RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

The publication of this commentary is inconveniently sandwiched between two important events – the UK Budget and the US Presidential election. And while the former was more impactful for UK-based investors (especially, as we had anticipated, from a financial planning perspective), the latter could well have a greater impact on global bond and equity markets. We shall obviously be providing further comment once the result is confirmed, although there is no guarantee about how soon that will be. Let us hope, at least, that we are not waiting until December, or even January (as in 2020/21 when we had to wait for the Georgia Senate run-off) for the final outcome.

And so let us start with the Budget, a momentous event in that it was Labour's first since 2010. It had also had a very long gestation period following Labour's resounding victory (in terms of seats won) back in July – possibly too long. A lot of potential taxation measures had been floated, giving ample time for lobbying against, and the impact of making a scapegoat of the previous government for leaving behind a £22bn "Black Hole" in the country's finances was beginning to wear thin. You can refer here for fine details and for financial planning thoughts, but the headline outcome was a combination of greater-than-expected tax increases, more spending than forecast and an increase in the amount of government bonds that will have to be issued.

As you might imagine, this was not taken well by bond investors, and we saw the 10-year Gilt yield rise above 4.50%, taking it back to levels similar to those seen at the time of the ill-fated Truss/Kwarteng "mini" Budget two years ago. However, the negative repercussions were not replicated this time. Despite the fact that the 10-year yield has now risen by around 0.75% since mid-September, that is still nothing like the 1.5% that preceded the 2022 event and then the further 1% that followed, which contributed to forced selling by some pension funds. At that time, there was also concern that inflation might run out of control because the Bank of England was being slow to tighten monetary policy; today, it is in loosening mode, with inflation deemed to be on a downward path. We could also point to the fact that in autumn 2022, the current account deficit was exaggerated by the rising cost of the UK's fuel imports to a hefty 4% of GDP owing to the dislocation caused by Russia's invasion of Ukraine earlier in the year; today it is a much more manageable 1.5%.

But neither can we ignore the bond market's judgement. After an initially positive response to the first headline of a £42 billion increase in taxation, it was only when the Office of Budget Responsibility published its report later in the day that the remorse set in. Not only was the scale of the spending and debt issuance made clear, but the spending was front-loaded into the first couple of years of the Parliament. This created concern on two fronts. First, it could boost activity and inflation in the short term, thus tying the Bank of England's hands when it comes to cutting interest rates; second, if the spending fails to gain sufficient traction, will Labour be inclined to return with even more tax and spending increases, especially as it might feel the need to do that to maintain favourable economic momentum into the next general election?

Another point to consider is the effect of the increased level of private sector employers' national insurance contributions (NICs) and the big increase in the National Minimum Wage. How will companies deal with this extra cost? One solution would be to pass it on in prices, although one feels that existing resistance to higher prices and the lingering effects of the cost-of-living crisis might make that difficult for many. The other options are equally painful: take a hit to profit margins or scale back employment and/or wages, which is, of course, a de facto tax on "working people". Hardly the "Budget for Growth" that we were promised. Optimists might hope for some sort of productivity miracle to come to the rescue, with companies being forced to invest more in automation, for example, but that, for now, at least, drifts into the realms of wishful thinking. All in all, this was not the bill of goods that investors felt they had been sold ahead of the election and it feels as though it will take some time to rebuild confidence, with much depending upon the efficacy of the government's spending.

Looking further afield, the UK is far from alone in having to struggle with its deficit problems. For example, France's new government has had to promise €60bn in combined tax increases and spending reductions in an attempt to get anywhere near complying with the EU's debt rules (which, in theory, but not always in practice, limit the annual fiscal deficit to 3% of GDP). Incredibly, France has failed to produce a budget surplus since 1974 and government spending accounts for more than half of economic output. France now has to pay a higher interest rate on its debt than either Spain or Portugal, both of which were at the centre of the eurozone crisis in the early 2010s, which is a considerable reversal in their fortunes.

