

Monthly Market Review

Review of markets over June 2024

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Voters driving market volatility

In brief

- June elections in Europe, India and South Africa caused market volatility due to political surprises, but investor calm was restored in India and South Africa after coalition governments were formed.
- Political uncertainties cause market volatility, but stability returns post-elections. Investors are focused on fiscal discipline and trade policies, with diversification as a hedge against uncertainties.
- Developed market central banks have started their rate cuts, albeit very slowly and unwilling to commit to a set path given sticky inflation.

June was a busy month for politics around the world. South Africa, India and Mexico all announced their key election results. The European parliamentary elections saw a surge in popularity of far-right parties, which triggered the French parliamentary elections. All these events have caused some market volatility amid surprises and political uncertainties. In some cases, such as India and South Africa, investor calm was restored. These events could serve as useful precedents for the U.S. elections in November.

India roaring ahead despite BJP losing its majority

Prime Minister Modi and his Bharatiya Janata Party (BJP) lost their majority in India's lower house of parliament in the latest elections and needed to form a coalition with their political partners. This initially raised concerns over policy continuity in building infrastructure and developing the country's manufacturing sector. However, these concerns were addressed as PM Modi was able to retain his top ministers in key positions, including the finance minister, home minister and external affairs minister. As a result, MSCI India was up another 3.8% after the election-induced volatility.

South Africa also saw its ruling African National Congress (ANC) party lose its absolute majority for the first time since the end of apartheid. It was forced to form a coalition, with some ministerial posts allocated to business-friendly opposition politicians. The potential improvement in the business environment and fiscal discipline was welcomed by the market, as reflected by the rebound in the stock market.

A further shift to the right in Europe

The 2024 European parliamentary elections saw far-right parties gaining significant ground, especially in Austria, France, Germany, Italy and the Netherlands. However, it is worth noting that these far-right parties are far from a homogenous group and have significant variations in the policies they advocate. Also, it is important to realize that few, if any, of these far-right parties are looking to push their countries to leave the European Union or the euro area.

The results from the European parliamentary elections prompted French President Macron to call a snap parliamentary election. The first round of elections saw the Rassemblement National (RN) far-right party leading the race with 34% of the votes, followed by the left and far-left coalition. The second round of elections is scheduled to take place on July 7, and at the time of writing, it is still too early to call who will win. A key concern for the market is the new parliament's fiscal policy intentions. More spending and fewer taxes to boost growth seem to be the preference, which could raise questions about the fiscal sustainability of France. This could be a snapshot of the policy bias of other European political parties in the medium term.

The race to the White House

Each country's political and economic background is clearly different, but it is still worth trying to link back to these experiences and extrapolate how the U.S. presidential and congressional elections would impact markets. We see three takeaways that are relevant for Asian investors.

First, investors clearly do not like political uncertainties, which was a source of market volatility. We note the same pattern in the U.S. with higher volatility before the elections, but volatility quickly calmed after the results were announced, regardless of which party candidate won. This was the case for both India and South Africa. The key is the continuity of a supportive environment for businesses and economic development.

Second, investors would be focusing on the future government's fiscal discipline. One of investors' concerns over populist governments gaining power in Europe is whether politicians will placate voters' demands for more spending and fewer taxes, without a realistic way to fund such deficits in the long run. Many would recall the turmoil in the UK government bond market in September 2022, when the government proposed tax cuts without a credible way to rein in the deficit in the long run. In the U.S., there is limited room to cut health care and Social Security spending. Former President Trump suggests that he would make the 2017 tax cut permanent, which would make the long-term fiscal picture even more challenging.

Overall, the difference between the two candidates on the fiscal outlook is small. The key would be the outcome of the congressional race. If the next president's party also wins both the House and the Senate, then the risk of a wider fiscal deficit and a more rapid buildup of fiscal debt could be a bigger risk. For example, Trump could extend the 2017 tax cuts. This could imply a higher risk premium in U.S. government bonds in the long run, not only because of the high supply of bonds but also the possibility of higher inflation from greater fiscal stimulus.

Finally, all elections naturally aim at domestic voters. The perceived damage from international trade could also be a factor to consider. President Biden raised or imposed new tariffs on Chinese exports of electric vehicles, batteries and medical equipment, citing unfair trade practices and national security concerns. Former President Trump threatened to impose a 60% tariff on all Chinese exports to the U.S. and a 10% tariff on all imports. As we discussed in our mid-year outlook, the best way to hedge against such uncertainties would be through diversification. Companies may seek to mitigate their supply chain risk by investing in up-and-coming manufacturing hubs, such as India, Mexico or Southeast Asia.

