RATHBONES | Incorporating Investec Wealth & Investment (UK)

04 June 2024

Market commentary

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Overview

Despite that fact that many major stock market indices remain very close to all-time highs, it is remarkable how little euphoria is generally evident amongst investors. Client conversations often focus on what could go wrong rather than on what might go right. Financial media are well stocked with commentary focused on potential negative outcomes. It is widely accepted that negative news generates more readership than positive news, and we can also refer to Prospect Theory, which states that fear of loss is a far greater influence on (the majority of) humans than the promise of gains, especially when those gains are subject to a volatile path.

It is not difficult to believe that the events of recent years have left many feeling vulnerable. The Global Financial Crisis (GFC) of 2008 threatened to topple the whole financial system; the result of the Brexit referendum and the election of Donald Trump as President of the United States in 2016 signalled a tectonic shift in the political economy; the Covid pandemic was literally life-threatening; since then we have seen the threat to Europe's Eastern border raised by Russia's invasion of Ukraine, not to mention the further threat of the use of tactical nuclear weapons; most recently there has been an escalation of hostilities in the Middle East; and ahead of us lies a potential invasion of Taiwan by China – a racing certainty according to various military figures, although one could be suspicious of their motives in predicting such an event.

And yet, remarkably positive things keep happening, not least in the field of technology. The speed with which generative artificial intelligence (AI) has captured the public imagination is unprecedented, at least in terms of how many people have tried some of the products on offer. Admittedly, we are in the very early stages of wider adoption, and we would also suggest that asking ChatGPT to write a song about a Prime Minister launching an election campaign to the tune of "Singin' in the Rain", while amusing, is hardly going to increase productivity.

The big initial gains have gone to the providers of "picks and shovels", which is not unusual when there is some sort of technological breakthrough. There is always a risk that the initial "gold rush" will not be matched by the discovery of enough "nuggets" to justify the investment, at least in the short term. But while we are aware of such a risk, it seems undeniable that, in the longer term, AI will permeate our lives, often in ways that we have yet to imagine. One oft-quoted consequence of the launch of the iPhone was the rise of disruptors such as Uber, for example; not something that was envisaged by Apple. And so, while we might not be willing to "bet the farm" on the future of AI, it would certainly not seem prudent to bet against it.

"The Next Financial Crisis" is the sort of headline that invariably attracts readers. We have long argued that a repeat of 2008 is improbable. Regulation is much tighter than it was then, and banks are much better capitalised too. Yes, there have been accidents such as the bankruptcy of Silicon Valley Bank in March 2023, but a wider impact was immediately averted by the relevant authorities stepping in to provide liquidity. The swift resolution of the problems at Credit Suisse soon after was another case in point. Banks in the US, UK and Europe are currently very profitable, and rather than using those profits to create loans of a dubious nature, they are more inclined to be returning them to shareholders in the form of dividends and share buybacks.

Of course, that does not preclude some losses on loans already made, but bankruptcies (or at least debt renegotiations) are a fact of life. Indeed, one might argue that there have not been enough of them in the post-GFC world, when "zombie" companies with limited growth prospects were kept on life support thanks to very low interest rates. They have potentially diverted capital from more deserving causes as well as holding back productivity gains. It seems inevitable that certain areas of the economy will experience more bankruptcies, and one of those will probably be Commercial Real Estate. Having endured the storm of retail disruption as a result of the growth of online shopping, it now faces the pain of lower office space utilisation owing to changing working habits as well as the threat of buildings being rendered obsolete because of their negative environmental impact. The industry had been hoping for some relief on the interest rate front ("stay alive 'til '25" was the mantra), but that is looking less likely, at least on current data and market pricing. Even so, there is no reason to expect a sudden avalanche of defaults. Strugglers will be picked off one by one and a lot of the pain will be experienced by equity holders. The path might look a lot more like the US Savings & Loans crisis of the late 1980s and early 1990s than, say, the Financial Crisis – that is drawn out and tolerable as opposed to a sudden crash.

