TAM Asset Management

Quarterly Market Update

Q3/Q4 2024

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Highlights

Q3 2024

- Looking back at Q3 performance, global equities lost 0.3% and global bonds rallied 1.30%. This contrasts with Q2 where stocks went up and bonds went down.

- Largely speaking, the two major contributors to the switch in equity vs bond performance was US mega cap tech selling off (Nvidia dropped 7.8%, Alphabet lost 14%, Microsoft lost 11%), therefore dragging the global cap weighted equity index lower.

- A bumper 0.5% interest rate cut coming in from the US lit up the bond market with positivity focusing on the shorter dated part of the curve.

- Further speculation about more frequent cuts coming in from the Federal Reserve (Fed) over the next 12 months continued to drive further outperformance as investors bought further up the duration curve.

- The headline negative performance from global equities somewhat betrays the movements under the surface of the market, which were positive for active model portfolio service (MPS) managers like TAM. Global value stocks, emerging markets, China and small caps all outperformed US mega cap tech.

- Investors remained bullish in Q3 but started to broaden out their risk appetite into more attractive stock opportunities from across the global market such as value and small caps. This is perfect for a diversified portfolio that owns more of this part of the market, and why a lot of MPS managers, including TAM, outperformed their market indexes by a greater margin in Q3 compared to previous months.

Q4 2024

- Looking forward to Q4, we believe a soft landing is the most likely outcome for the global economy, and specifically the US economy. This will see inflation continue tracking back to its 2% target whilst the employment market cools, and interest rates are cut back to the 3% level to prevent a further detraction in unemployment.

- A soft landing scenario remains something of a rarity over previous economic cycles. This should boost investor sentiment towards both corporate and high yield bonds as interest rates come down, but also towards equities as we avoid a global recession and receive stimulus from interest rates coming down. This positivity will likely manifest itself in more cyclically exposed areas, such as value sectors in Europe and the UK, as well as globally.

- A recession is not off the table, and one should not discount the probability that interest rates at 5%+ for over a year have put the global economy onto an unavoidable recessionary path.

- Whilst this is not our base case, this course of events warrants preparation to plan and execute a diversified portfolio of high-quality companies in recession proof sectors as well as an overweight to developed market government bonds, which should prove a great source of capital appreciation as a 'safe haven' asset class.

Q3 2024 Strategic Review

Bonds and Equities: A Return to Normality

At a headline level for Q3, a 50/50 portfolio of global stocks and bonds delivered a performance gain of 0.7%. Specifically, global equities lost 0.3% and global bonds rallied 1.3%. Whilst this return of 0.7% was the same as Q2, the major difference was that Q2 saw stocks going up and bonds going down. The positive tone from the last two quarters is that stocks and bonds are once again behaving counter to one another, which is the way the relationship is supposed to work in a normal market.

Volatility in July and August

July and August saw an increased level of volatility with both months posting 2% and 5% sell-offs in equities, with a subsequent rally back towards the end of each month. So, whilst both months finished flat in terms of gains and losses, this betrays the volatile nature of both months. Much of this volatility in Q3 surrounded the fear that the global - mainly the US - economy was about to head into an early recession. Positively, the market shrugged off these concerns to stage a strong rebound. The roots of the recovery from August's sell-off was from the promise of imminent rate cuts from central bankers, which the US delivered in September with a bumper 0.5% cut.

Bond Market Recovery

The global bond market's 1.3% over Q3 pared some of the previous six months' losses of -2.35%. Clearly, there has been a step change in the performance of government bonds over the third quarter, which has been heavily influenced by the US finally starting to cut interest rates in Q3. This is a fantastic development in which many clients who are invested in bonds can finally start to see this part of their portfolio delivering profits.

US Stock Market Performance

So, with American stocks powering the lion's share of investor returns, up 15% in the first six months of the year, Q3 was another step change in which the US stock market delivered -0.67%. Understanding why this has happened is key to the quarter's narrative. Thankfully the rationale behind this quarter's dour moves is not overly difficult to get a handle on.

