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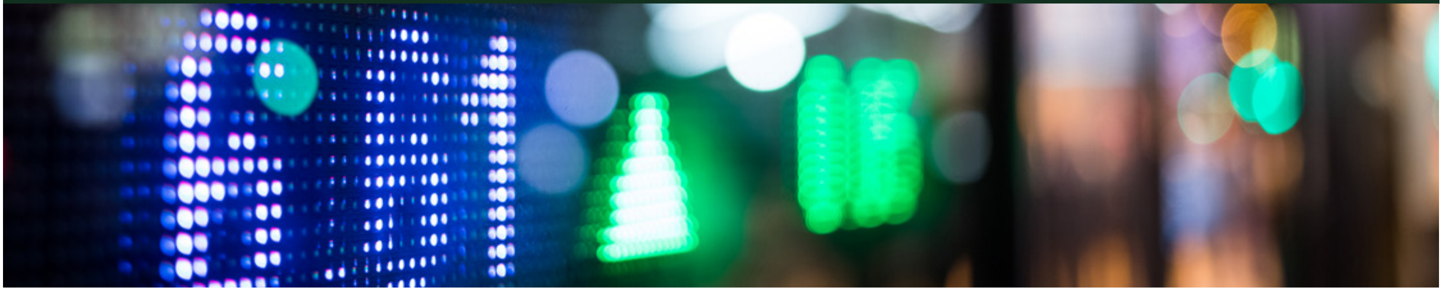
# Quarterly Market Commentary

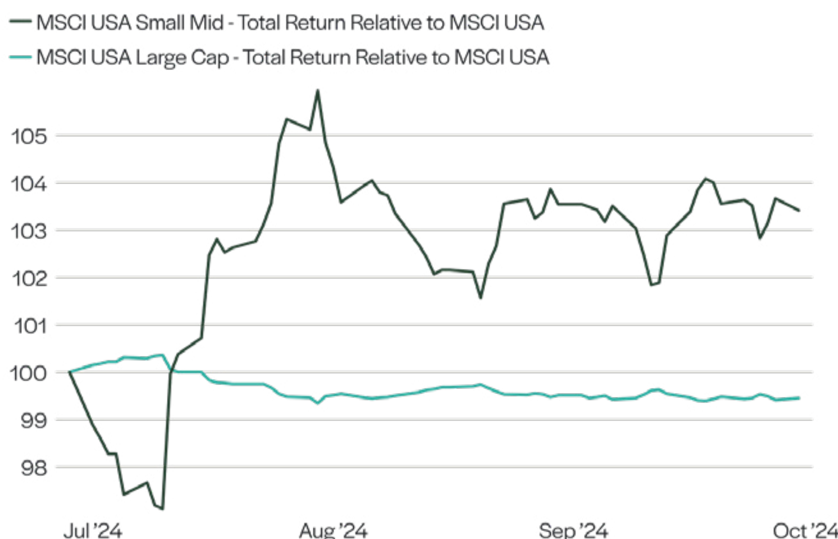
For clients of Atomos Investments Ltd — July to September 2024



## What moved markets over the quarter?

Global equities had a challenging third quarter in a reversal of the trends seen over 2024 so far. Enthusiasm around artificial intelligence (AI) stocks weakened as the equity markets saw a shift in investor demand away from these mega-cap tech stocks and towards smaller, more lowly-valued stocks. This was in addition to published weak economic data in August around a weaker US labour market and wider US economic activity, causing heightened volatility within the global stock market. This proved relatively short-lived, as more resilient corporate earnings data published by the end of August provided some reassurance.

**Small- and mid-sized companies began to outperform in Q3**




*Source: FactSet*

Within the UK, the Labour Party won a significant majority in the general election which took place on 4 July. This had a minimal impact on markets given a Labour win was widely expected, and helped fuel hopes for a sustained recovery in the domestic economy.

The Bank of England cut interest rates by 25 basis points to 5% in August, but held steady at the September meeting after headline inflation for August came in at 2.2%, marginally above the Bank's target inflation rate of 2%.

## US cuts rates and Biden steps back

Turning to the US, inflation showed signs of falling over the quarter. The CPI (Consumer Price Index) for the US released in July was 3.0%, down from 3.3% the previous month. This meant that the Federal Reserve (the Fed) held interest rates steady at 5.25%-5.5% at its July meeting. The Federal Reserve is responsible for setting interest rates in order to manage inflation and the health of the economy.

Later in the quarter, at the September meeting, the Fed cut its policy rate by 0.5% to a new range of 4.75%-5%, its first reduction since 2020, off the back of slowing inflation signs and weaker US economic data.

Although a substantial cut, this was largely already priced into markets just prior to the decision.

