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OUT OF THE ORDINARY

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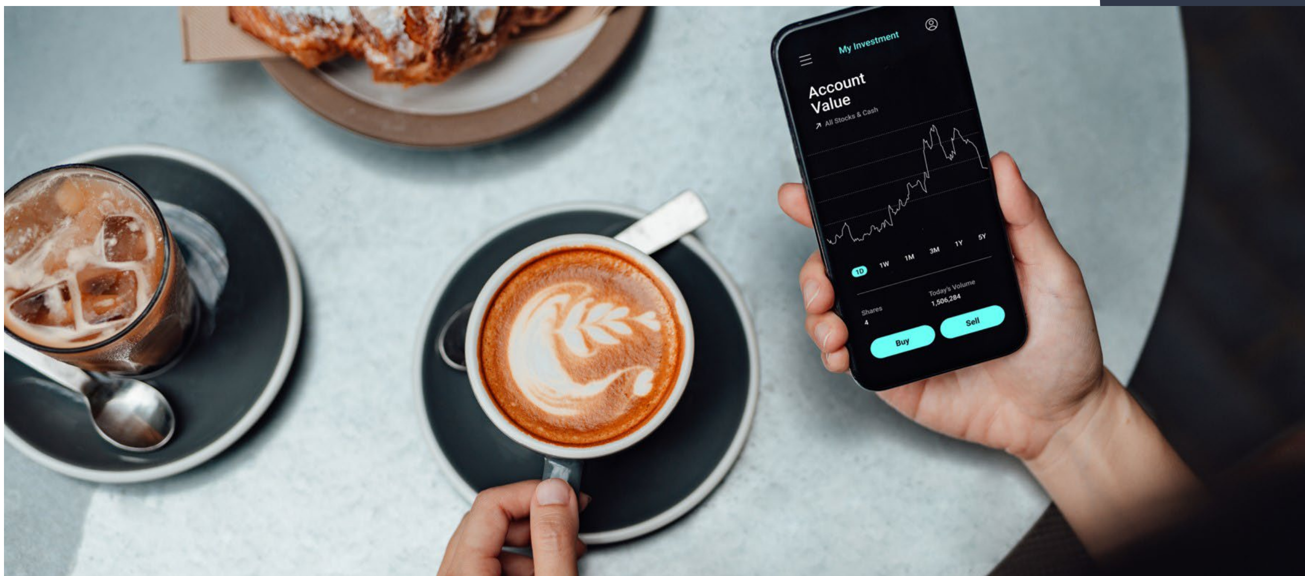
Time For A Break



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Last week I offered some thoughts about the unfolding corporate earnings season and the forthcoming central bank meetings, suggesting that they might provide some clarity for investors. Judging by market movements, the outcome was marginally positive without being definitive. Earnings are beating expectations, but not by enough to excite, and both the Federal Reserve (Fed) and the European Central Bank (ECB) returned to a more “data dependent” stance. Let’s start with earnings. As of last Friday, we had seen reports from

about 40% of the members of the UK's FTSE 350 Index, a third of the EuroStoxx 600 and almost exactly half of the S&P 500 in the US. That gives us a pretty good base to work from. In the previous weeks, companies and analysts had been playing the usual cat-and-mouse game in which earnings expectations are massaged down ahead of the release, setting a lower bar for positive surprises. And so, unsurprisingly, the aggregate outcome is that earnings are beating expectations, although not by as much as they usually do. That has led to an asymmetrical reaction. Companies that fail to hit the target are being punished more than those that beat are being rewarded.

Earnings season trends

There have been some notable trends. Resource companies (both Energy and Mining) have been disappointing, owing to lower commodity prices and some increase in costs. Financials have comfortably weathered the storm of bank failures back in March and April and have yet to experience any material pick up in loan losses. Consumer Staples continue to display incredibly strong pricing power in an environment of flat volume growth. Consumer Discretionary companies are benefitting from consumers' desire to keep spending down the savings that they accumulated during the pandemic, although there are some signs of caution emerging.

