Quarterly investment outlook
Q2 2024

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Foreword

By Ben Seager Scott

Foreword

The first quarter saw equity markets continue to rally, with global equities up another +9% in Sterling terms – in fact overall equity returns have been going up in almost a straight line since the rally began in November last year. Look beyond the headlines, though, and we see forces are potentially shifting within markets. The rally is no longer being driven primarily by the Artificial Intelligence story and US mega-cap technology stocks. Indeed, market wunderkinds Apple and Tesla suffered uncomfortable falls of -11% and -30% respectively during the period, reminding us that no stock has special immunity from market forces. Rather, the rally in the first quarter was much broader and included strong returns from companies in Japan and Europe alongside the US.

A significant factor in the ongoing optimism is the apparent strength and relative resilience of the global economy, especially in the US, coupled with inflation that continues to trend down towards the effective 2% target.

So far, so good, but there are two important counterpoints against joining the optimists from here. Firstly, valuations seem to have a lot of good news baked in and markets could be at risk of becoming complacent. Secondly, whilst inflation has indeed been coming down, we may be facing a bit of a last mile problem getting from an inflation print starting with a 3 to prints starting with a 2. Indeed, short-term readings are suggesting the fall in inflation could be levelling off and as a result bond markets have been scaling back expectations for interest rate cuts for this year. We still see opportunities in markets and continue to maintain our current exposures but are resisting the urge to lean any further into this potentially fragile rally.

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The tech rally and its perils

By George Lagarias

The tech rally and its perils

Since the beginning of the pandemic, global stock markets have gained +48%. At the same time, the US stock market has increased its capitalisation by 69%, led by the tech sector which more than doubled in value, gaining 134%. Those numbers come against a backdrop of lockdowns, trade wars, broken supply chains, below-trend economic growth, high inflation and fairly restrictive monetary policy. Ex-technology, the US large-caps have gained +49%, almost in line with global stocks.

This tech rally echoes the 2000'dot.com' bubble. Back then, markets were right to think that all major companies would be built on the Internet. They were just a decade early. Have we run ahead of ourselves once again?

The long and short answer is one I would perilously put in print: "This Time is Different". In 2000 it was all about the promises of software. This time around, the rally is mostly about tangible hardware. **Hardware, in 2024, is the new software.**

A key resource

Most of my generation grew up with the fear, if not the actual imagery, of long queues in gas stations, every time OPEC threatened to turn off the taps. Oil price spikes have always sent tremors across the globe. Oil was the be-all-an-end-all commodity that would power the future. Up to a point it still is.

Currently, The Middle East holds 58% of oil reserves, and more than a third of natural gas reserves (and sells only a third of that).

Whilst the green transition is well underway, fossil fuels still account for over 80% of global energy usage and it will take a significant period of time to move away from a commodity which has been powering the world's economy for over 150 years.

As global resources go, oil is valuable. But there is one at least as valuable: computing power. While this resource is not measured in 'proven reserves', like most commodities, it is much more scarce than we may believe.

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In the last three decades, the internet changed our interaction with the world. The globe has never been so small in terms of communication, business and culture as it is today. Young people are increasingly 'citizens of the world'. For all the restrictions and tariffs in the last few years, global trade continues to expand.

Virtually every person in the world is connected to one another through social media. Our food, our literature, and our thinking are now inundated with global influences. It is no exaggeration to say that all modern civilisation depends, one way or another, on expanding computing power.

This was just the third industrial revolution.

The Fourth Industrial Revolution

Then came the fourth. Artificial Intelligence. The human race is primarily a toolmaking race, advancing by evolving tools. AI has been around for more than eight decades, ever since Alan Turing created the world's first computer.

It was studied at Dartmouth in the 1960s and was backed by government funding by the 1980s. By the 1990s it was beating the world chess champion and becoming the subject of many a film and book. Yet progress towards real human-like intelligence remained slower than originally anticipated. By 2010 we were talking about Deep Learning and Machine Learning, with real-world applications, but never really about AI.

Then, in 2022, we asked a computer a question. For the first time in history, one of our tools answered back in human language. The Turing Test (a series of questions by which a person can discern whether they were talking to a human or a computer) was smashed, for the whole world to see. Chat GPT took AI from the realm of sci-fi and testing, into the realm of real-world applications.

History books will probably see this moment as the one that kicked off the fourth industrial revolution. Much like when local miners in Klondike started a 100,000-people mass migration in what became known as the 'Gold Rush', thousands of small companies, that we know nothing about, are already experimenting with Artificial Intelligence applications. Law firms and investment banks have Chat GPT writing simple documents that used to take hours of associate's time. Within a year, 'Large Language Model' became a household term.

The tech rally and its perils

The investment community jumped on the opportunity... and on history. The lesson from 1869 is that the miners made less money than the pick-and-axe stores at the bottom of the mountain. Focusing on the hardware is important. Also, while the next AI-generated behemoth might still be in a garage in Silicon Valley, it has several rounds of seed money before it goes public, or is taken over by a larger tech competitor. A large part of institutional money is placed with listed equities.

It's all about tech

Since the end of 2022, global equities have gained +29%. US equities, which are more tech-heavy, have gained +35%. Meanwhile, the Magnificent 7, the seven largest US tech companies, have made over +94% (see Figure 1). At the time of writing, the top 10 US large-cap stock account for more than a quarter of US large-cap capitalisation, the largest concentration in recent history. Just last year, these companies generated over 60% of returns in the space.

Since the end of 2022, global equities have gained +29%, US equities +35% and the Magnificent 7 over +90%

Cumulative price return (USD)

Source: Mazars, Macrobond

But not all tech is created equal. There are a small number of firms that are both hardware focused and listed, and these are mostly data centres, like Google, Amazon (AWS), Equinix, Microsoft and a few more. But these companies get no more than a third of their earnings from data centres, and a much smaller part from the AI revolution. They are mature businesses that may participate and even lead in some fields, but for the time being, we have no idea what these fields will be.

This narrows the field down to the three microchip companies that power data centres, such as AMD, Intel and Nvidia. Of these, the latter is a company which not long ago made 70% of its earnings from high-end microchips for gaming. Just three short years later, Nvidia makes 70% of its profits from networking hardware. As it produces the most high-end microchips, it now powers 75% of data centre computing power.

