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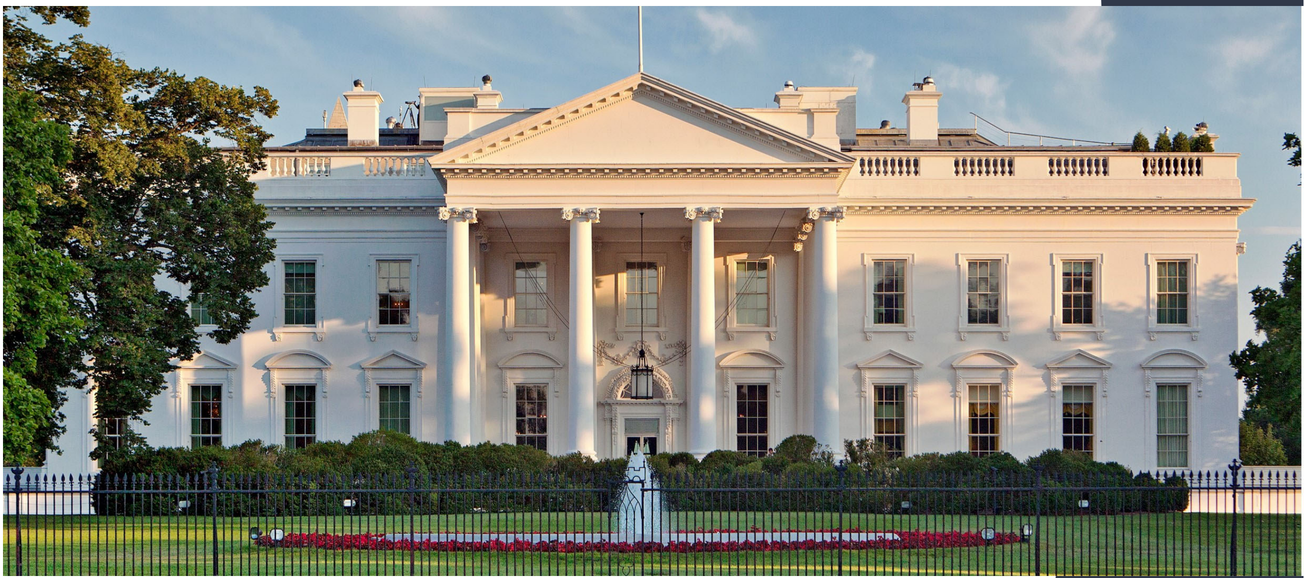
WEEKLY DIGEST | 16 July 2024

A miss is as good as a mile



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This week marks the real beginning of the mid-year company results season. For analysts and investors it offers the opportunity to get stuck into the nitty gritty of what it is that, in the long term, drives the performance of shares – the ability to generate growth in sales, profits and distributions to shareholders. It is these factors that ultimately define returns rather than the more cyclical ones such as discount rates or preferences for certain types of shares (such as Growth vs Value or Large Cap vs Small Cap). It's the old Benjamin Graham principle again that in the short term the market is a voting machine, but in the long term it is a weighing machine.

Even so, it seems that we still cannot escape the influence of external factors, and the latest is the assassination attempt on former President Donald Trump at the weekend. It is amazing how small the margin was between a defiant recovery and the potential for political turmoil. It is not for us to express a preference for any candidate in the US election race, but to position portfolios for possible outcomes, and the odds swung in favour of the challenger over the weekend. The weight of money is a reasonably good indicator of where the vote is heading, and I follow this on the PredictIt website. At the time of writing, you would have to put down 67 cents to win a dollar if Trump becomes President again, making him the clear favourite. A week ago the same bet would only have cost you 58 cents.

Meanwhile, the chance to win a dollar backing President Biden will only cost you 27 cents, offering the chance to triple your money. Three-to-one odds in what is effectively a two-horse race is pretty generous and tells you what the betting market makes of Biden's chances. Of course, some of that generosity reflects the not unreasonable possibility that he won't actually end up running. The "obvious" replacement is Vice President Kamala Harris, but her chances of ending up in the White House are on offer for just 12 cents.

