RATHBONES | Incorporating Investec Wealth & Investment (UK)

07 May 2024

Market commentary

John Wyn-Evans
Head of Investment Strategy

Overview

A well-worn phrase, apparently derived from a German proverb, that gets wheeled out after a strong run in the stock market or in specific stocks and sectors is that “trees do not grow to the sky”. It probably helps to know whether you have planted a giant redwood or a bonsai before estimating how tall it can grow. It doesn’t take much Googling to find all sorts of references to investment analysts and fund managers warning of the dangers inherent in rising prices in the past, but in many cases their caution has not aged well, especially where it concerned the leading technology companies which today dominate the global indices.

Nevertheless, even the healthiest trees sometimes need a bit of a trim, and during April markets were subjected to a lopping following what had been one of the strongest and most persistent rallies seen for many years. Global equities suffered their first monthly reversal since October 2023, falling 3.2% (Total Return in US dollars), while the dominant S&P 500 Index in the US lost just over 4%. Notably, though, the UK's FTSE 100 Index gained 2.7%, an outcome that we shall investigate in more depth in the country sections below*.

As we often reiterate, the main driving forces behind equity performance in the long term are liquidity (largely interest rates and bond yields, but also other central bank actions) and earnings growth expectations. We could also cite investor sentiment and positioning in the short term. We shall see in a moment that earnings appear to be relatively stable. It was interest rate expectations that upset the apple cart last month.

Of course, interest rate expectations do not move in a vacuum. They are driven by the outlook for economic growth and inflation, in particular. While at the beginning of this year inflation was generally expected to be on a steady glidepath back towards central banks' 2% target, it is proving to be somewhat stickier. US Consumer Price Index readings, covering the first three months of 2024, have all come in higher than expected. And while there are idiosyncratic factors possibly at play, including higher motor insurance premiums, rising asset management fees (thanks, ironically, to rising stock markets) and the outsized contribution from housing rent (actual and Owner Equivalent), the trend has been persistent enough to become unnerving.

The situation is not as worrisome in the UK, especially as the latest drop in household energy bills will feed through to the headline calculations in April, but there is some concern about service inflation, which is still running at 6.1%. Some of this is attributable to a tight labour market, leading to a similar level of wage growth. There are all sorts of explanations put forward for the paucity of workers, ranging from poor investment in education and training to the inevitable finger-pointing at Brexit, but the fact that 2.8 million people are on some kind of long-term sick leave is viewed as a primary cause. This has been noted by the government, which is trying to manage the situation, but there would appear to be no quick and easy fix. And whereas increased levels of immigration could be seen as a possible practical solution, that is not politically acceptable at the moment in the UK, the US or in many European countries.

Thus we have seen an increase this year in the future rate of inflation implied by the relative prices of conventional and index-linked government securities (known as the breakeven rate, which is the average expected inflation rate over the referenced period). The 2-year breakeven in the UK has risen from 3.2% to 4%, for example, with the 10-year rate up from 3.46% to 3.77%. Even allowing for the fact that these markets can be somewhat illiquid and therefore subject to exaggerated price movements, the trend is undeniably higher. If there is some good news, it is that we are nowhere near the peak 10-year breakeven rate of 4.63% hit in August 2022 at the height of the inflation scare.

It's a similar story in the US, where the 2-year breakeven rate has jumped from 2.02% to 2.43%. We have observed that during the period from the Global Financial Crisis to the effective end of the Covid pandemic signalled by the vaccine announcements in late 2020, the 2-year breakeven rate rarely broke above the 2% level. In fact, 2% became a very firm ceiling for short-term inflation expectations in the US. Since 2021, however, it has turned into a floor, with barely a blip below. It would appear that a combination of fiscal and monetary stimulus combined with broader geopolitical events have flipped us out of the so-called "lowflation" world, although we will only be able to say that for sure in a few years' time with the benefit of hindsight. Even so, we will have to allow for the possible consequences for future monetary policy and portfolio construction.

The US 10-year breakeven has also risen, from 2.16% to 2.41%. This does not really constitute an unmooring of longer-term inflation expectations, which is positive, but we will need to keep a close eye on it, allowing for the fact that the US Treasury Inflation-Protected Securities (TIPS) market is less evolved and less liquid than the UK Index-Linked market.

This bond market rabbit hole goes deeper and evolves into a warren, but it's worth taking the time and expending a bit of effort to get out a powerful torch and do some exploring, especially if it helps us find a way out.

