Kestrel
Wealth Management

Quarterly Financial Market Update, June 2024

The second quarter of the year has in general been supportive for equities. However the risks have also increased, fueling investors' nervousness. Thus, a small consolidation in the equity markets would be somewhat healthy in the short-term, helping the current bull market to continue in a longer term perspective.

During this quarter, global equities posted a return of 3.1% (11.6% since the start of the year), once again led by the United States of America. Indeed, the S&P 500 Index grew 4.3% (15.3% YTD). US stock prices benefited from several factors, such as renewed anticipations of cuts in the benchmark interest rate by the US Federal Reserve (the Fed) and by overall better-than-expected results published by companies for the first quarter. For example, the results of 80% of members of the S&P 500 Index beat consensus' estimates. Lagging behind this quarter were the European and the Chinese equity markets, respectively up 1.6% (9.5% YTD) and down 0.5% (+2.1% in the first semester).

Equity Index Performance, rolling 12 months (%)

Source: Kestrel Wealth Management

European stocks were hammered by the victory of the far-right parties in the European Parliament election, particularly in France, which has led President Macron to dissolve the French parliament and to call for a snap election, facing the risk of having to govern with a far-right Prime Minister from the "Rassemblement National" (RN) party. The French CAC 40 index lost 6.5% since this announcement on June the 10th, before stabilising. If a Prime Minister from RN were to govern France (the second round will take place on July the 7th), immigration to France would be much more difficult, but we do not believe it would endanger the European Union, nor do we believe that France will leave the EU. However, this will add another source of volatility in the financial markets (if there were not already plenty enough), in particular on French government bonds.
Not only in France, but 2024 is an election year in many other countries. Taiwan, South Africa and India are some examples where elections already took place. Yet to come is the election in the USA and at the time of writing, UK citizens are about to go to the polls. As said in the past, new governments could have an impact on foreign policies, but we do not believe they can change the underlying fundamental trends of a country's economy, at least in democracies.

Elections could have an impact on currencies too, amongst many other elements. They are a reflection of the trust investors have in a country (we all have seen the free fall in the British pound when former UK Prime Minister Truss

Kestrel Wealth Management SA, Chemin de Trois-Portes 11, 2000 Neuchâtel, Switzerland
Tel: 0041 32 723 25 90 | contact@kestrel.ch | www.kestrelwealth.ch

announced her plan back in 2022, before recovering when she resigned). Looking at consensus' forecast, the euro is expected to strengthen vs. the US dollar to 1.11 (from 1.07) over the next twelve months. As far as the British pound is concerned, it is expected to strengthen slightly vs. the greenback, reaching the 1.29-region in a year's time (from 1.26 today). Separately, aside from the upcoming presidential election, the expected relative weakness in the USD is due to softening US economic data, as well as anticipations of future decreases in the rate by the Fed.

Geopolitics is also a significant source of intense volatility for equities and given the overall development across the world, we advise investors to get used to this environment, as we do not see international tensions in general to fade anytime soon unfortunately.
When Iran launched its direct attack over Israel on April the 14th, stock prices lost 3% over the following days on a global basis, before starting to recover. As very often, once investors have digested the news and evaluated the impact on the world's economy, the financial market "moves on". What is happening with the war between Russia and Ukraine is worrisome though, as the rhetoric is worsening week after week despite the peace conference that recently took place in Switzerland. Although easier said than done, in this anxiogenic environment, we would recommend investors to take a step back before acting, removing as much as possible the emotions from the investment rationale.

Anticipations of rate cuts resurfaced over the past month, driven by a decline in the inflation rate. For example, US inflation declined to 3.3% from 3.4%, after a couple of months of disappointing data overall. Looking ahead, the consensus foresees the inflation rate to be at 2.4% in twelve months. Some market participants are therefore predicting that the Fed will start reducing its benchmark interest rate as soon as September, following the recent move done by the European Central Bank (ECB). In June, the ECB decreased its benchmark interest rate by 25 bps, about two years after the start of the upcycle.
We believe that the Fed will start cutting rates only when it is confident that inflation is firmly back on the downtrend. However, keeping the benchmark interest rate at 5.5% for a prolonged period is not sustainable, as it would seriously endanger US companies with weak balance sheets, as well as significantly increase the likelihood of a hard landing of the US economy, which remains the major risk for equities. Therefore, we believe that the beginning of downcycle in the Fed's benchmark interest rate will occur sooner rather than later, but not necessarily as early as September, supporting the equity markets overall.

Regarding the bond market in general and interest rates in particular, the latter have been on a roller-coaster ride during the quarter, driven by the news flow over a weakening economic environment and expectations of future decreases in benchmark interest rates (or not). For example, the yield of the US 10-year government bond ended the quarter at 4.4%, virtually unchanged from end of March, but after climbing to 4.7% in April. In this context, bond prices remained about stable in 2Q (-3.2% YTD). Overall, yields in USD, EUR and GBP remain attractive to build long-term exposures to bonds, in our opinion, without onboarding significant risks as long as investors keep focusing on the Investment Grade segment.

In view of all the above, we remain cautiously optimistic about the financial markets for the time being. Admittedly, US equities are trading at an estimated price/earnings ratio of 21x, which is not particularly cheap (nor irrationally high). Indeed, the expected 12-month growth in earnings per share is estimated at 11%, still in line with an economy in the soft landing phase. Separately, we continue to monitor the evolution of various international tensions and the likelihood of a severe recession in the US.

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