Influence of the Magnificent 7

For the first half of 2024, one doesn't have to look too far for a protagonist before you arrive at the US tech sector and specifically the Magnificent 7. Home in further and you're left with Nvidia, the formidable maker of AI chips whose stock price performance has been unstoppable this year.

Out of the 1,400 companies within the global benchmark, these 7 companies (Apple, Nvidia, Microsoft, Amazon, Alphabet (Google), Meta and Tesla) are just over 0.5% of the total 1,400 yet occupy a whopping 20% weighting within the global market given the value of their shares. This goes to show how much the fortunes of these 7 companies govern the overall performance of the global market. Nvidia, one of the largest companies out of the 7, occupies 4.32% of the entire global market and made 156% in the first two quarters. With performance like that, combined with a massive weighing in global indices, it's easy to see how these companies drove the lion's share of the 11% performance in Q1 & Q2.

Q3 Pullback of Tech Stocks

So, back to Q3, and that age-old saying of "what goes up, must come down" applies. Given the large concentration these 7 stocks have in the global market, all it takes is a small pullback within these 7 stocks to see the broader market come under pressure, and largely speaking that's what played out in Q3. Nvidia dropped 7.8% in Q3, Alphabet (Google) lost 14% and Microsoft lost 11%.

Broader Investor Sentiment

Thankfully this wasn't a complete deterioration in confidence in which investors usually run for the hills. Rather, investors' exuberance around the potential for these 7 stocks to keep growing exponentially was just starting to cool. Let's be clear, this is a good thing; investors behaving rationally in stepping back from company shares that have become overvalued are the hallmarks of a properly functioning market.

Continuing in the vein of positivity, Q3 has seen another positive development that's a broadening out of investor appetite. What that means is those same investors stepping back from buying these big 7 tech stocks have not gone into hiding but have instead chosen to start buying other, more attractive opportunities from across the global market. Why? Well, much of the change in appetite comes from the cuts to US interest rates, which are a cause for positivity.

Interest Rate Cuts and Market Dynamics

Cuts to interest rates are a loosening of financial conditions which help boost consumers' wealth and corporate profits, and thus feed into a more buoyant stock market. In turn, this leads investors into buying stocks that can rally the most in this easier environment than that of US tech, which looks comparatively expensive, hence the Q3 rotation. Finally, the earnings of companies that are not in the tech sector have been gaining ground since the start of the year.

This frames a large part of the stock market, which is cheap against tech stocks whose earnings are now recovering nicely, and the market started to notice this in Q3.

One can see this in the performance of UK and US smaller companies, which delivered fantastic Q3 outperformance over the US tech-led global rally. Again, this is a healthy development for client portfolios that focus on investing into a diverse basket of global opportunities, which was rewarded in Q3.

UK Market Performance

The UK market was a bright star in Q3, rallying 0.86% against the US and European markets which both posted a loss. This reflects some global confidence in UK stocks off the back of the UK now looking like a stable economy, with stable (ish) growth and a majority Labour government in power for the next 4 years. With UK stocks trading hands at large discounts, there is also wound-up potential in the market which investors were clearly snapping up in Q3. Whilst this is encouraging, we need to keep an eye on UK growth to ensure the economy doesn't slip into a recession, which would certainly spill over into the perceived attractiveness of UK stocks.

European Market Challenges

The European market, at an index level, was negative like the US and underperformed the UK. Given the political turmoil across the EU and the economic slowdown in Germany, as well as the continued war in Ukraine, we think Q3 should be framed as a positive result. That's because under the surface, there were success stories such as the German DAX returning strongly. However, it's likely that a lot of the positivity seen in the German market is more reflective of the international nature of the companies within those stock exchanges, rather than an upbeat indication of the state of Europe, which at the time of writing sees right and left-wing parties in France and Germany taking majorities in government, and nearly 4 million auto workers threatening massive pay strikes as VW tries to close down auto factories.