And so what is the market telling us about the prospect of a second Trump presidency? In a nutshell: "inflationary growth". Following President Biden's poor performance in the first debate and again following this weekend's events, there is a consistent pattern of higher bond yields, a steepening of the yield curve, gains for the dollar and higher equity prices in the US, but less so in other countries that might find themselves on the wrong end of Trumpian trade policies. These moves are predicated on the view that Trump will continue to run a large fiscal deficit, although more by dint of tax cuts rather than increased spending (which would be the policy of the Democrats).

There is one notably big wedge between the policies of the two candidates, and that concerns corporate taxes. The Democrats intend to allow the tax cuts incorporated into the 2017 Tax Cuts & Jobs Act (passed under Donald Trump) to expire, and this would raise the headline corporation tax rate from 21% to 28%. That could knock quite a big hole in reported earnings. Trump intends to extend the cuts. Lower taxes would be helpful for profits and potentially for growth, but less helpful in terms of constraining the already large fiscal deficit initially (although higher growth could conceivably generate more tax in future), hence there is a two-pronged threat to US government bonds: stickier inflation and increased supply to fund the deficit.

Inflation could be exacerbated by the proposed tariffs imposed on imported goods, amounting to 60% on imports from China and 10% on anything from elsewhere; not only would prices be raised to account for the tariffs, but any substitution towards domestically produced goods could run into limited supply. The Federal Reserve might then have to counter these pressures by keeping interest rates higher, hence the support for the dollar, especially if other central banks are faced with waning demand for their countries' exports and feel the need to cut rates faster. Even then, there is speculation that President Trump might interfere with the independence of the Fed and find a way to engineer lower rates and a weaker dollar (something which, as a mercantilist, he favours), which complicates the issue.

Even taking all of that into account, we are not inclined to make a big bet on the election outcome today. There are still almost four months to go until polling day, and there are probably going to be a few more twists in the tale. Not least might be a different Democratic Party candidate, and we might have to wait until the Democratic Party Convention in late August to get a more definitive answer on that front.

I mentioned the impending earnings season at the beginning, and so it's time to go into a bit more detail on that. Overall global equity market returns so far this year have been driven by a roughly equal combination of earnings growth expectations and rerating. But with equity valuations, notably in the US, at high levels compared with the past, there is a feeling that earnings will have to do more of the heavy lifting from here. The good news is that earnings are on an improving trend.

Given that US equities account for around two-thirds of the global equity market capitalisation, the projected 9% year-on-year increase in second quarter earnings per share is encouraging. However, it's also expected, and so potentially already "in the price". Furthermore, there has not been the usual massaging down of expectations ahead of the results season, which might make beating the estimates a bit harder than usual. It is also the case that the lion's share of the earnings growth is being generated by a relatively narrow cohort of Technology leaders, with chip-designer Nvidia to the fore. Indeed, IT and Communications Services (which includes Alphabet and Meta) are expected to grow earnings by 17%. Narrowing it down further, the Top 6 by market capitalisation are forecast to grow their earnings by 30%, while the other 494 companies in the S&P 500 Index will only cobble together 5%.

As is often the case, headline numbers fail to tell the whole story. Such was the case in the market on Thursday last week, when the S&P 500 Index fell by 0.88% despite the fact that 396 of its component's share prices were higher. There was a violent rotation within the market driven by a benign inflation print. That encouraged investors to price in a greater probability of interest rates being cut sooner rather than later, and that was a positive factor for companies exposed to economic and interest rate risk. The demand for those shares set off something of a short squeeze, and the flip side of that was heavy selling in the shares that have been the big (momentum) winners of this year. It was not really a judgement on their absolute merits, more a (forced) shift in positioning. Things settled down again on Friday, but there is no doubt that the mega-caps will have their earnings and outlook statements heavily scrutinised when they are published. The evidence from recent earnings events is that any hint of disappointment, even by a relatively narrow margin, will be harshly punished, although we continue to believe that the secular tailwinds remain friendly.