If we consider the conventional bond market, the movement in yields is theoretically driven by a combination of the breakeven rate and the real yield (I could also introduce the concept of the "term premium" at this point, which is the extra yield demanded by investors to compensate for the risk of future changes in interest rates, but that would risk the commentary beginning to resemble Watership Down).

Looking specifically at the US bond market, we can see that the nominal yield of US 10-year Treasuries has gone up from 3.87% to 4.67% this year, or by 80 basis points (bps). That is a lot more than the rise in the breakeven rate (25 bps). This means that the real yield has gone up by 55 bps to a current level of 2.26%. It's worth reminding ourselves that this was minus 1% during 2021, which was a key reason for the incredibly high, not to say stratospheric valuations of all sorts of speculative stocks. Arithmetically, a negative real yield meant that future earnings could have an infinite net present value; certainly, there was no anchor. The increase in the real yield to 1.5% in 2022 as the world priced in a combination of higher inflation and interest rate normalisation unleashed a fearsome bear market in both bond and equity markets.

It is our central view that this was a once-in-a-generation reset from an unsustainable low, and so we are not expecting a rerun. However, investors are worrying about other things. The current major concern, if not inflation itself, is the creditworthiness of many western governments, not least that of the United States. The bond market scare that took the 10-year Treasury yield up to 4.99% last October, with the real yield hitting 2.51%, reflected that concern before nerves were calmed, primarily thanks to some nifty footwork by US Treasury Secretary (and former Federal Reserve chair) Janet Yellen who fiddled with the composition of government debt issuance by increasing the issuance of more market-friendly short-term Treasury Bills. We cannot rule out another such scare, but the latest announcements regarding this year's federal funding requirements appear to have been well received by markets. Maybe the next crunch will come once we know who gets to sit in the Oval Office next year. The US Presidential election will take place on 6 November and neither candidate seems willing to exercise fiscal restraint. While Biden will aspire to carry on spending, Trump would opt for tax cuts. A lot will hinge on the outcome of the Congressional elections, as Congress will have the ability to apply some restraint.

Circling back to where we started, then, equity markets are largely toiling against the headwind of higher (real) bond yields at the moment. Expectations for interest rate cuts have also been pushed out thanks to the sticky inflation, but at least some of that appears to be down to better-than-expected growth, and so corporate earnings remain resilient in aggregate, as evidenced by the unfolding first quarter results season (see below).

We would not be at all surprised to see markets remain around current levels for a while as they navigate all of these crosscurrents, and, in many ways, it would be healthy to consolidate the strong gains made through the end of March. A deeper reversal might require a more negative catalyst, such as a US recession (which has largely been priced out of the reckoning) or a major geopolitical event (which, by its nature, will be difficult to predict exactly, especially regarding timing). Our most recent asset allocation committee survey asked members to probability weight four possible economic/market outcomes: immaculate disinflation; resilient growth; mild recession; and higher for longer (interest rates) / (monetary) Tightening 2.0. Although individual members had stronger directional views, the average responses were, respectively, 28%, 25%, 25% and 22%. That might look like a copout, but, in reality, it reflects the conflicting signals that economies and markets are sending. Until we have a clearer picture or markets offer us a more compelling valuation opportunity, we will keep a tight balance between risk and reward.

Markets – US

In terms of specific events, April for the US stock market was all about the first quarter earnings season and the latest meeting of the Fed's rate setting Open Market Committee (FOMC). At the time of writing (3/5/24), around three-quarters of the constituents of the S&P 500 have reported, and around three-quarters of those have beaten earnings estimates, which is not unusual. As is often the case, earnings have, in aggregate, beaten expectations, with year-on-year growth for the first quarter coming in at 4%, some 9% better than forecast. Strong demand, with domestic consumption growth of 2.8% reported during the period, helped sales to rise by 4% and it looks as though a much-feared squeeze on margins has not materialised. It does appear that many companies, heeding the possibility of a recession last year, had already taken measures to control costs. The results reactions from six of the 'Magnificent 7' stocks (Nvidia reports in May) were quite diverse, with Alphabet (parent of Google) being the biggest winner and Meta (Facebook) the biggest loser. While all of these companies aspire in some way to capitalise upon the potential riches that are expected to flow from the adoption of generative artificial intelligence, they are going by different routes and at different speeds. Even so, the general direction of travel is forward and we continue to maintain exposure to this important theme. The Federal Open Market Committee (FOMC) left interest rates unchanged, but the slower progress in lowering inflation prompted chair Powell to comment that they will remain at their current level for longer than previously envisaged. More positively, he said nothing to suggest that the next rates move would be an increase, and this helped to soothe investors nerves.

