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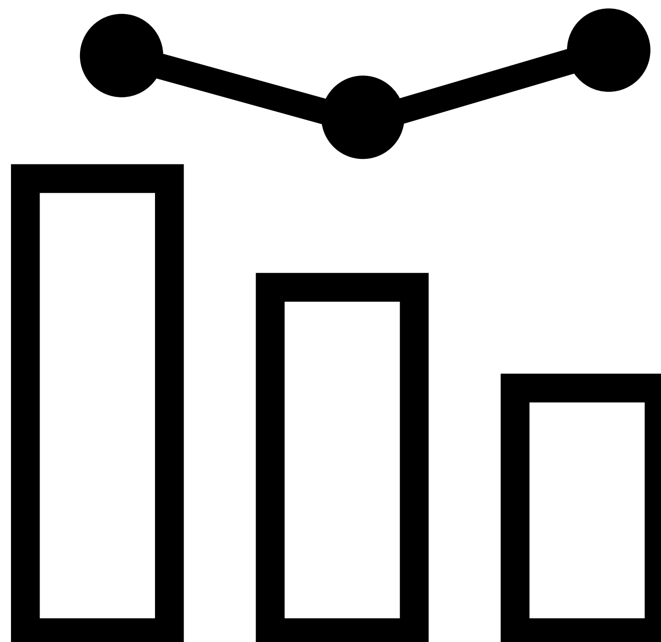


Market update

September 2024

August 2024:
It'll all be OK, won't it?

Financial markets got off to a stormy start in August, with lower interest rates and sharply lower stock prices, particularly in Japan. But there was not much evidence of this by the end of the month. US and European equity markets actually closed the month in positive territory, returning 0.4% and 1.6% respectively. Emerging markets lagged, returning -0.4%. European bond markets experienced a good month on balance, partly thanks to a decline in bond yields. This also helped listed real estate, which was the best performing asset class for the second month in a row with a yield of 3.6%.

The returns on the various asset classes were as follows:

Rendementen (total return, in euro's)	August	Q3	2024	12 mths
Bloomberg Barclays Eurozone Staatsobligaties	0.4%	2.7%	0.7%	5.0%
Bloomberg Barclays Euro Bedrijfsobligaties	0.3%	2.0%	2.6%	7.3%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	1.2%	2.4%	5.3%	11.5%
FTSE/EPRA Europe Onroerend Goed	3.6%	7.1%	1.6%	18.5%
MSCI Europe Aandelen	1.6%	2.8%	12.1%	17.5%
MSCI North America Aandelen	0.4%	0.7%	18.4%	23.9%
MSCI Asia Pacific Aandelen	-0.3%	0.6%	11.7%	15.5%
MSCI World Developed Markets Aandelen	0.5%	1.1%	15.4%	20.3%
MSCI Emerging Markets Aandelen	-0.4%	-1.2%	9.5%	12.9%
EUR/USD	2.1%	3.1%	0.1%	1.9%

Source: Bloomberg

Fear reaction on Japanese stock exchange

One notable event last month was the 12% decline in Japan’s Nikkei index in a single day (on 5 August). But the Nikkei recovered by 10% on the following day, and is now 10% higher on the year in local currency terms. The sharpness of the decline was however exceptional. The last time such a decline occurred was in 1987, when the Nikkei fell by 15% in a single day.

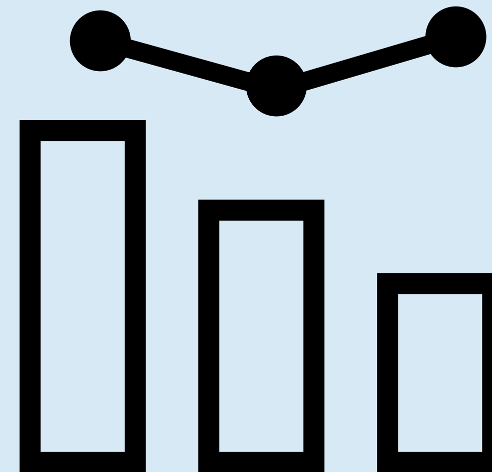
The decline in early August was due to a policy interest rate hike by the Bank of Japan (or ‘BoJ’). This made what is known as the Japanese ‘carry trade’ (borrowing yen and investing the proceeds in foreign assets such as US government bonds) a lot less attractive. This caused demand for Japanese yen to increase sharply (partly to repay these loans in yen) and the yen thus appreciated strongly against the US dollar. This could be bad news for the competitiveness of Japanese companies, with potentially a heavy negative effect on economic growth.

