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OUT OF THE ORDINARY

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Information Overload

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Monday is usually the busiest day of the week for me, but several of my colleagues in Investec's Investment & Research Office are bracing themselves for the onslaught of the second quarter/first half corporate earnings season, later in the week. I shudder to think how many forests were consumed in the past by the proliferation of preview and post-results notes. When I was on the broking side I only had to cope with the output from my own firm. Fund managers' desks would groan beneath the weight of output. Email has, at least, reduced the post room's burden, although electronic distribution creates its own problems in terms of inbox management.

What do we expect from earnings season?

In aggregate, the bar appears to be set reasonably low for the current earnings season, although that might turn out to be a bit misleading. If we look at how matters have evolved so far this year, data collected by Citigroup suggests that earnings forecasts for the MSCI All-Countries World Index (ACWI) have fallen by 3% since January. But a lot of those downgrades are concentrated in just two sectors – Energy (mainly Oil and Gas producers) and Materials (largely Mining companies), where forecasts have dropped by 15% and 11% respectively.

One of the hardest hit by this reduction has been the UK market, where the two sectors account for around a fifth of the market capitalisation. The situation has been exacerbated by a strengthening pound (much of which stems from a weaker dollar), given the high non-sterling element of UK-listed companies' profits. There remains a consistent negative correlation between the FTSE 100 Index and the performance of sterling (which was illustrated once again last week when the pound fell on the back of lower peak interest rate expectations, more of which anon). Thus, the FTSE 100 has only managed to gain 2.8% in 2023 in sterling terms, although a healthier 9.2% when expressed in dollars or 5.4% in euros, which brightens the picture for anyone planning to travel overseas. Even more impressively it's up 14.3% in South African Rand terms and 17.5% in Japanese Yen if your horizons are more distant.

Winning the upgrade race this year is Continental Europe, where aggregate earnings estimates have increased by 3%. Cyclical sectors such as Industrials, Consumer Discretionary and Financials have been the main beneficiaries, mainly on account of unwinding the pessimism that was built into expectations at New Year. Although Europe has flirted with a recession, the outcome has been nothing like as bad as it might have been without a mild winter, which alleviated the squeeze on natural gas prices.

The first knockings from the US reporting season (which tends to lead the way) have been mixed. Banks acquitted themselves well relative to fears of a net interest margin squeeze, but the first members of the FANG+ group of shares that have led the market up this year (Netflix and Tesla) underwhelmed. Given that the US Information Technology sector has enjoyed a near 50% re-rating of its forward price/earnings ratio since last autumn's trough, the onus is on it to some degree to produce the goods in terms of concrete earnings rather than promises about the future.

What other events should we be monitoring?

For those not obsessed by the latest quarterly offerings (or not contractually obliged to care about them), there is plenty of other stuff to keep one busy, not least the forthcoming round of central bank meetings. The US Federal Reserve's Open Market Committee delivers its monetary policy message on Wednesday, followed by the European Central Bank on Thursday and the Bank of Japan on Friday. (We have to wait until 3 August for the next Bank of England meeting). Everyone is trying to pin down the peak in the interest rate cycle (or the start of a tightening cycle in Japan). The last Fed meeting was deemed to be a "hawkish pause", meaning that they left rates unchanged but intended to increase them in future. This week's could be a "dovish hike", with the Fed suggesting it has no more rate increases left in the tank. Certainly, it will have been encouraged by the last reading of the Consumer Price Index, which undershot forecasts, although it will still be wary of the persistent strength in many segments of the US economy. We're pretty sure we are close to the end of this rate rise cycle, as is the futures market, which is now pricing in just this week's 0.25% increase to 5.5%.

We then move on to speculating about how fast rates will come down. In the immediate aftermath of the bankruptcy of Silicon Valley Bank, the futures market saw the Fed Funds rate being as low as 3.75% by the end of this year. That now stands at 5.36%, effectively saying no cuts in 2023. But the market is projecting several cuts next year, with the December 2024 future at 4%. There are two paths to lower rates which offer different scenery. The more desirable features naturally declining inflation and resilient growth, the so called "immaculate deflation". This has always been the outcome with the longest odds, but those odds have fallen. The less desirable sees falling inflation being delivered by a sharp slowdown in economic activity, which would trigger earnings downgrades. We have tended to believe in the latter outcome as being more probable, although less so recently. Even so, we are not betting the farm on either extreme.

There must have been much rejoicing at the Bank of England (and in Downing Street) last week when June's reading for consumer prices came in below forecasts. We always believed that expectations of a peak base rate of 6.5% were too pessimistic, thinking that consumer debt burdens would not be able to bear the pain. That figure has now rattled back to 5.75%, even if that does portend another three quarter-point increases from the current 5.0%. There was a sharp repricing of bonds, with the rate-sensitive two-year yield falling from a peak of 5.5% to 4.9%. That will come as a huge relief to people in search of a two-year fixed rate mortgage. Wages remain the stickiest inflation factor in the UK, and one suspects the Bank will want to see more restrained pay deals before contemplating a pause, let alone rate cuts. The futures market does not see rate cuts in prospect until next summer at the earliest.

The positive inflation surprise and lower bond yields took the wind out of the pound's sails as traders priced in lower prospective interest rate differentials with other countries. I referred earlier to the negative correlation between sterling and UK equities, and so, as one might expect, the FTSE 100 put in a strong relative performance last week, at least on the face of it. It rose by just over 3%. Unfortunately, those extra pounds now don't go quite as far as they did overseas.

And so, there is plenty to digest this week. One would hope that by next week the picture will have become at least a little bit clearer in the aftermath of such a huge barrage of information.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	15.6%
Hikma Pharmaceuticals Plc	12.7%
Barratt Developments PLC	11.4%
Taylor Wimpey plc	11.3%
Hargreaves Lansdown plc	10.4%
Persimmon Plc	10.2%
Land Securities Group PLC	8.1%

FTSE 100 weekly losers

Polymetal International Plc	-10.0%
Flutter Entertainment Plc	-4.0%
Prudential plc	-2.6%
Standard Life Aberdeen	-2.1%
Coca-Cola HBC AG	-2.0%
Rio Tinto plc	-1.4%
BT Group plc	-0.9%

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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