RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

As another year passes, most investors should be able to look back on having made reasonable gains in their portfolios, although at times they have been hard won and often made in defiance of a "doom and gloom" narrative about the state of the world. It has certainly paid off to ignore the "noise" and to focus on the "signals".

We approached 2024 with a degree of cautious optimism and it's fair to say that overall returns have outstripped our expectations, especially when we look at the performance of US equities. That, in turn, leads us to ask whether some of those returns have been borrowed from the future. The rather frustrating answer is "maybe", although we certainly have no desire to bet against further progress in 2025 and discuss this in more detail below.

2024 dawned to a chorus of speculation over the outcome of a number of elections scheduled to be held around the world which would involve more than half of the global population. Several of these were being defined as a test for democracy and there was also a fear that voters' support for more extreme candidates, reflecting a shift towards what might loosely be termed as "populism", could herald socio-economic disruption. Although there were a couple of market-related wobbles, notably in India, where Prime Minister Modi's BJP Party underperformed against expectations, the outcomes have been generally favourable for investors. One exception is France, where President Macron called a snap parliamentary election in the summer, the consequences of which are still rippling through the country.

The defining election of 2024 was the US Presidential election, which, again, threatened to bring chaos. However, whatever one's opinion about the result, the fact that it was decisive helped to clear the air and to underpin a phenomenon that has become known as "American exceptionalism". American companies dominate global equity indices and US equities have delivered the lion's share of returns to global investors. The UK wealth management industry has gradually embraced a more global approach to equity investment and this has enhanced returns, although there will always be a sense of frustration during such good times that the exposure was not even greater. Whilst the UK's FTSE 100 Index delivered a total return (including dividends) of 9.6% in 2024, the US's S&P 500 Index gained 25%.

Jim Bowen, the presenter of the TV show Bullseye (which somewhat implausibly combined darts with general knowledge), used to taunt less successful contestants at the end of the programme with the words "And this is what you could've won", and the same could apply to market participants. The more technology focused NASDAQ Composite Index was up 30%, while the Magnificent 7 group of leading technology shares (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) put on 67%. And if one had put all of one's eggs into the basket labelled Nvidia (the pre-eminent provider of processors to power the Artificial Intelligence revolution), one could almost have tripled one's money (+171%). But that is not how we assemble portfolios, and the risks have to be spread across different asset classes and securities. By the same token, one might have concluded at the beginning of the year that France's booming Luxury Goods industry combined with cheap financial stocks and the prospect of interest rate cuts from the European Central Bank would be a tonic for that country's stock market. Alas, the political turmoil and a downturn in demand from China's well-heeled consumers meant that the CAC40 Index's total return was exactly 0%. But, as the Telegraph's ever-reliable cartoonist, Matt, had one of his characters put it: "The worst thing about our government's blunders is that we can't properly enjoy France's problems!"

And talking of our government's blunders, October saw the new Labour government deliver its first Budget, which has won few friends in the business community. Neither has it gone down well with households. Warnings of the need to fill the alleged £22bn "black hole" in the country's finances bequeathed by the Conservatives had raised fears of tax increases, especially in relation to wealth and savings, which had reduced confidence. Perhaps because the Chancellor had anchored expectations to extremely negative outcomes, the relatively small rise in capital gains tax rates and the fact that pensions and ISAs were undisturbed provided some relief, although financial planners remain in high demand owing to changes to Inheritance Tax, in particular. But the real body blow was to businesses, especially to those in the retail, leisure and hospitality sectors. This was on account of an increase in the rate of private employers' National Insurance Contributions and, more importantly, a reduction in the threshold for contributions being made, with the latter factor bringing a lot more lower paid workers into the net.

Trade bodies representing these sectors have suggested that the extra cost will have to be absorbed through some combination of higher prices, reduced profits, lower wage increases or lower employment, none of which are helpful to the economy. Many companies have also indicated that they will cut back investment plans.

