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OUT OF THE ORDINARY

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Market commentary

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Overview

Although the summer holiday season is upon us, there has been little evidence of a summer lull developing in financial markets. The second quarter results season is in full swing, and policymakers and investors alike are scrutinising every piece of economic data for clues as to the path of inflation and what it might mean for monetary policy and growth expectations. The result has been another constructive month for credit and equity markets, although government bonds continue to struggle to generate positive returns. In the context of a balanced portfolio, 2023 continues to be a more pleasant experience than 2022, even if there is a lingering degree of scepticism about the sustainability of equity market gains.

As we have commented upon previously, global equity gains this year have been built on two primary foundations. The first is that economic growth in all major economies (with the exception of China) has proven to be more resilient than was expected. Although the UK and Europe continue to flirt with recessions, a reduction in energy and food prices combined with the protracted recovery in the post-pandemic services economy has boosted consumption. Remember that the Bank of England was forecasting a five-quarter long period of economic contraction at the end of 2022, while at the same time there were real fears that Europe would run out of natural gas in the face of supply constraints associated with the war in Ukraine.

The fact that economic activity is at least flat has supported labour markets. Although the UK employment rate has risen from a cycle low of 3.5% to a current 4%, this has been as much a function of more people re-entering the labour market as of workers losing their jobs. Indeed, annual wage growth of around 7% speaks to a still-tight market. In the eurozone, unemployment remains at the cycle low of 6.4%. Remarkably, this is as low as it has been since the introduction of the euro in 1999.

Although higher interest rates are a weight on economic activity, historically it has been rising unemployment that has delivered more severe downturns, especially in housing markets as homeowners are deprived of the income to service mortgages. The resilience of the UK labour market has been ascribed to a couple of key related factors. One is a shortage of workers. Although fingers have been pointed at Brexit, immigration laws and a swathe of early retirements, the reality is that several hundred thousand potential UK workers remain unavailable owing to long-term illness. As a result, there is some evidence that companies are hoarding labour, having experienced the pain of having to rehire following the pandemic. This is supportive of consumption and the housing market, but not exactly beneficial to productivity. It is also keeping the Bank of England in policy tightening mode, as any sort of wage/price spiral is seen as enemy number one in the fight against expectations of higher inflation becoming entrenched.

The US brushed aside a technical recession as long ago as the first half of 2022, although it was never officially tagged as one by the National Bureau of Economic Research, the body which adjudicates on such matters. That was because although a reduction in inventories and reduced government expenditure produced a drop in overall activity, underlying consumption growth remained positive. The latest reading of US GDP for the second quarter of 2023 displayed no signs of weakness, showing growth of 2.4% on an annualised basis over the previous quarter. Consumption continues to be bolstered by the drawing down of "excess" savings accumulated during the pandemic. The exact quantum of such resources is difficult to pin down and every economist appears to have their own methodology. We have seen estimates ranging from an assertion that this well has already run dry (interestingly, from the Federal Reserve itself) to calculations that there is still well over a trillion dollars left in the tank.

Other than pandemic savings, what is driving international growth?

Growth is also being propelled by incentives offered by the Biden administration. Enshrined in the Inflation Reduction and CHIPS and Science Acts, these encourage investment in, and purchases of, vehicles and technologies that will accelerate the transition to a low(er) carbon economy as well as providing a lure to invest in domestic manufacturing capabilities, especially those related to the production of semiconductors.

The second key factor that has driven markets higher this year is the dawn of the age of Artificial Intelligence (AI). The release and fast adoption of intuitive, interactive applications such as ChatGPT triggered the first wave of enthusiasm. This was magnified by a positive earnings release and outlook statement from Nvidia, the leading designer of the chips required to power AI-based offerings. The positive sentiment then spread to other companies deemed to be key players in the industry, including Technology behemoths such as Microsoft, Alphabet (Google), Meta (Facebook) and Apple. Our long-term view on all things AI remains constructive. However, we are somewhat concerned that the exceptionally bullish narrative is in danger of running ahead of the shorter-term reality and also about valuations in a classic "hype cycle" manner.

