RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

There was almost bound to be a New Year hangover following the very strong performance of both bond and equity markets towards the end of 2023, and it's fair to say that markets took a while to wake up. After equity leadership broadened out in November and December, it was more concentrated again in January, led by the Magnificent 7 (or, for now, the Magnificent 6 – see US report below). Europe's Technology leaders (ASML and SAP) joined the party too, and another one of last year's winners, appetite-suppressing drug manufacturer Novo Nordisk, has continued to power ahead. The best performer in the FTSE 100 is betting company Flutter, but for unwelcome reasons. It has decided to move its primary share listing to New York, where it feels its virtues will be better recognised. On current evidence, that's hard to argue with (see UK section below for more on the headwinds faced by the UK stock market).

This month's commentary takes a slightly different route from normal in that it visits Tokyo for an ad hoc comment on Japanese equities and the sources of support for them. The other regional sections also have a more structural focus as we try to put the more noisy short term market movements into a longer term perspective. Even so, the Overview section that follows will have the usual commentary on what investors are concentrating on today.

The market is focused on interest rates

As we noted last month, the market's current obsession lies with interest rates. When will central banks start to cut them? And how fast and how far will they be cut thereafter? The question we posed to start the year was "will central banks cut rates because they can (owing to inflation falling back towards target) or because they have to (activity slows, threatening a recession)? So far, and by far the preferred outcome for investors, it's very much the former case. The pace of increase in consumer price indices has slowed markedly and it looks as though headline CPI rates will reach the 2% target in the first half of this year in many countries. Core inflation (which excludes the more volatile components of energy and food) is slowing less rapidly, though, which means that central bankers, while generally acknowledging that further rate increases are off the table, are not quite ready to fire the starting gun on the rate-cutting cycle.

Additionally, they remain haunted by the experience of the 1970s, when a premature declaration of victory over inflation contributed to a second surge in the latter half of the decade. And then there is the also the fact that economic growth has been a lot more resilient than expected. The Bank of England called for a five-quarter UK recession starting in early 2023 and it never arrived, although growth has been anaemic. The almost unanimous consensus opinion that the US would enter a recession in 2023 has also been proved emphatically wrong. US GDP grew by 4.9% (quarter-on-quarter annualised) in the third quarter of 2023 and by 3.3% in the fourth, buoyed primarily by domestic consumption. The Atlanta Fed's GDPNow tracker currently projects growth of 4.2% in the current quarter.

This all means that there is no hurry to cut rates and in January's meetings, the heads of the US, UK and European Central banks all pushed back on the idea of early reductions. Futures markets have extended the horizon from March to June. The upside to better growth is that corporate earnings, the other key variable that drives equity performance, remain resilient too. We are around half-way through the current reporting season and the aggregate outcome is fine with the majority of companies topping beaten-down forecasts as they do more often than not. Yes, there has been the odd idiosyncratic misstep and even pressure on distinct subsectors, but nothing to suggest the imminent danger of reaching a cliff-edge.

As always, there are plenty of worrisome headlines to deal with. Most of them seem to relate to geopolitical risks, which, as always, are difficult to predict, both in their severity and their ultimate impact on financial assets. It is our policy to take out tail risk insurance where appropriate as well as to continue to invest in resilient assets, but we do not make escalating disruption our central investment case.

Markets – US

Not many people remember that at the end of the 1960 film The Magnificent Seven, only three survive. And so it is a little worrying that investors have given the same moniker to the shares that helped power the performance of US indices last year. We have discussed this group in some detail before, but, as a reminder, it comprises Apple, Microsoft, Amazon, Alphabet (better known as Google), Meta (Facebook), Nvidia and Tesla. The themes that unify them are technology leadership and the growth potential from Generative Artificial Intelligence (GenAI), although they will all exploit those opportunities in different ways. Six of them have reported their results for 2023 (with Nvidia being the exception owing to having a January year-end). Tesla, which has achieved cult-like status with retail investors, provided the outstanding disappointment, mainly on account of waning momentum in its key electric vehicle manufacturing division. The shares are down some 35% from last July's high. Microsoft and Apple, the world's largest

companies, neither really excited nor disappointed, although there were concerning hints of weakness for Apple's iPhone sales in China. Alphabet's advertising revenues were below expectations and there is concern about the extent to which they could be impacted in future if more online search migrates to GenAI-powered tools. The clear winners were Meta and Amazon, both benefitting from a clear emphasis on cost control following a pandemic-induced spending spree. It is healthy that investors are becoming more discerning in their views. Even so, we would be even happier if market leadership were to become more broadly spread out amongst the other 493 companies in the S&P 500 Index.