Another area we are monitoring is Private Credit. This is, effectively, the loans that are made to companies by non-bank entities, which can range from private equity and hedge funds to insurance companies and pension funds. It is sometimes referred to as

“shadow banking”, which probably sounds a bit more ominous than it needs to. The concern is that it is less well-regulated than bank lending (if at all), and so lenders might be taking on too much risk. However, the lenders would tend not to be as leveraged as banks and so less vulnerable to losses. Supporters of private credit note that many of the loans are made to businesses where the lenders are already owners of the equity and therefore have a good understanding of and relationship with the business. For many, such lending will be part of a wide and diversified range of investments and therefore less likely to undermine a whole portfolio. We have little doubt that there will be some headline-generating failures and attendant losses, but we have yet to see evidence to convince us that these will be a precursor to a wider systemic failure.

As alluded to earlier, geopolitical risk is also widely cited as a factor of current concern. We note an interesting debate on the subject that was kicked off recently by an op-ed in the Financial Times written by a strategist from Citigroup. His contention, supported by work from researchers at the Federal Reserve Board, was that investors tend to overreact to negative geopolitical news, building in “worst case scenarios” and elevating risk premia beyond a fair level. He noted that despite the cited measure of geopolitical risk being elevated currently, it is not much higher than the average going back to 1900 – admittedly a period that encompasses two World Wars. The most recent peak coincided with the 9/11 attacks on the US.

One problem with analysing geopolitical risk is that it is very wide ranging. Elections and referendums, for example, might create big local headlines but have less global influence, with, perhaps, the US Presidential and Congressional elections being an exception which proves that rule – and, of course, those lie just a few months away. Wars, these days, tend to be more localised, but, as we witnessed with the invasion of Ukraine, can play havoc with supply chains. Indeed, the biggest factor in this case was arguably Europe’s voluntary shift away from buying natural gas from Russia, which was still capable of producing plenty of it. Any future sanctions that might involve China could leave the West short of critical components, and if Taiwan was directly involved, a parlous shortage of semiconductor chips. No wonder so many western countries are racing to build fabrication plants.

In response to the FT article, there were several letters written to the editor expressing concern that the writer had been too dismissive of geopolitical risk. Unsurprisingly, perhaps, one came from the Head of Macro Policy Research at a large US asset manager and another from the Head of Geopolitics at a European asset manager. They were both eloquent and argued passionately for building geopolitical analysis into portfolio management, but neither offered a solution. And that’s the problem. One can write long essays and build scary presentations about all the dreadful things that might happen, but how does one actually invest, especially when it comes to dealing with “tail risks”, or low probability events that could have a big impact? If one constructs a portfolio that is predicated upon disastrous events, it is very difficult to benefit from the good things that will happen, and it would have been very easy to adopt that mindset for the last fifteen years or so when equity markets have performed very well. Even a meaningful drawdown today would not make up for years of bunker mentality.

Practically, we have to maintain balance in portfolios. Government bonds, which at least now offer a reasonable yield, are the classic defensive option in times of stress, but we also note that they are prone to risk from high fiscal deficits and the threat of persistent inflation. Indeed, many of the geopolitical risks that we identify carry the threat of higher and more volatile inflation in future (and one can add climate change and the green energy transition to the mix). We have identified US dollar cash and Gold as the asset classes which tend to perform best as “safe havens” across a range of risks. We can also invest in very specific Structured Products to hedge against an adverse movement in an individual commodity, such as oil, for example. At the company level it is possible to invest in shares of those that might benefit from conflict, maybe with exposure to defence spending (now viewed as more acceptable owing to the benefits of preserving peaceful and democratic societies) or cyber security. The build-out of renewable energy and distribution assets also offers opportunities. However, we believe

that it will be very difficult to generate reasonable returns without taking the view that a lot of the worst case scenarios will remain just that – scenarios.

Markets – US

US equities made new all-time highs during May, with the Dow Jones Industrial Average topping 40,000 points for the first time, which made for great headlines even if the index's composition and method of calculation leave much to be desired – there are only 30 shares and the relative importance of stocks is derived from their dollar share price and not their market capitalisation! Technology, and the prospects for AI, continue to be the driving force. Even Utilities, once viewed as a defensive sector with a strong correlation to interest rates, has joined the party owing to the need to build out infrastructure for the "electrification of everything". The clear winner, yet again, was chip designer Nvidia, which unveiled another expectation-beating set of results with no signs of the outlook clouding. Over the course of May alone, the shares rose by 28%, increasing its market capitalisation by $587bn, which is more than twice the size of the largest company in the UK (AstraZeneca, $240bn) and roughly equivalent to the largest in Europe (Novo Nordisk, $596bn); or how about the same as America's 10th largest company (JP Morgan, $581bn), which is also the world's largest and most significant bank. Since the start of the year, Nvidia's market capitalisation has risen by $1.477 trillion, which means that it has added more market capitalisation than the entire value of any US company except Microsoft, Apple, Alphabet and Amazon. This is a phenomenon on a scale never seen before.

