RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

As we pass the halfway mark of the year, a moment that lends itself to a review of market-related developments during the first six months of 2024, one word seems to come to mind: “unresolved”. Many of the things on investors’ worry list at the start of the year have not been removed. These range from the outlook for inflation and interest rates, to possible results from several important elections – indeed, a couple of those which will take place this week in the UK and France, were called unexpectedly. On the geopolitical front, we seem to be no closer to a cessation of hostilities in Ukraine or the Middle East.

And yet, as we seem to have noted relatively frequently over the years, investors have been well looked after by markets. Equities have built on the recovery that started during the final months of 2023, and although bonds have yet to sparkle, they seem at least to have found an equilibrium. While the gains in global equity markets have been relatively concentrated into a small group of (mainly) leading technology companies, we are not unduly concerned that those gains are unsustainable and certainly push back on arguments to suggest that we are in a bubble similar to the one that developed at the turn of the millennium.

As we entered the year, one of the strongest expectations was that central banks would soon be in a position to start cutting interest rates as inflation continued to recede from its highs. Interest rate futures were pricing in the first cuts for March, but here we are in July and neither the US Federal Reserve nor the Bank of England has acted. There have been some small reductions made by, for example, the European Central Bank (-0.25%) and the Swiss National Bank (-0.5%), but certainly not to the extent that was anticipated. The main reason for the lack of action is that inflation has failed to drop quite as fast as the authorities would have liked. Positively, this reflects resilient economic activity; more negatively it also reflects tight labour markets and some lingering effects of past supply chain bottlenecks.

This delay notwithstanding, we maintain our opinion that inflation will continue to trend lower, although not necessarily to settle at the very benign levels that were prevalent in the decade before the Covid pandemic. Global trade tension, climate change, the green energy transition, demographics, increased levels of spending on defence and the appeal of “populist” politicians conspire to make inflation a greater threat than we have been used to for many years. And central bankers seem to be acutely aware of this, refusing to take for granted that they have it beaten. The good news is that investors continue to have faith in central banks’ policymaking, at least as indicated by the relatively benign long-term inflation expectations that can be inferred from the prices of index-linked government bonds relative to conventional bonds. That being the case, we also believe that future interest rate cuts are a question of “when”, not “if”.

Should interest rates remain “higher for longer”, market outcomes will be highly dependent upon why. If it’s a case of resilient growth and no real inflation scares, then increasing profits should be supportive of risk assets, although bondholders will do little more than clip coupons. If it’s a case of inflation being too sticky, while higher rates finally depress activity, generally described as “stagflation”, then the outlook would be less rosy. In a similar vein, we have always cautioned that investors should be careful what they wish for in terms of falling interest rates. A benign “immaculate disinflation” leading to rate cuts would constitute the best of all possible worlds, but lower rates born of a recession would be much less friendly to equities and corporate bonds. In terms of tactical asset allocation, we continue to find it hard to tilt portfolios heavily in favour of any of these potential scenarios, although we do consider government bonds to be more attractive as an insurance policy against negative economic developments now that yields have been set higher.

As for the politics, we go to print just ahead of the UK general election and the second round of voting in the French legislative elections. It has long been our opinion that the UK election would be something of a non-event from a financial market perspective, and so it has proved. The strong showing of the pound this year is testament to the lack of investor concern. The first round of voting in France’s election was deemed to have reduced the risk of the worst two possible outcomes, those being a majority victory for either the far right National Rally party or the left-wing New Popular Front coalition. The current view is that the second round will lead to a “hung” parliament, with limited ability for any party to deliver on their promised policies. President Macron will continue to preside over international and defence policy. But the world is now on notice for a potentially more radical president in 2027.

The biggest uncertainty still surrounds the US election. Indeed, the first presidential candidates' debate brought into question whether President Biden would even make it as far as November's poll. We might not know for sure who the candidates are until the Democratic convention in late August. Despite the high levels of polarisation observed in US politics (amongst both the participants and the voters), both parties appear committed to prolonging the spending spree that has characterised recent years and led to high annual fiscal deficits and a rising ratio of debt to gross domestic product. Whether "bond vigilantes" force the next President to rein in the spending remains to be seen. The best outcome would be a surge in productivity spurred on by the adoption of generative artificial intelligence (AI) allowing the economy to outgrow its debts, although that might be wishful thinking.

