RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Foreword

The commentary that follows was written on August 1st, but you will no doubt be aware that financial markets have experienced severe turbulence in the following days. Even so, the opinions expressed below remain valid, and so we have decided not to rip it up and start again. The next few paragraphs have been added to sum up the events of the first few days of August.

The new questions that have to be asked are: has the investment outlook materially changed? And why did volatility increase as much as it did so quickly? On the first, we think the answer is no, given that our tactical allocation was already positioned for the possibility of a mild recession (holding government bonds as insurance against weaker economies and with a bias towards higher quality equities).

The catalyst for the shift in market sentiment was monthly US labour market data which was released on Friday 2nd August. This showed a much lower-than-forecast increase in employment for the month of July and a step up in the unemployment rate to 4.3%, encouraging the view that the US economy is heading into a recession. Past releases have been subject to all sorts of revisions and we would be disinclined to read too much into one month's data, especially as there were some mitigating factors such as the effects of the weather and the fact that the increase in the unemployment rate was partially a function of more workers entering the labour market.

However, we do acknowledge that the US economy, from which the global economy will take its cue, has decelerated since the second half of 2023 as household savings built up during the pandemic have been depleted, the fiscal impulse (the year-on-year growth in government spending) has flattened and employment growth has slowed. The positive result of that though is that inflation has also come down, leaving the Federal Reserve (Fed) more latitude when it comes to easing monetary policy. Indeed, the futures market pricing of interest rates is telling the Fed unequivocally that it is "behind the curve" and should start to cut rates immediately. Our opinion has been for a while that the US interest rate cycle has peaked and that it was only a matter of time before the cutting cycle commenced.

As for the huge jump in volatility, this can largely be ascribed to a sudden enforced selling of positions by leveraged traders (i.e. those who borrow money to increase their market exposure) and to a rapid reversal by those who had been selling volatility – all exacerbated by low, summer holiday liquidity. It is impossible to know exactly the extent of such positions and what has been unwound, and so making judgements around this becomes more art than science, although one can infer from the market movements that a lot of the unwinding has taken place already. And so far, there is no sign of any contagion running through the financial sector, which is a blessing, although some investors will have booked substantial losses.

One example of the unwind is the "yen carry trade", in which traders borrow Japanese yen at very low interest rates to invest in other currencies with higher interest rates. This trade is akin to making money for nothing when it is working, but when the yen starts to rise (as it has done recently in response to tighter Bank of Japan monetary policy) a year's worth of profits from the interest rate differential can be more than wiped out in days, forcing the trades to be closed (which only fuels more gains for the yen). There will then often be a knock-on effect in other positions which will have to be sold to manage risk or to offset the losses. One only finds out in periods of stress just how interdependent these positions are.

One positive thing that we can observe in this environment is that government bonds have reassumed their role as "insurance assets" in balanced portfolios. This makes the situation very different to 2022, which was a perfect storm in which both equities and bonds lost value in the face of rising inflation and interest rates. We can also point out that central bank policy rates are substantially higher than they were in the immediate post-pandemic period and so can now be cut in response to economic weakness. Of course, in many ways, especially with respect to corporate earnings growth, it would be preferable if interest rates were able to remain higher because the economy was humming along accompanied by low inflation, but that sort of "goldilocks" scenario would appear to be more in the realm of wishful thinking today.

In summary, while we believe that the current episode is unlikely to deteriorate further into a fully-fledged crash or financial crisis, there is a period of uncertainty ahead and it will be a while before equity indices are able to make more new highs.

Overview

There are periods when financial markets have the characteristics of a coiled spring. They get wound tighter and tighter until something triggers a release. The catalyst could be economic data, a geopolitical event or a natural phenomenon, all of which, by their nature, are difficult to predict from a timing perspective. Sometimes, it is the precursor to a prolonged period of turmoil, at others just a temporary interruption in the previously established trend. Equity markets experienced one of those episodes during July, from which investors appear to have escaped relatively unscathed, although it has increased the level of questioning about the sustainability of the leadership of a narrow cohort of mega-cap growth companies.