But it is the United States that remains at the front of investors' minds as the Presidential election campaign (which sometimes feels as though it has been going on since the last election was decided) reaches its climax. Here, too, projected fiscal deficits are concentrating investors' minds, with neither candidate seemingly interested in reducing the debt, although we acknowledge that such a policy would not be appealing to most voters today. Maybe one of them might be brave enough to take that on once installed in the White House, but they would also need to control both houses of Congress, which appears to be an improbable outcome based on current opinion polls. The fact that Donald Trump has announced that he will appoint the industrial entrepreneur Elon Musk as head of a new Department of Government Efficiency might be a sign of some fiscal rectitude to come, but there has been no detail provided and Trump's past record on following up on pre-election promises is hardly encouraging. The fact that the department's initials (DOGE) match the letters of a particularly speculative cryptocurrency just adds to the sense of unreality!

One feature of markets today is that measures of implied volatility remain elevated across all asset classes. This underlines the sense of uncertainty in markets but might also reflect the fact that investors have already taken out some insurance against forthcoming adverse events being unhelpful to their portfolios. It is possible that once we know where we are, whatever the outcome, investors will be able to move on with greater conviction.

Markets – US

We noted last month that the S&P 500 Index marked the end of the quarter by registering its forty-third new all-time high of the year. It went on to rack up another four in October, although ultimately succumbed to some minor profit-taking. The main point of focus for equity investors in recent weeks has been the third quarter earnings season, which, while not a vintage one, has been perfectly respectable. The expectations bar was set quite low following a period of reduced forecasts since July, but, with around two-thirds of companies having reported (and a greater percentage by market capitalisation), 75% of those have beaten estimates, with EPS growth for these companies coming in a +9% year-on-year, which JP Morgan calculates to be an 8% positive surprise. Topline growth of 5% (a +1% surprise) suggests that margins remain robust. In terms of sectors, the weak links were Energy, Materials and Industrials, with Technology, Communications Services and Healthcare leading. Amongst the mega-cap Technology companies (or members of the so-called Magnificent 7 stocks), there was quite a mix of outcomes over the month, with Amazon (+6.2%) and Alphabet (+3.3%) being the winners and Tesla (-4.8%), Microsoft (-4.6%) and Apple (-4.3%) lagging. Tesla's performance over the month fails to capture the fact that it was down 18% before its results following a disappointing reaction to its big robotaxi launch event, but it bounced back strongly after reporting higher-than-expected sales and profits. It remains a very volatile stock.

UK

The Budget was something of a damp squib for the stock market, with service sector companies exposed to higher NICs and a rising minimum wage underperforming on the news. There was a sigh of relief that banks' profits would not be subject to a higher levy and positive results from HSBC and Standard Chartered helped to push Financials to the top of the leaderboard. The rise in bond yields weighed heavily on the Real Estate sector, which fell almost 10% during the month. We maintain the opinion that there is attractive relative value in UK smaller companies, although the Budget failed to provide the catalyst for outperformance that we had hoped for. Even so, we note that merger and acquisition activity has increased and we expect this to continue. A report from the investment bank Berenberg calculated that the average bid premium for deals so far this year has been 44%. Although such a premium can provide a nice short-term performance boost, it is a somewhat dispiriting way to generate investment returns if it means that the pool of investible companies continues to shrink. The onus remains on the government to help increase the attractions of listing on the London Stock Exchange.

Europe

We remarked last month that Europe remains in the doldrums, but its Q3 GDP data surprised to the upside, with aggregate growth for the eurozone coming in at +0.4% quarter-on-quarter (vs +0.2% expected). Even sluggish Germany produced +0.2% and Spain managed +0.8%. A report produced by a team led by former European Central Bank President Mario Draghi made some interesting observations about the region which emphasise the need for greater investment and innovation. He pointed out that there is no company in Europe with a market capitalisation over €100 billion that has been set up from scratch in the last fifty years, while all six US companies with a valuation above €1 trillion have been created within this period. His report stated that Europe is stuck in a static industrial structure with few new companies rising up to disrupt existing industries or develop new growth engines. This lack of dynamism is self-fulfilling. As EU companies are specialised in mature technologies where the potential for breakthroughs is limited, they spend less on research and innovation (R&I) than their US counterparts. The top three investors in R&I in Europe have been dominated by automotive companies for the past twenty years. It was the same in the US in the early 2000s, with autos and pharma leading, but now the leading three are all in the technology industries. Another problem is that innovation is blocked by inconsistent and restrictive regulations. As a result, many European entrepreneurs prefer to seek financing from US venture capitalists and scale up in the US market. Between 2008 and 2021, close to 30% of the "unicorns" founded in Europe – startups that went on the be valued over $1 billion – relocated their headquarters abroad, with the vast majority moving to the US. It is good that the problems have been identified, but now something needs to be done about it.

