BOV ASSET MANAGEMENT
A MEMBER OF THE BOV GROUP

# 2024 MID-YEAR MARKET OUTLOOK

# INTRODUCTION

The first half of the year delivered strong returns across risky assets. Global equities were up 12% during the first six months of the year, with a return of 15% and 10%, across US and European equities, respectively. The upside across US equities was disproportionately attributed to a small group of equities, led by Nvidia which has rallied 150% year-to-date. This is mainly attributed to the ongoing investment in AI which has boosted the earnings fundamentals of companies that are expected to benefit. This improvement in earnings expectations has so far managed to offset the volatility attributed to the timing of when the Fed will start cutting rates. In contrast to the ECB, which delivered its first rate cut in June, the US Fed has delayed the start of monetary policy easing to later this year. Bond markets have repriced downwards to factor a more gradual easing cycle and the more recent rise in political risks emanating from elections. The high yield market also locked a positive return of 3% during the first six months of the year.

We remain positive that economic growth will be steady while Central Banks embark on monetary policy normalisation in the second half of 2024. Even so, political and fiscal risks will continue to feature, with France in the spotlight following a surprise election, as well the US Presidential Election towards the end of the year. Following the strong performance year-to-date, we retain our preference to equities whilst tactically balancing beta exposures in our equity allocation and credit risk across fixed income. Investment grade bonds are expected to benefit from further rate cuts, lowering yields and therefore, increasing in value.

The key main drivers for the next six months are:

**• Macroeconomic conditions remain supportive despite signs of moderation.**
Following better than expected data in the first half of the year, the growth outlook has improved. Unemployment rates remain low with tight labour markets keeping wage growth at elevated levels. Positive earnings results also provide evidence of healthy economic fundamentals. The more recent softer data, such as US hiring rates at ten-year lows and disappointing retail sales signal only a moderation in economic growth. As a result, we expect earnings to remain steady with potential for equity market performance to broaden across sectors.drive further rate cuts in the second half of the year.

**• Inflation is expected to progress lower, driving monetary policy normalization**.
Disinflation has been slower than expected but progressing across all regions. Global headline inflation is close to the pre-covid level, but core inflation has proved sticker than expected, particularly in the US. This has led to monetary policy divergence between the US and Europe and a slower pace of easing. The path of monetary policy normalization is highly data dependent and is expected to remain a source of market volatility. The US Fed is likely to cut less than expected if the economy continues to perform well. However, the current tight monetary policy is likely to continue to slow growth which would help cool services inflation, the strongest component, and drive further rate cuts in the second half of the year.

**• Election uncertainty features in the second half of the year**
France's snap parliamentary election has increased fiscal uncertainty to one of Europe's largest economic players. The possibility of a hung parliament where no party obtains a majority triggered moderate spread widening as additional risk premium was priced in. The impact is likely to be contained to France and could present opportunities in companies that have a more international revenue exposure compared to domestic plays. The presidential election in the US is another source of geopolitical risk with odds increasingly favouring Trump following the first debate. This election outlook would more likely continue to support US outperformance compared to Europe.

# EQUITY OUTLOOK

The stock market has shown remarkable strength this year, with the S&P 500 up 15% and the Euro Stoxx 600 rising 10%. Major indexes continue to hit record highs, supported by solid earnings and positive momentum, despite higher for longer interest rates.

Notwithstanding adequate breadth in this bull market, leadership remains quite narrow on a rela-tive basis due to earnings concentration. The market-weighted S&P 500 driven by a few mega-cap stocks outperformed the equally weighted equivalent by circa 10% in the first half of the year. Broader market gains could occur if central banks cut interest rates and earnings converge.

In Europe, political uncertainty in France has hindered outperformance amid a fragile economic recovery. While extreme political outcomes now seem less likely, instability may persist. The eco-nomic recovery remains delicate, susceptible to external shocks, especially from China's structural issues. Continued ECB rate cuts could enhance growth, benefiting consumers through rising real incomes.

In the US, the gap between investor expectations for significant rate cuts earlier this year and the Fed's more conservative projections has narrowed, and investors have adjusted to the "higher-for-longer" rate environment. Signs of moderating rather than collapsing US growth, normalizing labour markets and disinflation indicate that the Fed may lean towards easing. If the Fed entertains the possibility of a potential rate cut in September, markets may react positively, interpreting bad economic data as a sign of forthcoming easing. This year is also particularly significant as the fourth year of the US presidential-election cycle. Historical patterns indicate strong market returns during this period, potentially extending the bull market.

