economic soft landing. The 'spread' is the difference in yield between two debt instruments, such as an investment grade (high quality) corporate bond and a government bond, which often widens in a negative economic environment.

Global high yield corporate bonds outperformed lower quality bonds as spreads tightened, with the eurozone being a notable outperformer on the back of robust growth.

Real estate investment trusts (REITs) and listed infrastructure struggled over the quarter as persistent high interest rates continue to hurt property valuations, particularly in the commercial sector.

How did this affect portfolios?

Being globally diversified helped our overall performance in Q1. Our lower exposure to UK stocks compared to other wealth managers, combined with strong returns from global and emerging markets, was positive for the equity portion of our portfolios.

Global government bonds produced negative returns as stronger-than-expected inflation figures and robust economic growth in the US decreased the number of expected rate cuts this year. In the UK, strong wages acted as a similar driver for negative returns.

We currently have more in US bonds than our benchmark, and this was a slight drag on performance because yields on these bonds increased more than those from other developed countries (bond yields and bond prices have an inverse relationship so, when yields go up, prices go down). In January, we halved our overweight to US treasury bonds to crystallise and reinvest some of the profits we made from this position in Q4, which helped to offset the worse performance in Q1.

Our view on the major asset classes

Equities

Developed market (such as the UK, US, and eurozone) equities have bounced back on expectations of a 'soft landing' in 2024. This is a situation where central bank moves to cut inflation cause economic growth to slow down, while avoiding recession. Equities look attractive in an environment of falling inflation, which we expect to see this year. Company earnings estimates are rising and are at the higher end of our expectations for the next one to two years. In the US, company valuations are pointing to exceptional growth over the next five years, reflecting strong earnings since the global financial crisis in 2007-2009. We still see moderately better value from Japanese equities for the next couple of years.

Bonds

In the short term, we expect to see slightly higher credit losses than investment grade bonds are currently pricing in. We are cautious on speculative grade bonds (meaning bonds issued by companies of lower credit quality) where we see some risks, while current bond pricing only seems to suggest an average level of defaults.

Turning to government bonds, we expect to see volatility from here as central banks adjust their interest rate policies in line with falling inflation. UK government bonds look more attractively priced given the significant interest rate rises seen last year, as well as a weaker growth outlook. Overall, we think higher quality corporate bonds will deliver better returns than equivalent government bonds over the medium term.

Real assets

Listed real assets such as property and infrastructure have rebounded strongly over the first quarter, outperforming wider equity markets, but this followed a tough year for performance. Real estate investment trusts in particular have struggled, impacted by problems in the US banking sector.

Overall

We construct our portfolios without a particular focus on an any one type of investment style such as 'value' or 'growth' stocks. We're maintaining a 'neutral' view on equities over the next five years, but we are more cautious in the shorter term.

How we view portfolio composition moving forward

We have reduced our exposure to some types of US government bond we had been using as a defensive element in portfolios. We took profits in some of the global equity positions we held that had done well over the last year and reinvested these gains in other areas such as UK equities to bring us more closely into line with our peer group. We are still positive on the prospects for Japanese equities and are happy with our positioning here.

Looking forward, we believe that maintaining a diversified portfolio that uses risk protection and active management remains the best way to navigate uncertain times and maximise the chance of investment success.

Haig Bathgate
Head of Investments

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