This makes the company something close to a monopoly in powering the AI rally. Essentially, the 'Magnificent Seven' has been narrowed down to the 'Magnificent One'. Since the end of 2022, Nvidia has led the pack, increasing its capitalisation by 464%, and becoming one of the most important companies in the world. Semiconductor companies are becoming what James Watt and Co. was for the first industrial revolution, Vanderbilt, Standard Oil and Ford for the second, and Microsoft, IBM and Apple for the third. The engine of growth towards a new era.

Many an investor are now primarily focusing their portfolios on technology. Its five-year relentless bull run and the good fundamentals underpinning it only reinforce this attitude.

Supporting the sentiment, valuations are nowhere near where they were in 2000. Presently, the US large-cap IT stocks trade at 36x times their last 12 months earnings. In 1999-2000 the number was closer to 70x, reaching 445x at their peak. This was the very definition of 'irrational exuberance'. Nvidia, which was trading 218x times its historical earnings by the end of last July, saw the number drop to 100x and then to 66x (at the time of writing), after consecutive blowout earnings announcements. So, earnings support valuations which may be above average but by no means exuberant.

But make no mistake. There are significant pitfalls to this 'trade of trades'.

The perils of investing in one theme

There are four key risks one needs to consider:

1. That AI underdelivers
2. That 'chip wars' mute the supply of high-end microchips
3. That computing power stops increasing
4. That one stock can't support a global market

Overpromising

Let's start with the first key risk. That AI under-delivers. At this point, the above-average valuations and the rally rest on one hypothesis: **that in the near future, Artificial Intelligence will provide us with enough real-world applications that will change the world and provide us with a productivity leap, the same way Google and Apple did in the previous decade**.

At the time of writing, no such application had been discovered. If anything, the performance of ChatGPT has been deteriorating as it interacts more with humans and less with simple data. As our quant analyst Tao Yu says in an upcoming article:

"At first glance, it is not obvious why an entity with these abilities shouldn't be able to fully replace humans already. Coders write code. If AI can also write code, why do we need coders?

It turns out that this logic does not work in practice. In the case of software engineering, LLMs can ace programming interview questions, but perform far worse on real-world problems – which fall outside of their training data. Princeton's SWEbench software engineering benchmark showed that AI models still fail to solve a majority of real-world programming problems (100% of SWEbench problems are solved by humans)."

In layman's terms, what if the tech does not live up to expectations, at least in a speedy manner? It wouldn't be the first time. Five years ago, analysts were raving about the possibilities of the Metaverse. Since then, the hardware hasn't lived up to the expectations. Facebook, which became 'Meta', has slowed down its investment after losing $21bn per year. Seven years ago, the Blockchain and Cryptocurrencies would change how we interact. Fifteen years after Bitcoin's launch, about 250 major companies accept payment in cryptocurrencies, which doesn't exactly make it a global tender.

Chip wars and capacity

The second major risk is the availability of high-end microchips.

A microchip (officially an 'integrated circuit' is a very small electronic device, consisting of transistors, resistors and capacitors, etched on a small piece of semiconductor material, usually silicone. The more transistors that can fit in a small silicon wafer, the bigger the computing power. In 1965, Intel's co-founder and engineer Gordon Moore suggested that computing power would double roughly every year (later revised to two years). To this day, 'Moore's Law' more or less holds.

In the 1970s, transistor sizes decreased from tens of micrometres (one millionth of a metre), to just 2-3 nanometres (one billionth of a metre). For comparison, a human virus is 150-300 nanometres in size.

The lower-end electronic machinery, such as a run-of-the-mill laptop or a 'smart' toaster, use 28nm chips or larger. For AI applications and the newest iPhones, the computing power of smaller 2-3nm chips is required.

This is where the problems begin.

The first problem is availability. The chips are constructed with very expensive and specialised lithography machinery, usually produced by Dutch company ASML. Then they are transported to Taiwan, where specialised factories produce high-end chip, using many inputs, such as specialised chemicals mostly produced in Japan.

In fact, 90% of high-end chip production takes place in Taiwan, creating an important choke point for the distribution of global high-end technology.

Taiwan's independence is fiercely contested by China, a mere 90 miles away. Chinese leader Xi Jinping has stated that he would consider invading the country by 2027. As geopolitical rifts between China and the west grow, the technology and capacity to create high-end microchips necessary for the development of the next generation of AI applications is at risk. The more the West continues to block China from high-end technology, the larger the incentive for China to block the West's access to the high-end technology produced just off its border.

Capacity could, of course, be built elsewhere, but it would come with significant costs and would take time.

The second problem is a simpler one: computing capacity. While Moore's law still stands, Gordon Moore himself has acknowledged that "no exponential is forever.". But, he told his engineers in 2003, "Your job is delaying forever". Since 2005, processor clock speeds (measured in Megahertz, a unit of frequency), have been stable. However, engineers continue to fit more transistors into a chip at roughly the same rate since the 1970s.

Because of the near-atomic size of the chips, most production happens in 2 dimensions. Engineers have been working on ways to print chips in 3 dimensions, increasing capacity. This could buy a few years of computing power increasing at the current pace. But will that be enough to develop high-powered AI applications? Or will the development of quantum computers (still very experimental) be needed before Artificial Intelligence becomes part of our daily lives?

The One Stock

The simplest of problems is concentration. In the last few months, it is not a sector that has driven the rally, as much as one stock, Nvidia. While we have demonstrated the clarity of the fundamental case behind it, the simple fact remains that one stock can't drive a whole bull market for equities.

For the time being, valuations ex-tech are near average, and so are most of the big tech companies. Google is trading at 26x times its historic earnings (average since 2009 is 27x), Apple also at 26x (average since 2009 is 19x) and Meta at 25x (average since 2014 is 40x). Amazon, a company that has historically operated on losses which makes valuation very difficult, is trading at 60x, about half its post-2016 average of 133x. Only Microsoft is trading above-average valuations, at 37x (average since 2009 is 22x).

This leaves Nvidia pulling the stock market cart. While the rally has become broader in the last few months, the effect of Nvidia on global equity returns continues to be outsized.

In conclusion – what this means for investors

So where does that leave investors who have, whether by design or by following an index, been dependent on chasing the returns of a handful of stocks?

As far as technology itself is concerned, we don't see evidence of 2000-like 'irrational exuberance'. Nvidia's dominant market position in the semiconductor sector is unquestionable. Markets are not betting on a company that may do things tomorrow, but rather on one that delivers today, due to strong demand for cloud processing power. But, given current high valuations, a lot of good news is priced in, while risks may not be.