In the final section of the retrospective analysis, it is worth recalling the events of early August, when global stock markets fell sharply. The catalyst was a combination of weak US economic data (something of an aberration, as it turned out) and an unexpectedly aggressive tightening of monetary policy in Japan. This triggered a reversal of a phenomenon known as the "yen carry trade", in which investors borrow yen at very low interest rates to invest in higher returning assets in other currencies, ranging from more currency-based yield-enhancing strategies to leveraged bets on go-go growth shares. The biggest reversals were seen in trades involving the Mexican peso and US mega-cap technology companies, especially members of the Magnificent 7. This group collectively dropped by 18% during that period. The effect across markets was amplified by a rise in implied market volatility which forced certain investors to reduce their exposure to risk assets.

Why is it important to bring this up again? We have observed that financial markets are increasingly vulnerable to such episodes, where seemingly inconsequential catalysts can have outsized effects far beyond what one might describe as any shift in the "fundamentals". The key thing when they do happen is to evaluate whether they are the beginning of something much worse or a brief squall that will quickly blow out, as happened in August. But it's important that investors recognise that such events seem to be an integral feature of the wealth accumulation process and not a bug, so that they are prepared emotionally to ride them out.

With 2024 neatly wrapped, what is the outlook for 2025? Investment banks, as often seems to be the case, are generally herding towards a forecast of mid-to-high single digit returns for global equites and for bond investors to receive their yield and little else. As sensible as this sort of prediction might appear, it comes with the caveat that, for example, US equities have achieved a return in the 5-10% range only eight times in the last hundred years despite the long-term average being around 8%. We are very wary of setting price targets for equity indices owing to the fact that they are driven by a combination of earnings growth and valuation, with the latter made up of a discount rate comprising a risk-free rate (which is, at least, observable) and some sort of equity risk premium (which is a lot harder to pin down). The interaction of such variables can make for surprising results, as happened in 2024, when around half of the appreciation in the S&P 500 Index resulted from rising valuations, with much of that down to ebullient animal spirits. In fact, the latest reading of the Conference Board's survey which asks where individuals think the stock market will go over the next year was a record high of 56% of respondents saying "higher". It seems improbable that US equities can deliver a third consecutive year of returns higher than 20% with lower-than-average volatility. And despite their cheaper relative valuations, other markets will need to experience some sort of underlying cyclical recovery to lead global indices substantially higher.

Markets – US

A trending catchphrase of 2024 was "US Exceptionalism". The US had the strongest major economy, one of the best stock markets dominated by world-leading companies and the dollar gained around 6% on a trade-weighted basis. Global investors continue to increase their weightings to US equities whilst domestically there is a persistently strong bid from mechanical monthly savings allocations and around $1 trillion per annum of share buybacks. Corporate earnings are forecast to grow by more than 10% in 2025. The main sticking point with investors is valuation, with the forward Price/Earnings ratio sitting at a lofty 22x. While we can justify this to some degree thanks to the extremely profitable nature of the leading companies, we struggle to see it expanding further. It would also be vulnerable to any evidence of weaker growth or profitability. Even so, it remains difficult to bet against the US. Another imponderable is the effect of Donald Trump's second presidency. The initial response to his election victory was euphoric, but that wore off in December. His policies range from disruptive (for example on tariffs) to inconsistent (everything he promises suggests a stronger dollar but he wants it to be weaker). Unsettling missives from the White House are to be expected, although the threat of extremely disruptive legislation could be tempered by the fact that the Republicans have only the slimmest of majorities in the House of Representatives.

UK

UK GDP growth drifted lower in the second half of 2024 as consumers and businesses retreated into their shells, first in anticipation of Labour's first budget of the new parliament and then in reaction to it. The Bank of England is loath to cut interest rates faster owing to sticky services inflation, a factor that has helped to take 30-year Gilt yields above 5% and to levels not previously seen in this millennium. UK equities continue to look relatively cheap on a global basis, but with the enduring caveat that the FTSE 100 is not sufficiently well stocked with the sorts of companies that attract higher valuations in a sluggish growth environment. Interestingly, small cap shares ex-Investment Trusts (+13.8% total return) outperformed their large cap peers (+9.6%) and we continue to see this as an area of potential further outperformance, especially should the Bank of England rediscover its appetite for rate cuts. There is also the ongoing trickle of bid activity, which tends to result in hefty premiums being paid.

