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OUT OF THE ORDINARY

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Market commentary

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Overview

If one were to characterise the investing year so far, one could say that it has been a period during which several things that could have happened have not (yet), and that some potentially nasty accidents have been avoided. The result has been low single-digit gains for a typical private investor balanced portfolio, but gains that have been made with limited conviction and almost grudgingly against the expectation of imminent disaster. There is an old saying that "a bull market climbs a wall of worry", and there are certainly plenty of reasons to worry. But whether we are in a new bull market or just another bear market rally is the subject of widespread debate and one that will only be laid to rest with the benefit of hindsight.

We should set out our stall early. We tend more towards the "bear market rally" point of view and would not be greatly surprised to see markets test their lows of 2022. Having said that, neither would we expect the lows to be maintained for long as they would be the result of either the long-expected weakening of economic activity or some sort of shock to the system. Both of which would, in all probability, elicit supportive action from policymakers. Thus, we continue to maintain only a moderately defensive position in portfolios rather than extreme, with our equity exposure weighted towards companies that could not only survive during a slowdown, but potentially prosper from one.

What trends have defied expectations?

What are the things that have not happened? If we cast our minds back to the beginning of the year, economists were almost unanimous in their forecasts for a recession in the US, UK, and Europe. Even the Bank of England expected the UK to be mired in a recession for the whole of 2023. And yet, five months later, the "most anticipated recession in history" has not arrived. Only Germany, of the major countries, has recorded two consecutive quarters of negative growth.

How could the consensus have been so wrong? One mitigating factor in the UK and Europe was the weather. Winter turned out to be pleasantly warm relative to long-term averages and expectations. This reduced the demand for energy for heating and punctured the price of natural gas that had been squeezed up aggressively in response to supply reductions from Ukraine and Russia. Last August the wholesale cost of gas to produce one Megawatt hour of energy peaked at €311 as consumers scrambled to ensure they had sufficient inventory to keep the power on during the winter. Today it is just €24, although that is still very much at the higher end of the price range in which it traded during the 2010s. We note a similar, although not as extreme, trajectory in the oil price, currently at $72 per barrel versus its peak last summer of over $120. Higher energy prices can be viewed as the equivalent of a tax on consumers, and so the reductions effectively delivered a timely "tax cut".

It is also possible that the strength of the animal spirits of consumers on both sides of the Atlantic was underestimated. The concept of potential post-Covid "revenge spending" was postulated back in the depths of lockdowns, when the idea of a new "roaring twenties" did the rounds. Buoyed by the extra savings that were accumulated during lockdowns and by rising wages, consumers are almost single-handedly keeping economies afloat. But the nature of spending has shifted, meaning that we are witnessing a two-speed economy. Demand for services and experiences (such as were denied during Covid) is strong; demand for goods (which boomed) is soggy – with the sogginess exacerbated by weak housing markets which are having to cope with much higher interest rates for new mortgages.

The fall in inflation is slower than expected

The strength of consumer demand in what remain tight labour markets (thanks, in no small part, to many workers having exited for good during the pandemic and a considerable number on long-term sick leave) has led to something else not happening: a swift reduction in the rate of inflation. While headline consumer price indices in all regions have retreated from their peaks, that retreat has not been fast enough to satisfy central banks, who continue to aim for 2% inflation, especially when one strips out volatile elements such as food and energy to reach the "core" rate. In the US, the core rate for April was 5.5% (down from a peak of 6.6%); in the UK it was 6.8% (a new high for this cycle, and the highest rate since March 1992); the latest eurozone data for May at least finally undershot expectations but core CPI remains elevated at 5.3% (vs a peak of 5.7%).

Interest rates are higher

As a result of this higher inflation, another thing that has not turned out as expected this year is the path of interest rates. Based on the expectations priced into futures markets at the start of the year, the UK base rate should have been topping out now at around 4.7%. Instead, traders are expecting the peak to be around 5.35% later this year. In the US, the peak expectation in January was for around 5%. There is "only" an extra 0.25% priced in here, but of greater importance, perhaps, is that the forecasted rapid rate reductions in the second half of the year are no longer on the radar. The European

Central Bank was always viewed as a laggard in implementing tighter policy, and here the expected peak rate has moved even less, from 3.5% to 3.6%. But there is definitely a feeling that rates will now be "higher for longer".