Central banks' commitment issue

The European Central Bank has started its rate cut cycle, even though it is not willing to commit to a set path given the volatility of inflation. For the U.S. Federal Reserve (Fed), its latest forecast of the policy rate showed that the members of the Federal Open Market Committee (FOMC) are on average expecting only one rate cut in 2024 and four cuts in 2025. While a September cut is still possible, it would need a series of soft inflation data in the coming 2-3 months. In addition to the Fed policy outlook, the bond market could also be worried about future bond supply from the next government as mentioned above. This would imply investors may opt to remain short duration in the near term.

Global economy:

- In the U.S., inflation data came in softer than expected, with the May headline consumer price index flat compared to April and core inflation up 0.2%, below market consensus. The personal consumption expenditures deflator showed a similar trend, supporting the Fed's view to start cutting rates before the end of the year. Retail sales and housing data indicate that high rates are cooling the economy. The Fed's latest forecast shows most FOMC members expect 1-2 rate cuts this year, extending into 2025. The European Central Bank has also started cutting rates but is not committing to a set path. (GTMA P. 22, 28, 32)
- Politics and elections captured market attention in June. Ruling parties in India and South Africa lost their parliamentary majorities and formed coalitions. European parliamentary elections saw far-right parties gaining ground, especially in Germany, France and Austria. While these parties no longer advocate leaving the euro area, their populist policies could increase fiscal deficits, raising concerns for the bond market. (GTMA P. 27)

Equities:

- Global equity markets had mixed performance in June. The U.S. market continued to rise, led by tech companies, with the NASDAQ up 6% and the S&P 500 up 3.5%. A potential risk is a squeeze on profit margins, especially in the consumer sector, as U.S. consumers become more price-sensitive after years of high inflation, limiting retailers' ability to raise prices. (GTMA P. 34, 50)
- Europe was weighed down by the rise of populist far-right parties and potential changes to the business and economic environment, with the Stoxx 600 Index down 1.3% in June. (GTMA P. 54)
- Asian tech exporters outperformed, with MSCI Taiwan and MSCI Korea up 9.2% and 5.3%, respectively, outperforming MSCI Asia ex-Japan's 1.2% return. The ongoing recovery in Asian exports and expectations of artificial intelligence (AI) driving hardware demand should support earnings and market outlook. China's performance was disappointing due to a lack of fresh stimulus and cautious consumer sentiment, with MSCI China down 4.3% for the month. (GTMA P. 34, 40)

Fixed income:

- Softer economic and inflation data in the U.S. have nudged U.S. Treasury (UST) yields lower, despite the Fed's revised forecasts for fewer rate cuts this year. The 10-year UST yield dropped from 4.45% to 4.2% in mid-June, and the 2-year yield fell from 4.9% to 4.75%. However, concerns about U.S. fiscal sustainability, especially with Trump leading the presidential race and the potential extension of the 2017 tax cut, are reflected in the long end of the yield curve. (GTMA P. 56, 60)
- In Europe, the shifting political landscape, particularly in France, is raising concerns about high fiscal deficits and rising government debt. The yield spread between French government bonds and German bunds widened as the far-right RN gained considerable voter support. (GTMA P. 60)
- Corporate credit spreads remained largely steady in June, with U.S. high yield spreads staying between 350-370 basis points. Given that spreads are already trading at the bottom of the multi-year range, returns for corporate credits are expected to come mainly from yields rather than capital appreciation. (GTMA P. 56, 59)

Other assets:

- The U.S. dollar index rose from 104.15 to 105.70, boosted by the Fed's reluctance to cut rates. The Japanese yen fell 3.3% against the U.S. dollar, pressured by the Bank of Japan's cautious approach to monetary policy normalization amid weak economic performance. (GTMA P. 70)
- Brent crude prices rose 10% in June, from USD 77 per barrel to USD 86 per barrel, driven by steady global economic growth, ongoing OPEC supply cuts, a sharp drop in U.S. oil inventory and potential short-term supply disruptions from hurricanes. (GTMA P. 73)
- Gold prices moved sideways in June, as demand from central banks slowed following strong gains in the past year. The Fed's delayed rate cuts and easing inflation are also cooling demand for gold for now. (GTMA P. 72)

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