UK

Last month we referred to the persistent selling of London-listed shares by UK-based institutions which has been blamed, at least in part, for the ongoing de-rating of the market and its sluggish performance. We spotted an interesting publication from Ondra Partners, an independent financial advisory firm, which put more flesh on the bones. Here are some of the more interesting observations. UK Pension Funds and Insurance companies have been the main source of capital flight. Since 1990, their ownership of the UK share market has fallen from 55% to around 5% thanks to a more conservative approach to matching current assets with long-term liabilities which was largely driven by regulation. The good news is that there is pretty much nothing left to sell. Higher Defined Contribution scheme liabilities (arithmetically driven by falling bond yields) have also forced companies to top up their pension funds to the tune of £250bn over the last decade. That's been handy for the government in terms of demand for bonds but is money that has been diverted from more productive uses in the real economy. In a similar vein, 75% of the generous dividends being paid by UK Plc are today leaving the country and being pocketed by non-UK investors. These trends have helped to exacerbate a negative self-reinforcing spiral of decreasing liquidity and less issuance of primary capital (i.e. new share issues tend to go elsewhere). Furthermore, several big UK companies, especially those with substantial revenues in the US, have de-listed from London and headed to New York. There has also been a big shift in Mergers & Acquisitions activity. Whereas UK companies were net buyers of overseas assets before 2005 (admittedly not always with sparkling results), there has only been one year since when that has been the case, with UK Plc effectively up for sale to the highest bidder. Worryingly, the investment horizon for the UK market has shortened considerably, with much of that attributable to its composition (especially very little Technology). Ondra calculates that whereas in 2006 around 62% of the FTSE 100's market capitalisation could be attributed to earnings expected to be generated more than ten years hence, that has now fallen to 35%. No doubt that helped in 2022, when the UK market was almost alone in registering a positive total return, but it bodes less well in a world of more stable bond markets. It's possible that structurally higher global inflation could be of relative benefit to UK equities, but that comes into the category entitled "be careful what you wish for".

Europe

One key characterisation of eurozone monetary policy is that "one size fits all". Despite the fact that the individual country economies have their own idiosyncratic drivers, ranging across politics, demographics, culture and climate, they all depend upon the policy sent down from the European Central Bank in Frankfurt. In the early years of the euro, the loose monetary policy required to boost the German economy played a big role in Southern Europe's property bubble. The ensuing fallout and threat to the solvency of countries including Italy, Ireland, Spain, Portugal and, of course, Greece, necessitated extreme intervention including Quantitative Easing and negative interest rates. Today, it is Germany that is once again struggling, with its manufacturing sector under pressure from the weakness in China's economy, high energy costs relative to other manufacturing countries and a fast deflating property market. Quarter-on-quarter growth of -0.3% in the final three months of 2023 contrasts with a flat economy in France and actual growth of 0.2%, 0.6% and 0.8% in Italy, Spain and Portugal respectively. If we look at inflation across the same countries, it is running at 3.7%, 4.1%, 3.3%, 0.5% and 1.9%. Do all of these countries need the same interest rate? This divergent performance gives the European Central Bank a headache in terms of policy setting. It currently seems to be more worried about too much inflation in the core countries, but it usually ends up reacting to any signs of strain in the weakest link.