While market gains in the first half of the year were dominated by this very small group of (mainly US) beneficiaries of the prospective AI boom, we have witnessed a broadening of leadership during July. This partially reflects the belief that the US will not (yet) fall into recession, but there is also an element of catch-up being played, as investors who missed out on the gains in the earlier part of the year (but who cannot stomach paying up for the winners) find solace in the laggards.

Will we see a US recession?

Will the long-awaited and 'most anticipated' recession in history, ever develop? At the beginning of 2023, Bank of America's Fund Manager Survey had 10% of respondents saying that the US was already in a recession; 77% said one would materialise during 2023; another 10% said it would arrive during 2024. In the latest survey, published in mid-July, the figures for the same periods were 2%, 23% and 59% respectively. And so, the expectation is of recession delayed, not cancelled, but, according to the same respondents, only a shallow one.

How are central banks reacting?

Meanwhile, central banks continue to juggle growth and inflation as the key determinants of monetary policy. The good news is that inflation appears to have peaked in most regions, especially at the headline level. However, there remains much uncertainty about how long it will take to return to central banks' 2% target and whether it will take some damage to the labour market to achieve that target.

Fed Chairman Jerome Powell was not taking any hostages to fortune at the last meeting, staying very much in "wait and see" mode. He acknowledged the recent resilience of the US economy and suggested that inflation will not sustainably get back to target until 2025. At the same meeting, the Fed raised interest rates by another 0.25%, to a target rate of 5.5%, but suggested that it now feels more inclined to see what lagged effects a cumulative 525 basis points of increases since March 2022 will have had. The European Central Bank also adopted a more emollient tone at its last meeting, although the Eurozone is by no means out of the woods on the inflation front, with the latest core reading coming in at a still-elevated level of 5.5%. The Bank of England still has the stickiest inflation problem, with a core rate of 6.9% to contend with, and so is deemed to be further from the end of the rate increase cycle.

The main drivers of markets have not changed much this year, but it is fair to say that sentiment has improved dramatically, as evidenced by a positive re-rating for equities whilst earnings expectations have been little changed. This has elicited an increase in targets for equity indices at the half-year stage from several investment banks and fund management houses. We have seen investor sentiment indicators swing from bearish to bullish and hedge funds scrambling to close short positions. Volatility has collapsed in both equity and bond markets, allowing volatility-targeting funds to increase their leveraged exposure. Funds that follow the momentum in markets have switched from short to long positions. Given our concern that the lagged effects of past interest rate rises are yet to be fully felt, we remain reluctant to chase markets higher.

Markets – US

We wrote last month about the narrow leadership of the US market, dominated by a handful of Technology companies. We have since noted a broadening of performance which has made for a healthier technical situation. Laggards in more cyclical sectors have rallied as investors who missed out on the Artificial Intelligence-inspired boom look to capture the benefits of stronger-than-expected growth in the US economy instead. We have written in the past about the quirky nature of the Dow Jones Industrial Average, which is generally deemed to be an anachronism in terms of accurately measuring overall market performance. However, owing to its lower weighting to Technology companies, it sometimes provides some insight into market sentiment. During July it achieved a run of 13 consecutive positive days, something that had not previously occurred since 1987 (somewhat ominously the year of a market crash). Had it extended the run to 14, which it failed to do, it would have been for the first time since the index's inception in 1896.

The equal-weighted version of the S&P 500 Index also managed to make up some lost ground against the more usually referenced market-capitalisation-weighted index.

UK

One of the main attractions of UK equities is the dividend yield. A recent study from Bloomberg highlighted some of the pros and cons. As of 14 July, the dividend yield on the FTSE 100 Index was 4.23%. That compared with 3.43% for the EuroStoxx 600 Index and with 1.55% for the S&P 500. However, it's fair to say that a premium dividend yield has not historically been a harbinger of great performance for the UK's flagship index. That might have something to do with the source of the dividends – mainly cyclical sectors. Financials (24.3%), Materials (15.6%) and Energy (13%) contribute almost half of the income, but none of these sectors have what one might describe as "progressive" dividend polices, where the growth of the pay-out is smoothed across the cycle, although some of the dividend volatility is dampened by the use of share buybacks to mop up excess cash generation. Bloomberg sees the overall yield falling back this year to 4.13% as Mining and Energy companies feel the pinch of lower commodity prices. The other big dividend-paying sector is Consumer Staples (19.2%), which does at least have a steadier track record of increasing payments.

