Investec

OUT OF THE ORDINARY

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Missing the Boat (or Plane)

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It's hard to believe that four weeks have passed since I last wrote a Weekly Digest. A lot of things have happened since then and so I will attempt to catch up on a few of the most important ones. Perhaps the best piece of advice I can give, though, is to check your travel itinerary. After more than twenty years of successfully dealing with Ryanair's imaginative approach to flying from airports that are nowhere near the cities they serve, I finally turned up at the "wrong" Brussels airport to find there was a big gap in the departure

schedule where my flight was supposed to be. A mad taxi dash to the "right" airport got us there ten minutes too late to check in and ended in a hire car drive to Paris Beauvais to catch a timely connection to our final destination. Maybe that's learning the hard way, but if I ever make the same mistake again, then more fool me.

A lot of investors are beating themselves up, too. Not for not reading the small print (although that might have been a mistake made by holders of Credit Suisse's Contingent Convertible bonds back in March), but for underestimating the enduring power of the US economy, and, in the process, "missing the boat" of the recent US equity market rise. The long-touted recession seems to be no closer to arriving, at least when viewed through the lens of equity markets. The S&P 500 finally broke out of its narrow trading range and is now above last summer's peak. It is 23% above the lows of last October. All of this has been achieved despite the Federal Reserve's avowed intention to keep on raising interest rates.

What contributed to the US equity market performance?

What's going on? There are four major factors that I can point to, three of which are things that could have gone wrong but have not. The first is that lack of recession. This means that corporate earnings and employment have held up better than expected. The reasons for strong demand are various, ranging from post-Covid consumer spending of "excess" savings to generous government spending and increasing investment in domestic supply chains (with further fiscal incentives attached). The long average maturity of mortgages in the US, combined with tight supply, has insulated the housing market too. While we never expected anything worse than a shallow US recession, we have still been surprised by its resilience.

Then there is the lack of fallout from the collapse of three regional banks (the first of which was Silicon Valley Bank in March). An incipient crisis was averted by swift action from Federal institutions. Indeed, at the time of the bankruptcies in March we were confident that a financial crisis was not about to occur. However, we do seem to have underestimated the positive influence of initially falling interest rate expectations and the provision of liquidity in helping to reanimate animal spirits.

The final catastrophe that was averted was a US debt default, although this is another thing that we thought was a very low probability event. As a potential "left tail risk", though, it was definitely holding sentiment back.

If these are all potential negatives that never happened, there was one huge positive influence. On 24 May, the day after the last Weekly Digest was published, the US semiconductor chip designer Nvidia released its quarterly earnings. They exceeded expectations, driven by demand for chips that are essential to the growth of generative Artificial Intelligence, but the forward guidance was even stronger. While Nvidia's pre-eminence in the field was hardly a state secret, the extent of current and future demand was entirely unanticipated. At the extreme, Wall Street analysts were having to double their price targets for the shares, which opened 25% higher the following day and have continued to rise since, elevating Nvidia to the exclusive one trillion-dollar market capitalisation club.

Some have dubbed this the equivalent of an "iPhone moment", although in retrospect, I think, nobody really realised just how important the iPhone (and other smartphones) would become thanks to the huge number of applications that could be built around their operating systems. You could say that the iPhone was responsible for things ranging from the disruption of the taxi industry (Uber, etc.) to, most recently, the demise of Silicon Valley Bank (deposit withdrawal requests from your phone).

We are going to have to wait and see what the killer applications are this time, but it is interesting that, generally, the market is treating the

acceleration of AI as being a "glass half full", with much being made of its ability to enhance productivity, especially in clerical functions. Perhaps the most thought-provoking thing about AI is encapsulated in Moravec's Paradox, a concept that I was only introduced to last week (attributed to Hans Moravec, a professor of robotics and AI). This states that for AI "the hard things are easy... and the easy things are hard". The inference is that trained (and, more importantly, self-training) computers find it a doddle to compete with a chess grand master, but might find it much harder to, say, prune a wisteria successfully. This idea was also expounded by the popular science author Stephen Pinker as long ago as 1984: "As the new generation of intelligent devices appears, it will be the stock analysts and petrochemical engineers and parole board members who are in danger of being replaced by machines. The gardeners, receptionists, and cooks are secure in their jobs for decades to come".

We have noted that every company that could possibly claim to be embedding AI into its business in any shape or form is telling the world about it. There is a feeling of "dot.com" madness in the air, and we are always well aware of the words of Bill Gates regarding new technologies: "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten". And so, we are very happy to be exposed to AI but will trim or add to positions as appropriate to a balanced and diversified portfolio. We are certainly not planning to bet against it.

Central Bank action

Despite all those fireworks, the next leg of market performance might yet boil down to the central banks. Last week, the Federal Reserve decided not to raise the Fed Funds rate for the first time in this cycle. However, the "dot plot" of Fed members' interest rate expectations still sees further increases to come and their rhetoric also points that way. No doubt, if there is data to persuade them to hold back from further increases, they will take that into account. But the message still seems to be that keeping inflation expectations well anchored is the key objective. Fed Chair Jerome Powell wants to be remembered as a Paul Volcker (inflation-tamer supreme), not an Arthur Burns (who failed to extinguish it in the 1970s).

Thus, we are still wary of the "long and variable lags" of the effects monetary policy. With rates globally having risen sharply over the last year or so, the cost of capital and the cost of servicing debt has risen, and there is more in the pipeline as loans locked in at low interest rates mature and have to be refinanced at higher rates. Specifically, here in the UK, the Financial Times's headline on Saturday was "Sunak faces mortgage time-bomb". With 1.6 million fixed-rate mortgages forecast to expire in 2024, the average annual interest payment increase is forecast by the Resolution Foundation to be £2,900.

We'll see what the Bank of England has to say about that on Thursday. Futures markets are fully pricing in another 0.25% increase in the base rate to 4.75% this week with more to come. In fact, the peak rate according to the market will be 5.75%. That feels a bit extreme, even with inflation having surprised to the upside. There again, I never thought that the base rate would make it back to (close to) 5% in my working life. Having been at effectively 0% since 2009, it's hard to believe we can just sail through such a big adjustment in the price of money.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	19.5%
International Distributions Services plc	9.8%
CRH public limited company	8.6%
Glencore plc	7.4%
Antofagasta plc	5.6%
Smith & Nephew plc	5.2%
Croda International Plc	4.9%

FTSE 100 weekly losers

BT Group plc	-7.2%
Entain PLC	-5.8%
Intermediate Capital Group plc	-5.4%
Admiral Group plc	-5.2%
Polymetal International Plc	-5.1%
SEGRO plc	-5.1%
Hargreaves Lansdown 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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