Investment Outlook

A monthly round-up of global markets and trends

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Investment outlook

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Diversifying the diversifiers amid geopolitical tensions

Headlines around the conflict in the Middle East contributed to an increase in market volatility this month. One way to gauge this intensity is to count the number of words related to geopolitical tensions in the press using the Geopolitical Risk Index (GPR). The GPR covers categories such as "war threats" and "terror events" from the electronic archives of newspapers going back to 1900. Unsurprisingly, this index has been trending up, led by the war in Ukraine and the Israel-Hamas conflict, but it remains well below levels seen during both world wars and 9/11 in 2001.1

Events in the Middle East now directly involve Iran. The latest headlines come after the alleged Israeli attack on the Iranian consulate in Damascus, Syria, on 1 April. In response, the Iranians launched an attack on Israel involving drones and missiles on the 13 April. This was followed by a reported Israeli strike against a military air base in Isfahan, a central province in Iran, in what has now become tit-for-tat exchanges.

Paradoxically, this increase in geopolitical uncertainty is happening against an improving economic backdrop. As such, government bonds — the traditional portfolio diversifier — are at risk from the potential return of inflation. As a result, we believe it is prudent to diversify portfolios to include energy stocks and gold, as discussed below.

Energy stocks: Energy companies in the MSCI All Country World index have made energy one of the best performing sectors so far this year. It's not hard to see why. The Brent crude oil price has risen 10% year-to-date due to shipping disruption issues and concerns around the Middle East.[2] For example, Iran seized an Israel-linked container ship in the Strait of Hormuz in April. Traders are worried that the oil supply could be shut off. After all, an estimated 17% of global crude oil flows through the Strait.[3]

Although nothing has changed in terms of restricting energy supply, should crude oil prices take a sustained leg-up from heightened geopolitical tensions, the earnings outlook for the energy sector would improve. Currently, analysts forecast Earnings Per Share for global energy stocks to fall 6% in 2024 — the only sector to show a contraction out of the 11 major categories in the MSCI benchmark.[4]

In terms of portfolio protection, energy is attractively valued on a one-year forward dividend yield of 4.0%, the highest of any sector, and it's backed by healthy cash flow.[5] This suggests that the energy sector offers some defensive characteristics, particularly against higher inflation.[6]

Gold bullion: Bullion is sometimes employed to diversify portfolios from risks associated with equities and bonds. Gold can perform particularly well during times of increasing geopolitical risk. For example, the gold price appreciated in the build up to the 1990 Gulf War, while global equities struggled. Gold is also working as a portfolio hedge today: bullion rose by around 3% in April in sterling terms, while equities fell 2.4%.[7]

Alongside increasing geopolitical risk, the gold price rally has been supported by foreign central bank bullion purchases following Western financial sanctions against Russia. Globally, central banks bought over 1,000 tonnes of the metal (roughly 28% of mined gold) for the second consecutive year in 2023, which compares to an average of 48 tonnes sold per annum between 1970 and 2021.[8]

The private sector is also becoming more actively involved in the gold market. Costco, a US wholesale retailer, has reported brisk sales of one-ounce 24-carat gold bars. Wells Fargo, a US bank, estimates that this is equivalent to half of Chinese central bank demand.[9] Meanwhile, in China, many citizens are collecting "golden beans", which weigh around a gram. Costing around US$80 each, they are more affordable than standard gold bars and have wider appeal. Similarly, Chinese jewellery demand grew 10% in 2023.[10] The bottom line is that this structural demand has reduced the opportunity cost of owning zero-yielding assets, like gold, when rates have gone up.

Government bonds: The iBoxx Global Government bond index (including all maturities) has underperformed equities by over 10% so far in 2024.[11] This difference can be partly explained by faster global economic growth, which has supported company earnings and equities, but lowered expectations for interest rate cuts. For instance, the futures market currently anticipates that the US central bank will lower interest rates by around 0.3 percentage points, compared to the 1.5 percentage points expected at the end of 2023.[12] With the improving economic backdrop, the spectre of inflation continues to linger as a risk to bonds, especially because crude oil prices are rising.