Globally, economic and policy cycles vary by region. Though global growth may be slowing, strong private-sector fundamentals and substantial fiscal support could sustain earnings and profit margins. A generally supportive macroeconomic environment suggests we are in the mid to late-cycle phase. Disinflation trends support the possibility of further central bank easing later this year. Thus, while the bull market is maturing, it may still have room to run.
As markets transition from a valuation-led to an earningsled bull market, strong Q1 earnings, especially from mega-cap stocks, have provided market support. The Magnificent 7 mega-caps are trading at about 34 times earnings, while the rest of the S&P 500 is at 21 times. This disparity high-lights opportunities for stock selection as earnings growth may expand beyond current leaders.

US earnings estimates for 2024 and 2025 are optimistic, with projected growth of 12% and 17%, re-spectively. As the second-quarter earnings season approaches, elevated growth estimates suggest potential double-digit gains. High earnings expectations for 2025 at a time when valuations are hisWtorically elevated could lead to market volatility if economic growth is revised downward. Currently rising profit margins are driving this momentum, reducing the S&P500's forward P/E ratio to approximately 21 times.

The EU, on the other hand, presently has much lighter positioning and cheaper valuations, with the MSCI Europe's current and forward P/Es at 13.6x and 11.96x respectively, offering room for further modest expansion if the mid to late-cycle script stays on track.

In conclusion, growing earnings and a dovish central bank stance currently outweigh concerns over high valuations and higher for longer rates. Strong market trends, momentum, and liquidity continue to support the ongoing bull market while earnings revisions and political uncertainty may drive volatility.

# FIXED INCOME OUTLOOK

The slower than expected monetary policy easing cycle has led bond yields to remain high, in a scenario of better-than-expected growth. This has presented opportunities for investors to lock in attractive yields in the fixed income markets.

A slow but steady monetary policy easing cycle in the coming months, should provide further support to investment grade bonds. The high-quality fixed income market is expected to benefit from a lower shift in yields, with the short end reacting to central bank decisions and longer dated bonds repricing both monetary policy and term premium. With the yield curve already deeply inverted, the magnitude of shifts is unlikely to be even across all tenors. Nonetheless, longer dated bonds are expected to benefit from increased price sensitivity to changes in interest rates. This continues to support our view to tactically add duration risk to the fixed income allocation.

The improvement in economic fundamentals during the first half of the year has led to spread tightening across fixed income assets, particularly lower quality investment grade bonds and the high yield market. With signs of softness in economic indicators, we expect central banks to continue to pivot towards interest rate cuts, which should help support economic growth expectations. On this basis, we expect spreads to remain range bound for the rest of the year.

Despite our positive view, we continue to monitor the main sources of volatility, namely the Fed's decision on the US rate cycle, which could lead to more monetary policy divergence and pose a challenge for other central banks to deliver on expected rate cuts. Meanwhile, election outcomes across both regions could result in short term volatility. However, we expect reactions to remain moderate and contained, with fundamentals remaining the key driver for bond markets for the rest of the year.

# LOCAL MARKET OUTLOOK

The local economy is expected to deliver strong economic growth for rest of the year, despite a moderation from 2023 levels. Latest central bank forecasts show an expected economic growth forecast of 4.3% and 3.5% in 2024 and 2025, respectively. Despite the slight downward revision in private consumption, this component is expected to be the key driver of economic growth for the rest of the year. In line with the broader European market, unemployment rate is also expected to remain low at 3.1%, with a tight labour market expected to push wages higher. Malta also mirrors the progress on inflation, with the annual HICP inflation easing from 3.7% to a projected decline to the 2.4% level as at the end of the year, and below the 2% central bank target by the end of 2026. Central bank forecasts show a faster disinflation process than anticipated with progress in food, services and non-energy industrial goods inflation. Energy prices are expected to remain stable, given the ongoing government support.

For the local bond market, we expect the ongoing ECB's monetary policy easing to be a key driver of returns. Despite the repricing of expectations over the first half of the year, the ECB is expected to deliver more rate cuts in the coming months, pushing yields lower. This should benefit the local Malta Government stock market, particularly longer duration bonds which carry a higher sensitivity to changes in the level of interest rates. Meanwhile, the corporate bond market has enjoyed positive returns during the first six months of 2024, up by 4.11% as at end of June, as spreads tightened. We continue to remain selective on the bond issuers, focusing on companies with strong financial positions and offering attractive risk adjusted returns. Across the local equity market, the first half of the year recorded strong earnings results across the largest companies, namely Bank of Valletta, Malta International Airport and HSBC Bank Malta, which represent 45% of the equity index total market capitalisation. We continue to expect the supportive economic backdrop as well as local market dynamics, such as the demand for dividend to drive local equity market returns for the remaining half of the year.

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