RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

The end of the first quarter invites a retrospective of what has unfolded in the world and markets so far this year. In many ways the period has been notable for what has not happened: perhaps most significantly, the fact that none of the major western central banks cut interest rates (Switzerland's was an idiosyncratic exception). Sadly, there has been no progress towards more peaceful outcomes in either Ukraine or the Middle East. On the political front, in the UK we are still waiting for the date of a General Election to be announced, while in the United States, incumbent and former Presidents Joe Biden and Donald Trump remain the shoo-in candidates for their respective parties in November's election.

The retention of this status quo worked out well for balanced portfolio investors, as riskier assets such as equities and corporate bonds continued the ascent that they had begun in the last two months of 2023. Government bonds had a slightly harder time of it. The key reason for this is that growth has turned out to be more resilient than anticipated, especially in the United States. Indeed, the US recession that was widely expected to materialise in 2023 appears not to be going to happen in 2024 either. And while both the UK and Germany have suffered consecutive quarters of shrinking GDP, thus entering technical recessions, the downturns in both countries have been marginal and growth might already have resumed.

We suggested back in January that some of the markets' expectations seemed to be a bit contradictory, as they were pricing in a strong earnings growth, inflation declining serenely towards central banks' 2% target and rapid interest rate cuts as economic growth weakened. We thought that at least one of these would have to give way. As it turned out, inflation has been a little stickier, leading central banks to push back on the hope for early rate reductions. Whereas policy rate cuts starting in March in the US, UK and Europe were a racing certainty in terms of how they were priced in futures markets at the turn of the year, now we are looking at June. The Fed Funds rate was expected to be 3.8% by year-end and is now priced at 4.6% vs a current level of 5.25%. The respective figures for the UK base rate are 3.5%, 4.5% and 5.25%, while in Europe they are 2.25%, 3% and 4%.

Equity markets were the stars of the show during the first quarter, with several registering new all-time highs. While some investors fear such territory to be unsustainable, the breaking of new ground often tends to herald a shift to a higher level, and this was certainly the case for US equities, where almost 40% of the trading days during the period resulted in a new closing peak. A key driver of sentiment in the US was, once again, enthusiasm about the adoption of generative artificial intelligence (AI), but there were also signs of a healthier broadening of participation in the bull market. The trends were similar in Europe, although the UK FTSE 100 remains frustratingly short of its February 2023 high.

Another feature has been the ascent of Gold to new all-time highs. During the quarter, it appreciated by 8.1% in dollar terms, and by 8.6% in sterling. Since last October's lows, it has risen by 22.4% (17.9% in sterling). These are huge moves for such an asset and have to be examined for the messages they are sending, because demand for Gold usually reflects investors' meaningful fears about something else. While Gold is often viewed quite simply as a hedge against inflation – and it has certainly held its value against other assets over millennia – we believe that there is more to it than that. We note the increased buying of Gold by non-western central banks in the aftermath of Russia's invasion of Ukraine and the freezing of Russia's dollar-based assets. Many countries around the world, while not necessarily being hostile to the US, have seen some merit in diversifying their reserves away from dollars owing to concerns about the direction of US policy (the fact that Gold's price is generally quoted in dollars is not a factor – it's the value in the local currency that counts).

The recent move appears to reflect greater concern about the conduct of monetary policy in the face of elevated government debt. We have written previously about the threat of "financial repression", by which interest rates for savers are held at an artificially low level to allow the debt to be reduced in real terms by inflation, and we have also noted the potential for the "monetisation of debt", whereby central banks buy the debt directly from the government by "printing" money (Quantitative Easing was implemented by buying bonds in the open market, which is a subtle distinction, but enough to deflect accusations of outright monetisation). Both of these would tend to devalue a currency. But if everyone is doing it, and there is no "safe" currency to hide in, then real assets such as Gold become relatively attractive as a store of value. We regard Gold as a viable tail risk hedge (or insurance policy) against these potential outcomes within the context of a balanced portfolio where the minimum objective is to retain its value in real terms over a cycle.

