

QUARTERLY INVESTMENT REVIEW

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Markets rose during the third quarter as most Central Banks started to ease policy by cutting interest rates, causing the yield on the US 10-year bond to fall from 4.40% to 3.78%. Stock markets moved up in tandem with the rate cuts, but this masked significant gyrations in early August. The combination of falling US interest rates and rising Japanese rates caused the yen to rise dramatically, and the Japanese market crashed 22% in three days. The VIX index, which measures volatility, reached its third highest ever reading. Most of these moves occurred within a few hours on the 5th and 6th August in thin trading, and the recovery was equally abrupt. By the end of the month the Japanese index had recovered everything when measured in dollars. However, the size of the moves indicates the potential vulnerability of markets even with relatively minor disruptions.

The rise in Japanese interest rates marks the end of the last source of free money in global markets. Since 2008 global Central Banks have kept interest rates close to zero and provided plentiful liquidity. The inflationary burst in 2022/23 brought this to an end and led most banks to raise interest rates and rein in liquidity, except in Japan. Japan was more reluctant to normalise its policy because it has spent the last thirty years escaping from a debt and deflationary bust caused by one of the largest property and stock market bubbles in history that peaked in 1989. It cut interest rates to zero in 1997, and from 2013 adopted an aggressive printing policy. As a result, Japanese money was pressured into seeking returns elsewhere, and Japanese liquidity has flooded world markets. These flows have supported asset prices but may start to retreat. Meanwhile the summer saw other developments. There were increasing signs that the US economy was less strong than previously thought with a record revision of US jobs numbers, and China's economy has continued to disappoint. There were also signs that the dominance of the massive technology companies may be starting to wane. These three areas have been the major supports to the bull market in the last decade, so if they are deteriorating it will have significant implications for investors.

Some slowing in the US economy should not be a surprise. The US Federal Reserve raised interest rates by 5.25% between early 2022 and mid-2023. The lagged effects of this tightening are weighing on the economy now. The dollar has been strong, which has weakened exports. Now the labour market is cooling and income slowing which signals a slower economy. However, there are still powerful supports to growth. The wealth effects from the boom in housing and stock market shores up consumption. Immigration remains supportive, and the AI revolution can boost productivity. The Fed also has plenty of room to cut interest rates after the steep hikes of a couple of years ago. However, one problem for the Fed is that the impact of interest rates is harder to judge these days because the size of private equity and debt markets in the economy has expanded so much (some estimates put this at 50% of GDP). Changes in interest rates effect the private markets much more slowly and randomly than the banking system. Taking all these influences together suggests that the US economy is slowing but not heading into an immediate recession. In recent years when the US slows world growth has been bolstered by China, but China too is struggling. While exports from China have been strong the property market remains mired in the doldrums. Property prices have fallen 30% from the

peak, and with households holding two thirds of their wealth in property this has depressed animal spirits. It is the first time that Chinese households have experienced a substantial property decline, and it has caused an extreme loss of confidence which has led them to hold their savings in low yielding deposits, thereby weakening consumption. Until China underpins its property market the economy is unlikely to recover meaningfully, despite short term boosts. The European economies also remain sluggish, and the closer to Ukraine and the auto industry the worse the sentiment, epitomised by Volkswagen's succession of profit warnings.

The background to world markets remains the unprecedented debt that has built up in Western economies. The US's government's debt has risen from \$17 trillion to \$35 trillion in two Administrations and is adding \$2 trillion a year even in a growing economy. In a recession that fiscal shortfall could reach \$4-5 trillion a year. The cost of servicing this debt is \$1 trillion which is greater than the US's military budget, which itself is greater than the combined military budgets of the next ten countries. It's hard to see what will stop this debt growing. Indeed, on current trajectories it's hard to see the debt profile improving in the next ten years. Neither Presidential candidate is advocating any attempt to reduce it. It was striking that during the Presidential debate the candidates spent more time discussing whether immigrants eat pets than the fiscal deficit. The situation in Europe and Japan is just as bad. France, for example, has more Sovereign debt than the whole of Africa. Astonishingly French 5-year bonds pay a higher interest rate than Greek 5-year bonds. With €3 trillion of Sovereign debt and a fiscal deficit approaching 6%, if France doesn't act soon it appears to be heading towards a slow-motion Liz Truss situation. The fundamental problem is that governments globally have lost the political will to deliver austerity. The electorate doesn't want to hear about cuts to spending. Instead, they want more spending after the years of austerity. The runaway debt will only be disciplined by a crisis in the bond or the currency markets. This is one of the major reasons that gold is performing so well as it performs its role as the ultimate safe haven.

