RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

John Wyn-Evans

Head of Investment Strategy

Overview

The results are in, and far from there being any element of doubt leading to accusations of foul play and the possibility of civil unrest, as was feared, a resounding victory for Donald Trump in the US Presidential election has cleared the air, leading to more gains for US equities, although an altogether less supportive environment for risk assets elsewhere.

Whatever one's opinion on the outcome of the election - and opinions remain polarised, to say the least - investors hate uncertainty, and so a clear resolution was greeted positively. And while we will never know, it is quite possible that markets could have responded well to an equally decisive Democrat victory. Implied volatility indices such as the VIX index, which had been elevated into election day and implying that markets could remain choppy until well into the New Year, retreated rapidly, allowing investors who scale their positions according to the volatility outlook to increase their exposure.

As is often the case, headline index movements fail to tell the whole story. While the MSCI World Index gained 3.8% (Total Return) in November, there was a big gap between the "haves" and the "have nots". The S&P500 Index rose 5.9%, while the rest of the world was down 0.9%, with the effect being amplified by a strong performance for the dollar against other currencies, especially the euro. But even within the US there were some interesting developments, not least the 11% return from small cap stocks as represented by the Russell 2000 Index. While there had already been some recovery from this part of the market, the election result boosted the chances of the economy being stronger and also the potential for corporate tax cuts, both of which would be relatively more supportive of small caps, especially if interest rates continue to be cut as expected. We provide more details on US sector performance in the Markets section below.

European equity markets struggled the most (especially when viewed in dollar terms) as the threat of tariffs on its countries' exports to the US weighed upon sectors as diverse as car makers, luxury goods producers and food manufacturers. There have been news reports that, for example, Italy's olive oil and parmesan cheese producers have been requisitioning every shipping container they can get their hands on to get supplies into the US before the tariff barriers go up. Such actions, if more widespread, could further confuse economic data if they lead to unusual inventory patterns - and we have barely finished negotiating the distortions created by the pandemic.
And so, what to make of the imminent return of Donald Trump to the Oval Office? Our central view is that he is a disruptive and unreliable force, which makes firm predictions somewhat challenging. His nominations for various key roles in government, with a few exceptions, range from bizarre to perplexing, but loyalty to the President has been a key factor in his choices. "Expect the unexpected" might be a reasonable guide. His philosophy, as much as there is one, is to introduce policies that favour American manufacturers (who do actually make stuff in America) at the expense of foreign competition. Even so, we know that he is transactional in nature, and that there is always a deal to be done. He has even been known to announce deals when the other party was not aware that one had been made! It's all about playing to his supporters. We might also conclude that his barometer for success is the stock market, and so any major drawdown might well elicit a softening in his position, as much as that is able to turn the tide. Obviously, the steep falls seen during the last year of his first presidency as Covid spread were outside his control.

He was also somewhat impotent in the face of monetary policy tightening by the Federal Reserve (Fed) during 2018, and his relationship with the Fed could be a crucial factor during the next term. Speculation persists that he will sack the chairman, Jerome Powell, immediately upon assuming office, although Mr Powell has stated publicly that this is not within even the President's powers. But Powell is expected to stand down when his current terms ends in 2026, and there is bound to be some concern about who replaces him. A Fed chair who is in the pocket of the President could risk the pursuit of inappropriately lax monetary policy. And while this might be fun to begin with, it would almost inevitably set up future problems of a "boom and bust" nature, especially if accompanied by fiscal largesse.

One thing that we could hope for is that moderate Congressional members of the Republican Party will stand in the way of the more destabilising policies and nominations. They have already seen off prospective Attorney General Matt Gaetz, for example. And it's worth reminding ourselves that despite Trump's resounding success in the "swing states", which delivered a big majority in electoral college votes, the margins in the Senate (53-47) and House of Representatives (220 – 215), are tight. In fact, the House split

will be 217-215 in the opening months of the Trump administration because Trump is taking two House Republicans into his cabinet and Gaetz resigned. And, dare I say it, in about a year's time the Washington machine will be starting to gear up for the mid-term elections!