Europe

The two largest stock markets in the eurozone performed very differently in 2024, providing a reminder that the bloc is not a homogenous blob and also that market performance often bears limited relation to economic growth. Germany's DAX (+19%) was the winner thanks to strong performances from companies such as SAP (global technology), Rheinmetall (defence) and Deutsche Telekom (on account of its US business). France's CAC 40 returned exactly zero, even accounting for dividends. Its woes came on two fronts. The fraught political situation undermined domestic companies, especially banks, and poor demand from Chinese consumers weighed on the big Luxury Goods sector. Across Europe as a whole, the best performing sector was Financials, as improving banking profitability drew investors to shares that were still cheap on most valuation measures. Returns to investors outside the eurozone were diluted by the weakness of the single currency. Europe is firmly in the crosshairs of President Trump's tariff policy sights and the European Central Bank is more committed than most to continuing to cut interest rates. While we can continue to find good individual company plays in Europe, a broader rally will need a more durable economic recovery, which still looks somewhat elusive.

Emerging Markets

2024 was another forgettable year for EM investors, with the broad MSCI EM Index returning 8.3% in dollars. Local currency returns will have looked better because of dollar strength (JP Morgan's Emerging Market Currency Index declined by 10.5% over the year). As in Europe, there was a big gap between winners and losers. Chinese equities came back from the dead with a return of 20% thanks to the announcement of various stimulus measures in September. Even so, the best of the gains were not maintained and global investors remain sceptical about the willingness and ability of the government to follow through on its reflationary ambitions. But there is undoubtedly value there if they succeed. EM ex-China indices fared less well, gaining just 3.9%. The threat of tariffs on exports to the US is an outstanding concern, and despite having dealt well with inflation, it is difficult to cut interest rates when the US Federal Reserve is less inclined to and the dollar is so strong. Once again, it looks as though we will have to wait for a more aggressive US rate-cutting cycle to spark interest in EM. One notable outlier was Argentina, where new President Milei's policies have had some success and bolstered confidence. The local MERVAL Index rose 172% in 2024, and even 114% when measured in dollars. That's a rare vote of confidence in a politician, these days!

Fixed Income

It was another difficult year for government bonds as inflation failed to retreat at the desired speed to deliver as many interest rate cuts as expected. Furthermore, resilient US growth kept the longer end of its yield curve elevated, especially when combined with the prospect of a stimulative Trump presidency and the threat of tariffs that might raise price levels further. The net result was a negative total return of -1.6% in dollars for the Bloomberg Global Aggregate Bond Index (with the sterling hedged version managing a small gain of 3.1%). UK Gilts suffered a similar fate, but this background was more favourable for credit investors, and spreads continued to compress and remain close to the lows for this cycle. The good news about higher bond yields is that it allows bonds to play a better role as a counterbalance against equity risk in the event of economic weakness or market disorder, as we witnessed in August 2024. Also, in stand-alone terms, the yields are more attractive and the associated shortening of modified duration promises reduced volatility of total returns (now that income is a greater proportion of the prospective return), meaning higher potential risk-adjusted returns. Short-dated low coupon Gilts still offer a tax-efficient home for surplus cash.

All UK Gilts have delivered a total return of -3.1% over the last three months and -3.3% over the last year. Index-Linked Gilts returned -6.1% and -9% over the same respective periods. Emerging Market bonds produced a total return of +2.2% in sterling over the three months to end December (+14.6% over 12m). Global High Yield bonds delivered +0.8% (+8.1% over 12m) in sterling.

Conclusion and Outlook

As another year passes, there seems to be little celebration of the fact that typical balanced portfolios delivered decent returns and well above what would have been achieved by holding cash. The world feels unstable and bad news is amplified by (social) media; and yet good companies continue to be able to generate growth and to compound their returns. 2024 provided an object lesson in sticking to one’s guns when following an investment process and not being deflected by the “noise” that can sometimes be overwhelming. It is inevitable that we will hit more bumps in the road in future, but we must always bear in mind that market volatility is the price that we pay for superior long-term returns. It would have been very easy to have been scared out of one’s equity investments on several occasions in the last few years, and yet here we sit with global equities within a few percent of their all-time highs.

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