Markets – US

With the S&P 500 Index hitting new highs, there is a mixture of elation and fear in the air. Are the gains sustainable? A lot of comparisons are being made with the Technology boom of late 1990s which peaked in early 2000, only to be followed by a long bust. While there are certainly elements that are similar, not least the parabolic chart patterns of certain stocks, the levels of speculative activity are nothing like as high, especially when one looks at the much-reduced levels of corporate actions, notably in Mergers and Acquisitions (M&A) and Initial Public Offerings (IPOs). Turn-of-the-century deals including Time-Warner's acquisition of AOL, quickly followed in Europe by Vodafone's purchase of Mannesmann, marked records in terms of their value and we have not seen such devil-may-care use of shareholders' equity in this cycle. While there were quite a few companies opportunistically brought to the market during the pandemic, most of that froth has already been blown away. Furthermore, we have already seen many lossmaking companies forced to pivot towards more sustainably profitable business models. We would also note the sheer weight of profits being generated by the leading US companies, with the returns on capital being much higher than in the past owing to the nature of many of these businesses. We're not talking about the capital-hungry "smokestack" businesses of the past, or even the technology hardware giants and dodgy retail concepts that dominated the Tech boom in 2000. And it has been good to see investors becoming a little more discerning in their views. Although there are still a lot of references to the Magnificent Seven US stocks that led the market up in 2023, the year-to-date performance difference between the leader, Nvidia (+82%) and the laggard, Tesla (-29%) can only be described as a chasm. US Presidential elections usually trigger an increase in market volatility as the date approaches, especially when they are closely contested, as this one is likely to be, and so we would not be surprised to see at least a pause for consolidation at some point. However, in the absence of a recession or resurgent inflation, there is no specific reason to believe that "what goes up must come down".

UK

The FTSE 100, as previously mentioned, has been unable to close at a new high despite being viewed by many as one of the world's cheapest markets. However, whereas highly rated US Technology shares dominate the S&P 500, around a third of the UK's market capitalisation is made up of Energy, Mining and Banks, sectors which struggle to command price/earnings ratios in double digits. The second best large-cap performer so far this year is paper and packaging company D.S. Smith (+29%), which has found itself on the receiving end of competing bids from rivals Mondi and International Paper Co. This sort of action does reflect the cheapness of UK assets, at least in the eyes of international corporate buyers. There have been similar competing bids from overseas for transportation company Wincanton and for telecoms equipment company Spirent Communications, with substantial premiums being paid to the undisturbed prices – more than 100% in the case of Wincanton and 86% for Spirent. The value of take-overs announced in the first quarter of the year surpassed the whole of 2023. It is rather sad to see the value of UK Plc being recognised in this way rather than by more enthusiastic buying of shares in the open market by active investors, but at least it is providing a rewarding exit for those who have clung on to companies they believed in despite a long period of lacklustre performance.

Europe

Several indices across Europe have made new all-time highs this year, including France's CAC 40 (+8.9% year-to-date) and Germany's DAX (+10.4%). The recovery in Germany is interesting given the fact that the economy is in a recession, albeit a shallow one. Germany's index is heavier in industrial stocks than most others, with the Auto Manufacturers, Aerospace & Defence, Manufacturing and Chemicals sectors accounting for almost 40% its market cap. Thus it tends to follow the lead of the global manufacturing cycle. There are signs that it is recovering following a long recession and a clearing out of excess inventories and this has been reflected in the fact that JP Morgan's Global Manufacturing Purchasing Manager Index has risen above 50 into expansion territory for the first time since August 2022. Germany's industrial base will also have been helped by the fact that the price of natural gas in Europe has remained around its post-Ukraine invasion lows following a mild winter. Europe is also buoyed by the expectation that the European Central Bank will be the first to follow the Swiss National

Bank in cutting rates. Meanwhile, the higher interest rates have been a boon to bank profitability, leading to strong performances in countries like Spain and Italy. Banks in those countries have been showering shareholders with dividend increases and share buybacks while demand for new loans remains muted, meaning they are generating plenty of excess capital even in the face of more stringent regulatory capital requirements.