In the review of the first half of the year, we commented upon the fact that equity returns had been dominated by relatively few companies, with technology giants being the biggest component owing to the excitement about the developments in generative artificial intelligence (AI). While we continued to push back against the idea that related shares were in a bubble reminiscent of the boom that ended in 2000, we noted that "we are mindful of the risk of a hiatus in the growth of AI-related demand and manage our exposure accordingly." We also suggested that "a seasonal pause for breath is possible over the summer, and we know that more thinly traded markets are vulnerable to surprises".

And so it turned out, the first-half trend extended beyond the first week of July, but the seeds of uncertainty were already sown, and from somewhat unexpected hands. Sequoia Capital (a leading US venture capital firm) and Goldman Sachs (the blue chip investment bank) published separate pieces of research questioning the returns that might be generated from the enormous amounts of capital expenditure ($600bn - $1 trillion) being directed towards AI. They suggested that there might be a moment of reckoning by both investors and companies that could lead to a reset in expectations and prices. To be clear, neither paper dismissed the potential for AI out of hand - it was more a case of the risk of investors getting ahead of themselves in terms of their expectation of economic returns in the absence, so far, of a "killer application".

The trigger for the reversal turned out to be the release of benign US inflation data on July 11th. It's not often that one can pinpoint so specific a moment, but the price charts all point to this. Even so there were other factors at play, including media reports that the Biden administration is planning to tighten restrictions on supplying technology-related equipment and services to China as well as Donald Trump's then-increasing lead in opinion polls ahead of the US Presidential election – he is deemed to be in favour of tougher regulation of Big Tech. Better news on inflation increased the probability of the Federal Reserve being able to cut interest rates sooner, which was seen as supportive for the areas of the market that had been left behind at the expense of the leaders (there are more details in the US country section below). Furthermore, as we increasingly have to deal with these days, the rotation that ensued was exacerbated by extended market positioning having to be reversed and by leveraged funds being compelled to reduce their overall market exposure in the face of rising volatility.

All in all, this was quite a potent cocktail to digest and it came just as investors were having to deal with the second quarter corporate reporting season. The bar was set quite high in the US, with consensus forecasts looking for 9% year-on-year earnings per share growth, the highest since the fourth quarter of 2021. The large banks, always first to report, received only muted applause for results that were adequate but which contained no positive surprises and hinted at increasing stress amongst customers. This was reflected in some disappointing numbers from companies which sell directly to consumers, raising concerns that persistently higher interest rates were finally taking their toll. And so, any hint that interest rates might come down soon were gratefully received.

The result of all this was a month in which, at the surface, everything might have appeared to be calm, with the MSCI All-Countries world Index delivering a total return of 1.6% thanks to a late spurt, but the peak-to trough drawdown of 4.1% will have caught a few investors on the hop. As we might expect, those with more diversified portfolios will have experienced a relatively calm ride. More details on specific moves are presented in the sections below, including a comment on bond markets, which had their best month of the year so far.

It seems that we cannot get through a monthly commentary without some reference to (geo)politics. July saw the UK general election, in which Labour cantered home with a big majority as expected. We never saw this as a big market-moving event, and so it proved. Even so, investor appreciation for the stability that might come from a fresh government could be seen in the strong performance of the pound as well as signs of interest in more domestically oriented companies. We shall have to see whether the enthusiasm is carried past the "honeymoon period" into the autumn. An important date to put into diaries is Wednesday 30th October, when the new Chancellor of the Exchequer, Rachel Reeves, will present her first Budget. She has already laid some of the groundwork by accusing the Conservatives of bequeathing a £20 billion "black hole" in the public finances and, as well as cutting spending, has warned of increased taxes. It will be important that she finds the right balance between fiscal conservatism and maintaining incentives, but at least we have some confidence that there will be no shocks capable of undermining the bond market such as happened in 2022 with the infamous Truss/Kwarteng "mini" Budget.