And so, what of the Fed itself? Having kick-started the rate-cutting cycle with a bumper 0.5% move in September followed by another 0.25% reduction two days after the election, it has been a lot more coy about the timing of the next move, especially as investors have sounded caution about the persistent strength of the US economy and the inflationary bias of Trump's policies. As we have mentioned on several occasions before, the ghost of Arthur Burns, the ill-fated Fed chairman of the 1970s who prematurely declared victory over inflation, continues to haunt the corridors of its Washington headquarters and Mr Powell does not wish to be remembered similarly. We continue to believe that he and his fellow voting members will remain pragmatic and conduct policy based on the observation of data. There is a bias towards loosening, which is evident in the "dot plot" of members' future rate expectations and also in their median expected "terminal rate" of 2.875%, although, to be fair, the projections for that range from 2.375% to 3.75%. It is generally accepted, though, that the terminal rate (at which the economy is in perfect equilibrium) can only be observed in retrospect, and so we will never be entirely free of fears of a Fed policy mistake.

It would appear, then, that the fate of markets and investment portfolios lies largely in the hands of Messrs Trump and Powell, at least from the perspective of economic and monetary policy. However, we must also keep a keen eye on the pronouncements of China's President Xi and Russia's President Putin. China's reaction to tariffs and its attitude towards Taiwan will be crucial, as will the next steps in its desire to stimulate its domestic economy. Meanwhile, we will have to wait and see whether Trump's promise to end hostilities in Ukraine on "day one" of his presidency hold water and what the nature of any ceasefire agreement might look like. Hedging against geopolitical risk remains one of the harder challenges in a balanced portfolio environment, and it is clear that taking too defensive a stance would have cost investors dear in the last couple of years. Gold, defence stocks, structured products related to the oil price and, of course, government bonds, tend, for us, to be the main counterweights to such risk.

Markets – US

The election outcome was a catalyst for change in investors' sector preferences in the US. Financials did extremely well, with the sector returning almost 10% during November. Trump is viewed as being in favour of reducing the regulatory burden on the industry which should increase its money-making opportunities. As animal spirits improve, there is expected to be greater demand for loans (and the willingness to approve them) as well as an uptick in Merger & Acquisition (M&A) activity and an increase in the number of Initial Public Offerings, both of which tend to generate juicy fees for the banks involved. There is also the possibility of less onerous capital requirements being placed on banks, which would free up money to be returned to shareholders in the form of dividends and/or share buybacks. Other cyclical sectors also fared well as investors anticipated persistence in the strength of GDP growth. The worst performing sector was Healthcare (-1%), and this reflects one of the less positive sides of a Trump presidency – his penchant for choosing mavericks to run important government departments. In the case of the Department of Health, his nomination was Robert F. Kennedy Jr., a well-known vaccine sceptic and general thorn in the side of the pharmaceutical industry (for which Trump himself has little love, either). The only other sector to record a loss during November was Information Technology (IT), which had been the leader for most of the year. There was little during the recent results season to advance greatly the already well-documented bull case for IT and the sector became a source of funds to pursue other opportunities in the market. But a final word should go to the best sector of all, which was Consumer Discretionary. This was largely thanks to the presence of Tesla (which is the second largest stock in the sector after Amazon). Tesla's shares rose 38% as Elon Musk's big bet in backing the President-elect paid off and expectations of reduced regulatory barriers to his ambitions in full self-driving cars being dismantled rose.

UK

With so much going on elsewhere in the world, the UK has been out of the spotlight following October's Budget - although, domestically, there has been considerable dissatisfaction aired about the policies announced by Chancellor Reeves, not least the big increase in private employers' National Insurance Contributions. Trade bodies representing retail, hospitality and other service-based industries are especially aggrieved, suggesting the extra cost will have to be absorbed through some combination of higher prices, reduced profits, lower wage increases or lower employment, none of which are helpful to the economy. Many companies have also indicated that they will cut back investment plans. The malaise that has taken over the UK since the election in July can be seen through the lens of Citigroup's UK Economic Surprise Index, which measures economic data releases against the consensus of analysts' expectations. The index level has fallen precipitously since August, from +66 to -45. If there is any consolation, it tends not to fall much further than this, other than in extreme circumstances such as the Global Financial Crisis or the Covid pandemic. The reticence of the Bank of England to continue to cut interest rates in the face of sticky service sector inflation is also something of a hindrance, and domestic equities could react positively to any signs that inflation is abating faster. This would be of specific benefit to small and midcap companies, where we continue to see good value, as it seems do corporate buyers, if we consider the pickup in M&A activity so far this year.

