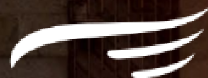
PEREGRINATION

SECOND QUARTER 2024



PEREGRINE
WEALTH

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WILL GLOBAL CENTRAL BANKS SAVE THE DAY?

Maarten Ackerman
Chief Economist

As we head into the second half of 2024, we are finally starting to see some green shoots. Economies are winning their fight against inflation, and a number of central banks are starting to offer some relief by easing monetary policies and cutting interest rates. Most developed markets, except the United States (US), are also slowly emerging from their economic growth slump. Furthermore, a number of high-profile elections are behind us, however the outstanding few are likely to have a significant impact on markets during the latter part of this year.

A CONVERGENCE FOLLOWING DESYNCHRONISED GROWTH

The Bank of Canada was the first to cut rates in June and was closely followed by the European Central Bank (ECB). The Bank of England (BoE) then cut rates the first week of August. While these central banks usually move in line with the US Federal Reserve (Fed), their cutting rates first, indicates how out of sync the US economic cycle is with its global peers.

Following its unprecedented growth over the last two years, we are now starting to see the world's largest economy showing signs of cooling, and we believe it is set to experience some headwinds going forward. With the US economy coming off a fairly high base in 2023 of around 4% growth, we expect it will revert to capacity growth of around 2% over the next three years.

In comparison, its peers are coming off a very low base – the European Union (EU), for example, saw an average growth rate of 0.5% - following significant slowdowns in their economies. By the end of 2023, countries like Japan, Germany and the United Kingdom (UK) found themselves flirting with negative growth and recessionary environments on the back of economic headwinds. However, they are seeing an uptick, and we expect the EU to return to capacity growth of around 1.8%, which is a convergence of the unsynchronised market cycles between the US and its peers.

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CENTRAL BANKS’ CAUTIOUS WAR ON INFLATION

Despite the economic winter of 2023, a global recession was prevented. We attribute this to the way in which central banks have proactively managed their monetary policies to target soaring inflation. It has taken 18 months, but we are seeing inflation being brought under control and interest rates being cut without any real damage being done to their economies. In addition, the desynchronised growth, where the US is slowing as the rest of the world is starting to pick up speed, can be seen as a positive. This is because as the US slows down, there are other cylinders coming online, which will help maintain global capacity growth over the next two to three years.

The risk for economies, however, lies in how central banks continue to manage their monetary policy. While it appears that most of the major central banks have avoided any damage by keeping rates high for an extended period, any policy mistakes at this point could cause unintended harm. For example, keeping policy tight for too long could result in an economic slowdown. Cutting rates too soon, however, could open them up to the risk that they do so before inflation is under control, which could prolong the need to keep rates higher for longer – putting businesses and consumers under ongoing pressure.

An example of this is the ECB. Although it has started to cut rates, it has increased its inflation expectation. This means that over the next two or three quarters, if EU inflation has not been adequately controlled, it will rear its head again, meaning that the ECB will have to pause its rate cuts, or even hike rates again, which could trigger another slowdown or, worse, a recession.

ELECTIONS: COALITIONS AND POPULISM

Another key theme that is set to continue to the end of the year is that of elections, with the buzzwords being “coalitions” and “populism”.

If we look back at the second quarter of 2024, the world saw a number of elections take place, including the Indian, Mexican and South African elections, all of which provided surprising results. In South Africa, the African National Congress (ANC) saw its support fall to just over 40%, and Jacob Zuma’s uMkhonto weSizwe (MK), which was only launched in December 2023, garnered over 15% of the votes. This result forced the ANC to negotiate a coalition government in the form of a Government of National Unity (GNU).

In India, Prime Minister Narendra Modi, although elected president for his third term, failed to win a majority. As such, his Bharatiya Janata Party (BJP) party has also had to form a coalition government called the National Democratic Alliance for his next term. The Mexican elections saw a woman, Claudia Sheinbaum, being elected as president for the first time in that country’s history. Despite critics hailing it as a win for women, her election was closely tied to outgoing-President Andrés Manuel López Obrador, and some of his more controversial policies.

