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OUT OF THE ORDINARY

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A Confusing Picture

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In the last Weekly Digest, I reviewed asset class performance for the first half of 2023 and concluded with the observation that "the 'pain trade' is still the 'Immaculate Disinflation/No Landing' outcome". And guess what, that was pretty much exactly how investors chose to interpret the bulk of last week's US economic data releases, leading to a combination of rising equity markets and falling bond yields, which is about as good as it gets for balanced portfolio investors. However, the industry mood is still downbeat,

rather than euphoric, because the average portfolio is positioned for a weaker growth environment and remains underweight in equity risk.

And so, although professional investors are generally making positive returns, they are underperforming their benchmarks, and it is the performance relative to the benchmark upon which they tend to be evaluated. One consequence of this failure to outperform is that more and more investment funds are channelled into index funds that replicate the underlying benchmark (for example, the S&P 500 Index or the FTSE 100), and this only tends to exacerbate the problem as the large capitalisation winners hog even more of the inflows. Various fund managers and academics have attempted to calculate the point at which the ownership of index funds makes markets extremely inefficient, but the truth is that we will only ever know that point in retrospect.

Data causing debate among strategists

The datapoint which set the hares running last week was the US inflation report for June, in which both the headline and core rates came in below consensus expectations. This was a welcome development after the previous week's stronger-than-expected private sector employment report from ADP and it cemented the belief that the Federal Reserve's policy tightening cycle can be relaxed to some degree in the months ahead. Even so, the situation is far from clear-cut. Friday's monthly consumer sentiment survey from the University of Michigan showed a renewed burst of confidence from consumers which encouraged a bit of a reassessment.

Another area of confusion is the marked difference between the trajectories of the manufacturing and services sectors. It is possible that one reason for the persistent expectation of economists that a (US) recession is imminent is that they have focused too much on the manufacturing sector, which these days constitutes a much smaller share of GDP than it did in the past. Indeed, if one were to assume that manufacturer purchasing manager surveys were the most reliable barometer of economic health, the overall economic data should be a lot worse. Taking into account that any reading under 50 represents contraction, here is a selection of manufacturing PMIs from around the world: US 46; China 49; Euro Zone 43.4; Germany 40.6; UK 46.5. JP Morgan pulls together a global reading, which is currently 48.8.

That would certainly seem to be enough evidence to suggest that we are in the midst of a global manufacturing recession. What is not clear, though, is how much of this is a function of weak final demand and how much a result of inventories being flushed throughout the supply chain. We have commented in the past on the "bullwhip effect" which affects inventory management, by which retailers and wholesalers are unable to get demand and supply properly synchronised. The after-effects of the pandemic will only be exacerbating this phenomenon.

If manufacturing is struggling, there seems to be little holding back the services sector, although we would point out that readings have most recently come off the top. The widely held belief is that consumers are saturated with "stuff" and are now in full party and holiday mode. Ryanair recently announced its highest ever monthly passenger count. And on 30 June, the US Transport Security Administration processed more passengers through airport security than on any other day in history. Given the lousy reputation of US airports, I can't imagine quite how hideous an experience that must have been for travellers.

How are other regions faring?

And if the US is in reasonably fine fettle, the same cannot be said of other regions important to investors. Europe is officially in a recession, even if only marginally. Both the fourth quarter of 2022 and the first quarter of 2023 showed a 0.1% decline in GDP. Even if it recovers to growth of 0.2% in the second quarter (which is the consensus expectation of economists polled by Bloomberg), that will hardly constitute a boom. And, of course, the market

also thinks that there are another two 0.25% interest rate increases in the pipeline from the European Central Bank. The gap between Citigroup's Economic Surprise Index for the US (+75) and Europe (-134) is by far the biggest I have ever seen.

Here in the UK, May's month-on-month decline in activity of 0.1% was greeted with relief against an expectation of -0.3% but is hardly grounds for celebration. The size of the economy (in real terms) remains 0.3% below where it was before Covid struck. And the tourniquet of rising mortgage rates is being tightened gradually as loans come up for refinancing. It's hard to see where respite is coming from.

And then there is China. It has just reported a GDP growth number for the second quarter that most political leaders would give their right arm for, namely 6.3% year-on-year. However, that was well below the expected 7.1% and, crucially, a big disappointment in light of the boost to growth that was supposed to come as a result of the end of a stringent Covid-related lockdown. With youth unemployment hitting a potentially socially destabilising record high of 21.3%, there remains hope that the government will react with some sort of stimulus, although it will probably not result in the sort of debt-fuelled construction boom that we have witnessed in the past. Poor consumer confidence and sluggish retail sales growth suggest the need for a policy targeted much more at middle-income households.

There is another fascinating contradiction that is worth pointing out, and that is the difference in consumer confidence reported in the US, depending upon whether you identify as a Republican or a Democrat. This was written up by the Bloomberg journalist John Authers in his Monday Points of Return column and is a phenomenon that I have noted regularly in the past as an illustration of the increasing polarisation of political opinions in the US. Unfortunately, I have not found similar survey-based evidence of such a wedge in the UK or any European countries, although I would expect the same to be true based on my own observations.

As mentioned earlier, the University of Michigan's sentiment survey saw an unexpectedly big increase in both the current conditions and expectations elements. Democrats gave a score of 96.5 for current economic conditions (against a historical high/low range of 119/47 to give it some context), and a score of 96.8 for expectations (range 108/43). That's pretty optimistic on the face of it. Might that have something to do with the current incumbent of the White House? Republicans are living and working in exactly the same economy, but you wouldn't know it. They score 54.3 for current conditions (range 133/38) and 46.1 for expectations (range 122/29).

What is clear from looking at charts of the data is that there is a crossover of opinions that takes place coincidental with the result of Presidential elections, but that Republicans are more volatile in their opinions compared with Democrats, depending on who is President.

The differences in expectations even extend to the inflation outlook. Democrats expect to see Consumer Prices rising at a tolerable 2.4% over the next 12 months, whereas Republicans say 4.9%. Maybe Democrats have bought into President Biden's Inflation Reduction Act at face value, although in reality it has added to the construction boom by granting tax breaks for investment in clean energy products and the purchase of electric vehicles. That's on top of the CHIPS and Science Act which provides incentives to invest in domestic semiconductor manufacturing. No doubt Republicans view these handouts as inflationary boondoggles.

Putting all of this together, we are not currently motivated to stray too far from our own benchmarks, although we continue to be moderately cautious in our outlook. Yes, we have been outflanked by the strength of the US economy, and maybe we did underestimate the fiscal tailwind (not that we identify as either

Democrats or Republicans). Our primary concern remains that an epic tightening of monetary policy in the form of higher interest rates will have negative consequences for economic activity sooner or later, although a combination of longer debt maturities and (US) fiscal intervention is extending the cycle.

Economic Commentary

FTSE 100 weekly winners

Just Eat Takeaway.com N.V.	13.2%
International Distributions Services plc	12.6%
Flutter Entertainment Plc	8.9%
Persimmon Plc	8.8%
Antofagasta plc	8.6%
Smurfit Kappa Group PLC	8.1%
JD Sports Fashion Plc	7.8%

FTSE 100 weekly losers

Bunzl plc	-2.6%
Hikma Pharmaceuticals Plc	-2.0%
British American Tobacco p.l.c.	-1.9%
Rolls-Royce Holdings plc	-1.8%
International Consolidated Airlines Group SA	-1.7%
Evraz PLC	0.0%
Unilever PLC	0.1%

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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