In this market, it really pays to be diversified and strategic. The market offers many opportunities. Valuations ex-Nvidia and Microsoft are average, while earnings have not been disappointing. European and UK stocks are trading below their averages. Japanese equities returned to levels not seen since the late 1980s. Meanwhile, short and long-term bond yields are back at December levels. Gold has also been rallying on the back of strong demand from central banks and Asian consumers. We have one part of the market rallying, on strong fundamentals but high valuations, and the rest of the market either rallying on lower valuations or waiting for positive catalysts. A diversified portfolio can capture more opportunities, rather than take a singular bet.

Managers with a strong Strategic Asset Allocation proposition may weather volatility over the longer term, especially in the bond market, and take tactical advantage of opportunities.

Even if this looks like a one-stock-driven market, the question for investors is not whether or not to buy it, but rather whether investors are positioned to take advantage of the opportunities created by increased volatility.

The economy and markets

Economic outlook - summary

Global markets: Global equity markets entered 2024 with significant momentum from the last two months of 2023 fueled by falling inflation and hopes of lower interest rates during the year. Despite a fast reduction of rate cut expectations in 2024, from 7 to 2 (and even possibly none) in the US, and persistent Quantitative Tightening, equities carried the momentum forward, gaining 7.5%, a full year's return on the first quarter of the year.

Global economy: The global economy has been slowing down in the past few months, as a result of tighter monetary and credit conditions in the developed world and the real estate bust in China. Global demand conditions remain fairly anaemic, compelling both state and private consumers to increase their borrowing.

UK economy: British economic growth remains subdued, despite significant fiscal spending in the past few quarters. The economy is affected by both domestic and international pressures. Domestic pressures arise mostly due to persistent inflation, higher interest rates and a fast monetary transmission policy, which have caused a technical recession.

Consumption: Consumer spending and real incomes should expand, supported by lower inflation. 2024 should be a positive year for consumers. Falling inflation means that a consumer-led recovery should take hold this year. Real wages grew by 2.5% year-on-year in 1Q24, and we expect the growth rate to accelerate in the coming quarters. Low unemployment and the recent pick-up in GDP growth should also give consumers confidence that now is a better time to spend rather than increase their savings rate.

Inflation: Inflation set to undershoot the 2% target this year. Headline inflation is expected to fall to 2% in the second quarter and to remain slightly below that level for most of the second half of the year. There are two main risks to our forecasts: a stronger-than-expected labour market, which could put upward pressure on wage growth, and a negative energy shock stemming from geopolitical events.

Interest rates: Bank of England likely to cut rates before the Fed. We expect the BOE to move ahead of the Fed and announce the first rate cut at the June meeting. We also expect the BOE to be more aggressive in the rate cuts than its US counterpart. This should lead to a weaker Pound.

Labour market: Mixed signals in the UK labour market. We see employment levels stagnating in the coming months and the unemployment rate gradually rising. Although economic growth is anaemic, employers are reluctant to lay off staff in the context of structural labour shortages. Hiring and vacancies are likely to continue their downward trend. We expect the unemployment rate to rise to 4.5% by the end of the year.

Real estate: House prices have started to recover. House prices rose 1.4% year-to-date and 1.6% year-on-year in March, according to Nationwide. This is only the second time since January 2023 that annual growth has been positive, and a sign that sentiment in the property sector is picking up. We expect house prices to remain flat until rate cuts materialise in June. We expect that property prices will increase moderately (2-4%) in 2H24 as mortgage rates gradually come down.

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The economy and markets
Global Markets

Global equity markets entered 2024 with significant momentum from the last two months of 2023 fuelled by falling inflation and hopes of lower interest rates during the year. Despite a fast reduction of rate cut expectations in 2024, from 7 to 2 (and even possibly none) in the US, and persistent Quantitative Tightening, equities carried the momentum forward, gaining 7.5%, a full year's return on the first quarter of the year.

The rally was spearheaded by US technology companies, mainly Nvidia which saw its profits explode and Meta, which announced its first dividend. However, other markets followed, with Europe catching up and the Japanese Nikkei rallying breaking a previous all-time high level achieved in 1989.

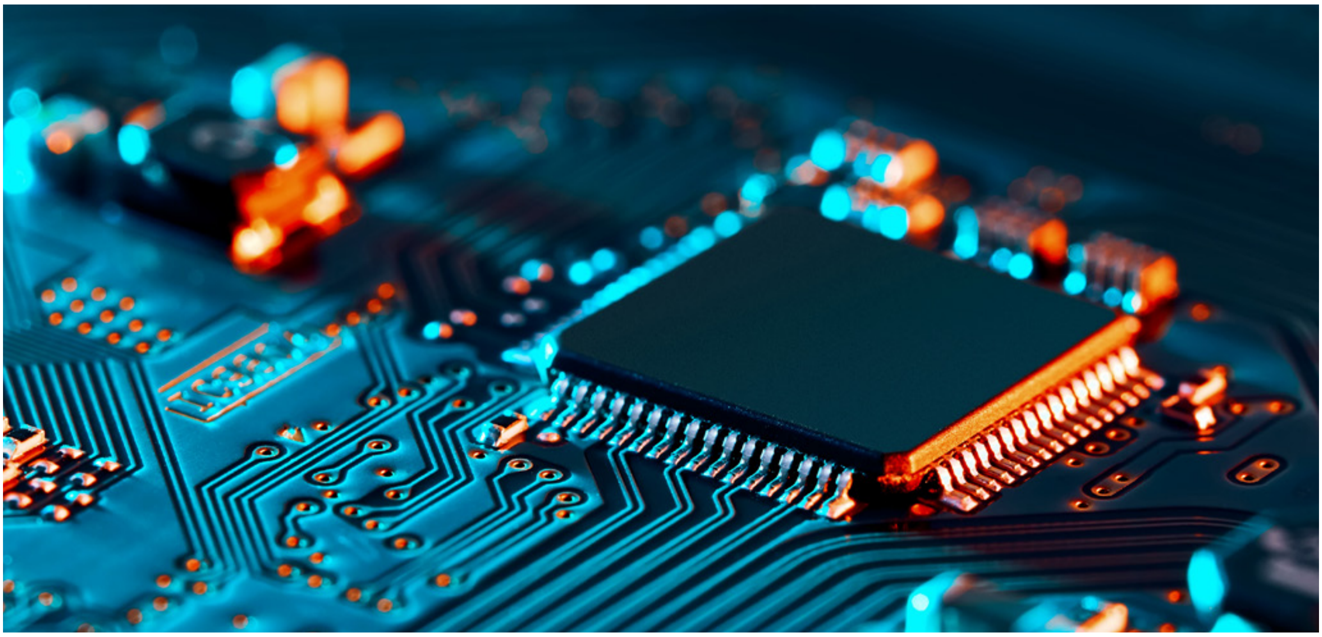
The equity rally, while fairly broad-based, is not backed by solid fundamentals. Valuations in the US are on the expensive side, while in Europe less so, but still higher than average. In the UK equities appear to be cheaper, but it is the only DM market that hasn't rallied significantly in the past few months. Meanwhile, risks are building up, mostly around Commercial Real Estate, worsening bank balance sheets and fickle Geopolitics (which could start another inflation wave).