However, the economy of Japan is not doing that poorly. The BoJ still expects the Japanese economy to grow by 0.6% this year, a modest but positive growth. It is also important to note that wage growth has increased sharply in Japan this year. CLA negotiations (known as the ‘Shunto’ negotiations) have led to an average wage increase of over 5% this year, which is exceptionally high by Japanese standards. High wage growth and the normalisation of inflation in Japan were also reasons for the BoJ’s recent rate hike to 0.25%. Japan is also a net importer, importing more than it exports. So, on balance, a stronger currency is more positive than negative for the Japanese economy. This is much less true for the Japanese stock index, which is dominated by exporting companies. As a result, the sharp decline in the Japanese index appears to have been more a reflection of the reversal of the Japanese carry trade and the impact of the stronger yen on the stock index rather than any impact on the Japanese economy.

US jobs market cools, but no sign of recession yet

In the US, we see signs that the jobs market is cooling. Unemployment rose to 4.3% in July, from 4.1% in June. Financial markets reacted quite strongly to this, with the S&P500 falling by 3% on the first trading day after the announcement. To explain the decline, there was frequent mention in the media that what is known as the 'Sahm rule' was triggered by the rise in unemployment. This rule, named after US economist Claudia Sahm, states that there has been a recession in the US every time the 3-month average of the current unemployment rate has been half a percentage point higher than the unemployment rate of 12 months previously. In this case, the Sahm rule was triggered because the unemployment rate in the US for June was 4.3%, bringing the three-month average of the US unemployment rate to 4.1%. This is indeed half a percentage point higher than the unemployment rate of 3.5% a year ago. However, there are some comments to be made here.

Firstly, the recent increase in unemployment is partly driven by an increase in the supply of labour (the number of people who can and want to work). The increase in the unemployment rate is therefore partly due to the fact that more people want to work. This is not as negative as a situation in which unemployment is rising mainly because more people are being made redundant. Claudia Sahm herself has also mentioned this point. Secondly, an unemployment rate of 4.3% is still historically low: the long-term average in the US is 5.7%. And finally, wage growth in the US at 3.6% is still higher than inflation (2.9%), which is positive for the purchasing power of US consumers.



There are also other macroeconomic signs that the US services sector is still operating reasonably well. Economic growth actually increased last quarter, from 1.4% annualised in the first quarter to 3.0% in the second quarter (the figure was originally 2.8%, but then revised upwards). The current consensus expectation among economists polled by Bloomberg is that the US economy will grow by 2.5% this year, which is higher than the long-term average. The Services Purchasing Managers' Index (the 'Services PMI') also rose to 51.4 in July from 48.8 in June and consumption of services rose by 2.9% in the second quarter of this year. Both these indicators indicate that there is still growth in the US services sector, which is not insignificant in an economy in which services account for 80%.

Mixed signals from the European economy

The story is less straightforward for the European economy. On the one hand, there are signs that there is still growth in the services sector. For example, the Services PMI (an index that measures sentiment among procurement managers in the services sector) stood at 53.3 for August. This indicates growth and is an improvement on the July figure (51.9). On the other hand, consumers appear to be pessimistic. Consumer confidence weakened again, from -13 in July to -13.5 in August, and retail sales fell by 0.3% in June compared with a rise of 0.5% in May. In addition, there still seems to be contraction in the eurozone manufacturing sector, as evidenced by the Manufacturing PMI for August, which came in at 45.8 (a figure below 50 indicates a contraction).

There is also a difference between the north and the south of Europe. The eurozone's largest economy, Germany, continues to show weakness. The recent Ifo Business Climate Index (which measures sentiment among German companies for the next 6 months) declined for the fourth consecutive month, from 87 in July to 86 in August. German companies have thus become increasingly pessimistic about the economic outlook over the next 6 months. In contrast, the economies of Spain and Italy seem to be doing reasonably well. In Spain, for example, both the manufacturing PMI and the services PMI still point to growth (50.5 and 53.9 respectively).

All in all, the economic growth outlook for the eurozone still looks weak, with economic growth forecast to be 0.7% this year, with no sign as yet of any upward revision to these low expectations.

Bigger US government deficit under Trump than Harris under Penn Wharton model

Furthermore, in the US, the election campaigns of presidential candidates Donald Trump and Kamala Harris are in full swing. Harris looks to be leading Trump in the polls (at least, those of FiveThirtyEight and Yougov). But caution is advisable regarding these polls, as they are not particularly accurate so far ahead of the election. With that in mind, it is worth reflecting on the potential impact of Trump and Harris's economic plans on the US government deficit.

