RATHBONES | Incorporating Investec Wealth & Investment (UK)

05 March 2024

Market commentary

John Wyn-Evans
Head of Investment Strategy

Overview

February saw a continuation of the positive trend for equities. Government bonds found the going harder as Consumer Price Indices generally showed inflation to be a bit too sticky for comfort. This led to a repricing of the timing of the first interest rate cuts of the cycle, with an almost unanimous expectation of a March cut by the US Federal Reserve being pushed out to June, and the UK and Europe heading in the same direction. Even so, any immediate risk of a derating of equities has been offset by the prospect of stronger and more sustainable growth, with several research houses abandoning their US recession calls for 2024.

Whilst the US prospers, the UK fell into a technical recession in the last quarter of 2023, although only by the slimmest of margins, with seemingly little negative momentum. The balance was tipped the wrong way by the latest junior doctors' strike. We recall that during the pandemic, monthly GDP data was influenced by vaccination numbers, a reminder that healthcare accounts for around 11% of the UK's economic activity. Some of the economic data for January, such as mortgage approvals, showed evidence of a recovery. Continental Europe as a whole is in a "zombie" state - not growing but not in a technical recession either.

The corporate earnings season progressed well in aggregate, with better average "beats" in the US than in the UK or Europe. Positive features included "beat and raise" announcements from important Technology companies including Meta, Amazon, ASML and SAP. Semiconductor chip designer Nvidia provided the icing for the cake with yet another astoundingly positive report. A better tone from some of the Luxury Goods companies helped France's CAC40 Index to new all-time highs. Even Germany's DAX Index has reached a new peak, despite the travails of its manufacturing and real estate industries (although remember that it is a total return index). China finally showed some signs of life; its equities were the top performers in February.

There is little doubt that the dominant investment factor is the US economy, and especially the inflation component. If GDP can continue to expand while inflation steadily declines, then we could congratulate the authorities on pulling off an unexpected "immaculate disinflation" (at least if we are willing to ignore the fiscal cost). Should the expansion falter, much will then depend upon the path of inflation and how fast the Fed might be able to cut rates. Too fast growth and sticky inflation would bring the risk of higher interest rates and bond yields, setting up the potential for a re-run of 2022. This is not a central case for us, but definitely a tail-risk.

Supply chain risks owing to disruption in the Red Sea (and consequently the Suez Canal) are a short term worry but should be containable as long as there is no demand stimulus to exacerbate the situation (as per the Covid era). We note also the 80% fall in traffic through the Panama Canal owing to low water levels. It is exceptional for two of the world's key man-made waterways to be constrained in such a fashion, and this can only be negative at the margin owing to delays and higher costs. Container rates from China to Europe have already tripled. Fuel costs have increased owing to the extra ten days required to navigate around the Cape of Good Hope, as well as the fact that ships are sailing a bit faster to make up time. The shipping industry had adopted a "slow steaming" policy in recent years to cut costs and reduce carbon emissions but needs must. Remarkably, according to one study we saw quoted (Sea Intelligence), as little as a two knot increase in speed from the prevailing average of fourteen knots increases fuel consumption by 31%. The higher speeds and longer route combine to increase emissions by 70%.

None of this is welcomed when cutting carbon emissions remains high on the agenda, and yet incentives to reduce emissions are not working either. The cost of a permit to emit a tonne of carbon in Europe has almost halved, from a peak of €97 in 2022 to a current €54, although that is around twice the level which prevailed before the price took off in 2021. On the positive side, some of this reduction is down to lower demand after there was a pivot away from some carbon-emitting fuels when supplies from Russia became constrained. More negatively, it also reflects the parlous state of the German manufacturing sector. There also seems to be a surfeit of permits in issue, something that needs to be addressed by the European authorities if such as system is to succeed in changing behaviour. One study by Goldman Sachs, which we have referenced in the past, suggested a carbon price in the region of €150 per tonne would be required. That compared to a global average (as best they could estimate) of around €1.50. And someone will have to pay that difference, which makes for some challenging decisions about how to treat higher carbon prices when it comes to inflation.

We continue to believe that increasing average temperatures should be thought of more from the perspective of "climate change" rather than "global warming". The latter tempts

one to fall into the trap of imagining oneself basking in a Mediterranean climate, in a British garden, sipping the contents of a fine bottle of bubbly from a vineyard in Yorkshire (what would Monty Python's four Yorkshiremen make of that?!). The reality will be more extreme weather events, in terms of climate, drought and flood, and wind and longer periods of calm. Thus we see the potential for greater volatility in inflation as supplies are disrupted, providing a very different background for building balanced portfolios to the one which we have experienced for much of the last forty years. This is not necessarily anything to fear but does need to be approached with a keen eye for the right solutions.

