RATHBONES | Incorporating Investec Wealth & Investment (UK)

WEEKLY DIGEST | 21 November 2023

A Kind of Magic

John Wyn-Evans
Head of Investment Strategy

Continuing the musical theme from last week, a recent project at home has been to refurbish my mum and dad's vintage 1970 record player and amplifier. OK, I paid someone to do it because it was a very specialist job requiring all sorts of new valves, resistors and capacitors, not to mention a lot of cleaning and lubricating of gummed-up (not) moving parts of the turntable and tone arm. But worth every penny in terms of the enjoyment of listening to my old vinyl records which had been stored in the attic for a couple of decades. It's a

proper treasure trove up there, even if Mrs Wyn-Evans is more inclined to view the majority of contents as junk!

This week's title references Queen's single (and album, which is in my collection) of the same name released in 1986. One of the lyrics refers to "one golden glance of what should be", and it seems to me that this is what markets have offered us in the last two or three weeks: a magical world in which interest rates and bond yields come down and equities rise. At least that is what everyone would like to see.

I wrote last week about how comments from the US Federal Reserve had initially sparked the November rally, with various technical factors contributing to the squeeze higher in both equity and bond markets. The latest fuel came in the form of a lower-than-expected US inflation figure for October last Tuesday. Although the beat was only marginal, the key point was that it confirmed the trend of falling inflation. Even so, consumer sentiment remains low because falling inflation is not the same as falling prices, which remain, in aggregate, around 18% higher than they were three years ago.

For once, the UK went one better with its inflation data release, and in a good way. The headline annual Consumer Price Index rise came in at 4.6% against expectations of 4.7%, down from 6.7% in August. Here again, though, consumers are still dealing with overall prices that are 19% higher than they were in September 2020.

This increase in prices is possibly the biggest factor undermining support for incumbent governments in the US and the UK, both of whom face elections in the not-too-distant future. The US Presidential election is less than a year away now (5 November 2024), while the UK General Election must be held before January 2025. In fact, elections are going to be a big global theme in 2024. More than half of the world's population (also accounting for around half of global GDP) are scheduled to go to the polls next year. Some other important country elections include Taiwan (January), Russia (March), India (April) and, for my former colleagues, South Africa (TBA).

The better-than-expected inflation data galvanised interest rate markets, which have concluded that we have seen the peak of interest rates in the US, the UK and Europe. We have been saying for a few weeks now that economists were only arguing over the possibility of a final 0.25% upward tweak to conclude the cycle and so we were not particularly fearful of further policy tightening. Even so, the speed with which potential rate cuts are now being priced in has taken us a little by surprise, especially in the absence of significantly weaker economic data. Having said that, our increased appetite for government bonds as yields pushed higher has been rewarded with some pleasing capital gains as yields fall again.

In terms of potential interest rate cuts, futures markets are now pointing at June 2024 as the key date, with the probability of a reduction by then rising above 50% in the US, the UK and Europe. No doubt this depends upon inflation indices continuing to behave. There is plenty of evidence to suggest that they will, notably the fact that we will be lapping higher readings from the past. Specifically, energy prices are behaving well, and the biggest element of last week's month-on-month reduction in the UK Consumer Price Index was the cut in the energy price cap.

Obviously, energy prices are more susceptible than most to geopolitical events, with the Middle East currently a focal point. On that front it is notable that the oil price is lower than it was the day before Hamas attacked Israel. Remarkably, it's also lower than it was before Russia invaded Ukraine. There seems to be no underlying supply shortage relative to demand. In fact, members of the OPEC+ producer cartel have had to reduce production to support the price. Many of them (including Saudi Arabia and Russia) cannot afford for prices to fall too low because they need the revenue to finance themselves.

In equity markets last week, it was sectors most at a business risk from the effects of higher interest rates that rallied hardest. Smaller companies did particularly well. Real Estate, which is also exposed to valuation risk, topped the charts in the US and the UK. Our analyst's opinion is that there are several companies in this sector where the market is applying a much higher discount rate to their cash flows that he thinks is deserved, effectively pricing in a much deeper recession (and a limited probability of cheaper money ahead).

Bottom of the pile in those markets were Consumer Staples. They're seen as quality defensives, so there was no way they were going to be at the top of buy lists, but these stocks have also been hit hard by being the potential losers against the winners from the development of appetite-suppressing drugs. There is an interesting test case ahead in the form of the US Thanksgiving holiday later this week. This is a celebration that is characterised by excessive consumption, but it will be the first year in which drugs such as Novo Nordisk's Wegovy have been available.

Consumer Staples companies have excelled themselves during the period of higher inflation by being able to impose heavy price increases on consumers. For the last year or so, sector revenue growth has been driven almost entirely by price increases, with volumes pretty much flat. It certainly speaks to resilient underlying demand and to the power of their brands, with the heritage of some of them stretching into centuries. As inflation falls, it is harder to play the price card, but one would hope that lower inflation might create a better environment for real wage growth, which would, in turn, support consumer demand. It's certainly an area to keep an eye on.