Bond markets have been more sanguine and the bond rebound –following an annus horribilis in 2022- remained unfinished. For the year, bonds are down 1.9%, after a 9% rally in November and December. This happened mostly due to a correction in rate expectations. Falling inflation and dovish comments from the Fed in late October sparked a bond rally (along with equities). However, as the US central bank began to reign in expectations, returns fell again. The most important point is that the fixed income, the "safer asset" in portfolios remains volatile, cast adrift after years of curation by central banks.

As equities rally so does Gold (a safe haven) and Bitcoin (a bellwether of ultra-positive sentiment). Part of gold's movement can be explained, by increased demand from both Asian central banks and Asian consumers. The Bitcoin rally, on the other hand, is possibly a symptom of wider euphoria in the tech sector.

Going forward we would remain sanguine. Lack of sound fundamentals, like significant earnings expansion, sharp rate cuts or the end of QT suggests that the equity rally should be approached with a modicum of caution. While bonds are weak and have been weaker on stronger inflation data, we don't see the potential for another 2022-type bust.

Key risks going forward include a negative inflation surprise (possibly induced by further and as yet unpriced geopolitical shocks). Another important risk comes from bank balance sheets. Large banks are sitting on top of high unrealized losses (which means they can't afford many outflows) while more local US and large European banks are exposed to worsening commercial real estate conditions. Meanwhile, the Basel III requirements coming at the beginning of the year are already stressing their balance sheets.



The economy and markets
Global economy

The global economy has been slowing down in the past few months, as a result of tighter monetary and credit conditions in the developed world and the real estate bust in China. Global demand conditions remain fairly anaemic, compelling both state and private consumers to increase their borrowing.

Manufacturing appears to have bottomed out everywhere but in Europe, but we have yet to see evidence of a meaningful rebound in production. We will likely continue to see subdued growth, due to the inventory overhang from the pandemic era. Meanwhile, moderate price pressures on the energy and raw material side of the supply chain are threatening margins. The services sector has remained more resilient. Despite the slowdown in the past few months and persistent wage pressures, services continue to expand. In many cases, however, companies have been eating into their backlogs, which means that at some point activity could contract.

Global inflation conditions are improving, but at a slower pace than at the end of last year. We have now reached a point in the cycle where inflation is mostly on the services and wage side. This makes it stickier and harder to beat. Central banks remain optimistic that their economies are closer to the 2% target. However, although headline inflation is indeed coming down at very little cost to the economy and employment, central bankers remain apprehensive, understanding that the data is still volatile.

In the US, higher borrowing and resilient consumption have kept the economy afloat, removing scenarios of a recession, or possibly even a soft landing. The UK, while it is also in extensive fiscal expansion mode, is in a technical recession. The country is very much influenced by the structure of the housing market, which allows rate hikes to pass faster onto consumers, as well as from the general European slowdown. The EU is hit by the triple headwinds of higher interest rates, more expensive energy and stiff competition from China in terms of industrial production.

While we expect the Fed to cut rates later in the year, we would now see European central banks, the ECB and the Bank of England, moving faster, due to poorer demand conditions which can be very helpful in containing price pressures.

Long view: The pandemic has unleashed forces that could keep affecting growth, inflation, supply chains and geopolitical relationships in ways that may yet be unforeseen. The world is unbalanced and strives for a new post-pandemic equilibrium. A world in such imbalance can't be easily understood let alone modelled. This implies that final outcomes will remain unpredictable. The larger question is whether the Great Moderation is over or temporarily deferred and if Secular Stagnation will drive consumer decisions in the near future. If that is the case, macroeconomic variables could continue to fluctuate in a way no one has experienced in years. In that environment, inflation is set to remain above the central banks' 2% target, which could be revised upwards in the coming months. This sort of economic volatility could have profound consequences in macroprudential policies, economic policymaking, supply chains and inventories as well as wider business decisions. A key driver of developments going forward would be the regulatory stance on bank capital.

The economy and markets
UK economy

British economic growth remains subdued, despite significant fiscal spending in the past few quarters. The economy is affected by both domestic and international pressures. Domestic pressures arise mostly due to persistent inflation, higher interest rates and a fast monetary transmission policy, which have caused a technical recession. International pressures have risen due to low global demand for goods and services and poor economic performance from Europe, which still accounts for two-thirds of UK trade. Manufacturing remains subdued, as part of international economic weakness.

Nevertheless, the services sector has been expanding since the beginning of the year and construction is holding up. Consumption numbers may be sluggish but they are not overly disappointing and the labour market remains robust. Although inflation remains above 3%, it has been dropping fast in the past few months. Despite tough economic conditions, British businesses remain optimistic.

Outlook: The outlook for growth remains subdued. The high deficit (mostly used to pay off inflation-linked debt) precludes further fiscal expansion to counter low growth. While growth is expected to remain sub-par in the next few quarters, satisfying consumer numbers and strong labour suggest that the technical recession is probably temporary. Inflation will probably continue to fall, especially after April when energy price caps are expected to lower by about 15%. We believe that by year's end, inflation will be closer to the central bank's 2% target.

As such, we expect the Bank of England to begin lowering rates, possibly even in the summer. To be sure, we don't expect massive rate cuts as the Federal Reserve will likely maintain high rates. Quick rate cuts from the UK would see the currency depreciated and thus higher imported inflation, while UK banks could face a capital flight to higher-rate US banks. But we do expect a paced rate cut cycle to begin in the summer.