The usual litany of (geo)political risks is in evidence, although none of them are escalating sufficiently to throw financial markets off course. There is no strong reason to expect the course of events concerning Russia/Ukraine or China/Taiwan to change dramatically, although these both represent high impact risk. We continue to believe that the UK election is not a big market-sensitive event, but the US election could be. However, there are still too many uncertainties to make it a key factor in our tactical asset allocation today (even running to the possibility that neither Biden nor Trump will be on the final ballot).

Markets – US

Over the last few weeks, we have had face-to-face contact with eight different economists and strategists (and that's before all the usual reading of notes and comments). It remains a feature of this cycle that there is a very broad range of opinions about the state and outlook for the US economy and the prospect for equity returns. To some degree, this is reflected in our own Global Investment Strategy Group, where there is a sharp divide between those members who are more cautious and those who are relatively relaxed (although not necessarily extremely optimistic). The positive case for the economy is "more of the same". The jobs market and household consumption are resilient, as is the housing market (in terms of pricing, if not turnover); capital expenditure remains strong, driven by "reshoring" and the green energy transition; and government spending is showing no signs of letting up ahead of this year's Presidential election.
The more negative view is that it is only a matter of time before higher interest rates finally weigh on activity, triggering a retrenchment in the jobs market. Some are trying to have it both ways, maintaining that the current momentum will only weaken much later, possibly in 2025. The fact of the matter is that the consensus forecast for US GDP growth in 2023 at the beginning of the year was just 0.3%, while the outcome was 2.5%. For 2024, the consensus has risen from 0.6% last summer to a current 2.1%. It is clear that most observers are struggling to read the growth, and that translates into forecasts for the equity market, which range from 3550 at the bottom to 4500 at the top, with the average currently at 4897 according to a Bloomberg poll. That is about 200 points below February's closing level.

UK

While many stock markets around the world are being propelled to new highs by strong tailwinds, the UK is stuck in the doldrums, displaying a small negative return so far in 2024. Although there are a few notable gainers in the FTSE 100, led by aerospace company Rolls Royce (+26%), none have the critical mass to lead the overall index forward. Big sectors including Energy and Mining are weighed down by poor commodity price action, while Consumer Staple stocks are deemed to have neither sufficient growth appeal nor the potential for cyclical recovery. The country waits for a General Election date to be set against the background of there being no fiscal policy headroom, while at the same time the Bank of England appears happy to sit on its hands in terms of monetary policy, and so there is no catalyst for change. Thus we make no apologies for an unusually short UK section this month.

Europe

With there being much talk about the (narrow) leadership of equity markets, quite a lot of headlines have recently been given over to the GRANOLAS. These have nothing to do with breakfast cereal, but the more contrived group of leading (mainly) European long-term quality compounders put together by Goldman Sachs three or so years ago to

complement the US FANGMATs (as they were at the time, having since evolved into the Magnificent 7). The list comprises Glaxo, Roche, ASML, Nestlé, Novartis, Novo Nordisk, L'Oréal, LVMH, Astra Zeneca, SAP and Sanofi, and so is a broader and more diversified list than Mag 7, as well as offering something of a barbell in terms of cyclicality and defensiveness. With the best will in the world, we're not sure that even the clever people at Goldman Sachs saw either the boom in GLP-1 appetite suppressing drugs or AI mania coming, but they ended up in the right place, with the GRANOLAS contributing around half of the gains in European indices since the beginning of 2022 and even outperforming the Magnificent 7 since the end of 2021, thanks to not having suffered the catastrophic drawdown of the very long duration names in 2022. Not that it's been roses for all of them. Since the beginning of 2023, for example, Roche (-17%), Nestle (-9%), Astra Zeneca (-5%) and Sanofi (-6bps) have all delivered negative total returns in sterling terms. The outright winners are Novo (+76%), SAP (+72%) and ASML (+67%). A couple of immediate observations: first, this is what portfolio investing is all about – balance and diversification. If everything you own is going up simultaneously you probably have too much risk; second is the divergence of performance within the Pharmaceutical/Healthcare sector, which reminds us that drug discovery is a key driver of single stock performance, overwhelming factors such as long-term demographic trends which tend to be cited as a thematic reason to own the sector. AI is being touted as a positive factor to the pharmaceutical industry, thanks to the promise of faster and more targeted drug discovery, although we're still waiting for hard proof.