Researchers from the US University of Pennsylvania have calculated the effects of Harris and Trump's policy plans. Calculations based on the Penn Wharton budget model suggest that Trump's policy plans will lead to a significantly higher government deficit than Harris's. According to this model, the government deficit under Trump will increase by USD 5.8 trillion over the next decade, representing 21% of US GDP. For Harris, the figure is 1.2 trillion (4% of GDP). A key reason that Trump's policies will lead to a higher government deficit, and likely higher public debt is that he wants to make the income tax cuts he initiated in 2018 (the Tax Cuts and Jobs Act) permanent rather than expiring as planned in 2025. To pay for this, Trump is proposing a 10% import tariff on all foreign goods, with a 60% tariff on Chinese goods.

Among other things, Harris's policies focus more on making it easier for Americans to buy a home and tax cuts for low and middle incomes. Harris is proposing to pay for this by increasing the tax on corporate profits from the current 21% to 28%. But she will need approval from the US Congress to implement this tax increase. This means that the Democrats will need a majority in both the House of Representatives and the Senate, and it's very questionable whether they can achieve this. The same applies to some extent to Trump as well, because it is also less likely that the Republicans will win a majority in both the House and the Senate rather than in just one of the two. Trump however does not need congressional approval for his import tariff plans, so this would appear to be more likely if he becomes president.

The calculations should be interpreted with caution. If Harris's profit-raising plans do not get approval, and Trump is less aggressive with his tariffs, the difference between Harris and Trump's plans could be less than that sugge-sted by the Penn Wharton model. That said, Trump's plans are likely to be worse for the US government debt than Harris's.

Inflation is falling faster in the eurozone than in the US, but core inflation remains persistent

In the eurozone, inflation has fallen relatively sharply, from 2.6% in July to 2.2% in August. But this relatively strong decline is due in large part to lower energy prices, which fell by 3% in August. Services inflation rose to 4.2% in August, from 4% in June. So there is still pressure from the services sector on inflation, and this pressure is only slowly easing. This may also explain why core inflation is declining only modestly. Core inflation fell only to 2.8% in August, after remaining at 2.9% for three months.

The development of wage growth is also important for the development of service inflation and core inflation. ECB figures show that the collective labour agreement negotiations in the eurozone led to an increase of 3.6% in Q2 this year. This is well below the 4.7% increase in Q1, but still above inflation. Wages are still rising in real terms. The most recent wage growth figures also support this. The Wage Tracker on employment agency Indeed's website shows that eurozone wages increased by 3.8% in July. This is only a fraction lower than the increase in June (3.9%) and actually higher than the increase in May (3.4%). A striking detail here is that, according to the Indeed indicator, wages in the Netherlands grew by 7.3% in June. Admittedly, inflation here is also higher (3.6% in August), but fortunately real wages are apparently still rising in the Netherlands.

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In the US, inflation fell marginally in July, from 3% in June to 2.9% in July. Core inflation also fell modestly, from 3.3% in June to 3.2% in July. As in previous months, it is notable that services inflation in the US is still high. While goods have actually become cheaper (0.4%), services have become more expensive (4.9%). Furthermore, the inflation index of particular interest to the Fed, the so-called Core Personal Consumption Expenditure index, has shown growth of 2.6% for three months.

Central banks to cut rates, but cautiously

It looks as though both the Fed and the ECB will cut their policy rates in September, as inflation eases rather than increases in the coming months and the labour market continues to cool. This has been highlighted to a greater or lesser extent by both central banks in their communications. However, both central banks will be cautious and are more likely to risk cutting too late than too early, as the latter would damage their credibility as fighters against inflation. All the more because core inflation in both the US and the eurozone is declining, but at a depressingly slow pace. Based on the pricing of overnight index swaps, markets expect 4 rate cuts of 0.25% from the Fed and 3 rate cuts of 0.25% from the ECB this year. This estimate looks to be reasonable. However, there is a risk that there will be somewhat fewer cuts this year, unless there is a sharp recession.

Still no clear opinion on any specific asset class

The macroeconomic environment and the outlook for interest rates and inflation do not lead us to a clear preference for any specific asset class. Despite the cooling jobs market in the US, economic growth there still appears to be holding up well. This could help stock prices. But stocks, especially in the US, are sensitive to disappointing data because of relatively high growth expectations. 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. There is also still geopolitical uncertainty, which could cause volatility in bond yields. This does not support taking a position in bonds. And policy rates are still more likely to fall rather than rise, meaning that the current attractiveness of cash will wane rather than rise in the coming months.

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