In July, President Biden withdrew from this year's presidential race following pressure to step down, endorsing Vice President Kamala Harris as the new Democratic nominee.

## Policy diverges in Asia

At the end of the quarter, Chinese authorities announced a range of coordinated stimulus measures to boost economic growth and ease pressures in the property market. This led to a strong rally in the Chinese equity market.

In Japan, the yen experienced significant appreciation over the quarter, in a reversal of the trend seen over Q2. This was in part due to the Bank of Japan increasing its policy interest rates on 31 July to 0.25%, resulting in a shift of capital away from the US and towards Japan.

## How did this affect portfolios?

Global equities had a difficult quarter as some of the shine came off AI stocks. Meanwhile, weaker-than-expected economic data from the US around jobs and payroll created heightened volatility within the stock market at the beginning of August. US stocks rebounded slightly following the Fed's rate cut, finishing Q3 with marginally positive performance.

UK equities performed well over the quarter, outpacing returns from global equities. Our relative underweight to UK equities versus the peer universe detracted slightly from relative performance of the portfolios over Q3.

For most of the quarter, emerging markets struggled as weakness in the Chinese real estate sector continued to weigh on investment sentiment. However, emerging market equities rallied strongly at the end of Q3 on the back of Chinese stimulus. This meant EM equities finished the quarter by outperforming both UK and global markets.

The performance of Japanese equities was largely dictated by the significant movements in the yen. The yen appreciated strongly over July and August (where one yen now buys you more pounds or more US dollars than it did before). This helped to offset the negative equity performance with a sharp sell-off in August due to tech stock weakness. Overall, Japanese equities delivered fairly flat performance over the quarter. Our dynamic overweight to Japanese equities detracted from relative performance versus the peer universe as Japanese equities underperformed the wider equity market.

Government bonds in both the US and UK performed strongly in Q3. Our dynamic overweight to long-dated US bonds contributed to positive relative performance versus peers. Investment grade credit had a largely muted performance over Q3, with the spread (the difference in yield between an investment grade bond and a government bond of a similar maturity) largely staying the same.
Our investments in high yield and emerging market debt contributed to portfolio performance.

Both listed infrastructure and real estate investment trusts (REITs) performed strongly over the quarter, outperforming global equity markets as bond yields fell due to their interest rate sensitivity (where these assets tend to perform well when yields fall).

# Our view on the major asset classes

## Equities

Equity markets were volatile in early August, due to softer US inflation and labour data which increased concerns over a slowdown in US economic growth. However, more positive market data later in August eased investor concerns resulting in the initial equity fall reversing to end the month positive.

US valuations continue to reflect expectations of good earnings growth over the next five years, reflecting earnings outperformance since the global financial crisis.

Over the medium term, we continue to expect moderately better value from Japanese markets despite the falls in early August.

## Bonds

### Corporate bonds

Global investment-grade spreads are pricing in a below-average allowance for the level of credit losses over the medium term. High-quality credit is likely to provide moderate returns above equivalent government bonds.

We have a cautious outlook for developed market high-yield bonds given shorter-term risks.

### Government bonds

Central banks are focusing on the data. In the US, policymakers seem confident of inflation returning to target by the end of next year.

Rates in Japan have been increased from negative territory. Pressure is mounting for further tightening due to a combination of strong domestic inflation dynamics and currency weakness.

In the UK, we expect growth weakness to lead to lower longer-term rates compared to current market pricing. In Japan, we expect a gradual tightening to continue.

We expect interest rate volatility to fall, with the pricing of 10-year bonds neutral from a medium-term perspective.

## Real assets

Listed real assets have been acutely sensitive to changes in interest rates over the past two years. Both REITs and listed infrastructure indices outperformed wider equity markets as US bond yields pulled back in July.

Within REITs, sector performance has been positive over the past year. Data centre REITs have capitalised on the AI and digitalisation trends, while healthcare REITs have benefited from strong senior housing demand.

## Overall

Overall, we believe our strategy to remain well diversified across a range of asset classes helped our relative performance over the quarter.

## How do we view portfolio composition moving forward?

We are still positive on the prospects for Japanese equities as we think they will be supported by improving corporate governance standards and relatively lower inflation compared to other developed markets.

We removed our overweight position in long duration assets (duration is how long it takes for a bondholder to receive interest and principal payments, and is a measure of the interest rate sensitivity of bonds).

This is because we saw a fall in interest rates over August and were able to lock in some gains. We retain a strategic holding in long-dated assets which should do well if interest rates fall further from here.

We maintain the view that holding an allocation to assets whose returns are not directly linked to traditional equity and bond markets can help generate better returns and lessen the impact of falling markets on your portfolio value.

**Haig Bathgate**
Head of Investments

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