Mazars and analysts' consensus forecasts for the UK economy

	2022	2023	2024	Consensus 2024
Real GDP (%YoY)	4.3%	0.1%	0.5%	0.4%
Inflation (%YoY, year average)	9.0%	7.4%	2.5%	
Inflation (4Q, %YoY)	10.7%	4.2%	2.0%	2.2%
Unemployment (%)	3.7%	4.1%	4.2%	
Unemployment (%, 4Q)	3.7%	4.0%	4.5%	4.3%
Wage Growth Ex. Bonus (%YoY)	5.1%	7.0%	4.7%	3.6%
Real Wage Growth (%YoY)	-3.6%	-0.3%	2.2%	
Consumer Spending (%YoY)	5.0%	0.4%	0.7%	0.5%
BoE interest rate (%, year average)	1.9%	4.9%	4.8%	
BoE interest rate (%, year-end)	3.5%	5.25%	4.5%	4.5%

Source: Mazars EIH and HM Treasury.

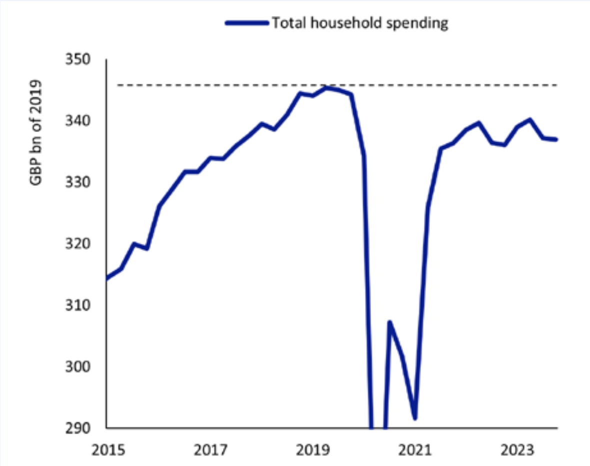
Consumer spending and real incomes should expand, supported by lower inflation.

The latest available data on household spending show that consumption picked up in the first quarter of the year, after a weak second half of 2023. Retail sales grew 1.8% quarter-on-quarter and 0.3% year-on-year, a healthy rebound from the trend seen in 2023: retail sales fell at an annualised rate of 3.7% in 3Q23 and 4Q23.

However, there are clear signs that the consumer remains under pressure. Total household consumption remains below pre-pandemic levels: in 4Q23, household consumption was 2.5% below its pre-pandemic peak (latest data available, see chart). And surveys show that UK consumers are cutting back on non-essential spending and confidence remains subdued.

Household spending still below pre-crisis peak

Total household spending (in real terms)



Source: Mazars EIH, ONS

Consumption's weak performance comes despite rising real disposable incomes. In 2023, real disposable incomes increased 2.2%, while household consumption barely grew 0.2%: the elasticity tends to be close to 0.6, meaning that for every percentage point increase in real incomes, consumption grows by 0.6%.

Several factors could explain the recent divergence between incomes and spending:

- Uncertainty: the fear of a recession made households increase their precautionary savings: in the previous two quarters, the portion of household income being saved rose to 10.2%, the highest savings rate since 2015.
- Higher interest rates: higher rates also stimulate savings due to better remuneration and increased credit growth, disincentivising durables consumption.
- Highest mortgage payments: Homeowners with mortgages (37.5% of the UK population) will face higher debt servicing costs this year. Many households may have increased their savings expecting higher mortgage payments in the near future.
- Wealth effects: house prices declined in 2023, printing negative wealth effects. There is evidence that wealth effects are an important driver of household consumption.

UK consumer confidence remains weak

Consumer Confidence and Retail sales volumes

Source: Mazars EIU, Gfk, ONS

Outlook: Looking ahead, we believe that 2024 should be a positive year for consumers. Falling inflation means that a consumer-led recovery should take hold this year. Real wages grew by 2.5% year-on-year in 1Q24, and we expect the growth rate to accelerate in the coming quarters. Low unemployment and the recent pick-up in GDP growth should also give consumers confidence that now is a better time to spend rather than increase their savings rate.

Inflation

Inflation set to undershoot the 2% target this year

Headline CPI inflation fell from 3.4% to 3.2% YoY in March (consensus 3.1%), with core inflation down from 4.5% to 4.2% (consensus 4.1%). Services inflation slowed from 6.1% to 6.0%, while goods inflation fell from 1.1% to 0.8% YoY.

The persistence of headline inflation is explained by high wage growth, the main driver of services prices. Wages continued to grow at a fast pace in 1Q24 (above 6%), raising doubts about the pace of disinflation in the coming quarters.

Despite strong services inflation, it remains likely that the headline rate of CPI inflation will continue to fall. April will show a sharp disinflation, supported by the new Ofgem new energy price cap and lower food prices. We project headline inflation to be close to 2% in the second quarter and then to undershoot the 2% target slightly over the following six months.

The flattening of the economy and the steady easing of the labour market give us confidence that wage growth will continue to slow. We see wage growth below 4% YoY in 4Q24, which would be consistent with core inflation of around 2.3-2.5%. International prices will also contribute to lower inflation: our models show negative year-on-year contribution of food inflation prints in 2H24, and the impact of deflation in China is leading to low input and consumer goods inflation.

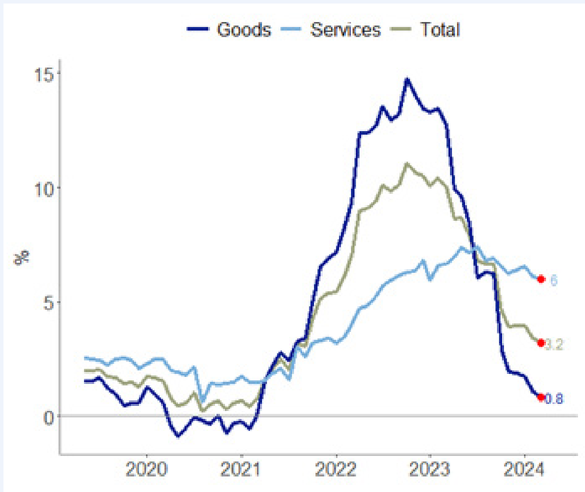
Surprisingly, the risk now is that prices will be too cool rather than too hot. With the March inflation print, the UK CPI is rising at a slower pace than in the US (3.4%), and this should come as no surprise given the strong growth of the US economy and the lacklustre performance of the UK economy.