The good news is that the application of tighter monetary policy means that longer term inflation expectations have not become unanchored. And while bond markets (see Fixed Income section below) are struggling to generate decent positive total returns this year, at least they are not delivering the losses experienced in 2021 and 2022. The not so good news is that the world is having to learn to live with higher interest rates and a higher cost of capital. Monetary policy is often described as acting with "long and variable lags". Just because the effects of tightening have not been fully felt yet, it does not mean they will not be in the future. The far greater use of fixed-rate mortgages these days slows down the transmission of monetary policy to some degree. While it has quickly slowed demand for new mortgages, holders of existing mortgages face a less immediate increase in debt servicing costs. The biggest buffer is in the US, where 30-year mortgages are the norm and where there was frantic refinancing activity when rates were low. The average mortgage rate in the US is estimated to be around 3.5%, against the current rate for a new loan of around 7%. The fuse on the UK mortgage refinancing time bomb is much shorter, with a greater prevalence for fixes in the two-to-five-year range. Around 150,000 mortgages come due for refinancing every month. The two-year fixed rate was 1.4% in June 2021; it's now 4.6% according to Bank of England data.

House prices have fallen less than expected in some markets

If we then turn our attention to average house prices, it is possible to see the result of various maturities (although this might not allow for other factors including underlying supply and demand). In the US, the CoreLogic Case Shiller National Home Price Index is only down 3.6% from its June 2022 peak and has actually bounced off its lows already. In the UK, prices as calculated by Nationwide are about 4% below the peak (although worse than the US in real inflation-adjusted terms). However, let's look at a market where the vast majority of mortgages are variable rate – Sweden. Here, house prices have fallen 13.5% from last June's peak, a much swifter descent. Australia is in a similar position, although here the decline is a more muted 7.5%. And so at least the UK and US are not experiencing house price crashes (and we never thought they would in the absence of much higher unemployment), but neither is it likely that prices will reaccelerate upwards again until mortgage rates have declined meaningfully.

As for the nasty accidents avoided, they are a banking crisis and a US debt default. We have covered the demise of several banks triggered by the fall of Silicon Valley Bank in early March in previous commentaries. Suffice to say that fears of an all-out banking crisis (which we did not entertain) were exaggerated. But the seeds of the bankruptcies were sown in the higher interest rate environment, and they are symptomatic of the corrosive effects of higher rates. If rates are to remain "higher for longer", then we would expect more evidence of corrosion to be revealed.

The negotiations over the US debt ceiling (a concept that we continue to view as a non-sensical anachronism, but with which we seem to be stuck) went close to the wire without touching it. The last call from Treasury Secretary Janet Yellen was that the government would run out of money on 5 June 2023. The implications of a US debt default are so negative that everyone believed that even the most recalcitrant members of Congress would not allow it to happen, but the man hours wasted pondering over what might happen if they did will never be retrieved. And it could all happen again when the newly negotiated suspension of the debt ceiling expires at the beginning of January 2025. That will, at least, be after the next Presidential and Congressional elections (November 2024), but much will depend on how the votes are cast. Something to look forward to...

Markets – US

The narrow leadership of the US equity market became even thinner in May. The theme that sustained the latest move was generative Artificial Intelligence (AI), a subject covered

in a separate article in more detail by my colleague Simon Lapthorne. The last leg of the frenzy was set off by quarterly results from chip designer Nvidia, which blasted through expectations and were accompanied by bullish comments about future demand. This left investment banks scrambling to raise their price targets (PT) for the company's shares and to increase their assessments of the potential size of the AI market. For example, JP Morgan's analyst raised his Nvidia PT from $250 to $500 overnight, which is a move rarely seen. The highest PT has been published by HSBC. The analyst there has gone from $150 at the beginning of this year to $600 (end-May Nvidia price was $380). As a result, the widely quoted market-cap weighted version of the S&P 500 Index is +9.5% year-to-date, thanks to the outsized contributions of potential AI winners including Microsoft, Alphabet, Meta, Amazon and Apple (not to mention Nvidia itself), while the NASDAQ Composite Index (even more concentrated in Technology leaders) is +24%. Meanwhile an equal-weighted version of the S&P 500 Index was actually down in capital terms in the five months to the end of May, suggestive of broader concerns about the underlying economy.