The key point is that there is no real evidence of either a boom or an impending bust, and so both bulls and bears are struggling to take control of the narrative. Indeed, looking at the consensus earnings forecasts from Bloomberg for calendar 2023 and 2024, one would struggle to suggest that we are in anything other than a very unremarkable environment. At the global level, the MSCI All-Countries World Index is expected to post earnings growth of 8.8% in both years. That will be led by the US (11% and 10%), with World Growth (15.5% and 13%) outperforming World Value (5.3% and 6.4%). I'm afraid that the FTSE 100's composition, combined with this year's strength of the pound versus the dollar, leaves it at the bottom of the pile (2.4% and 3.7%). For completeness, the Stoxx 600 expectations are 5.8% and 6.8%; the Nikkei 225 in Japan is expected to grow earnings at a respectable 10% in both years; and Emerging Markets' growth is put at 6.4% and 7.2%.

If price/earnings ratios remained unchanged for the next 18 months and those earnings were delivered, investors could relax and look forward to some pretty decent total returns. If only life were so easy. As you are no doubt well aware, there is still a healthy debate in session about the possibility of a more negative outcome, with much of that predicated upon the path of inflation and the policy decisions of central banks.

Have American investors given up on the prospect of recession?

Much will depend on whether the US economy decelerates or even falls into a recession. Back in January, a US recession was widely expected to have already started by now, but there is no sign of one yet. That's not to say that investors have given up on the prospect. 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 a couple of weeks ago, the figures for the same periods were 2%, 23% and 59% respectively. And so, the recession is pushed out, but it's still expected to arrive.

What did central banks have to say about matters last week? Interestingly, the Fed now believes that there will not be a US recession. However, if that really is the case, it's hard to see how they will do anything other that keep interest rates at more elevated levels, and the expectation of lower interest rates has been at least one of the forces helping to drive equity markets higher. Futures markets have now priced out any chance of US rates being cut this year and are gradually edging up the level for the end of 2024. In early July it was as low as 3.6% and is now 4.2%. Even so, that's a healthy reduction from the current 5.5%.

There was also a slightly more dovish tone to comments from the ECB last week. No longer is it firmly committed to further rate increases. Like the Fed it is going back to being "data dependent". And so that delivers us back to a world in which economic data releases pertaining to inflation and growth assume an even greater importance for markets.

The good news on inflation is that it appears definitely to have peaked for this cycle. The big question remains how long it will take to return to central banks' 2% target and whether it will take some damage to the employment market to achieve that target. Fed Chairman Jerome Powell was not taking any hostages to fortune last week, 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. Now we are potentially going to have to wait until the end of September for further opinions, given that the next Fed meeting is not scheduled until the 20th of that month.

And whether we like it or not, it will be the fate of the US economy that tips the market balance. Much of that will hang on the behaviour of the consumer. One feature of the resilience of US consumer spending has been the drawing down of "excess" savings accumulated during the pandemic. The exact number is difficult to pin down and every economist appears to have their own methodology. We have seen estimates ranging from the assertion that this well has already run dry (interestingly, from the Fed itself) to calculations that there is still well over a trillion dollars left in the tank. That just increases the range of potential outcomes.

How is the UK faring?

The UK and European economies are not doing much better than flatlining. It is slightly dispiriting when a month-on-month decline of 0.1% in UK activity is heralded as good news because it was better than expectations. Even so, the Bank of England is the one central bank that appears to be still committed to raising interest rates, thanks to a stickier inflation problem, and so it's hard to see any relief coming for the economy. Neither is there much scope for fiscal largesse.

On the Continent, the latest bank lending data for Europe have seen overall outstanding loans shrinking, which, again, suggests an economic headwind. There has definitely been a benefit to Europe from a resurgence in tourism this year, but one also wonders about the sustainability of that boom once the past-pandemic euphoria wears off.

Like the Fed, I will be taking a bit of time off over the next few weeks. Indeed, the fact that next week is a Monthly Digest week and that the 28 August is a Bank Holiday means that I won't be putting virtual pen to paper again until early September, although a couple of my colleagues will be giving you their thoughts in my absence. Markets have a reputation for producing some surprises during what is traditionally a low-liquidity period during August. Let's hope they remain calm this time.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	42.1%
Rolls-Royce Holdings plc	24.1%
Polymetal International Plc	13.2%
Entain PLC	7.8%
Antofagasta plc	7.1%
International Consolidated Airlines Group SA	6.0%
Smurfit Kappa Group PLC	5.6%

FTSE 100 weekly losers

St. James's Place Plc	-18.6%
SSE plc	-6.9%
Hargreaves Lansdown plc	-5.8%
Barclays PLC	-4.6%
Compass Group PLC	-4.5%
SEGRO plc	-4.0%
Intermediate Capital Group plc	-3.8%

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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