Although the Bank of England has mimicked the Fed's rate tightening in 2022 and 2023, the sources of inflation are very different. The US is showing clear signs of an overheating economy, while in the UK the acceleration in inflation has largely been explained by international prices. In our view, this should lead to a divergence in monetary policy between the US and the UK, with the latter cutting interest rates at a faster pace.

Outlook: Headline inflation is expected to fall to 2% in the second quarter and to remain slightly below that level for most of the second half of the year. There are two main risks to our forecasts: a stronger-than-expected labour market, which could put upward pressure on wage growth, and a negative energy shock stemming from geopolitical events.

Most of the disinflation over the last year has been explained by lower energy prices

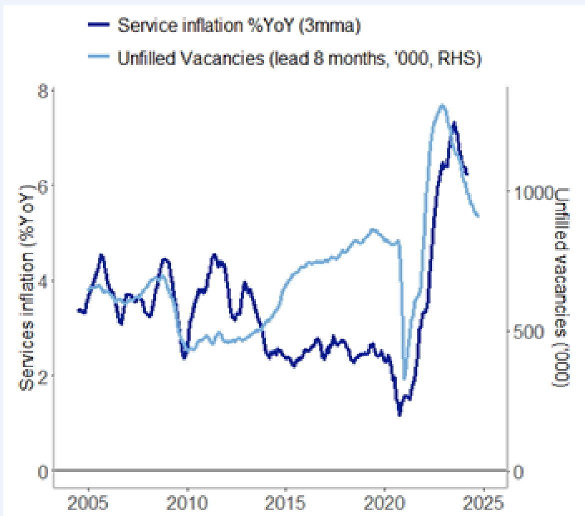
UK CPI inflation %YoY. Contribution (in ppts)



Source: Mazars EIH, ONS.

Wage pressures are fading and that should push services inflation lower

UK services inflation %YoY and unfilled vacancies at Jobcentres



Source: Mazars EIH, ONS.

Interest rates

Bank of England likely to cut rates before the Fed

In its latest Monetary Policy Report (MPC), the Bank of England (BOE) updated its inflation forecasts. It now expects prices to rise by 2% year-on-year in April, in line with its target. It also made an important change in the wording of its monetary policy communications, from stressing the need for "sufficiently restrictive policy" to emphasising that the discussion is now about "how long the Bank Rate should be maintained at its current level", signalling that interest rates have peaked and that the next step is downwards.

The views of the members of the Monetary Policy Committee have also changed dramatically in recent weeks, with key members now appearing to favour a rate cut at the next meeting. In a recent speech, Deputy Governor Dave Ramsden stated that his "assessment is that the balance of domestic risks to the outlook for UK inflation is now tilted to the downside relative to the MPC's February forecast, with a scenario in which inflation remains close to the 2% target over the entire forecast period [of 3 years]". In a similar vein, Governor Andrew Bailey said that inflation data was "pretty much in line" with the central bank's forecasts, and he insisted that there was less "demand-driven" inflation in the UK than in the US. Implying that the BOE does not have to follow the Fed.

We believe that Ramsden's recent dovish stance may reflect the views of other internal BOE members such as Broadbent and Bailey. Ramsden and Bailey disagreed only three times in the 34 meetings they attended together, with Ramsden always taking a more hawkish stance. This increases the likelihood of a cut as early as the May meeting.

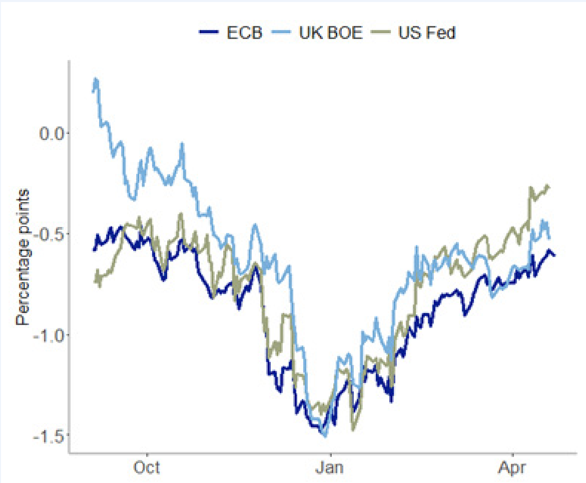
Currently, the market is pricing in two 0.25% rate cuts this year, the first one occurring in August. This is a massive shift from the market pricing observed at the beginning of the year (see chart), when the market was pricing in 6 moves. Market pricing is moving hand in hand with developments in the US, even though the inflation dynamics in the US and the UK appear to be diverging.

The key question is whether the BOE MPC will depart from the Fed in its monetary policy. We think it will and it should. We believe that the April wage and inflation data, due later in May, will give the MPC enough elements to opt for a rate cut ahead of the US, where inflation seems to be stuck above 3%. As this is not currently priced into the bond market, it could be a market mover.

Outlook: We expect the BOE to move ahead of the Fed and announce the first rate cut at the June meeting. We also expect the BOE to be more aggressive in the rate cuts than its US counterpart. This should lead to a weaker Pound. The main risk to our scenario is the strength of the UK economy and labour market: if the economy proves more resilient, there is a risk that interest rates will remain at current levels for a little longer.