Q4 2024 Strategic Outlook

Economic Landscape and Predictions

Looking forward to Q4, with global inflation now convincingly below 3% and all major economies cutting interest rates by at least 0.25%, most investors have agreed that the inflation battle is, for now, won.

This scenario of inflation coming down, economic growth proving resilient, and interest rates being cut should see the equity and corporate bond market powering higher off the back of resilient economies and strong company earnings.

Recession Scenarios

On the flip side, if we see corporate earnings contract and economic growth slow, we don't see a deep recession but a shallow one, and importantly one which the investment community can look through without a broad stock market panic. Further, if the global economy slips into a steeper recession than predicted, central banks can cut interest rates down to the 1% range in short order, which should help to quickly stabilize the market and stimulate the global economy. If this happens, we see a large upside of more than 25% in government bonds, which we would look to heavily overweight to deliver further protection to clients' wealth.

Anecdotally, when thinking about a market crash, one must remember that large stock market crashes usually only occur after large economic booms. We certainly wouldn't say that global economies have gone through any major economic booms in the last few years, which should be reassuring for those reading.

Bond Market Outlook

In the land of bonds, investors have priced in a strong level of interest rate cuts (1%+) being delivered from developed economies like the US, UK, and Europe by the end of Q1 2025. Whilst this scenario is entirely plausible, we believe the global economy would need to see a rapid deterioration into recession to justify this level of interest rate cuts. We don't see this happening now, which should be good for stocks.

In this rosier scenario, we see government bonds underperforming corporate bonds in Q4, which we see as the main beneficiary of a slowing but not stalling economy that is being helped with interest rate cuts. As mentioned earlier, this call would be reversed if we see a larger economic recession, with TAM selling corporate bonds and buying government bonds as a strong layer of protection.

Stock Market Expectations

Looking at stocks into the end of the year, we see a similar scenario playing out, in which the market, encouraged by interest rate cuts and the promise of more, should be resilient to companies' earnings coming down a little bit without panicking. Broadly speaking, a soft landing, which we think is the most likely scenario from here, will be positive for stocks. Specifically, value stocks, which are primed to recover the fastest as the economy rebounds.

Indeed, this outperformance has already started to take root, with Q3 seeing the S&P 500 equal weight (passive) ETF delivering 2.20% against a flat market cap weighted S&P 500. Likewise, the active funds TAM invests into for US value stocks and US smaller companies delivered 8.5% & 6.3% respectively against the flat S&P 500 in Q3. A great retort to those who say active management is dead.

The Role of AI in Market Dynamics

The performance of the S&P 500 has, as you will know by now, become reliant on large US tech companies. We do see an inflection point in the market as the global economy starts to slow and rate cuts start to stimulate a rebound, and as previously highlighted, this looks like it's taking hold already. Much of the success of these companies' stock prices has been down to the advent of Artificial Intelligence (AI), and whilst we are huge believers in the application of this technology, we also think these stocks have collectively delivered an extraordinary level of performance as "AI enablers" vs actual real-world adoption.

It's reasonable to expect everyday companies in everyday sectors starting to make profits off the back of the AI innovation created from these massive US tech firms. So, either we see other (non-tech) companies' share prices begin to appreciate as they profit from the adoption of this innovation, or this next AI industrial revolution is found to be lacking adoption, and the stock price of these tech companies starts to come back down again. Either way, we see the tables starting to turn in favor of companies not classified as large US tech firms.

As previously mentioned, one of the goals of a good portfolio manager is to uncover great quality at great value, and we certainly see the next evolution of AI as a massive beneficiary to these undervalued stocks, which we are already seeing take root in global stock performance.