Japan

It has been a case of "onwards and upwards" for Japan after the Nikkei 225 Index finally surpassed its 1989 peak during February. The more representative TOPIX Index has yet to achieve the same feat, but continuing support for Japan's equity market suggests it will only be a matter of time. However, when measured in yen, the recent returns are not quite as spectacular as for domestic investors, given that the currency has depreciated substantially owing to the central bank's monetary policy, which has included negative interest rates and enormous purchases of government debt. There was a pivotal moment during March when the Bank of Japan raised interest rates into positive territory for the first time since 2016, even if only to +0.1%. This reflected the hoped-for permanent exit from the era of persistent deflation which has dominated policymaking for the past three decades. One important factor in this call was the annual round of wage negotiations with unions, which resulted in an average pay rise of 5.3%. It remains to be seen how much of this will be spent, but versus current inflation of 2.8% it represents a healthy increase in real terms. Japan is also benefitting from "not being China" as companies seek more stable (and politically friendly) countries in Asia in which to invest.

Emerging Markets

There are tentative signs that China's economy is beginning to respond to the stimulus that has been applied to it, but, following an equity market rally in February, there has been little in the way of a follow through. American investors, in particular, are reticent about increasing their weightings in China owing to the geopolitical tension. As the US election looms, an anti-China stance is one of the few things that unifies Congress. Beyond China, the strength of the US economy is a mixed blessing for EMs. While strong activity boosts trade, delays to US rate cuts have strengthened the dollar, which, as usual, has provided a headwind to EM equities. We continue to be impressed with the way that most of the EM regions have negotiated the pandemic and subsequent inflationary cycle. They did not incur as much debt as many western governments when responding to the Covid pandemic and they were much quicker to respond to the threat of inflation with interest rate increases, thus allowing them the potential to cut when appropriate. Although we are having to be a bit more patient than intended, we still believe that the eventual turn in the US interest rate cycle will provide a healthy tailwind for EM equities.

Fixed Income

The euphoria of late 2023 gave way to a dose of reality in early 2024. A combination of stronger-than-expected growth, stickier inflation and lingering concerns about fiscal deficits led to bond yields backing up again, although not to levels that were able to undermine the progress of equity markets. The US 10-year Treasury yield has risen from 3.87% to 4.21%, while the 10-year Gilt yield has gone from 3.53% to 3.93%. The Bloomberg Global Aggregate Index of investment grade bonds has delivered a total return of -2.1% so far this year in dollars and is flat in sterling terms – a slight disappointment given the more attractive yield basis now prevailing. It is our opinion that government bonds now hover somewhere close to fair value when compared to the potential nominal growth rate of their respective economies, which once again makes them a viable "insurance" asset in a balanced portfolio. There might yet be more testing times ahead should politicians become too expansive, although the warning shots fired by the "bond vigilantes" following the Truss/Kwarteng budget in 2022 and then when US Treasuries led the sell-off in the autumn of 2023 will, we hope, have been enough to rein in their most profligate tendencies.

UK Gilts have delivered a total return of -1.6% over the last three months and 0% over the last year. Index-Linked Gilts returned -2% and -5.7% over the same respective periods. Emerging Market bonds produced a total return of +6.6% in sterling over the three months to end March (+13.6% over 12m). Global High Yield bonds delivered +1.1% (+11.4% over 12m) in sterling.

Conclusion and Outlook

We are by no means complacent about the world at the moment despite the strong performance of risk assets. (Geo)political risks and the indebtedness of western governments are the key structural concerns, but they are manageable and, to a greater or lesser degree, have been hanging over markets for a long time. Undue attention to those risks would have cost investors a lot of return in recent years. More cyclically, the path of inflation will be a key determinant of short-term outcomes and it will define central bank policy. While we believe that central banks remain alert to the risk of a "second wave" of inflation breaking out as it did in the 1970s, they are also hinting that, if push comes to shove, they will err on the side of supporting employment and economic stability if a choice has to be made. This is especially the case in the US in the run up to the election. We continue to maintain a quality bias in our investments, especially in terms of balance sheet strength and access to liquidity.

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