Markets – US

US equities made 31 new all-time highs during the first half of 2024, having failed to make a single new high between December 2021 and December 2023. The S&P 500 delivered a total return of around 15%. Many have been surprised by this outcome, considering that interest rates and bond yields have remained high (and are now much higher than was expected in January). While there has been some evidence of increased valuations, the main driver has been company earnings growth, especially from those companies involved in all aspects of the development of AI. The heavy lifting has been done by a relatively small group of mega-cap technology leaders, and that concentration of leadership is also causing concern. We have seen various pieces of research which suggest that those concerns are overplayed and we tend to agree. One made the case that the share of economic profit of these companies continues to be higher than their share of market capitalisation. Another looked back at the years since 1950 when the market's returns have been dominated by a small group. There were only two years (out of nine identified) when the following year's returns were negative, and those years were 2000 (the Tech Bust) and 2008 (the Global Financial Crisis). Much as these have the potential to become "famous last words", we continue to believe that a replay of either is not imminent. On the first count, these companies are far more profitable than their predecessors, with fortress balance sheets and valuations that are nothing like as egregious. On the second, we continue to refer to the far greater strength of banks' capital today, as well as to the continued vigilance of central banks and financial regulators and their willingness to backstop the financial system (as witnessed in March 2023 when Silicon Valley Bank filed for bankruptcy). However, we are mindful of the risk of a hiatus in the growth of AI-related demand and manage our exposure accordingly.

UK

The returns from the FTSE 100 have not been as strong, but a total return of almost 8% is not to be sniffed at, especially as the UK stock market is not home to any global technology leaders. As always, a reasonable chunk of the market's return has been from dividend income, with the annual dividend yield running at around 4%. Around a quarter of the index's points gains have been generated by the pharmaceutical company Astra Zeneca (+18%), a world class company in its industry despite not having any exposure to the appetite suppressing drugs that have taken the world by storm. Much less is made of the concentration of the FTSE 100's returns, where 99% of the 430 points accumulated this year can be attributed to just six companies, with the others being Shell, HSBC, Unilever, Rolls Royce and RELX, of which only RELX can be said to be enjoying a boost from its association with the AI story (it has vast amounts of proprietary data which it can interrogate for the benefit of its customers, especially in the legal profession). That list certainly displays far less industry concentration risk. At the other end of the size scale, we have been encouraged by a recovery in smaller companies, with the total return of the FTSE Small Cap Index (ex-Investment Trusts) being marginally greater than 8%. There has been some recognition of value in the form of increased merger and acquisition activity as well increasing optimism about the benefits of a more stable political environment should Labour prevail in the election as expected.

Europe

European indices have done slightly better than the UK in local currency terms, but slightly worse when measured in sterling. The gains were concentrated into the first three months, and the mixed economic recovery and pushing back of interest rate cut expectations stalled progress. More recently, political developments have threatened to

cause an upset. While the results of European elections were not entirely welcome, thanks to the strong progress made by far right parties in the core countries of France and Germany, it was President Macron's decision to call a snap parliamentary election which really started to undermine confidence. The threat of a new, fiscally irresponsible government sent French government bonds tumbling, with their yield spread over German Bunds rising from 0.5% to 0.8%. While not anything close to the near 2% levels reached in 2011 during the eurozone crisis, it was still enough to remind everyone that France has been living beyond its means, having not generated a fiscal surplus in five decades. Part of the disaffection with Macron is that he has been trying to fix the deficit, with one of his more unpopular policies being to increase the state retirement age from 62 to 64 (if one has worked for 43 years). Stress in eurozone bond markets also reminds us of the lack of policy flexibility in Europe thanks to the fact that monetary policy is controlled by the ECB. It can really only act in the interests of a single country in the event of a major crisis and we would not wish to see that resolve tested. It remains to be seen whether National Rally, the likely winner in the second round, will be able to form a government, but there is also some hope that it would in the end be constrained by the realities of being in power, as we have seen in the past in Greece and, more recently, in Italy.