Moving to Europe, at the end of June and beginning of July, the French far-right made massive gains in the first stage of the French election, with the left only coming out stronger in the second ballot. The lack of an outright win has left Macron’s government also having to form a coalition for the next term. This situation not only presents massive political risk for France, but also for the stability of the EU. In the UK, Labour was elected to power after 14 years of Conservative rule. Unlike the French election, this is a positive for UK-EU relations.

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The wave of populism is potentially set to continue, should Donald Trump be elected for a second term as US President. This will bring increased political risk to global relations and trade.

WORLD TRADE FLATLINING

World trade, another trend that we've been observing, is still under pressure, despite the slow pickup in economic activity in some regions. This pressure is partly caused by tariffs being imposed on Chinese goods by the US and the EU. In the US, President Joe Biden has implemented tariffs on several categories of Chinese goods. While this may be a political move ahead of the election, these tariffs are in addition to what Trump implemented during his term. China is now also facing tariffs being applied by Europe on all Chinese electric vehicle imports. This move by the EU could cost the Chinese economy around $4 billion in trade with Europe.

Adding to these trade "wars", economies are now actively diversifying their supply of goods and commodities away from single sources, like China, as they seek to secure essential supply chains. The new model for supply is called China +1. This follows the supply-chain crunch of the pandemic and that which occurred at the start of the Russia-Ukraine war.

UNITED STATES – SLOWING FROM A VERY HIGH BASE

In the previous few editions of *Peregrination*, we have talked about the US economy in detail. This quarter has not seen our view change. Last year the US economy was largely unaffected by higher interest rates for a number of reasons, including fiscal spending, government support for consumers, high consumer savings, high real wages, and a robust labour market. However, we are now seeing all of these factors running out of steam, which we believe signals that the US is about to enter a slowdown phase.

This slowdown, however, as mentioned above, is from a high base in 2023 and the US0 is moving towards 2% growth annually, which is still considered to be solid growth. Nevertheless, the US economy is definitely blowing off steam at this point.

New home builds (houses that are built and have never been lived in before) are slipping and stand at their lowest level in a year. New housing starts (construction projects that are on the go) are also down by 14%. Both of these key economic indicators reflect a slowdown in the US economy. We are also seeing a gap growing between manufacturing and services. While the services side of the economy is still strong because there is pent-up demand for services, the manufacturing side is under pressure. On the back of a weaker manufacturing sector, the labour market is softening and unemployment numbers are growing. Added to this, a record number of consumers are taking on second or third jobs – there are more than eight million multiple job holders in the US currently. This indicates that the environment is not as friendly to the consumer as it was in 2023.

What is encouraging is that the US leading indicators suggest that the risk of a hard landing (long recession) for the US is fading, but that doesn't mean that its economy won't continue to slow. This is because of the aforementioned consumer headwinds, including a fall in savings, fewer job openings, falling wages and high interest rates. Pressure on the consumer has also resulted in the number of US credit and vehicle loan delinquencies rising.

Up until now, it has been argued that it is the lower-income consumer who is struggling and that high-income consumers are still keeping their heads above water, and as such, will keep supporting the US economy. However, if we unpack the statistics, while the poorest 10% of consumers are struggling and their credit and auto loan delinquencies over the last year have more than doubled, when we look at the wealthiest 10% of consumers, they have also seen a significant increase in

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delinquencies. This suggests that all US consumers are currently feeling the pressure and consumer confidence is slipping further.

These issues point to weak consumer activity in the future and are why we expect the US economy to continue slowing over the next 12 to 18 months. However, the US consumer can expect some relief in the near future, because with inflation starting to come in line with Fed targets, the Fed is talking about cutting rates as soon as September.

EUROPEAN UNION – SEEING THE LIGHT AT THE END OF THE TUNNEL

On the other side of the Atlantic, European consumers, who struggled in 2023, are now finally seeing something of a reprieve.