This backdrop means the risk in the equity market is more from the public sector than the private sector. This is an unsettling situation for investors given that so much investment valuation work is modelled on the principle that Government debt is the safest asset. The dire state of many governments' finances questions the foundation on which these assumptions are made. The most vulnerable stocks are those that trade on high Price:Earnings ratings. Among these types of companies that have disappointed and had heavy falls this year are Nike, Burberry, Budweiser, and Shiseido. The Rolex and Fine Wine indexes are down 30% though this is probably more a reflection of China woes. Investors also have to factor in the implications of the upcoming US election. For once the two candidates are offering starkly different policies so the outcome will matter. Trump is running on a low tax and high tariffs platform, while Harris is proposing higher taxes and more regulation. With the race so close and depending on a few tens of thousands of voters in key states there could be some dramatic moves as results come through. There is also the possibility that the result is contested as occurred in the last election in 2020. From that point of view probably the worst outcome would be Trump losing the election

by a whisker. Historically the best outcome in a US election has been when neither Party achieves a clean sweep, and power is divided between the Presidency and Congress.

For the past few years markets have been dominated by a few mega cap stocks such as Microsoft and Nvidia, but the market is broadening out this year. US and European banks and industrials have performed well. Areas are prospering that have been ignored for years such as infrastructure, particularly those parts that relate to the renewal of the grid which is necessary to help meet Net zero targets. The austerity of the last decade and a half has fallen heavily on budgets in areas such as transport, prisons, and power stations, and substantial investment in these has become urgent. If the US wants to remain pre-eminent it must reindustrialise. For example, you cannot be a military superpower with only 3% of world steel production. Rebuilding the basic infrastructure which has suffered decades of neglect is a powerful theme, and the valuations of stocks in these sectors are not stretched, having been neglected for years. Japan also offers opportunity as evidence builds of a complete transformation of companies' attitudes to shareholders. An active takeover market is developing, including a \$37bn foreign takeover attempt announced in August of the convenience store chain Seven & I. Japan is the market where private equity sees the best opportunities, and this theme can last for the next decade. Emerging markets also offer good value, though sentiment in them would be greatly helped by China stabilising its property market.

Gold has been strong. It has been an unusual bull market for gold, taking place despite a strong dollar and rising interest rates. The main driver behind gold seems to be diversification away from the dollar, and other major currencies, all of which look vulnerable. Gold has a three-thousand-year history of protection against the destruction of currencies. Further support is provided by China running a trade surplus of \$80 billion, and with the country's struggles gold is an attractive asset to the Chinese. But the principal buyers are Central Banks. Since 2008 gold as a percentage of international reserves has risen from 11% to 18% overtaking the euro with 16%. The bulk of this buying is coming from Asia. Gold's strength also reflects the loss of confidence in the major currencies. Since 2008 currencies have tended to trade based on their interest rate differentials, and with inflation low everywhere these have been small. This could start to change if countries start to target different priorities. For example, the Fed in the US is de-emphasising inflation in favour of jobs and growth, and a weaker dollar would assist this. The team around Trump have hinted that they would welcome policies that would devalue the dollar. As a result, diverging policies could lead to larger moves in currencies. Such turbulence should also support the gold price.

Economies are slowing as markets enter the final quarter with equities and bonds sending conflicting signals. The market leaders in equities are priced for a feather soft landing while bonds are pricing something much worse. In the short term there are good reasons that markets remain well supported. The US, China and the ECB are all cutting interest rates. China has just announced another stimulus package to support its economy. The

oil price has fallen which acts as a giant tax cut across the world, and corporate earnings remain robust. The long-term debt situation is concerning, but immediate news always determines the market in the short term. If the rate cuts, cheaper energy and stimulus revive the economy then the beneficiaries of that would be areas like Emerging Markets, energy and cyclicals. Most investors have little allocated to these sectors so they could have strong moves.

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