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OUT OF THE ORDINARY

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Old Men In A Hurry

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In some respects, it seems like an age since my last Weekly Digest which was written at the end of July, but in others the time has passed remarkably quickly. There are various theories about why we experience the passage of time in different ways as we get older, but I'm not quite ready to describe myself as "an old man in a hurry", especially when it comes to investing. After all, between my current age and his current age, Warren Buffet managed to turn $4bn into more than $100bn – although I can't claim to be starting from the same level!

However, it does seem to me that more and more investors (or should I call them traders) are in a hurry. Leveraged investment vehicles and the proliferation of zero-day-to-expiry options speak to a desire to get rich(er) quick. Maybe that's one reason why even small reversals in equity markets seem to elicit comments and headlines that are heavy on the gloom and doom. Or, perhaps, it's because the media knows that humans have an insatiable appetite for stories that lean towards the apocalyptic.

In my latest Monthly Commentary, I suggested that the latest bout of uncertainty in markets is, at least in part, because there is a distinct lack of synchronization in the global economy. For example, Services are strong while Trade is weak. This largely seems due to the fact that during the pandemic consumers stocked up on "stuff" and now they are letting their hair down with experiences – witness the boom in sales for tickets to see pop stars Beyoncé and Taylor Swift, as well to see films such as Barbie.

There are also significant regional differences. The United States is head and shoulders above other developed economies in terms of current growth. Almost everybody has been caught out by this. The Federal Reserve's campaign to bring down inflation by tightening financial conditions has had some counterintuitive results. It is most visible to ordinary citizens in the housing market, where house prices have been extremely resilient. From its low of 2.85% at the end of 2021, the US 30-year mortgage rate has risen to 7.2%, according to research from Deutsche Bank (DB). You might have thought that this would put a severe dent into the housing market. Well, it has decreased overall transactions, mainly because people who have existing mortgages are loath to move as they would lose the benefit of their current cheap mortgage. DB also points out that the "effective mortgage rate" (the average rate paid on the outstanding stock of all mortgages) has only risen from 3.52% to 3.6% over the same period. The lack of supply has buoyed prices. Furthermore, it has allowed homebuilders to step in and meet what demand there is.

The difference between the US and the UK is stark. Here, the fuse on the fixed rate mortgage time bomb is a lot shorter (generally in the two-to-five year range) and so the average rate paid has also risen faster and will probably continue to. The Bloomberg UK Homebuilder Index (measuring the performance of housebuilding stocks), despite enjoying a resurgence during the Covid work-from-home boom, trades at around half its pre-pandemic peak level. The US equivalent has almost doubled in the same timeframe.

Another booster for the US has been provided by, well, an old man in a hurry, namely President Joe Biden. It is a feature of US politics these days that an incoming President will probably only have two years in which to push bills to support his policies through Congress. This is because the mid-term elections now seem to have a habit of destroying any Congressional majority that might have been achieved in the Presidential election. President Biden quickly got through the American Rescue Plan ($1.9 trillion made up largely of stimulus cheques which accounted for a large amount of the "excess savings" accumulated by households) and the Infrastructure Investment & Jobs Act ($1.2tn). These were followed by the CHIPS & Science Act ($280bn to bolster investment in high-tech hardware) and the misleadingly named Inflation Reduction Act. The latter is a promise to provide uncapped incentives for investment in green technology. Originally pegged at around $370bn of funding through 2031, it is now officially projected to spend more like $660bn over that period, and it will probably just keep rising.

It's fair to say that new spending initiatives are likely to be in short supply between now and 2025 as we approach the one-year countdown to the next Presidential election in November 2024. But current odds suggest that the next (or continuing) occupant of the White House will still be an old man (and probably in an even bigger hurry).

What's happening in China?

The polar opposite to the US is China, which, although still projected to grow its GDP at 3-5% in 2023, is massively lagging behind expectations. China's President Xi is hardly a spring chicken either, having just entered his eighth decade, but he has handily sidestepped the maximum "conventional" ruling term of ten years by declaring himself effectively President for life. That has allowed him to force the country to take some pretty unpleasant medicine, ranging from a crackdown on corruption and reining in the power and profitability of the technology sector (amongst others), to imposing a draconian Covid lockdown. Even so, he is not expected to allow the economy to languish forever, and investors live in hope of more expansionary policies – but not the debt-fuelled escapades of the past.

Then there is the knotty question of Taiwan, the reunification of which with China seems to be a key part of the legacy that he wishes to leave. I fear that this is a subject to which we will regularly return. Suffice to say for now that the Taiwan Presidential election next January is the next date to focus on to see if the country leans back towards the mainland without any need for coercion.

I should probably mention Russia's President Vladimir Putin in a similar context. Heading towards his 71st birthday (and with rumours rife about his health and potential longevity, or lack of it), his desire to see Russia regain its former glory is another factor we have to contend with in the realm of global politics. I mean, at a certain age is it not more appropriate to aim for something less destructive, such as beating your peers at golf?!

What is the outlook for growth in the UK and Europe?

The UK and Europe are muddling along somewhere in between in terms of where they are relative to expectations. The outlook for growth at the start of this year was not great and it hasn't been, even if it's not been as bad as feared. Monthly GDP readings for the UK are consistently either side of zero, although we have just received some better news, in the form of positive revisions to historical data. That then leads to some difficult questions about whether policy was appropriate for the times and then whether too loose policy has left us with an unnecessary inflation problem. Certainly, the UK seems to be the poster child for the concept of "stagflation" at the moment.