Emerging Markets

We stated last month that the economic stimulus measures outlined by the government meant that it was no longer appropriate to bet against China's stock market, but that it was too early to adopt a more positive attitude before knowing the details. We are still waiting for them, but more should be become clear over the course of the National People's Congress which has just got underway. It is clear that more than monetary stimulus (which has been provided again) is required to increase confidence levels and the hope is for well targeted fiscal measures. These would preferably be in the form of funds that would directly boost consumption, but there is also a pressing need to shore up the real estate sector, and this is expected to be done by recapitalising local governments and the banking sector. This will allow unfinished properties to be completed and delivered to buyers who have already paid for them. Although China's GDP growth for the third quarter came in at 4.6% vs an expected 4.5%, it continues to undershoot the government's aspirational target of 5% and remains dependent upon manufacturing and industrial production growth, both of which might be curtailed by the imposition of higher tariffs should Donald Trump win the US election. China needs its high-saving households to start consuming.

Fixed Income

Global bonds went into reverse during October and gave back all the gains made so far in 2024. There were three primary catalysts. Positively, the resilience of economic output, especially in the United States, suggested that interest rates might not have to be cut quite as quickly as the market had started to price in. Of more concern was an increasing risk that inflation might not fall back towards central banks' 2% target soon. In the US, this was associated with the risk of the tariffs that could be applied to imports by Donald Trump; in the UK it was more about the short-term spending uplift planned by the Labour government and unveiled in the Budget. The shift in inflation worries can be seen in the rise of breakeven rates (the expected rate of inflation that can be inferred from the relative prices of conventional and inflation-linked bonds). In the US the 2-year breakeven rate has risen from 1.46% to 2.41% since mid-September, with the 10-year breakeven (the inferred average inflation rate over the next decade, which is somewhat less sensitive to shorter term expectations) up from 2.03% to 2.32%. In the UK, the respective rate moves were from 2.9% to 3.08% and from 3.28% to 3.56%. Finally, there are persistent worries about the levels of debt being carried by governments and the threat of greater supply in the future. The political zeitgeist, characterised as it is by various movements that might fall under the general umbrella term of "populist", continues to support more spending or lower taxes (depending upon which side of the political aisle they sit) over fiscal consolidation.

All UK Gilts have delivered a total return of -1.9% over the last three months and +5.6% over the last year. Index-Linked Gilts returned -2.63% and +4.4% over the same respective periods. Emerging Market bonds produced a total return of +2.4% in sterling over the three months to end October (+18% over 12m). Global High Yield bonds delivered +2.7% (+15.9% over 12m) in sterling.

Conclusion and Outlook

At the start of the year, much was made of the fact that more than half of the world's population would be going to the polls in 2024, and that did not include two unscheduled elections, namely those in the UK and France. For all the talk of volatility and disruption, equity markets (especially in the United States) have churned out excellent returns, especially on a risk-adjusted basis (meaning that volatility has, in fact, been relatively low, with the exception of a period of a few days in early August). It is in the nature of markets to find the next thing to worry about once another event has been ticked off on the calendar, and, with potential geopolitical flashpoints in Ukraine, the Middle East and possibly Taiwan, there is no shortage of candidates. Our tried and trusted process allows us to continue to invest in companies that can compound growth over a longer period of time while we can also take out a range of insurance policies to mitigate some of the more extreme risks.

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