In the UK, first half earnings for the FTSE 350 are forecast to be -5% year-on-year according to consensus data. As is often the case, the volatility of commodity-related companies' earnings carries some of the blame, but there is also a currency headwind - remember that around three-quarters of UK companies' sales and profits are generated overseas. The average sterling/dollar rate was $1.2339 during the first half of 2023, whereas it ran at $1.2652 this year. It's a similar case against the euro, with the 2023 rate being €1.1411 against €1.17 this year. All in all, though, it feels as though investors are happier to focus on better times ahead, at least during the early days of Labour's honeymoon period. And this should also help more domestically oriented companies. Since the polls closed on July 4th through to Friday's close, the FTSE 100 is +0.14%, while the Mid 250 is +2.90% and Small Caps (ex-ITs) are +2.86%.

Moving to Europe, there could be an important inflection point ahead of us as earnings growth is finally expected to turn positive following four consecutive negative quarters. The consensus forecast is for a 2% year-on-year increase, up from -4% in Q1. Looking further ahead, the full year consensus earnings growth forecast for 2024 is currently 4.8%, accelerating to 10.5% in 2025.

Economic Commentary

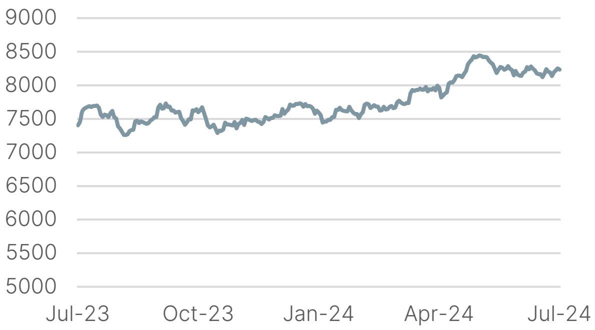
FTSE 100 weekly winners

Ocado Group PLC	15.8%
CRH public limited company	8.2%
Rightmove plc	7.3%
Severn Trent Plc	6.2%
Kingfisher Plc	6.1%
Entain PLC	5.8%
Ferguson Plc	5.1%

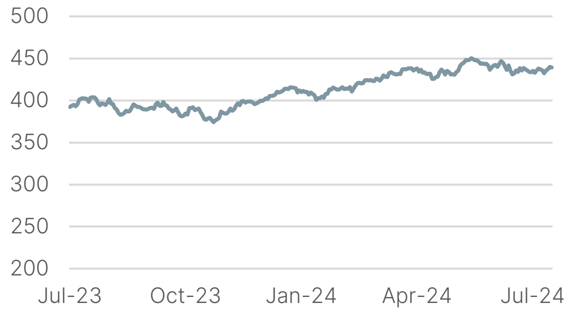
FTSE 100 weekly losers

BP p.l.c.	-6.0%
Sage Group plc	-2.1%
Anglo American plc	-2.0%
Shell Plc	-1.7%
Shell Plc	-1.7%
BHP Group Ltd	-1.5%
Standard Life Aberdeen	-1.3%

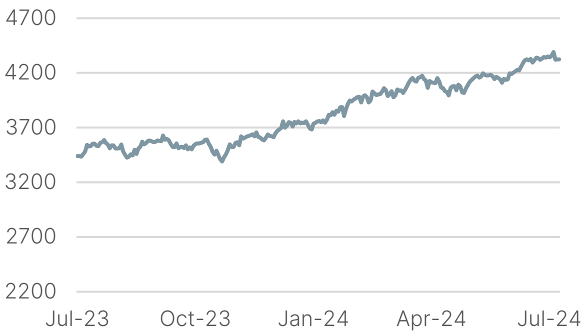
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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