Europe

If you were in danger of missing election fever and an escalation in political turmoil following the conclusion of the US presidential election, Europe has obliged as the government of Germany has collapsed with a similar fate seemingly awaiting that of France at the time of writing. The fragile (and somewhat improbable) "traffic light" coalition in Germany fell victim to wrangling over government spending, as did France's minority government (and we are talking here about the Parliamentary situation, not the Presidency), although the circumstances were quite different. In Germany, Chancellor Scholz (Social Democrat) sacked his Finance Minister (Free Democrat) when the latter blocked a proposed increase in government spending which was deemed necessary to stimulate a moribund economy. Elections are scheduled to be held in February, with the centre-right Christian Democrats expected to gain the greatest share of votes, but still not enough for a majority. What will be of most concern will be the extent to which the right-wing AfD Party will be able to gain influence in the Bundestag. Meanwhile in France, Prime Minister Barnier was trying to reduce the deficit by €60bn through a combination of cost cutting and tax increases, but his budget was rejected both by Marine Le Pen's National Rally Party and a left-wing group of parties. A vote of no confidence seems likely, although the rules mean that there can be no new elections until next summer, which suggests that some sort of lame duck/caretaker regime will remain in place. All of this uncertainty, especially when layered on to tariff concerns, has undermined the euro and European equities. We have also seen a big increase in the interest rate that France has to pay on its borrowings relative to Germany. However, there is nothing to suggest that we are on the cusp of another eurozone crisis. More opportunistically, there is a high probability that sound companies with a more global footprint are being relatively undervalued owing to the location of their share listing and there might well be some bargains to be had.

Emerging Markets

The fate of Emerging Market (EM) indices remains closely tied to China, Taiwan and India, which represent respectively 27.4%, 19.1% and 18.8% of the MSCI Emerging Markets Index. That represents something of a fall from grace for India, which earlier this year wore the crown as the largest constituent. Having reached new highs in the aftermath of its general election, the index fell 11%, leaving it in "correction" territory. Some of this was cyclical, with a slowdown in GDP and corporate profit growth weighing on the market, but some of it reflected bribery charges brought against Gautam Adani, a prominent businessman. Despite these short-term challenges, there remains plenty of runway in India's long-term growth story as it continues to climb up the GDP-per-capita curve, helped by a decent demographic profile. China's return to the top spot was catalysed by the government's stimulus programme announced in September, although the finer details

have left investors underwhelmed as they do little to encourage household consumption. But the reckoning is that President Xi has reached a maximum level of discomfort with the poor stock market performance and that he will continue to add measures until they gain more traction. More broadly, the stronger US dollar provides a headwind to EM returns. Donald Trump, for all his chest-beating about having a "strong" dollar, would prefer it to be lower from a trade perspective. Most measures of value suggest the dollar is expensive. EM's represent a decent call option on any decline in the dollar.

Fixed Income

Global government bond markets initially continued to sell off in early November in response to Trump's election victory, which was generally seen as having the potential to stoke inflation in the US. This came hot on the heels of the UK Budget, which also heightened domestic inflation fears. However, there was some reluctance to push yields towards last year's highs as investors appreciated the returns on offer – around 4.5% for both the 10-year US Treasury and UK Gilt. There is also a concern that if interest rates remain around their current levels for too much longer then there is an increased risk of indebted companies and consumers finally capitulating. And so, as we saw in August, bonds have the potential to play their role as risk diversifying assets. Even so, for now, at least, traders are less bullish about the prospect of more aggressive immediate cuts in base rates, although that might be music to the ears of cash depositors. There are some sovereign markets where yields are testing or making new lows for this cycle, and the key ones are Germany and China. That is a reflection of weak underlying economies in both countries, and, in Germany's case, in spite of political uncertainty and the Chancellor's desire to increase government spending. The spread of corporate bond yields relative to government bonds remains close to the cycle lows and we would have to return to levels seen before the GFC if they are to tighten much further, which we believe to be improbable.

All UK Gilts have delivered a total return of -1.9% over the last three months and -2% over the last year. Index-Linked Gilts returned -0.9% and +1.1% over the same respective periods. Emerging Market bonds produced a total return of +2.7% in sterling over the three months to end November (+6.6% over 12m). Global High Yield bonds delivered +2.1% (+7.1% over 12m) in sterling.

Conclusion and Outlook

As we approach the end of (another) trying year, there seems to be little celebration of the fact that typical balanced portfolios have delivered decent returns this year and well above what would have been achieved by holding cash. The world feels unstable, and bad news is amplified by (social) media and yet good companies continue to be able to generate growth and to compound their returns. This year has provided an object lesson in sticking to one's guns when following an investment process and not being deflected by the "noise" that can sometimes be overwhelming. It is inevitable that we will hit more bumps in the road in future, but we must always bear in mind that market volatility is the price that we pay for superior long-term returns. It would have been very easy to have been scared out of one's equity investments on several occasions in the last few years, and yet here we sit with global equities at all-time highs.

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