Japan

We haven't featured Japanese equities for a long time despite the fact that they merit a line in our regional asset allocation and we are quite upbeat about their relative prospects. With the main indices finally reaching levels last seen in 1990, new all-time highs are also in sight, an achievement which might signal that the country has finally overcome the epic hangover which followed a monumental real estate and equity bubble. It might be hard to believe that on the first day of 1990 Japan's stock market accounted for more than 50% of the world index market capitalisation. Today, even having rallied, it is just over 5%. League tables of the world's biggest banks were jammed full of Japan's. Unfortunately those league tables were based upon the scale of the loans they had made, and many of them turned out to be against vastly overvalued properties. Indeed, the evisceration of the banking and real estate sectors played a huge role in Japan's years in the investment wilderness. The seeds of a sustainable turn in its fortunes were sown in 2012 by the late Prime Minister Shinzo Abe with his "Three Arrows" policy. These planned to use the levers of monetary and fiscal policy to complement structural reforms. It is fair to say that the first lever has done most of the heavy lifting via a zero interest rate policy and a massive expansion in the central bank's balance sheet. While this has come at the expense of a huge devaluation of the yen, it has at least nudged inflation into positive territory and created more persistent GDP growth. There is finally the prospect of the Bank of Japan being able to raise interest rates back into positive territory (from -0.1%). The research that we see from investment banks is exemplified by the following title of a note from Jefferies: "Lost Decade to a Golden Age: A New Paradigm". It cites the inflation/growth inflection, as one might expect, but also a shift in corporate governance, and this could be a key element of future performance. Many companies in Japan trade well below the value of their assets and also have unnecessarily high cash balances as well as a spider's web of cross shareholdings with other companies. The Tokyo Stock Exchange has put companies on notice to close this value gap or face de-listing. At the same time, activist shareholders are having greater success in motivating boards to act in shareholders' favour. Such economic and cultural shifts rarely occur without a few bumps along the way, but the trend does appear to be favourable. We intend to provide more regular updates.

Emerging Markets

As we pointed out in our review of 2023, Emerging Markets is a broad label and it failed entirely to capture the divergent performances of India (good) and China (poor) last year, for example. China's woes have extended into 2024, despite the announcement of 5.2% GDP growth in the final quarter of 2023, although the figure was greeted with a high degree of scepticism. Much of the tension between the United States and China in recent years has emanated from the pace of China's growth and its potential to overtake the US in terms of economic output. Whether it be on account of the US's anti-China policies or the self-inflicted problems within China's economy, the point of convergence appears to have been pushed out. Goldman Sachs published some research showing that China's dollar-equivalent GDP fell from 75% of the level of the US in 2021 to 65% in 2023. It now sees China's economy overtaking the US in the early 2040s rather than the mid-2030s as it previously projected. We also note that China reported a second consecutive year of population decline in 2023. The US would seem to have the upper hand on that measure of growth potential.

Fixed Income

Global bonds, as measured by the Bloomberg Global Aggregate Dollar Index of investment grade bonds, have had a lacklustre start to 2024 following the storming recovery of late 2023. That seems to be a function of some understandable short-term profit-taking in the face of generally resilient economic data. It has also coincided with a pushing out of the horizon for the start of the central bank interest rate cutting cycle as well as niggling concerns about the amount of government bond issuance that will be required to fund still historically large fiscal deficits. We still believe that the readjustment of bond yields to more "normalised" levels is now largely complete and that bonds offer a more attractive "safety net" once more in the event of economic weakness.

UK Gilts have delivered a total return of +6.1% over the last three months and -1.1% over the last year. Index-Linked Gilts returned +4.9% and -7.2% over the same respective periods. Emerging Market sovereign bonds produced a total return of +6.4% in sterling over the three months to end January (+4.8% over 12m). Global High Yield bonds delivered +8.6% (+8.7% over 12m) in sterling.

Conclusion and Outlook

Our cautious optimism about the outlook for 2024, driven by the expected turn in the interest rate cycle, has been borne out so far, but it is very early days still. We have seen enough already to suggest that returns as viewed through the lens of average index performance are not going to be evenly distributed across their constituents, with rewards accruing to companies that can demonstrate resilient or even increased growth potential. The compounding of growth over the longer term remains a key criterion for our equity investment choices. However, we see the potential for tactical outperformance from more cyclical and/or leveraged entities as the interest rate cycle turns. Many of these opportunities can be found amongst the mid and small caps, where we see value potential.

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