While interest rate policy in Europe and the UK will have a strong bearing on domestic markets for consumption and housing, for example, it is US interest rate policy that retains the biggest capacity to move global financial markets. Futures markets – which are admittedly not infallible, as we have seen – are saying that the peak is in, or close in terms of "base" rates, where they have been rising. That's good news, although the effects of past rate increases will continue to filter down to actual activity. Even then, they appear to be mitigated by the increased return on cash deposits. Further along the yield curve, the market is resigning itself to "higher for longer" rates, estimating that they won't be cut as quickly as previously thought. That reinforces our preference for companies with strong balance sheets which can weather the storm and possibly even take advantage of it to pick off weaker competitors.

What is the outlook for equities?

However, it is the 10-year yield that matters most. Its passage from a low of 0.5% to 4.3% has been a massive headwind to valuations, but the good news is that this element of the damage to equities is largely behind us. Based on expectations for real GDP growth (say 1.5% to 2%) and where inflation settles (say 2-3% optimistically), that would pitch the "fair value" for the 10-year yield in the range of 3.5% to 5%. Somewhat conveniently it is now at 4.28%, which is bang in the middle.

A final thought

Finally, we should take a moment today to cast our minds back to the tragic

events at the World Trade Center and other locations in the US. Although it is now 22 years ago, I remember it clearly; watching the events unfold, going out later to look up at plane-free empty skies and then being glued to the footage of rescue attempts and the aftermath. It reminds me that I was born only 16 years after the end of World War II, and that the experience of that period would have been indelibly printed on the minds of anyone more than, say, 20-years-old when I appeared. I certainly had no concept of that when I was growing up. The pandemic, sadly, showed that there is always something novel ahead that we need to experience for the first time to grasp fully the reality. For many, the economic turmoil of the last 18 months will also have provided a rude awakening. Europe unified itself and found peace. The World Trade Center was rebuilt. We will have better days ahead.

Question of the week:

Last week's question: What is the youngest college at Cambridge University? Robinson

This week's question: The title character in the novel Robinson Crusoe is believed to be based on which real-life person?

Economic Commentary

This Week's Forthcoming Events

US	NFIB Small Business Index
US	CPI ex-Food&Energy SA M/M
US	Hourly Earnings SA M/M (Final)
US	CPI NSA Y/Y
US	Retail Sales SA M/M
UK	ILO Unemployment Rate 3-M
UK	Industrial Production SA M/M
UK	Manufacturing Production SA M/M
EU	Industrial Production SA M/M
EU	Industrial Production WDA Y/Y
EU	ECB Refi Rate
EU	ECB's Governing Council decision on Monetary Policy in Frankfurt, Germany

UK – The tightness of the labour market remains a concern in terms of its influence on inflation. Various indicators have pointed to a positive turning point. The KPMG/REC report on jobs added to this evidence, with the report finding that recruitment slowed sharply in August, with permanent placements falling at the sharpest pace in over three years. The report noted that firms were more cautious with hiring, as the challenging economic backdrop has dented confidence. Pay growth remains strong though, which is the main concern. According to the latest official ONS measure, private sector regular pay growth (ex-bonuses) was at 8.2% (year-on-year) in the three months to June, the highest growth rate seen outside the pandemic period, and not a rate of growth compatible with meeting the 2% inflation target. But there may be some signs of optimism ahead. The report noted that the rate of starting salary inflation in August was its joint lowest since March 2021, and pay growth for temporary workers at its second lowest since April 2021. This accords with the latest Bank of England (BoE) decision-maker panel for August. Businesses expect a sharp slowing in wage pressures, with expected year-ahead wage growth at 5.0%. For overall inflation, businesses now expect an inflation rate of 4.8% in a year's time, a 0.6%pt drop relative to the July survey. This downward trend in expectations will be welcomed by the BoE.

US – There were no major features in the US data last week, although a fall back in Weekly Jobless Claims continued to raise concerns that the economy is still too "hot" for the Federal Reserve's comfort. One interesting release showed that US Household Wealth rose to an all-time high during the second quarter of this year, increasing by 3.7% to $154.3 trillion. The gains were split almost equally between equities (where US investors benefited more than most from a strong domestic market) and real estate (with great resilience shown in the housing market). There wasn't a great amount of increased consumer debt to offset those gains, but the government continued to pile it on, with the fiscal deficit running around 8% of GDP, which is unusual, to say the least, for peacetime.

Europe – Q2 2023 GDP growth was revised down from 0.3% quarter-on-quarter to 0.1%, illustrating that regional activity remains sluggish at best. Services (as measured by the HCOB Services PMI) has joined Manufacturing in recession. This suggests that the European Central Bank will hold its deposit rate at 3.75% at this week's meeting, as predicted by the futures market. Indeed, we could already have hit the peak for this hiking cycle.

China – The latest lending figures showed some recovery in August after a very weak July. There are signs that borrowers are slowly responding to incentives such as lower rates, but it's early days to be sure if this persists. The trade picture improved from July too, with Exports -3.2% (vs -9.2%) and Imports -1.6% (vs -6.9%). Inflation snuck back into positive territory, but still only 0.1% annually against -0.3% in July. There are tentative signs of a bottoming out of activity taking place.

Economic Commentary

FTSE 100 weekly winners

RELX PLC	5.5%
Sage Group plc	5.2%
Pearson PLC	5.0%
International Distributions Services plc	4.5%
GSK plc	4.1%
Whitbread PLC	3.8%
Weir Group PLC	3.5%

FTSE 100 weekly losers

Smurfit Kappa Group PLC	-8.9%
Just Eat Takeaway.com N.V.	-8.5%
Prudential plc	-7.5%
DS Smith Plc	-7.4%
Ashtead Group plc	-6.4%
Croda International Plc	-5.7%
Anglo American plc	-5.3%

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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