UK

The FTSE100 Index continues to lag other developed equity markets, and is just about clinging onto gains for the year so far. Its fortunes have not been helped by weak commodity prices. The oil price, a key determinant of the fortunes of Shell and BP, has fallen from $85 to $75. Iron Ore has fallen by 12% and Copper is flat (having been more than 10% higher). These are important commodities for the likes of mining companies BHP, Rio Tinto, Glencore and Anglo American. The pound's recovery from $1.20 to $1.25 and from €1.13 to €1.16 has reduced the sterling value of overseas profits. These are factors out of the control of the companies themselves. Indeed, we believe that a much more conservative attitude to capital expenditure should, if anything, be shifting the demand/supply curve for extractive industries into more favourable territory for profits, cash flow and distributions to shareholders in the form of dividends and share buybacks. And a commodity such as copper is deemed to be crucial to the green energy transition, being such an important component of electric motors and electricity distribution.

Europe

Earlier this year we referenced Citigroup's Economic Surprise Index for Europe (CESI). It had recovered from -105 last July (which coincided with the peak in natural gas prices) to a high of 101 in January. This helped to deliver a fantastic period of performance for European equities, in both absolute and relative terms, as the "left tail risk" of a deep recession was priced out of risk assets. This was hailed by some as the beginning of a longer period of outperformance for European bourses, but they have succumbed to economic gravity. The CESI has since retreated to -72. Germany drifted into a recession in the first quarter of 2023, weighed down by a tough domestic property market and a global manufacturing slowdown. But eurozone unemployment in April hit a new record low for the euro era extending back to 1998 and May's inflation data for several of the large countries (and, by extension, the eurozone as a whole) was lower than forecast. This looks more like a soft patch than a major slowdown. And although the market continues to expect further rate increases from the European Central Bank, the peak of the rate cycle is imminent. European equities continue to offer decent value in aggregate.

Emerging Markets

At the beginning of this commentary, we wrote that some things that were expected to happen did not materialise. One of those was a robust recovery for China's economy. The ending of the country's zero-Covid policy accompanied by some monetary and fiscal stimulus was grasped by investors as a turning point for its fortunes. The reality has been a disappointment, with market outcomes exaggerated by over-optimistic positioning. The MSCI China Index is down 9% year-to-date and has fallen 22% from its January peak. Almost everyone agrees that Chinese equities offer good value now, although many remain deterred from investing by the political risks. One thing we do believe is that any recovery in China's fortunes will not be the result of the usual debt-fuelled investment in assets such as infrastructure and real estate, neither of which are sustainable

levers of growth. Middle class domestic consumers will play a greater part, and it seems that their confidence is taking time to rebuild.

Fixed Income

The Bloomberg Global Aggregate Index (BGAI) of all investment grade debt fell by 5.5% in 2021 and then a further 16.5% in 2022, a catastrophic outcome for holders of supposedly "safe" financial instruments and by far the worst since inception in 1990. So far this year it has delivered a total return of just 1.4%. And with bond yields having risen last year, that means a positive income return but nothing in capital terms. Before last year, the BGAI had never fallen for two consecutive calendar years. Longer term data for the US 10-year Treasury Bond going back to 1928 show that investors in that instrument have never lost money for three consecutive years. We do not expect this year to be the one that proves that rule. Higher starting yields and the fact that inflation is trending lower (even if not at the desired pace) have increased the attractions of bonds in balanced portfolios. Shorter dated bonds are also a decent alternative to lower yielding bank deposit accounts.

UK Gilts have delivered a total return of -1.9% over the last three months and -6.7% over the last year. Index-Linked Gilts returned -3.8% and -10.5% over the same respective periods. Emerging Market sovereign bonds produced a total return of -2% in sterling over the three months to end May (flat over 12m). Global High Yield bonds delivered -2.6% (+1.32% over 12m) in sterling.

Conclusion and Outlook

We continue to operate in "patient" mode. We trust that the preceding commentary helped to illustrate the unusually difficult nature of the current investing environment. Economic outcomes remain uncertain, and although risk assets remain well off their cycle highs, we still do not feel that markets are paying us enough to take on excess risk today. We don't doubt that this is frustrating for all stakeholders in this enterprise, from the strategists at the beginning of the investment process to the ultimate beneficial owners of our managed portfolios. We continue to believe that preservation of capital is the best course of action for now while at the same time continuing to seek out idiosyncratic investment opportunities that are not entirely dependent upon the whims of politicians and central bankers. But we continue to believe that the current cycle of uncertainty will be resolved over the next few months and look forward to being able to convey a more optimistic outlook in the months ahead.

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