Japan

As a coda to last month's ad hoc commentary on Japan, it should be pointed out that Japan's most referenced equity index, the Nikkei 225, did finally surpass the peak that it made on the final trading day of 1989, providing a moment of catharsis for long-suffering Japanese investors. Of course, a lot depends upon one's investment timeframe. Over the last decade, the TOPIX Index (which is more sensibly constructed) has generated a total return of 177%, easily beating the FTSE 100 (+81%), Euro Stoxx 600 (+135%) and MSCI Emerging Markets (+104%), even if keeping up with the S&P 500 (+385%) has proved too challenging. (All percentages are total return in Japanese yen, and so would have been the experience of a domestic Japanese investor). Given that the Japanese Government 10-year Bond issued in March 2014 was issued with a coupon of just 0.6%, a holder of that instrument will have generated just over a 6% return over the same period – and yet it has still been very difficult to get Japanese investors to embrace the equity culture. The TOPIX has yet to reach its 1989 peak, which is about 6% away. There is also an object lesson here for what happens in the aftermath of bubbles. The key sectors involved in Japan's bubble were Real Estate (the borrowers) and Banks (the lenders). The Japan Banks index is still down 80%, despite having trebled from its 2012 low.

Emerging Markets

Part of the bull case for EM assets is built upon the peaking of the US interest rate cycle, which would, in turn, be expected to lead to a weakening of the dollar. All other things being equal, a weaker dollar tends to be supportive of EM assets. It reduces the cost of dollar liabilities and increases investment flows into other currencies. Given that a strong dollar can be a symptom of safe haven-seeking by investors, a weaker dollar can be a sign of increasing appetite for risk. EM assets are generally judged to be riskier on account of displaying higher volatility, as well, perhaps, as not being as safe as their Developed Market counterparts in terms of governance (a claim that might ring hollow given some of the events experienced in recent years). Are EMs heading for trouble if US rates stay firm? Not necessarily. The good news is that sticky inflation is less of a problem in EMs generally as they are not experiencing the same demand pattern shifts which are holding up DM services prices. Neither did they hand out buckets of money during the pandemic. And if global trade is picking up from its lows, of which there are tentative signs, that is positive for overall activity. China remains another key sentiment driver, and March sees the National People's Congress at which the leadership will set out its latest growth targets and plans. Hope springs eternal for a more forceful response to the sluggish economy, with a focus required on the ailing real estate sector. Even a record 0.25% cut in the 5-year loan prime rate (which is the one

most closely linked to mortgage rates) has only lifted spirits marginally. On a brighter note, the Chinese Lunar New Year holiday saw 474 million trips undertaken, which was an increase of 19% over the most comparable pre-pandemic number from 2019.

Fixed Income

The relatively lacklustre start to the year in sovereign bond markets has given way to a period of greater calm. Global bond indices remain down for the year, but, to some degree, that reflects a touch of over-enthusiasm towards the end of last year. We continue to believe that the readjustment of bond yields to more "normalised" levels is now largely complete and that bonds offer a more attractive "safety net" once more in the event of economic weakness. High Yield credit spreads have fallen to their lowest level of the current cycle, suggesting limited stress.

UK Gilts have delivered a total return of +2% over the last three months and +1.1% over the last year. Index-Linked Gilts returned +1.9% and -2.2% over the same respective periods. Emerging Market bonds produced a total return of +6.3% in sterling over the three months to end February (+8.5% over 12m). Global High Yield bonds delivered +4.2% (+11.2% over 12m) in sterling.

Conclusion and Outlook

We entered the year with cautious optimism ahead of the expected turn in the interest rate cycle, and equity markets have extended their gains from the end of 2023. We continue to note a wide dispersion between the best and worst performers, with instant and severe retribution being handed out to companies which underperform expectations. While there are hints of speculative behaviour emerging, there is nothing yet to suggest the extremes of late 2021 or the heights of the TMT boom (Telecoms, Media and Technology) in 2000. Even so, we also note plenty of post hoc rationalisation for the good performance as well as rising targets for equity indices and a flurry of "this time it is different" notes on the subject of valuation. Such factors mean that we maintain a very high quality barrier for our investment selections.

RATHBONES | Incorporating Investec Wealth & Investment (UK)

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Investec Wealth & Investment (UK) is a trading name of Investec Wealth & Investment Limited which is a subsidiary of Rathbones Group Plc. Investec Wealth & Investment Limited is authorised and regulated by the Financial Conduct Authority and is registered in England. Registered No. 2122340. Registered Office: 30 Gresham Street. London. EC2V 7QN