

Monthly Market Review

Review of markets over February 2024

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Breaking records

In brief

- We anticipate that the combination of a soft landing for the U.S. economy and pre-emptive rate cuts by the Federal Reserve will bode well for both global equities and fixed income investments.
- Early adopters of AI and companies from sectors such as health care or financial services that can generate consistent earnings growth could lead the market's performance.
- We believe that government bonds have the potential to deliver healthy returns for the remainder of the year. The prospects of future rate cuts by the Federal Reserve should bring rates down and generate additional returns through duration.

Usain Bolt, the world record holder for the men's 100-meter sprint with a time of 9.58 seconds, has reached a performance that many scientists argue is very close to the pinnacle of human biomechanics. However, with advancements in sports science, training methods, nutrition and injury prevention, there is a possibility of surpassing this seemingly impossible record in the future. Nonetheless, achieving such a feat would be extremely challenging, and it may take a considerable amount of time before it can be accomplished.

On the other hand, the realm of stock markets operates differently. Theoretically, economic growth leading to higher profits should propel stock indices to reach record highs over time, with no inherent limit as long as companies continue to expand their earnings. Some markets, like the United States regularly experience this phenomenon, while it may take decades for others to achieve such milestones. In February, both the S&P 500 in the U.S. and the Stoxx 600 in Europe broke their all-time highs. Japan's Nikkei 225 also accomplished this feat for the first time since 1989. This impressive achievement is noteworthy, considering the high interest rate environment and recent disappointing growth data from Europe and Japan.

Stocks in the Spotlight

During the first two months of the year, global equities outperformed fixed income investments. Investors finally recognized that the Federal Reserve had no immediate plans to cut interest rates, thanks to robust job growth and persistent inflation. Consequently, the 10-year U.S. Treasury yield rose by 30 basis points in February as investors' expectations of rate cuts aligned with the Fed's more conservative forecasts. This led to government bonds and investment-grade corporate debt underperforming high-yield corporate bonds.

In the realm of equities, the expectation of consistent earnings performance propelled developed market indices to new highs. In the United States, the performance of the "Magnificent Seven" stocks diverged. Artificial intelligence (AI) developers and graphic card manufacturers continued to receive strong support, while the electric vehicle industry faced heightened competition, margin compression and weaker demand in the United States. On the other hand, selected financial institutions and health care companies enjoyed increased investor interest, contributing to the overall index gains. In Japan, ongoing corporate governance reforms fueled investor enthusiasm, while growth sectors such as technology, consumer discretionary and health care witnessed positive earnings revisions.

We anticipate that the combination of a soft landing for the U.S. economy and pre-emptive rate cuts by the Federal Reserve will bode well for both global equities and fixed income investments. While certain mega-cap tech companies in the United States may require time to consolidate, early adopters of AI and companies from sectors such as health care or financial services that can generate consistent earnings growth could lead the market's performance.

Apart from Japan, Asian markets also experienced a positive February. The MSCI Asia ex-Japan index rose by 6% during the month, with China, Hong Kong, South Korea and Taiwan leading the way. South Korea and Taiwan benefited from strong export performances and growing expectations for demand for electronic components in the ongoing AI boom. In January, Taiwan, South Korea and Singapore all posted double-digit export growth.

In the case of China and Hong Kong, investors took advantage of bargain opportunities presented by cyclical low valuations, along with ongoing policy stimulus such as the five-year loan prime rate cuts and increased financing for selected property projects in China. Additionally, there was an acceleration of northbound flow into onshore Chinese markets from Hong Kong via Stock Connect in February. However, for this trend to translate into a long-term strategic allocation, investors will likely keep an eye out for stabilization in the real estate market and improvements in business confidence. The upcoming National People's Congress may provide further insights into policy biases in the months ahead.

The role of fixed income

Despite the underperformance of fixed income since the beginning of the year, we believe that government bonds have the potential to deliver healthy returns for the remainder of the year. Risk-free rates are high, with the 10-year U.S. Treasury yield at 4.3%, surpassing prevailing inflation rates in the United States. The prospects of future rate cuts by the Federal Reserve should bring rates down and generate additional returns through duration. Moreover, government bonds provide protection against potential downside risks to growth or stresses in the financial system. Recent losses incurred by New York Community Bancorp and several international financial institutions due to commercial real estate serve as a reminder that high interest rates can still impact the real estate sector and put pressure on the balance sheets of individual banks, although regulators are expected to mitigate systemic risks.

Investment implications

We maintain our view that a soft landing for the U.S. economy and pre-emptive rate cuts by the Federal Reserve later in the year will have a positive impact on both fixed income and equities. This provides favorable conditions for diversified portfolios to outperform cash. In addition to U.S. equities, we anticipate stronger earnings momentum supporting Asian exporters, particularly in northeast Asia and Japan. In an environment where concerns about weaker growth or geopolitical volatility arise, government bonds and investment-grade corporate debt will play a crucial role in generating income and offering capital gain opportunities during a potential recessionary period.