Japan

In another of our occasional reports on Japan, it is pleasing to observe that enthusiasm for its shares is undimmed, although the total return for the TOPIX index measured in sterling (+6%) relative to the return in local currency (+20%) is testament to the continued slide in the value of the yen. Although the economy has escaped inflation and is showing some signs of sustainable growth, the Bank of Japan remains reluctant to raise interest rates by much. With other countries being slower than expected to cut rates, the yen "carry trade" is back in fashion, with yen being borrowed to invest in other higher-yielding currencies. The yen's fall below 160 vs the US dollar takes it back to levels last seen in 1986. But away from that, companies continue to be more attuned to the needs of shareholders, and this helpful trend should continue to generate positive returns.

Emerging Markets

There was some volatility surrounding elections in India, Mexico and South Africa, although markets have subsequently settled down. While Mexico awaits the inauguration of its new President, Claudia Sheinbaum, in October to see whether she will be as market-friendly as her predecessor, Indian shares have rallied to new highs after the initial disappointment of a less-than-resounding victory for the incumbent Prime Minister, Narendra Modi. South African equities also trade at their all-time highs, although a reduction in the value of the rand betrays continued uncertainty about the composition of the government. As always, emerging market indices look to China for leadership, and that is still not forthcoming. Hopes for further economic stimulus remain unmet, while the shadow of the country's real estate sector collapse looms large over the economy as a whole. Ongoing tension over China's claims over Taiwan and its claimed jurisdiction over the South China Sea (which has brought it into conflict with the Philippines), also weigh on sentiment. July's third Communist Party Plenum of the current Presidential cycle may yet present a chance to deliver a positive surprise, as this is the event at which the Party tends to lay out its long term growth plans. But what Emerging Markets would really benefit from is US interest rate cuts and a weaker dollar. All in good time.

Gold

Another occasional report. Gold has been a strong performer so far this year, rising around 13%. Past periods of strong returns have often been associated with inflation, although we believe that other forces have been more prevalent in this cycle. Chief amongst them is the desire of certain central banks to diversify their reserves away from dollar-based paper assets, such as Treasury bonds. China, Russia and Turkey have all been cited as major buyers. The rationale is that the US has too great an ability to freeze (or even seize) reserves held in its bonds or banks, which is exactly what happened to Russia when it was sanctioned following the invasion of Ukraine. This would appear to be a source of demand that is not yet drained.

Fixed Income

Government bond markets, having rallied strongly towards the end of 2023 in anticipation of the interest rate cuts that never came, have, unsurprisingly, struggled to find new direction this year. Economic growth and inflation are not weak enough to persuade central banks to cut, but neither are they so strong as to raise the prospect of further increases. And while the threat of persistently high fiscal deficits in many countries lurks in the background, investors do not yet appear ready to demand higher yields to compensate. Even so, we believe that current yields offer a reasonable return for those seeking insurance from potential economic weakness, and that central banks would be quicker to cut interest rates in the face of a threat of recession than is currently priced into forward curves, and so government bonds are worthy of inclusion in balanced portfolios.

The Bloomberg Global Aggregate Index of investment grade bonds is -0.7% year-to-date (total return in USD), while the sterling hedged version is precisely unchanged. The current UK 10-year Gilt has generated a total return of -3.2%.

UK Gilts have delivered a total return of -0.9% over the last three months and +6.4% over the last year. Index-Linked Gilts returned -2.2% and +6% over the same respective periods. Emerging Market bonds produced a total return of +1.7% in sterling over the three months to end June (+14.5% over 12m). Global High Yield bonds delivered +1.3% (+13.9% over 12m) in sterling.

Conclusion and Outlook

We entered the year with greater optimism than in either 2022 or 2023, encouraged by our opinion that inflation would continue to trend lower and that the prospect of an interest rate cutting cycle was ahead. Whilst our best hopes for inflation and interest rates have not (yet) been met, growth has been resilient and equities have prospered. We also noted the packed global election calendar, observing that investors tend to become a bit more cautious ahead of the result being clear, but that the threat of a major upset which might badly affect financial markets was limited. So far, so good, even taking into account the surprise election in France. We are not inclined to change our opinions at the halfway stage. A seasonal pause for breath is possible over the summer, and we know that more thinly traded markets are vulnerable to surprises, but we retain our faith in the ability of the companies we choose to invest in to continue to compound returns way beyond just the next few months.

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