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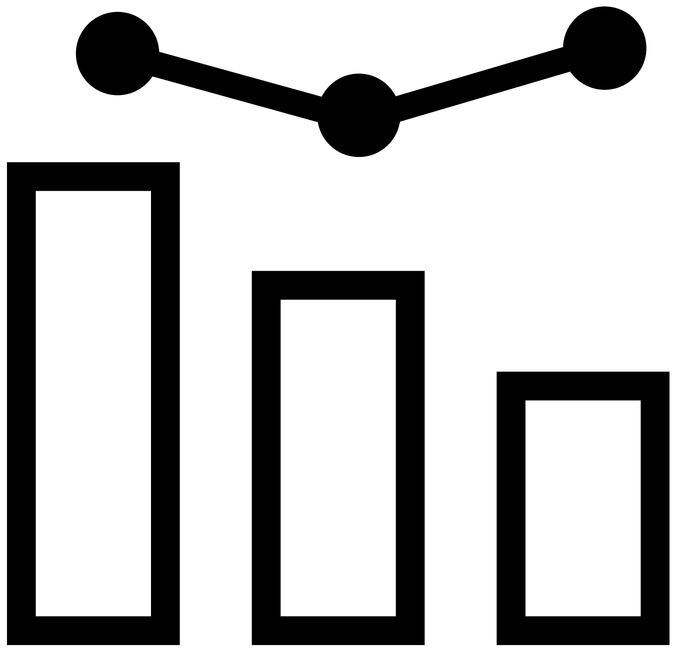


Market update

August 2024

July 2024: Anything but a normal quiet summer time

It's been anything but a normal quiet summer in the past month. We have had geopolitical events, surprising macro data, disappointing corporate earnings from the US, and even a policy rate hike by the Bank of Japan. But the month closed with positive returns for both equities and bonds.

US equities generated a relatively modest return of 0.3% in July, partly due to disappointing data from a number of large technology firms. Asian equities slightly outperformed, with a return of almost 1%. Emerging markets were the losers this month, with a negative return of almost 1%, partly due to disappointing growth in China. Government bonds outperformed equities with a yield of over 2%, helped by falling interest rates in July. Corporate bonds slightly underperformed government bonds, with a return of almost 2% for relatively safe corporate bonds and a return of just over 1% for the somewhat riskier corporate bonds. Listed real estate was the best performer this month with a return of over 3%, although this is the only asset class in negative territory over the year as a whole. US equities are still the best performing asset class over this period, with a return of almost 18%.

The returns on the various asset classes were as follows:

Rendementen (total return, in euro's)	July	Q3	2024	12 mths
Bloomberg Barclays Eurozone Staatsobligaties	2,3%	2,3%	0,3%	4,9%
Bloomberg Barclays Euro Bedrijfsobligaties	1,7%	1,7%	2,3%	7,1%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	1,2%	1,2%	4,1%	10,5%
FTSE/EPRA Europe Onroerend Goed	3,4%	3,4%	-1,9%	13,1%
MSCI Europe Aandelen	1,2%	1,2%	10,3%	12,8%
MSCI North America Aandelen	0,3%	0,3%	17,9%	22,9%
MSCI Asia Pacific Aandelen	0,9%	0,9%	12,1%	11,8%
MSCI World Developed Markets Aandelen	0,6%	0,6%	14,9%	18,4%
MSCI Emerging Markets Aandelen	-0,7%	-0,7%	9,9%	7,9%
EUR/USD	1,1%	1,1%	-1,9%	-1,6%

Source: Bloomberg

Economic growth is increasing

The eurozone economy grew by 0.6% year-on-year in the second quarter, based on Eurostat's initial estimate. This is slightly higher than the previous quarter (0.5%) and slightly higher than forecast by economists polled by Bloomberg (0.5%). The growth is however not broad-based. Spain and Portugal were relatively strong, with year-on-year growth of 2.9% and 1.5% respectively. Germany, the eurozone's largest economy, has however contracted by 0.1% year-on-year. On the positive side, consumer confidence is increasing in the eurozone. This has been rising consistently since February this year, reaching -13 for July, slightly below the long-term average of -12. This is in line with other sentiment indicators, such as the services PMI. This is an index that measures sentiment among procurement managers in the services sector, with a value above 50 indicating economic growth and a value below 50 indicating a contraction. In July, the services PMI came in at 51.9. While lower than the previous month (52.8), this still reflects growth in the services sector. All in all, it still looks like economic growth in the eurozone will be below average this year (according to the Bloomberg Economists' Consensus 0.7% for 2024), but with some tentative signs that a slightly higher growth figure could be possible.