Unlike their US counterparts, EU consumers still have excess savings, which is giving them a bit more of a buffer going forward. In addition, with inflation falling, consumer confidence is also increasing, as consumers are seeing their real wage growth exceed inflation. The fall in EU inflation numbers has also resulted in the ECB cutting rates. This has added a lot of confidence, not only to the consumer but also to the broader business community. Such overall improved sentiment will likely keep building momentum in the EU's economies with German and European business confidence already at their highest level in over a year.

Despite high interest rates and weak economic growth, the EU has been fortunate because unemployment figures have remained low, providing an additional boost for consumers. EU retail sales, however, remain depressed, but given the improvement in sentiment on the back of rate cuts, this should start picking up. We are also starting to see industrial production pick up in Europe, specifically Germany. This is highly correlated with the trade wars against China.

So, where the US is slowing to reach capacity growth of 2%, the EU, which is coming off a low base, is starting to move towards trend growth of around 1.8%.

CHINA – PICKING UP

In line with the EU, China is also picking up as it moves in sync with other major economies – except the US. This pick-up is slow, however, as unique challenges remain. The Chinese property sector is still under stress, and the government does not want to stimulate this part of the economy as it wants it to mature by removing excess capacity.

This is because the Chinese government now wants the consumer to start playing a bigger role in driving economic growth. Currently, consumer spending accounts for less than 40% of the Chinese economy. Compare that to the US, where this number stands at around 70%. The Chinese government's focus is now to increase its consumer spending to 70% as well. This will ensure greater sustainability for the world's second-largest economy, making it less exposed to global economic cycles, infrastructure development or trade, all of which China relies on heavily.

The good news for China is that its consumers still have excess savings that they can tap into. This is because China's interest rates are low with the country's inflation sitting at a meagre 1.5%. Consumers therefore have the ability to pick up spending by using their savings or even by borrowing more. What we are seeing, however, is a lack of consumer confidence, which is unlikely to change until there is greater clarity on which direction the Chinese economy is moving.

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Headwinds, however, remain for the country's manufacturing sector. It has an ageing workforce that is pushing up the cost of production, and the ongoing trade wars with the US and EU, as well as the diversification away from a single source of supply, are hurting the sector. However, having said that, while Chinese trade with the US flatlined from 2010, it started to decline over the last few years as a result of the implementation of trade tariffs. Yet, if you look at Chinese trade with the rest of the world, that has picked up substantially, and now exceeds what they have lost in trade with the US. So, while US trade tariffs are an issue for China, they have not impacted the volume of China's overall global trade. As such, manufacturing activity in China is, in fact, picking up and has grown at its fastest pace in two years, which is a significant increase in both production and new orders. New orders are forward-looking, as they are the orders that are in the pipeline.

Chinese demand indicators, however, have been mixed. So, while there has been an uptick in consumer spending and in manufacturing, we have seen weakness on the construction side of the economy. That is probably because the Chinese government is pulling support from the property and construction sectors because they do not want those sectors to overheat.

In summary, the Chinese economy is stabilising. In this environment, China will probably print growth numbers of around 4% to 4.5%, which is lower than historic numbers. However, it is an economy that is not only larger, but that is also maturing.

INVESTMENT OUTLOOK – CAUTIOUSLY OPTIMISTIC

Harold Strydom will cover our investment outlook in more detail, but the Peregrine Wealth Investment team is less cautious than it was at the start of the year. This is because we are seeing a pickup in the global economy, excluding the US, and yet the US has avoided any type of recession. While interest rates remain high, we will continue to take a cautious stance. However, when rates start to fall, we will start looking at increasing our risk exposure.

We are, however, not celebrating too early, because while there is an uptick in some regions globally, we do need to wait and see what is happening in the US. The economic reality is that if the US hits a bump in the road, its troubles ripple across the global economy very quickly.