UK

The earnings season data for the UK tends to be aggregated with the rest of Europe, at least in terms of what we see. Even so, we can report some decent wins in terms of market reaction. Leading the way in terms of FTSE 100 points contribution during April was Astra Zeneca, which contributed 78 of the 212 points gained. The company firmly beat both sales and earnings forecasts, whilst also delivering positive news on its drug discovery pipeline. HSBC (62 points) was another heavy-hitting winner, beating estimates thanks to strong net interest income (courtesy of higher interest rates) and fee generation. It also surprised positively by announcing a $3bn share buyback programme, a billion dollars higher than forecast. Banks are fearsomely strong generators of cash when the environment is favourable. If they are not required to bolster their capital position (something that has largely been completed in the post GFC period) and are not growing loan books aggressively (which few banks are at the moment), then they can reward shareholders with buybacks and dividends. The best performance in terms of share price appreciation in April came from the mining group Anglo American. Its shares rose 37% on news of an approach from BHP Group (whose primary listing is now in Australia). It has not yet made a formal offer and its approach is somewhat unusual in that it wants Anglos to spin off various South African subsidiary companies first, but this move is illustrative of the value that might be tapped from UK shares, upon which we have recently taken a more constructive view.

Europe

Europe's earnings season (including the UK) has been somewhat less bountiful than that of the US, reflective of a weaker local economy. With around 60% of companies having reported, just over half (56%) have beaten earnings expectations. The aggregate beat is around 4%, although the year-on-year growth rate is still -10%. That decline is mainly down to the lower commodity prices prevailing in the first quarter of 2024 versus 2023. If we strip out the Energy sector, earnings are about 3% lower than last year. One of the features of the results season so far has been the divergence of performance between two high-profile companies in the same sector, Luxury Goods. Kering, the owner of the Gucci brand, experienced a setback when it reported disappointing result from the Italian fashion house, partially owing to poor demand from Chinese customers but also because its offering seems not to be in favour at the moment. Such are the vagaries of fashion. Kering's results were quickly followed by those of Hermès, the fashion and leather goods house. Thanks to its exposure to a wealthier cohort of customers – everything is relative – Hermes fared much better and saw its shares rise nicely.

Owing to the unusually long overview section and the fact that we have less granular data on results in Emerging Markets and Japan, we will come back to those regions next month.

Fixed Income

As covered earlier in this commentary, bond markets have reversed many of the gains they made during the final two months of 2023, although yields have not reached the same levels. As long as inflation remains sticky and government deficits remain high, it will take a major economic setback to push yields back down a long way again, and that is not something we would wish for. The Bloomberg Global Aggregate Index of investment grade bonds is -4.8% year-to-date (TR in USD), while the sterling hedged version is -1.7%. The current UK 10-year Gilt has generated a total return of -4.4%.
UK Gilts have delivered a total return of -2.3% over the last three months and -1.3% over the last year. Index-Linked Gilts returned -1% and -5.4% over the same respective periods. Emerging Market bonds produced a total return of +5.3% in sterling over the three months to end April (+13.8% over 12m). Global High Yield bonds delivered +0.1% (+9.2% over 12m) in sterling.

Conclusion and Outlook

While we maintain a reasonably upbeat opinion about the longer term prospects for riskier assets including equities, owing to the fact that we continue to believe that the next move in interest rates will be lower and that a second big wave of inflation is not on the cards, it is probable that we will have to display a little patience. It helps at such times to take a much longer term view. The recently deceased author and psychologist Daniel Kahneman proposed that one of the greatest barriers to saving was an individual's inability to project forward twenty years or more and to imagine the circumstances they would be in, their financial needs and what they needed to start doing about that today. Popular health author and broadcaster Peter Attia makes the same point about our need to start training physically today to become the sort of person we will need to be to deal with old age. And so we will end this month's commentary with a Chinese proverb on the subject of trees: "The best time to plant a tree was twenty years ago... The second best time is now".
*All market data to 30/4/24

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Investec Wealth & Investment (UK) is a trading name of Investec Wealth & Investment Limited which is a subsidiary of Rathbones Group Plc. Investec Wealth & Investment Limited is authorised and regulated by the Financial Conduct Authority and is registered in England. Registered No. 2122340. Registered Office: 30 Gresham Street. London. EC2V 7QN