Europe

During July we had meetings with three external unit trust fund managers to whom we entrust clients' investments in Continental European markets. While we rarely encounter a fund manager who is cautious about the region or asset class to which they are exposed, and so have to apply a bit of a 'bias discount', it was notable how confident these managers were about the prospects for the companies they own. European equities have benefitted so far this year more from what didn't go wrong rather than what went right, but with Citigroup's Economic Surprise Index at lows matching previous troughs and with investors sniffing the end of the ECB's rate increasing cycle, there is scope for further improvement. By a number of measures, European equities are at a record valuation discount to those in the US, even if one adjusts for sector composition.

Emerging Markets

In this section we often end up talking about China's economy and equity market because they dominate proceedings in Emerging Markets (EM). This month, by way of adding variety, we shall discuss EM debt (EMD), an asset class that is not in our benchmarks, but which we believe offers positive risk/reward characteristics. EMD, unlike sovereign fixed income assets in the developed world, tends to prefer periods when growth is improving because the premium yield demanded by investors falls to reflect the improved credit risk. And while we still see outstanding recession risks in both the US and the UK, they are expected to be shallow. Meanwhile, EM economies in aggregate are forecast to be growing at around 4% per annum over the next couple of years compared to more like 1% in the developed world. EM sovereign issuers are also beginning to reap the benefits of a more proactive approach to heading off inflation in 2021 when DM central banks were slow to tighten monetary policy. This leaves EM central banks with the scope to start cutting interest rates sooner, which will boost capital values. The majority of EM countries are also in a better state than many DM countries with respect to both their fiscal and trade balances. They were not profligate in terms of handouts during Covid. The icing on the cake would be a weaker dollar, which is a trend that we expect to strengthen as the peak of the US interest rate cycle is passed. From a positioning perspective, EM assets remain under-owned and so should benefit from inflows as sentiment towards them continues to improve.

Fixed Income

It has been another tough year for sovereign bonds, with the Bloomberg Global Aggregate Dollar Index managing a gain of just 2.1%, which largely reflects picking up half a year's worth of yield. Thanks to the recovery of the pound/weakness of the dollar, this translates into a loss in sterling terms. The UK 10-year Gilt yield has risen sharply from 3.67% to 4.32% in the face of sticky inflation. The 3.25% Gilt maturing in January 2033 (that was effectively the benchmark ten-year Gilt at the start of this year) has delivered a total return of -2.8% in the first seven months. Short-dated Gilts offer risk-free yields of more than 5% with tax benefits even when not held within tax-exempt wrappers such as SIPPs or ISAs. Low coupons mean that the taxable income is negligible. But the "pull to par" on maturity delivers a tax-free capital gain. They remain an attractive home for surplus cash savings.

UK Gilts have delivered a total return of -3.1% over the last three months and -16% over the last year. Index-Linked Gilts returned -3.6% and -22% over the same respective periods. Emerging Market sovereign bonds produced a total return of 1% in sterling over the three months to end July (+1.2% over 12m). Global High Yield bonds delivered 0.8% (+4.9% over 12m) in sterling.

Conclusion and Outlook

We find ourselves in the same boat as many asset and wealth managers this year, having underestimated the resilience of economic activity and, perhaps more crucially, the willingness of buyers to pay substantially higher multiples for equities. Our long-term return projections for US equities continue to find them expensive relative to bond yields and to other equity markets, and that has informed our reluctance to be fully weighted in the region. However, we still have a decent exposure and are respectful of the innovative qualities of many of its world-leading companies.

We remain fully committed to equity markets in the rest of the world, where we see much better value on offer. This should be harvested when, to borrow a phrase from Benjamin Graham (widely considered to be the father of modern investing), markets turn from a voting machine to a weighing machine, which they tend to do across cycles. We are now more comfortable owning sovereign fixed income assets as risk diversifiers within a portfolio given their higher yields. This year, we have consistently recommended against taking a hard defensive stance in portfolios because we believed that the interest rate cycle would peak in 2023, and that seems to be the case. We continue to expect to become more constructive on risk assets at some point during the rest of this year or early in 2024 but have not ruled out another moderate downdraft in markets of which we could take advantage.

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