Another reason for higher bond yields is that geopolitical tensions are affecting foreign demand for US Treasuries at a time when US public debt is soaring. For example, given the risk of facing financial sanctions, the Chinese government has allowed its holdings of US Treasuries to drift down to a 24% share of its FX reserves — a record low.[13]

In summary, given the economic recovery amid plenty of geopolitical tensions, it probably makes sense to diversify portfolio protection to include beneficiaries from higher crude oil prices, like the energy sector. Gold too has a proven track record of offering portfolio protection during times of uncertainty and is supported by demand for bullion. Ultimately, while stocks sometimes trade down over the short term during geopolitical uncertainty, a strengthening global economy typically favours equities over government bonds.

Sources:

[1,2,4,5,6,7,11,13] LSEG Datastream, Evelyn Partners

[3] Goldman Sachs, Oil Comment: Early Thoughts on Potential Oil Market Effects of Iran's Attack, 14 April 2024

[8,10] Goldman Sachs, Oil Comment: Early Thoughts on Potential Oil Market Effects of Iran's Attack, 14 April 2024

[9] What China's central bank and Costco shoppers have in common (economist.com)

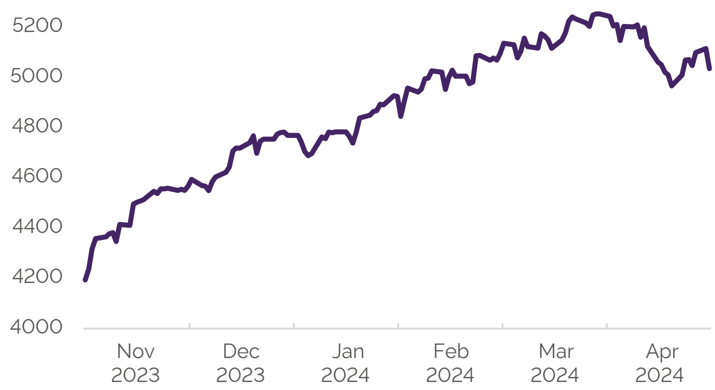
[12] Bloomberg

Market highlights

Equities

US equities sold off during April as recent inflation data out of the US startled markets. Core consumer price inflation (CPI), which excludes the volatile food and energy components, has risen by 0.4% on each of the last three monthly prints. Additionally, Core Personal Consumption Expenditures (PCE), the Federal Reserve's preferred measure of inflation, jumped to 2.6% for the first quarter of 2024. This prompted money markets to take a hawkish turn, pricing in less than two 25 basis point cuts this year, down from expectations of six in January. Despite an uncertain start to the month, US equities recovered some of these losses as strong earnings data, most notably from some big tech names like Meta and Google, surprised on the upside. Nonetheless, the S&P 500 ended April down just over 4%.

S&P 500 Index performance



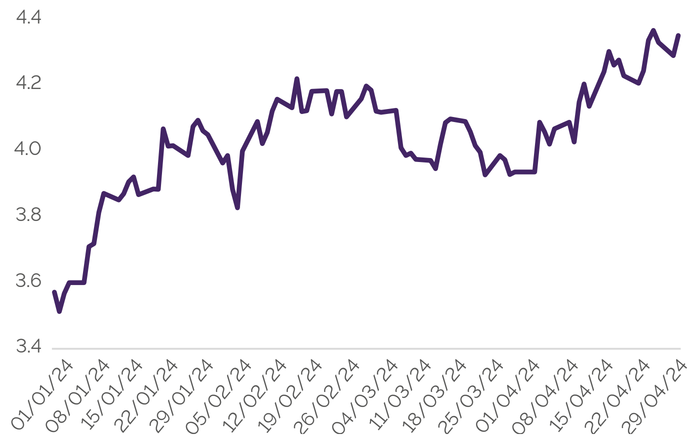
Source: LSEG Datastream/Evelyn Partners. Data as at 1 May 2024

Past performance is not a guide to future performance

Fixed income

The UK 10-year gilt yield has risen by nearly one percentage point since the lows achieved at the end of 2023 (yields move inversely to prices). Rate expectations have drifted higher across the US, UK and eurozone as inflation is proving challenging to return to target and economies remain resilient. However, we could see some progress on the UK inflation front over the coming months as recent reductions in the Ofgem energy price cap filter through to the CPI data. As inflation approaches the Bank of England's 2% target, money markets are likely to turn more dovish and price in additional interest rate easing.