The US economy grew strongly in the second quarter (2.8% annualised), also significantly stronger than in the first quarter (1.4%). What is also striking is that the growth is driven mainly by consumption. 1.6% of the 2.8% GDP growth was due to higher consumption. So households are still spending money in the US. But continued strong US economic growth is subject to certain caveats. First of all, the effect of higher interest rates is first visible in household consumption. A recent analysis by Oxford Economics shows that US household interest payments have increased sharply since 2022, particularly for poorer households. Meanwhile, defaults on credit card debt are also on the rise. Add to this the fact that the jobs market (though still tight) is beginning to show the first signs of cooling, and the US growth miracle could still falter later this year.

Slower economic growth in China

Recent Chinese macro data indicate that the pick-up in the economy may be faltering. The economy grew by just 4.7% year-on-year in the second quarter, compared with 5.3% in the first quarter of 2024. The slower growth was due to the services sector, where growth slowed from 5% in the first quarter to 4.2% in the second. The fact that the service sector is struggling was also reflected in retail data. Retail sales growth declined from 3.7% in May to 2% in June. This weakness reflects the effects of China's struggling real estate sector. The weakness of the economy is also reflected in the inflation figures. Inflation in China has been well below 2% since 2023, and has been hovering around 0.3% since March.

Given the weak growth rate and low inflation, it is understandable that the Chinese central bank recently decided to lower its policy rate by 0.1% (including the 7-day reverse repo rate) and by 0.2% (for the 1-year medium-term lending facility, which serves as a reference for corporate loans). The latter reduction would in particular appear to be a signal to financial markets that the central bank is ready to stimulate the economy if growth is disappointing.

Harris vs. Trump

Things have also been anything but quiet in the US. Trump survived an attack, Biden stepped aside as a presidential candidate and put forward current Vice President Kamala Harris as the new presidential candidate from the Democrats. These events did not however lead to any marked response in the financial markets. The S&P500 rose 0.3% the first day after the failed Trump attack. After Biden pulled out of the race and nominated Harris, the S&P500 index rose 1.1%. Both returns fall within the long-term daily standard deviation of the S&P500 (1.2%) and are therefore not outliers. The S&P500 is also still up 16% on the year.

One of the reasons for the market's stoic stance is that economic variables such as corporate earnings estimates, economic growth and inflation are more important than the identity of the US president. For example, there were some disappointing figures from a number of large technology companies that are part of the S&P500 on 24 July. The index ended that day down 2.3%, a much bigger reaction than the aforementioned political developments.

Another point is that policy-making in the US depends on who has power in the US Congress, which consists of the House of Representatives and the Senate. Democrats currently have a majority in the Senate and Republicans have a majority in the House of Representatives. If neither Republicans nor Democrats have a majority in Congress, who becomes the president will be less important in terms of policy. This does not apply in all areas, as the US president for example has a great deal of freedom to introduce trade restrictions such as import tariffs. Trump appears to have a reasonable chance of winning.

A Trump presidency could well be accompanied by higher inflation (partly because of the 10% import tax he wants to impose) and higher government debt, although these two metrics will also rise under a Harris presidency.

French elections lead to higher interest rate differential with Germany

European government bonds have had a wild summer so far. After French President Macron unexpectedly announced parliamentary elections for 30 June and 7 July, the difference between French and German government bond yields rose to 0.8%. Yield differentials of Belgium, Italy and Spain with Germany also rose. These declined again at the end of July, although France's 0.7% differential is still above the long-term average of 0.3%.

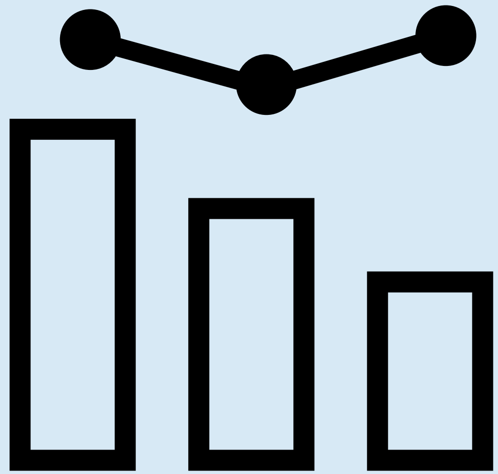
One of the reasons that the French yield differential is still so high is uncertainty with regard to policy. In fact, the parliamentary election has resulted in no political party winning a majority in the French parliament. So a coalition is going to have to be formed in order to make policy, while the positions of the three largest political parties are far apart. This makes policy-making more difficult, which creates uncertainty. In addition, it is becoming even more difficult to reduce France's public debt, something the country has struggled with for years (see our previous analysis). Moody's and Fitch will review France's rating in October this year. A downgrade to France's credit rating is not inconceivable. Due to these uncertainties, the yield differential between French and German government bonds could increase further in the coming months, also increasing the yield differentials of other eurozone countries with Germany.