The market is currently pricing in two 0.25% rate cuts this year

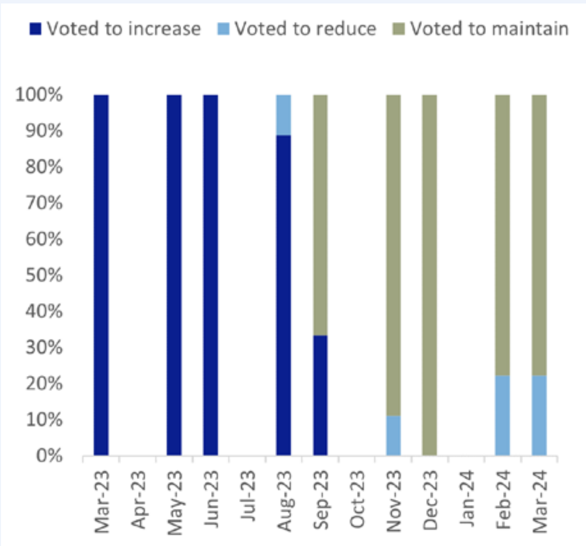
2024 change in policy interest rates priced into financial markets



Source: Mazars EIH, BoE

We think the MPC could vote for a rate in cut in June

Monetary Policy Committee voting history - Bank Rate



Source: Mazars EIH, BoE

Labour market

Mixed signals in the UK labour market

The cooling trend in labour market indicators continued in the first quarter of the year:

1. The unemployment rate rose to 4.2%, up 0.3 pts from the previous quarter, despite the fall in labour force participation. Employment, as measured by the ONS LFS household survey, fell by 156k (3m/3m sa) in 1Q24, an annualised decline of 1.9%.
2. The vacancy/unemployment ratio, a good proxy for labour shortages, is back to its pre-pandemic level of 0.6. It has been declining steadily over the past seventeen months (peaking at 1 in 3Q22).
3. The REC - Permanent Placements Index, which tends to lead employment growth by 6 months, posted its fifth consecutive month of decline. In its publication, the analyst highlighted "reports of hiring freezes", and "[a] marked decline in permanent placements as well as the steepest contraction in temp billings since July 2020".

Despite clear signs of easing in the labour market, wage growth in the first quarter of the year was once again above analysts' expectations. Regular wage growth fell from 6.1% in January to 6.0% in 1Q24, instead of the 5.8% expected by the consensus of economists.

We expect wage growth to remain elevated in the second quarter of the year in response to the near 10% increase in the National Living Wage announced this month. However, we expect wage growth to slow sharply in the second half of the year. We estimate that a wage growth rate of around 3.5% would be a reasonable target to achieve both the Bank of England's inflation target and moderate real wage growth.

Outlook: We see employment levels stagnating in the coming months and the unemployment rate gradually rising. Although economic growth is anaemic, employers are reluctant to lay off staff in a context of structural labour shortages. Hiring and vacancies are likely to continue their downward trend. We expect the unemployment rate to rise to 4.5% by the end of the year.

As for the implications of wage growth for monetary policy, we think the BoE's Monetary Policy Committee will probably want to see the impact of April's minimum wage increase before committing to a rate cut. We think that the June meeting is a likely candidate for the first rate cut announcement.

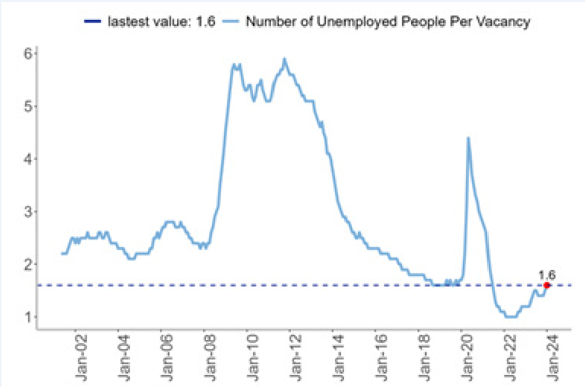
Wage growth remains elevated

Wage growth

Source: Mazars EIH, ONS
Last obs: 01-02-2024

The labour market is loosening

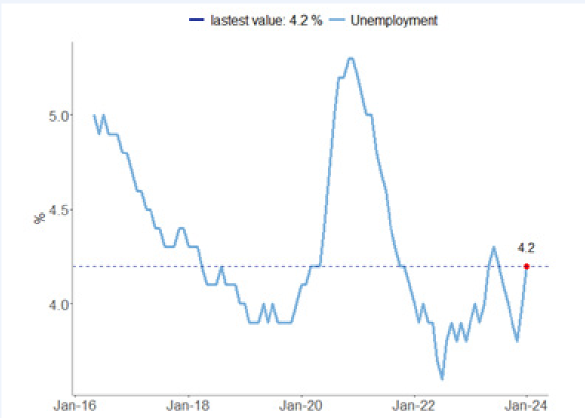
Number of unemployed people per vacancy



Source: Mazars EIH, ONS
Last obs: 01-02-2024

The unemployment rate jumped to 4.2%

Unemployment rate (%, sa)



Source: Mazars EIH, ONS
Last obs: 01-02-2024

Real estate

House prices have started to recover

House prices rose 1.4% year-to-date and 1.6% year-on-year in March, according to Nationwide. This is only the second time since January 2023 that annual growth has been positive, and a sign that sentiment in the property sector is picking up.

According to the BSA Property Tracker, a quarterly survey of consumer sentiment towards the UK market, there are two factors that explain the recent increase in demand: (i) less concern about future house price falls and (ii) an improvement in affordability. Indeed, the BSA buyer sentiment index, which tends to lead house prices by 9 months (see chart), has shown a marked improvement in the past quarters: it now stands at -16% (net respondents who think it is a good time to buy a property), compared with -36% at the peak of mortgage rates in July last year.

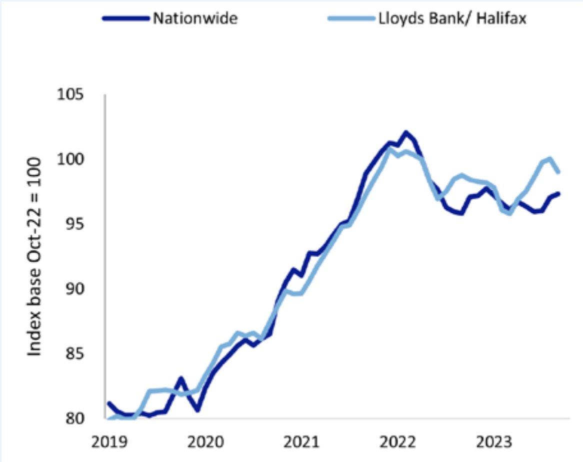
Despite signs of easing inflation and interest rate cuts in the horizon mortgage rate remains elevated, the Sterling 2 year (75% LTV) fixed rate mortgage for households currently stands at 5%, what many analysts think is a psychological threshold for buyers. We think it could end the year close to 4.5% once the BOE adjusts its Bank Rate. This should provide an additional boost to demand.

An additional element that could stimulate prices is the lack of supply. Housing starts and completions have declined 17.5% and 11% respectively in 2023 and more importantly the level of unsold stock is low: according to the RICS survey the Average number of Stocks of Homes on Books is 41.2, which is lower the past 10 year average and is 40% below the (46 year) historical median.