France also completed its legislative elections in July, although the result here was not conclusive. The French electorate rejected the idea of a far-right government in the form of the National Rally Party, which came as some relief to investors, but it did hand a lot of seats to a far-left grouping of parties. The situation is unresolved because President Macron has decided to wait until after the Olympics before naming a Prime Minister. Investor sentiment towards French politics can be viewed through the excess interest that France has to pay on its bonds relative to Germany. That jumped from around 0.5% before the election was called to 0.8% when the threat from National Rally was at its peak. The fact that it has only retreated to 0.7% informs us that investors remain nervous. This is not just about the immediate future, although a "cohabitation" parliament means that structural reforms planned by Macron will almost inevitably stall, but as much about the threat of what might happen in 2027's Presidential election, with a real chance of a more radical winner who might upset the fiscal balance or France's relationship with the European Union.

There have been several important developments in the United States. The headline is, unsurprisingly, the fact that President Biden has stepped down from the re-election campaign and endorsed Vice President Kamala Harris. This has completely changed the complexion of the opinion polls and has implications for markets. Trump favours the imposition of tariffs on imports into the US - 60% on goods from China and 10% on goods from the rest of the world. This would take overall tariff levels back to where they were in the 1940s before the development of more open global trade. It would also raise domestic prices by an estimated 1%, making it harder for the Fed to proceed with its intended monetary policy loosening. On the other hand, Trump offers more in the way of tax cuts. At the extreme, corporate taxes could be raised back to 28% by the Democrats or cut to 15% by the Republicans. At the earnings level, that represents a swing factor of as much as 17%, which is huge when set against a long-term average growth rate of 7%. This is just one of the factors that makes it very difficult to place big bets on the outcome within portfolios, especially as the result, based on current polls, rests on a knife-edge. And remember that the result could be decided in as few as three "swing states".

Finally, we note the widespread IT outage triggered by a badly executed CrowdStrike software update that impacted Microsoft operating systems and the most recent escalation of hostile actions in the Middle East as being unhelpful to risk assets. Unfortunately, these sorts of negative influences are almost considered to be "business as usual" today. While it is not always possible to take out specific insurance, we construct portfolios in a manner that we believe will be resilient to external shocks in the longer term.

Markets – US

Having made 31 new all-time highs during the first half of 2024, the S&P 500 index took the tally up to 39 before stalling in the face of the violent market rotation that took place following the release of US inflation data. As mega-caps succumbed to profit-taking, the pendulum swung in favour of small caps and value stocks, both seen to be positively influenced by falling interest rates (at least as long as a recession is not on the cards). To put this into some context, in the year up until 10th July, the

"Magnificent 7" tech leaders had gained 51%, the NASDAQ Composite index (home to a greater proportion of technology companies) was +25%, the S&P 493 (ex-Mag 7) was +9% and the Russell 2000 (small cap index) was +2% (all total return). The subsequent respective returns through to the end of July were -10%, -6%, +2% and +10%, with the difference between the NASDAQ and the Russell 2000 over that period (20%) representing the biggest swing since 2001. Of course, that does not close the gap for the year, but it offers some clues as to where potential value lies in the market. Small caps offer as good value relative to large caps as they have at any time since 2000 and have some of the "coiled spring" attributes that we mentioned at the beginning of the commentary. Is this the beginning of the end of the AI story? We would be surprised if that were case. However, we would also welcome some healthy broadening out of market leadership, and there are encouraging signs that this is taking place. Even so, it might be difficult for indices to escape the gravitational pull of the biggest companies. On the last day of July, Nvidia's shares rose 13%, meaning that its market capitalisation grew by $331bn, which is bigger than all but three of the companies in Europe (including the UK), those being Novo Nordisk, ASML and LVMH.

UK
The UK has been something of a haven of calm recently. One advantage of the indices not being chock-full of technology shares is that they have not suffered the same downdrafts. Meanwhile, as alluded to earlier, the UK stock market is being positively re-evaluated by global investors, even if only gradually. A prospectively stable political background is helpful, as is a low relative valuation against other markets and a still attractive dividend yield (close to 4%), although we continue to recognise that overall market returns on capital do not match those in, for example, the US owing to the different nature of the companies that dominate the indices. In terms of index points, the biggest contributors over the month were more defensive companies (which also happened to report decent results), including Unilever, BAT and contract caterer Compass Group. In terms of percentage gains, it was a case of domestic-focused companies winning out, with NatWest, Marks & Spencer, Persimmon and Vistry leading the way. Indeed, along with the latter pair, housebuilders Taylor Woodrow and Barratt Development also made it into the Top 10 as optimism mounted about the outlook for new home construction.