Political Landscape and Market Sentiment

Finally, as the US enters the last stages of the election campaign, we, like everyone else, can't see a standout front runner with the race so tight. We support our view that regardless of who wins, the stock market likes Trump's pro-growth agenda and will react positively to his prospects, and the bond market likes Harris's conservative approach to running the US fiscal deficit. However, both candidates are running a pro-growth campaign so expect the fiscal deficit to expand regardless.

Likewise, each candidate brings a very different approach to the presidency, and we expect wide-ranging outcomes and volatility from either side's domestic and foreign policy.

Conclusion: Navigating Uncertainty

To conclude, in any economic slowdown, which might occur as we move into the end of 2024, there are going to be points where it seems we are running off a cliff and markets will panic. There will also be the green shoots of growth showing up in the data which will make the market rally. We are focused on looking through each data point without succumbing to either short-term panic or euphoria, to concentrate on areas of the market we think are underappreciated, undervalued, and primed to deliver long-term compounded performance.

TAM has a 16-year track record of navigating volatile markets. If a deep recession does occur, we remain confident in our ability to guide clients through a challenging time.

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Current Positioning

View key:	🟥 Negative/Underweight	🟨 Neutral	🟩 Positive/Overweight

Asset Class	View	Summary
Equity	🟩	**TAM continues to maintain a neutral position to the equity market given the potential for market gains but the increased risk of a hard landing. TAM's position on the equity market remains positive but overlayed with caution as the global economy continues to steadily slow. We see the global equity market strengthening from here, buoyed by cuts to US interest rates, which is positive for equities so long as the economy avoids a severe recession. TAM does not have a severe recession priced into its models on account of there being a lack of excessive leverage and indebtedness within the global economy, as well as no signs of rapidly deteriorating employment to force a large bear market. TAM also sees more positivity as a result of rate cuts feeding into a stronger final quarter for value stocks over growth, which is a boon for active portfolios.**
UK	🟩	The UK market was a standout performer in Q3, and we see this continuing to recover into Q4. Much like Q3, the stocks in the UK remain oversold compared to those same competitors and despite a positive Q3, we still see comparative value from within the UK vs its peers like the US market. We believe the UK economy is on a good footing, which will paint a picture of economic stability that will feed into positive international investment, but likewise will likely erode the call for deeper interest rate cuts for the UK. This dynamic will strengthen the pound vs the dollar which, in Q4, benefits the international FTSE 100 vs the domestic FTSE 250.
US	🟨	The US's stock market performance went through a sea change in Q3, with the largest US tech firms falling back, and other cheaper stocks stepping forward as beneficiaries of the US cutting interest rates by 0.5% in September. We see this changing of the guard from growth to value remaining in play over the final quarter as interest rate cuts continue to come through, and the expectation that the US will avoid a recession should power investors to take on more stock exposure to undervalued companies.
Europe	🟨	European markets remain under both economic pressure and existing pressure from the ongoing war in Ukraine. Having said that, the EU is making positive cuts to its interest rates, and we are starting to see an uptick in consumer spending within the bloc. We see uncertainty ahead for Germany's economic prospects, as well as uncertainty on the political side for the wider bloc in the coming quarters. Despite this, we still think the prospect of a broader economic recovery and interest rate cuts will help to increase investment into the EU.
Emerging Markets (EM)	🟩	EM have kept up with the global market in Q3 and certainly received a boost from the dollar weakness coming from the US interest rate cuts. Like much of the wider market, we see a further boost to the EM performance from this positive perception that we are on track for a soft economic landing which will boost risk taking. The initial recovery within China will also help boost the entire region, which is still correlated to this large EM economy.
Japan	🟨	Japan remains under pressure as it looks to raise rates to combat inflation at a time in which other developed markets are now cutting interest rates. This has rallied the Japanese Yen vs other currencies, which is hampering the shares of Japanese firms which remain export led, and whose earnings are thus exposed to a rising Yen. We see some short-term weakness within Japan stocks and bonds because of this, but ultimately the corporate governance changes within the nation are one which we see delivering long-term gains for Japanese investors.
Asia	🟩	Asia, Like EM, remains good quality and in vogue with the international market. With China's recent stimulus package boosting the region, we see a positive performance uplift coming into the region over the coming quarters. There remains a large amount of scepticism around China so this positive outlook will revolve around that developing narrative, but we see a further boost to the region from the rate cutting, dollar weakening soft landing narrative which continues to drive the markets higher.