The last bit of the decline in inflation is still difficult

It still looks as though the central banks are having difficulty with the last piece of the decline in inflation to their 2% target, in both the eurozone and the US.

Inflation rose again in the eurozone, from 2.5% in June to 2.6% in July. Eurozone inflation has been hovering around 2.5% since February this year without any clear downward trend. Moreover, service inflation is still high (4%). This is important because most of the euro area economy consists of services, which also applies to the US. Also, core inflation (inflation without the volatility due to oil and food prices) seems to be stabilising rather than falling. Core inflation in July was the same as in June and May (2.9%), and has been hovering around this level for five months.

While it is still likely that inflation will fall further in the eurozone over time as the economy cools, there is still a possibility that this will take longer than financial markets expect. In the eurozone, for example, unemployment is still at an all-time low (6.4%) and wage growth is also relatively high as a result. According to recent data from the job site Indeed, wage growth in the eurozone was 4% in June. Wage growth is thus higher than inflation, so the purchasing power of European consumers is increasing and can therefore continue to put pressure on inflation in the coming months.



In the US, inflation has been falling somewhat more sharply in recent months, with inflation falling from 3.3% in May to 3% in June. Core inflation fell from 3.4% in May to 3.3% in June. However, the Fed's preferred inflation target, the so-called core PCE inflation, remained the same in June as in May at 2.6%. In addition, services inflation in the US, as in the eurozone, is still high (5%). Also, the US economy is still running well, unemployment is low (4%) and wage growth (3.9%) is higher than inflation. So while inflation in the US is falling, there is still a risk that it will remain high for a little longer than markets expect.

Lower short-term interest rates

Despite the somewhat higher-than-expected inflation figures, financial markets are still discounting a number of policy rate cuts this year. The pricing of overnight index swaps suggests that markets are expecting two ECB policy rate cuts of 0.25% in September and December this year.
For the US, the market is discounting three rate cuts of 0.25% in September, November and December.

In the coming months, it seems likely that short-term rates in the eurozone will fall further in anticipation of rate cuts by the ECB. As bond yields depend more on long-term expectations for economic growth and inflation, they are expected to move less. The European yield curve could therefore steepen (that is, the difference between short-term and long-term interest rates will increase).

Bank of Japan hikes policy rate again

Another notable monetary event last month was that the Bank of Japan (BoJ) raised its policy rate by 0.15% to 0.25%. This puts the Japanese policy rate at its highest level since 2008. In addition, the BoJ announced that it will reduce its purchases of Japanese government bonds. Monetary policy is thus tightening in Japan while it is about to ease in most of the other developed economies. This tightening seems to have been expected by financial markets, and could explain the 6% appreciation of the Japanese yen against the US dollar this month. Exchange rates are indeed affected by interest rate differentials between countries.

If the interest rate differential between Japan and the US widens in the coming months, the yen could strengthen further. This would normally be bad news for Japan, which has an export-oriented economy, as the products that Japan exports become more expensive in foreign currency if the yen strengthens. However, the important factor in this case is that the rate hike in Japan is prompted by a return of economic growth and the return of inflation to more normal levels. Expectations of these improving economic conditions are one of the reasons why Japan's Nikkei index is up 17% this year (measured in local currency). It has to be said, however, that higher interest rates also mean that Japan's public debt (more than 250% of GDP) will become much more expensive. Wages in Japan have also grown relatively strongly recently. Together with the stronger yen, this has led to a weakening of Japan's competitive position. So, while things are improving in Japan, it may be too early to assume a "cherry blossom" period for its economy.

No clear opinion on a specific asset class

The macroeconomic environment and the outlook for interest rates and inflation do not lead to a clear preference for any specific asset class. Economic growth still seems to be holding up well in the US, which could help stock prices, although the last week of July showed that sentiment could turn quickly given some disappointing data. Listed real estate has performed relatively well over the past month, but is sensitive to changes in expectations for policy rate cuts by the ECB. If inflation remains high (and therefore policy rates remain higher) for longer than expected, listed real estate could be negatively affected. Bond yields could continue to be volatile, partly due to geopolitical uncertainty. This does not support a position in bonds. Finally, policy rates are more likely to fall rather than rise, so while cash gives a reasonable return, the outlook for this is not particularly attractive.

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