Europe
As mentioned earlier, the French election uncertainty cast something of a pall over European indices. There was also a steady drip of uninspiring economic data, with Germany continuing to struggle. Its problems stem partly from the lack of demand from China for its exports (see below). Matters were not helped by price falls for the three largest companies in the European indices. Amsterdam-listed semiconductor manufacturing equipment supplier ASML (-12%) and Danish appetite-supressing drug manufacturer Novo Nordisk (-9%) both got caught up in the rotation out of previous momentum winners (with ASML also affected by the threat of export restrictions), while the French luxury goods conglomerate LVMH (-8%) fell alongside several other industry peers as their result pointed to dwindling demand for aspirational fashion items and even Champagne. Even, so with rotation supporting other areas of the market, the MSCI Europe ex-UK index ground out a positive return of 0.6%.

Emerging Markets
What could have been a pivotal month for China turned into a(nother) damp squib. The Third Plenum, at which five-year policies are set out, was long on rhetoric and short on activity, and the subsequent Politburo meeting, while marginally positive in acknowledging the need to boost consumption, was equally fruitless. Although interest rates were reduced again, including a surprise 0.2% cut in the one-year funding rate at which banks can borrow from the central bank, it all felt a bit like "pushing on a string" in the face of the continuing deflation of the real estate bubble and consumers lacking in confidence. The government remains reluctant to enact a big stimulus, mindful of the fact that such measures in the past have only created more speculation and imbalances in the economy and remains focused on technology-led investment. This all came after a disappointing second quarter GDP growth figure of 4.7%, still below the government's 5% target. Elsewhere, India's market continued to shake off any disappointment from June's election result, continuing to make new all-time highs. Remarkably, having fallen 6% when it became clear that there was no Modi landslide (June 4th), it has subsequently risen by 14%. The third largest emerging market by

capitalisation is Taiwan, with about half its value attributable to just one company, Taiwan Semiconductor (TSMC). Its shares, like some of the US and European tech giants, shed 20% of their value from the peak to the trough during July, ending down 5% in aggregate.

Fixed Income

Global bonds are finally back into positive territory for the year, with the Bloomberg Global Aggregate Index of investment grade bonds gaining 2.8% (total return in USD). Yields fell across the curve as investors factored in a falling inflation trend and disappointing economic data in the US, Europe and China. Citigroup's Economic Surprise Indices for all those countries are in negative territory (with the UK being a rare positive bright spot). If central banks need to cut rates in response to weaker economies, at least they appear not to be hamstrung by inflation that is too high. The Bank of England cut the base rate by 0.25% to 5% on August 1st, with Governor Andrew Bailey casting the swing vote in a 5-4 decision. That reflects other central bank decisions where they are maintaining a fine balance between the risks of a renewed burst of inflation and those of a weaker economy and rising unemployment. We continue to believe that the rates cycle has peaked and that they will continue to fall, although there remains some uncertainty about the pace of reductions.

All UK Gilts have delivered a total return of +3.9% over the last three months and +5.8% over the last year. Index-Linked Gilts returned +3.3% and +1.3% over the same respective periods. Emerging Market bonds produced a total return of +2.5% in sterling over the three months to end July (+12.9% over 12m). Global High Yield bonds delivered +4.2% (+11.6% over 12m) in sterling.

Conclusion and Outlook

The optimism with which we entered the year has been justified so far, although we are going through a more testing period currently. Such setbacks are to be expected and, statistically, often occur during the later summer months. Today, more than ever, short-term rises and falls can be exacerbated by investor positioning and market structure, and it is important that we do not overreact to short-term movements. Our base case remains that inflation is largely under control, that the global economy is not about to tip into a recession and that, should it weaken further, central banks now have the capacity to loosen policy.

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