UK 10-year gilt yield (%)



Source: LSEG Datastreadm/Evelyn Partners. Data as at 1 May 2024

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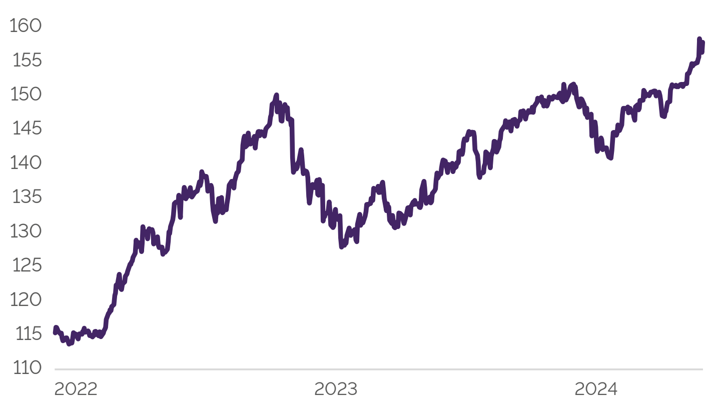
Currencies and commodities

The Japanese yen (JPY) has been gradually depreciating against other major currencies (most notably the US dollar) since the start of 2022. This has been driven by investors moving capital to other economies that offer higher interest rates as Japan continued to pursue a negative interest rate policy. At the end of April, the yen experienced significant fluctuations again, with the USD/JPY exchange rate hitting a 34-year low. Once more, the potential driver looks to have been the widening interest rate differential between the US and Japan. Recent signs of sticky US inflation prompted markets to decrease the quantity of rate cuts expected for 2024. Meanwhile, markets expect Japanese interest rates to increase by just 0.18% this year. This widening rate differential incentivises investors to sell their yen in favour of holding other currencies with higher interest rates, causing the yen to depreciate.

Japanese yen versus the US dollar exchange rate



Source: LSEG Datastream/Evelyn Partners, Data as at 1 May 2024

Past performance is not a guide to future performance

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-2.4	5.9	18.5	67.5
MSCI UK	2.8	8.3	7.7	33.5
MSCI UK Broad	2.3	7.6	7.4	28.4
MSCI USA	-3.3	6.0	23.8	93.2
MSCI Europe ex UK	-1.9	4.6	8.9	54.6
MSCI Japan	-4.0	2.8	20.1	44.7
MSCI Pacific ex Japan	-0.3	2.3	1.4	17.6
MSCI Emerging Markets	1.4	9.8	10.7	16.5
Bonds				
iBoxx GBP Gilts	-3.2	-2.7	-1.9	-19.8
iBoxx USD Treasuries	-1.5	-1.5	-2.8	1.2
iBoxx GBP Corporate	-1.8	-0.8	5.2	-2.0
Commodities and trade-weighted currencies				
Oil Brent Crude ($/barrel)	0.6	7.3	10.6	20.6
Gold ($/ounce)	3.7	12.1	15.4	79.0
GBPUSD	-0.9	-1.7	-0.4	-4.0
GBPEUR	0.1	-0.1	2.9	0.7
EURUSD	-1.0	-1.6	-3.1	-4.6
USDJPY	4.0	7.7	15.6	41.3

Past performance is not a guide to future performance.

Market commentary

Global equities struggled in April, contracting 2.4% as a more hawkish US rate outlook weighed on valuations. Crude oil has rallied this year, with demand stronger than expected on the back of a resilient global growth outlook. Moreover, oil supply has been constrained as some OPEC+ members extended voluntary output cuts. Geopolitical instability in the Middle East has also exerted some upward pressure on oil prices. This rally in the oil price helped drive the MSCI UK index higher, and it was the best performing equity region over April. The composition of the UK large-cap index is disproportionally weighted towards 'old-world' sectors such as energy, materials and financials which have performed well over recent months.

Key macro data	Latest	2024 Consensus forecast	Spot rates	30-Apr	Yields (%)	30-Apr
UK GDP (YoY%)	-0.25	0.30	GBP/USD	1.25	MSCI UK	3.82
UK CPI Inflation (YoY%)	3.20	2.50	GBP/Euro	1.17	MSCI UK broad	3.75
Bank of England Base	5.25	4.30	Euro/USD	1.07	10 Year Gilt	4.35

The market commentary, values and charts as at 30 April 2024. Total returns in sterling. Returns are shown on a total return (TR) basis ie including dividends reinvested (unless otherwise stated). Net return (NR) is total return including dividends reinvested after the deduction of withholding tax. Source: LSEG Datastream/Bloomberg

Sources

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