Global economy:

- Economic data continued to show resilience. The U.S. labor market remained robust, with the January unemployment rate staying at 3.7% and average hourly earnings picking up to 4.5% year-over-year (y/y). The U.S. economy also added 353k jobs in January. U.S. headline consumer price index (CPI) moderated to 3.1% y/y, but came in slightly above expectations, dialing back market expectations of the number of rate cuts in 2024. The U.S. composite Purchasing Managers' Index (PMI) suggested activity expanded over February. In Europe, there was an unexpected rise in eurozone composite PMI in February to 48.9. (GTMA P. 24, 25, 27, 30, 32)
- Japan's 4Q23 gross domestic product print surprised to the downside, contracting 0.1% quarter-over-quarter, although inflation continued to be sticky, with national CPI rising 2.2% y/y, above expectations. Consumption and manufacturing weakened, but the services side of the economy remains strong. (GTMA P. 14)
- In terms of central bank activity, the Federal Reserve left rates unchanged in February, leaving its benchmark federal funds rate in a range between 5.25% and 5.50%. The Federal Reserve shifted its interest rate outlook, providing flexibility to lower rates, but indicated that the Federal Reserve likely wouldn't be ready to cut rates in March. (GTMA P. 31)

Equities:

- Equities rallied across the board in February. Chinese equities fared well, with the CSI 300 index returning 9.1% (U.S. dollar net total return) during the month. Korean and Japanese equities also returned strongly, with MSCI Korea returning 7.4%, while Nikkei 225 returned 5.5%. In the United States, the S&P 500 returned 4.8%, while the technology stock heavy NASDAQ returned 6.2%. In Europe, Euro Stoxx index returned 2.9%. From a sector perspective, consumer discretionary, information technology and industrials sector outperformed, returning 7.8%, 6.2% and 5.8%, respectively (based on MSCI AC World sector indices). Underperforming sectors included materials and consumer staples, returning 1.6% and 0.6%, respectively, in February. The utilities sector declined 0.5% during the month. (GTMA P. 33, 41)
- Earnings season continued, with five of the "Magnificent Seven" U.S. stocks reporting results for the previous quarter. These companies broadly met or exceeded expectations, contributing to a 5.3% gain in the S&P 500 over the month. With over 90% of S&P 500 firms having reported, nearly three-quarters have beaten analysts' earnings forecasts. (GTMA P. 35, 37, 49)

Fixed income:

- U.S. 10-year Treasury bond yields continued to climb upwards after January, rising 17 basis points (bps) in February. Yields of German bunds and UK gilts also rose 17 bps and 31 bps, respectively. In Asia, yields fell generally, with China's 10-year government bonds leading the decline, falling 14 bps as the People's Bank of China continued to ease monetary policy. (GTMA P. 55)
- In the United States, the 2-year Treasury bond yield rose by 32 bps as markets dialed back on dovish expectations of the Federal Reserve's rate cuts. The U.S. 2-10 spread was only -0.19 on January 25 but has since widened to end February at -0.37.
- Turning to credit, yields to worst rose, with that of the Global Aggregate rising 14 bps, mainly driven by the rise in benchmark yields, as spreads across investment-grade and high-yield bonds remained stable. In terms of total returns, developed market bonds retreated slightly, led by U.S. investment grade returning -1%. Emerging markets (EM) was the bright spot, with yields for EM local currency debt falling by 18 bps, putting total returns at 9.8%. (GTMA P. 50)

Other assets:

- The U.S. dollar held its ground, rising 0.5% as measured by the DXY index, putting year-to-date gains at 2.8%. The Japanese yen fell by 1.3% off the back of softer economic data and softening expectations of the Bank of Japan hawkishness, putting year-to-date return at -5.8%. (GTMA P. 66, 67)
- Gold rose 1.3% in February, with strong momentum toward the end of the month, and continues to be supported by a deterioration in global risk sentiment and softer U.S. economic data. Going forward, the Federal Reserve's pivot and the impact on the U.S. dollar and real rates will be a key factor to watch on the trajectory of gold prices. Oil prices rose 1.3% in February as well, from supply concerns of the Organization of the Petroleum Exporting Countries cuts as well as winter storms in North America. The ongoing geopolitical tensions continue to act as a growing risk. Natural gas prices fell dramatically by 11.7% in February due to the unusually warm winter and soaring U.S. output. Adjusted for inflation, current prices are at one of the lowest levels since its futures started trading in 1990. (GTMA P. 68, 70)

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