OUT OF THE ORDINARY

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Holding Pattern

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Thanks to the intervention of two Bank Holiday Mondays, it's been three weeks since the last "Weekly" Digest. You might think that there would be a lot to catch up on, but very little appears to have changed over the three weeks from Friday 21 April to Friday 12 May. The MSCI All-Countries World Index is down half a percent in capital terms. The all-important US 10-year Treasury yield has ticked down from 3.57% to 3.46%, hardly the sort of movement that gets bond traders out of bed these days.

Such apparent insouciance is, perhaps, even more remarkable given that during the period yet another US regional bank had to be put out of its misery. This time it was First Republic Bank, which has now been subsumed within JP Morgan. I'm pretty sure that if, at the start of the year, it had been suggested that four sizeable US banks and one Swiss giant would become the victims of a bank run, very few, if any, pundits would have predicted that the S&P 500 Index would be up 7.5% by now.

Having said that, it is also fair to point out that the entire gains of the S&P 500 this year can be attributed to just a handful of stocks, primarily those large-capitalisation companies that are deemed to be potential beneficiaries of the latest hot technology, Generative Artificial Intelligence (AI). Having witnessed the unfulfilled (from a profit-generating perspective) hype in recent years about "next big things" such as 3D Printing, self-driving taxis, flying cars, hydrogen power, blockchain and the metaverse (to name but a few), it is tempting to be very cynical about the prospects for AI. However, given that the field is being led by very large companies with extremely deep pockets (and hugely cash-generative existing businesses to keep refilling those pockets), one would bet against this nascent industry at one's peril. Certainly, it seems as though nobody wants to be short of the companies involved right now, which has contributed to a steady price squeeze.

What current risks are being priced in?

The tension that is keeping markets pinned in a narrow trading range is still between the risk of a weaker economy and the promise of looser monetary policy, especially in the US. A majority of respondents to fund manager surveys such as those conducted by Deutsche Bank, Bank of America and Goldman Sachs continue to expect a recession to develop in the United States. They have a lot of arguments on their side, including measures such as weak Leading Economic Indicators and inverted yield curves, both of which have a near-perfect record of predicting recessions. Something is definitely afoot according to Citigroup's US Economic Surprise Index (CESI), which has fallen from a late-March peak of 60 to a current 6.

However, the economic picture remains blurred by the fact that different parts of the economy are going at different speeds (and possibly in different directions). The Goods economy is suffering from weaker demand and a reduction of groaning inventories, while the Service economy still has the tailwind of the post-lockdown spending boom, fuelled by "excess savings" accrued when we couldn't spend at normal levels. Even from region to region, there is no overriding trend. While the US is disappointing, the UK has surprised to the upside, where the CESI reading of 92 compares with -40 back in February. Europe, having dodged the recession bullet during the winter, has seen its CESI drop from 100 in February to -21.

China's CESI, at -78 in January, is now 100. Even so, there is creeping disillusionment with the pace of China's recovery – the index was as high as 162 a month ago. We detailed in May's Monthly Commentary how a recovery in Chinese demand for luxury goods has provided strong support to France's CAC 40 Index (home to LVMH, Hermes and Kering). But it is, perhaps, more interesting to note that hard commodities such as iron ore and copper have seen sharp price falls in recent weeks since China is not pursuing its "usual" debt-fuelled building programme to lead recovery.

What is the outlook for inflation?

Another big topic is the path of inflation. This is also moving at different speeds in different economies. The latest US Consumer Price Index print last week revealed a marginal reduction in both headline and core readings, which was a relief. But 5.5% core inflation is still a lot higher than the Federal Reserve's 2% target. Producer price indices are also falling back. Inflation looks a lot stickier in the UK and Europe (although it has almost certainly peaked), while it's barely visible in China (+0.1% year-on-year). This means that central banks are no longer moving in lockstep. The message from futures markets is that the Bank of England and the European Central Bank are not yet done with rate increases, while there is a growing expectation that the US Federal Reserve has raised for the last time and will start to cut rates before the year is out.

And this is where we reach the impasse. If the Fed has to cut rates, it will probably be because the economy is weak and job losses are piling up. All other things being equal, we would expect that to translate into weaker corporate earnings, a factor that tends to depress equities. But the prospect of lower rates is supportive to valuations, and everyone knows that rate cuts sow the seeds for the next economic growth cycle and for the next equity bull market.

It remains our belief that the lagged effects of a swift and aggressive monetary policy tightening cycle are yet to be fully felt in the economy and that markets will have to price in some earnings weakness before benefitting from the rate cuts. In a world of instant gratification and dopamine hits, many people now expect economies and financial markets to resolve themselves in a similarly speedy manner. However, the inflationary nature of this cycle is very different from, say, the Covid recession or the Great Financial Crisis, both of which were deflationary shocks. It’s taking a lot longer to play out and requires some patience.

Economic Commentary

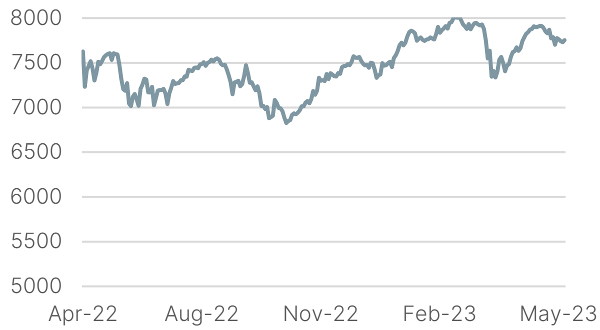
FTSE 100 weekly winners

Melrose Industries PLC	11.2%
JD Sports Fashion Plc	8.4%
Just Eat Takeaway.com N.V.	7.6%
Ferguson Plc	6.1%
International Consolidated Airlines Group SA	5.3%
3i Group plc	3.9%
Barclays PLC	3.8%

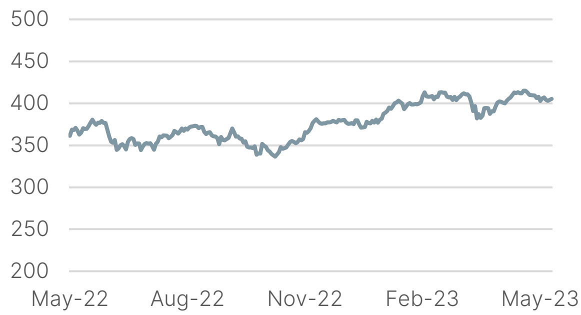
FTSE 100 weekly losers

Polymetal International Plc	-12.3%
Ocado Group PLC	-8.5%
Land Securities Group PLC	-6.5%
British Land Company PLC	-5.6%
Fresnillo PLC	-5.4%
Vodafone Group Plc	-4.9%
InterContinental Hotels Group PLC	-4.6%

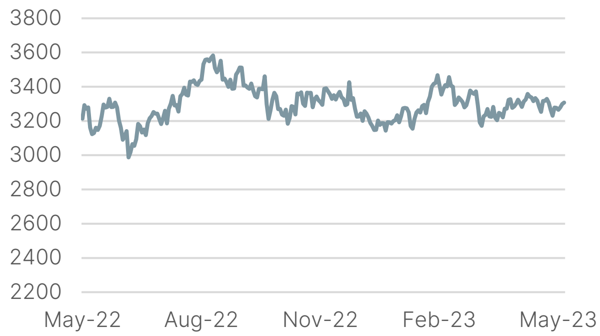
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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