UK

Last month we mentioned the role of large cap stocks leading the FTSE 100 to a new record high. It made further new highs in May as the UK seems to be experiencing a period of rehabilitation in global investors' minds. Part of the thesis is that a new Labour government would bring some much-needed stability to UK policymaking, attracting an increase in investment into the UK. Certainly, there is no sign of concern from markets about an imminent change of government, with sterling, the usual barometer of political sentiment, rising towards the top end of its post-Brexit trading range. Then there is also the fact that UK equities appear to offer good value against those of other regions, even allowing for a less attractive market composition. We are also starting to see this renewed optimism reflected in the performance of UK small cap shares, which have done better than their large cap peers so far this year, with a marked pick up in relative performance in recent weeks as the pound strengthened further.

Europe

Europe's economy continues its patchy recovery, boosted by a second mild winter which did a lot to alleviate the threat of energy shortages and high prices. The eurozone countries in aggregate achieved quarter-on-quarter GDP growth of 0.3% in the first three months of 2024, while inflation remains relatively subdued at 2.6%. These circumstances appear set to allow the European Central Bank to move ahead of the US Federal Reserve in cutting interest rates at its June meeting. Mainland European equity indices also hit new all-time highs during May. As in the US, the technology sector has been leading the market higher, but with strong support from Financials, which, at around 18% of the market capitalisation, is twice the size of tech. European banks have finally overcome the pain of past crises and are enjoying the strong profitability generated by higher interest rates and low loan losses. Furthermore, they are returning a lot of the profits to shareholders in the form of dividends and share buybacks, which are being well received.

Emerging Markets

Aggregate Emerging Market equity indices remain a long way off their 2021 highs, mainly thanks to the poor performance of China. That disguises the strong performance of India and, to a lesser extent, Mexico, both of which have just completed leadership elections. Projected strong wins for the ruling parties in both countries have been greeted in different ways. The BJP's victory in India sets up "more of the same" policy from Prime Minister Modi, which is expected to be friendly to business. The landslide win for new President Claudia Sheinbaum in Mexico, on the other hand, has raised fears of more

radical policies and a possible abandonment of her predecessor's relatively conservative fiscal approach. Mexico at least retains an enviable position as a strong trading partner with its neighbour to the north, although concerns that China is using Mexico as a "back door" for exports into the US could come to the fore if Donald Trump wins November's US Presidential election.

Fixed Income

Bond markets continue to struggle to establish a new trend, caught between the hope for interest rate cuts and the reality of resilient growth and inflation that refuses to fall as fast as investors and central bankers would like. If one were to peg the yield of 10-year government bonds to long-term nominal GDP growth expectations (which is a reasonable benchmark), then they currently appear to be around fair value. It would probably take a resurgence of inflation or more concrete concerns about the size of fiscal deficits to push yields sharply higher, while lower yields would more likely be the result of economic weakness. The Bloomberg Global Aggregate Index of investment grade bonds is -3.3% year-to-date (total return in USD), while the sterling hedged version is -0.85%. The current UK 10-year Gilt has generated a total return of -3.2%.

UK Gilts have delivered a total return of +0.25% over the last three months and +3% over the last year. Index-Linked Gilts returned +1.6% and +1.8% over the same respective periods. Emerging Market bonds produced a total return of +4.4% in sterling over the three months to end May (+14.7% over 12m). Global High Yield bonds delivered +0.6% (+4.3% over 12m) in sterling.

Conclusion and Outlook

Investing requires some degree of optimism about the long-term prospects for economic growth and innovation and it can often be hard to retain such a mindset in the face of a continuous barrage of negative headlines from the media. We would be the first to acknowledge that portfolio returns will not be achieved without the odd setback; indeed, we would be suspicious of any investor claiming never to suffer any losses. Many investors are most comfortable with a balanced portfolio of bonds, equities and other diversifying assets which help to smooth the bumps out of the ride, although the components of that suspension system are always subtly changing according to the terrain. It remains our goal to provide the right mix of assets to provide the best risk-adjusted outcomes according to investors' appetite for risk and volatility.

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