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ASSET VALUATION SIGNALS

Harold Strydom

Investment Strategist

Scenario modelling has formed part of Peregrine Wealth's investment process for two decades, and it enables us to better understand potential market outcomes and construct stronger portfolios. The Peregrine Wealth Investment team has a core or "High Conviction" scenario based on a three-year view, which is expressed as macro-economic and market assumptions, including economic growth, inflation, interest rates, price-earnings multiples, and credit spreads, to list a few. Based on these assumptions, our asset valuation models produce expected returns for various asset classes. This section is used to summarise our High Conviction view and the resulting asset signals.

Our current High Conviction scenario assumes that the global economy will grow close to capacity over the next three years. Headline inflation has moderated closer to target in most regions and this opens the door for central banks to start cutting interest rates, which should be supportive of growth. However, the effect of falling interest rates will, similar to rising interest rates, impact regions differently, and with variable lags. Overall, monetary policy is assumed to remain more restrictive than the previous cycle, with higher real interest rates.

Equity markets have done exceptionally well, and valuation expansion has been the biggest driver. Earnings growth has picked up this year and, under our High Conviction scenario, this is expected to continue over the next three years. From a price-earnings valuation perspective the United States (US) market and parts of emerging markets (EM) are expensive, while Europe and China are trading closer to fair value. Over the medium-term, global equity has a neutral rating, along with Europe and EMs, while US equity has a below neutral rating.

US cash is attractive under our assumptions. US government bonds and investment-grade credit are rated neutral, with yields and spreads close to our fair value assumptions. High yield bonds are less attractive, with tight spreads.

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The United Kingdom (UK) economy is gradually recovering and inflation slowing towards target. The Bank of England started its rate cutting cycle in August, which should support consumers and businesses. UK bond yields are close to fair value and government and corporate bonds are rated neutral. The UK equity market continues to be attractive from a valuation perspective, but projected earnings remain weak. The expected return outlook is now neutral.

The table below offers a summary of our Medium-Term Asset Class Valuation Signals based on our three-year High Conviction scenario. It is important to note that medium-term valuation-based signals are typically not good short-term market timing tools.

Medium-Term Asset Class Valuation Signals

	Below Neutral	Neutral Outlook	Above Neutral	
Local (GBP) Assets				
UK Enhanced Cash	○	○	●	Assume gradual rate cuts over the medium term
UK Goverment Bonds	○	●	○	Yields close to fair value; key diversifier in event of recession
UK Credit	○	●	○	Investment grade spreads close to fair value
UK Listed Property	●	○	○	Spread narrower than fair value; fundamentals under pressure in certain sectors
UK Equities	○	●	○	Valuations attractive, but weak earnings growth projected
Global Assets				
US Enhanced Cash	○	○	●	Assume gradual rate cuts over the medium term
US Goverment Bonds	○	●	○	Yields close to fair value; key diversifier in event of recession
US Credit	○	●	○	Investment grade spreads close to fair value
Gold	○	●	○	Sticky inflation, expected moderate equity returns, and attractive gold fair value
Global Alternatives	○	●	○	Deliver longer-term attractive risk-adjusted returns
Global Property	●	○	○	Spread narrower than fair value; fundamentals under pressure in certain sectors
Global Equity	○	●	○	Valuations less attractive; decent earnings growth projected over three years
US Equity	●	○	○	Valuations not attractive; decent earnings growth projected over three years
EU Equity	○	●	○	Valuations close to fair value, but earnings growth outlook weaker
EM Equity	○	●	○	Valuations close to fair value; decent earnings growth projected over three years

Outlook shown reflects the signals from Peregrine Wealth's asset valuation models and is based on each asset class's three year expected return. The model's expected returns are compared to what investors historically expected from these asset classes. As an example a Neutral Outlook will be roughly 0% real return for Cash, 2% for Bonds, 4% for Credit and Gold, and 6% for Equity and Property. Note that no currency views are taken and currencies are assumed to change in line with interest rate differentials for modelling purposes.

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