Asset Class	View	Summary
Fixed Income	🟩	**Overall, bond performance within the third quarter was positive and largely in response to the positivity of US cutting its interest rate by 0.5% against a backdrop of inflation continuing to come down to its broad 2% target. Government bonds picked up performance after a lacklustre 2024. Specifically, the shorter dated bonds expiring in under 8 years performed best, with this cohort reacting most positively to the US extra-large 0.5% cut. Looking forward, we see more positivity from all areas of the bond market, with corporate and high yield bonds being boosted from a soft landing, whilst government bonds rally on further rate cuts with the added boost of being an excellent defensive investment should the global economy slip into a recession.**
Government Bonds	🟩	We see the final quarter of the year continuing to benefit government bonds as inflation comes down without unemployment rising towards recessionary levels. We see government bonds remaining as a cornerstone to a properly diversified portfolio in Q4, as equities continue to charge ahead whilst government bonds tick higher as interest rates are cut but keep their potential to be a strong performer should the global economy slip into a recession. A point to watch will be inflation moving higher once again. This will put further cuts in jeopardy and add the potential to rate hikes, which would see government bonds under severe pressure.
Corporate Bonds	🟩	High-quality corporate bonds continue their outperformance as the economy shows signs of resilience. Importantly, with inflation coming down towards 2% and central banks cutting rates, we see this performance continuing to surge forward over that of government bonds and slightly behind that of high yield. We favour European and US corporates specifically but active management from within strategic bonds funds will deliver positive outperformance as we close out the year.
High Yield Bonds	🟦	High yield remains an outperformer, and we see this continuing as we move into the end of the year. Whilst this part of the bond market will continue to push forward, we do see it as the most susceptible to an economic pull back and thus the most volatile part of the bond market to be invested into in Q4. We prefer to maintain investments in the bonds of high-quality companies over lower quality high yield companies, which might not rally as much in the final quarter but remain a more stable investment with better defensive qualities should we move
Emerging Markets (EM)	🟩	Much like EM equities, we see EM bonds as a positive performer in Q4. Expectations of a weakening dollar, in response to the US cutting rates, should prove a powerful driver for EM bond outperformance. As well as a large cohort of emerging market nations already cutting interest rates, which should continue to feed through into positive economic performance. With the recent China stimulus package boosting sentiment, we see this as a further engine for positive emerging market bond performance in Q4.
Alternative & Absolute Return	🟩	**TAM's allocation to the alternative market has been reduced in the third quarter as portfolios focus on maintaining a larger allocation to core bonds. As the market continues to move towards a soft-landing scenario with inflation and interest rates coming down, we anticipate shifting back towards an increased investment into the alternative space. We expect to see continued strength from the precious metals markets as well as improved performance coming from alternatives such as commodities and absolute return strategies.**
Commodity	🟩	With the recent China stimulus package feeding through, as well as the wider cohort of EM nations cutting rates to stimulate economic growth, we see enhanced performance from the commodity market in Q4 as the anticipation of economic growth picks up. We also anticipate a further weakening of the dollar as the US continues to cut rates which should help the commodity market into the end of the year.
Property	🟥	Property remains too illiquid. Property funds' propensity for gating is a material risk for clients' portfolios.
Cash	🟥	**Tactically, we have been utilising lower cash levels as we invest more into bonds, equities and alternatives to help boost longer-term performance over that of cash.**

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