We continue to believe that we are navigating the final stages of what has been a long and difficult cycle for inflation, interest rates, economies and financial markets. To quote Queen again from the same song: "the waiting seems eternity" (sic – Roger Taylor chose rhyme over grammar). Concrete evidence of declining inflation is very helpful. Although we expect central banks to remain publicly cautious around the prospect of rate cuts for fear of prematurely declaring victory over inflation, the outlook is beginning to look rosier. And we should always remember that financial markets try to anticipate future developments and not to price off what is going on today.

Question of the week:

Last week's question: Which footbal l team paid £1m to sign Trevor Francis in 1979?
Nottingham Forest

This week's question: Question: In Disney's 1971 animated version of Robin Hood, the Sheriff of Nottingham is depicted as what type of creature?

Economic Commentary

This Week's Forthcoming Events

US	Leading Indicator SA M/M
US	Existing Home Sales SAAR
US	Durable Orders SA M/M (Preliminary)
US	Initial Claims SA
US	FOMC Minutes
US	Markit PMI Services SA (Preliminary)
US	Markit PMI Manufacturing SA (Preliminary)
UK	CIPS Services PMI SA (Preliminary)
UK	CIPS Manufacturing PMI SA (Preliminary)
EU	Markit PMI Composite SA (Preliminary)
EU	Markit PMI Manufacturing SA (Preliminary)
EU	Markit PMI Services SA (Preliminary)

UK – CPI inflation fell from 6.7% in September to 4.6% in October, a welcome catch-down to the rates in the US (3.2%) and Europe (2.9%). Annual utilities inflation fell from +5% to -21.6% as the Ofgem price cap was cut by 7%, against a 24.7% increase last year. Food inflation also fell, from 12.3% to 10.1%. The most domestically drive element of inflation, services, fell from 6.9% to 6.6%, and further progress here will be crucial to maintaining the declining inflation trend. Futures markets are now projecting no further increases in the base rate, with the first cut potentially coming next June.

US – October core CPI rose 0.23%, below expectations for a 0.3% increase, and the year-on-year rate edged down 0.1pp to 4.0%. The composition was mixed. While the reading was flattered by a sharp decline in hotel prices that one wouldn't expect to persist, the stickier Owners' Equivalent Rent and medical care services categories were softer than expected and trimmed measures of inflation similarly slowed. The health insurance component swung from its -4% monthly pace of the last 12 months to +1% as the Bureau of Labor Statistics incorporated new source data on insurer profitability, and it should remain at this new pace through April 2024. But the small miss was greeted euphorically in both bond and equity markets as it confirmed the falling inflation trend. Here, too, markets priced out any further rate increases, with June 2024 also the expected date of the first cut.

Europe – There were no revision to Europe's inflation data that had been released earlier in the month. The headline annual rate remained at 2.9%, with the core rate still higher at 4.2%. The latter excludes energy, which is now much lower than a year ago. For example, wholesale natural gas prices have halved over the period. As in the UK and US, there is now zero expectation of another rate rise from the European Central Bank, with the first cut also priced in for June. That represents the first time for a while that interest rate expectations have been so synchronised across the regions.

China – There is some evidence of China finally turning the corner, although it is not all-encompassing. Retail Sales in October were 7.6% ahead of where they were in 2022, handily accelerating from September's reading (+5.5%) and beating expectations (+7%). Industrial Production growth of 4.6% year-on-year also beat the forecast of 4.5%, which was the level in September. The fly in the ointment is real estate, where Fixed Asset Investment growth of 2.9% (year-on-year/year-to-date), missed the 3.1% expectation. Property investment was -9.3% on the same basis. The monthly fall in house prices (-0.38%) was the biggest of this already weak cycle. The government and central bank continue to provide support to the ailing real estate industry, but there is still a lot of excess to work off. Economic growth will have to come from other sources.

Economic Commentary

FTSE 100 weekly winners

British Land Company PLC	17.1%
DCC Plc	16.2%
Just Eat Takeaway.com N.V.	16.1%
Anglo American plc	10.7%
Glencore plc	9.5%
Experian PLC	9.3%
Barratt Developments PLC	9.0%

FTSE 100 weekly losers

Entain PLC	-7.5%
Burberry Group plc	-6.7%
BAE Systems plc	-4.3%
Unilever PLC	-3.4%
BT Group plc	-2.1%
DS Smith Plc	-2.1%
Pearson PLC	-1.8%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

RATHBONES | Incorporating Investec Wealth & Investment (UK)

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Investec Wealth & Investment (UK) is a trading name of Investec Wealth & Investment Limited which is a subsidiary of Rathbones Group Plc.
Investec Wealth & Investment Limited is authorised and regulated by the Financial Conduct Authority and is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street. London. EC2V 7QN. Member firm of the London Stock Exchange.