Outlook: Based on our forecasts for mortgage rates and wage growth, we believe that the current state of housing affordability will remain tight during the first half of the year. Therefore, we expect house prices to remain flat until rate cuts materialise in June. Our expectation is that property prices will increase moderately (2-4%) in 2H24 as mortgage rates gradually come down.

House prices rose 1.4% year-to-date and 1.6% year-on-year in March

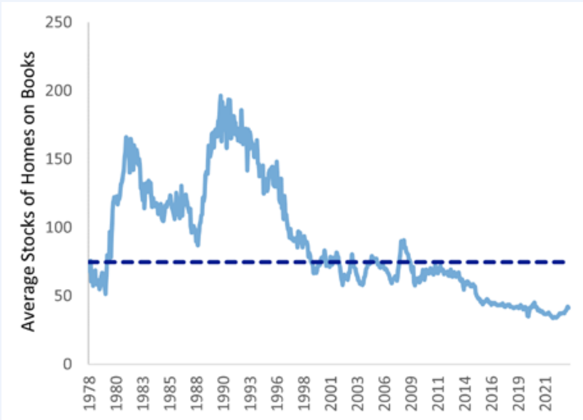
UK house price indices (Oct-2022 = 100)



Source: Mazars EIH, Macrobond

The level of unsold stock is low

Average Stocks of Homes on Books



Source: Mazars EIH,Royal Institution of Chartered Surveyors (RICS)

Key macro views

Economic growth

World: The global economy is set to move at a slower pace in 2024 than the previous year, a result of the fastest rate tightening in the past four decades. Demand conditions have been weakening across most markets as credit becomes more constrained. China's slowdown is exacerbating global demand conditions. Where the US, China and the UK are fiscally stimulating their economies to avoid recessions, the Europeans, who are much more conservative, are adopting a tighter fiscal stance, and thus leave themselves open to worse growth conditions.

US: The base case is a soft landing: fiscal stimulus has offset the drag from monetary tightening. Consumers still have excess savings, real wages are rising and the labour market remains strong, albeit gradually loosening. There are no clear signs of a significant slowdown in the near future. We expect growth of around 2% in 2024.

Eurozone: A bad mix: (i) ECB has overtightened (affecting manufacturing and construction), (ii) lack of fiscal stimulus and (iii) global slowdown affect exports. The corollary is more stagnation in 2024.

GB: The UK economy is likely to grow (~0.7/1%) moderately this year, driven by higher private consumption. Real disposable income is expected to rise as inflation decreases. Lower interest rates should also contribute to an increase in private investment. That said, potential GDP growth is expected to be low in the coming years: there is a structurally tight labour market, investment is low and, post-Brexit, the UK is gradually losing its integration into global value chains.

China: Three huge problems: debt, demographics and deflation. China is in the process of Japanisation: debt levels are high, the property crisis is still ongoing (it may take years for prices to stop falling), developers and banks are insolvent, confidence levels are low, foreign investors are taking their money out of the country, there is excess capacity in industry and government stimulus is insufficient to stimulate demand and restore confidence. Growth could improve in the short term, but we expect lower growth in the medium and long term.

Unemployment

US: With higher labour force participation and slightly weaker labour demand, unemployment is expected to rise moderately.

Eurozone: Unemployment will rise slightly amid weaker labour demand.

GB: Unemployment will rise slightly amid weaker labour demand. We project LUR at 4.3-4.5% by 4Q24.

China: Unemployment will rise amid weaker labour demand.

Inflation

World: Inflation is falling in all regions: the supply shock that hit the global economy in 2022 and 1H2023 is fading. China weakness means low commodity prices. Labour markets are also easing amid slower growth..

US: The baseline scenario is for inflation to fall to 2.5-3% by 2Q24 and to hover around 2.5% in 2H24. Goods inflation remains subdued, but services inflation is proving more sticky. Wage growth is gradually slowing, but remains elevated.

Eurozone: inflation will likely undershoot the 2% target. Economic growth is anaemic, energy and food inflation are contributing negatively to the CPI, and wage growth is slowing amid rising unemployment.

GB: Our baseline scenario is for inflation to fall to 2% by the middle of the year. The deflationary trend in energy and food prices will bring headline inflation down sharply in 2024. We expect wage growth to slow further as labour demand weakens.

China: China will try to export its way out of the crisis but its take of global trade is already too high. We expect deflation in good prices and low wage growth: structurally inflation will remain low due to lack of demand.

The economy and markets

Key macro views

Currencies

USD: +1. USD is set to remain strong amid a resilient economy, high fiscal stimulus, and few rate cuts.

EUR: -1. We expect the ECB to cut rates by 2024Q2 given the weakness in the economy (Germany in recession, France stagnated).

GBP: -1. Weaker growth, lower rates, large current account deficit are all elements that point a weaker pound.

CNY: -1. We expect further monetary easing to stimulate activity and sustain the property bubble.

Rates

World: Lower inflation has prompted central banks to cut interest rates. Emerging market central banks, which in many cases raised rates before the DM central banks, are also leading the easing.

US: Our base case is for three cuts this year, although there are risks that we will see fewer cuts given the strength of the economy. We think the Fed will accept higher inflation (2.5%) as the new normal and will adopt a less restrictive monetary policy once PCE is around 2.5% YoY.

Eurozone: We expect the ECB to cut rates by 2024Q2 given the weakness in the economy (Germany in recession, France stagnated).

GB: We think the BOE has room to cut rates. Three 25 bps cuts this year is our base case.

CN: We expect further monetary easing to stimulate activity and sustain the property bubble.

Real Estate

World: The Real Estate sector underwent significant adjustments in 2022 and 2023. It is expected that there will be a rebound in house prices in 2024 due to a more relaxed monetary policy.

US: Resilient economic growth and a deflationary outlook has been supportive of the US property sector.

Eurozone: European housing market seems to be bottoming out following a particularly sharp correction in real estate prices in 2022 and 2023. The recovery, however, looks set to be gradual

GB: Affordability remains stretched in 1H24, limiting any significant rebound in transactions and prices. Demand should recover in 2H24 as mortgage rates are lowered.

China: The housing crisis is still ongoing (it may take years for prices to stop falling), developers and banks are insolvent, confidence is low. Government policy has been insufficient to restore confidence.

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