RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

The turning of the seasons affords us the usual opportunity to look back over the last quarter and to look forward to what is to come. Although many are still questioning whether summer ever arrived in the UK, markets generally had a sunny disposition over the period, even if there were a couple of nasty squalls to shelter from. As the longer nights of winter approach, let us hope that they are not a harbinger of a darker period for markets as we continue to face uncertainty in the form of the US election outcome and rising tension in the Middle East. And, of course, how much weight will the "broad shouldered" have to bear when the Chancellor unveils her first budget at the end of the month.

The overview section will be a little shorter than usual this week as we have expanded the more detailed comments to include occasional views on Japan and Commodities.

The defining moments of the last quarter were generally positive, underpinning the gains for both equities and bonds and, by extension, balanced portfolios. The gains for sterling-based investors were somewhat attenuated by the pound's 2.1% gain on a trade-weighted basis, as wealth managers extend the global reach of portfolios. Furthermore, the lion's share of FTSE 100 profits are derived overseas. Viewed through a more positive lens, this will help to dampen UK inflation and increases our buying power when travelling abroad.

The dominant theme has been the turning of the interest cycle, a shift that really got into gear over the summer when the US Federal Reserve and the Bank of England joined the likes of the European Central Bank, the Swiss National Bank and the Bank of Canada in reducing rates. We have often commented that the motive for cutting rates would be defining for risk asset performance. If central banks cut "because they can" (owing to inflation heading to target), that's good news. If they cut "because they have to" (owing to a much weaker economy), that's bad news, because any potential valuation support from lower interest rates would be overwhelmed by falling profits (and a rising equity risk premium, in all probability).

We are happy to report that, for now at least, the decisions to cut rates are skewed towards the positive factor, which has been a tailwind for equities and corporate bonds in particular. Even so, we are far from complacent about the outlook, and maintain a high-quality threshold for our investments. Our subjective probability of a recession developing in the United States is 30%, and so far from negligible, although the larger-than-expected 0.5% cut by the Fed in September helps to reduce the risk. The UK is muddling along, helped by positive real wage growth, and Europe is a bit of a mixed bag. The biggest positive surprise came from China towards the end of September, when the government unveiled new policies to deal with the sluggish economy. More details are to be found in the sections below, as is a recap of the events in Japan which triggered a swoon in markets in early August.

The third quarter also delivered a new government in the UK, although the result was pretty much a foregone conclusion. The Labour Party's honeymoon seems not to have lasted for even the traditional hundred days, and a combination of downbeat commentary and a series of own goals have now raised the bar in terms of what it has to deliver to maintain credibility. At least it has a huge majority to work with and, potentially, a five-year runway, unlike President Macron in France, whose decision to call a snap election looks more ill-judged in hindsight.

The US election is being billed as pivotal, existential even, but then we also know that it is the sworn duty of all media outlets to whip us into a frenzy ahead of any event these days, with the emphasis placed heavily on the negatives. There are major differences between the intended policies of candidates Harris and Trump, and there will be implications for the path of the US and global economies and the potential outcome of the conflicts currently unfolding in Ukraine and the Middle East. But from an investment perspective, we would be more dispassionate. On average, there is very little to choose between how the US stock market has performed under Democrat or Republican administrations over the years.

Only two presidents since World War 2 have presided over falling stock markets, and, for all their other faults, they could be described as unlucky investors. Richard Nixon, whose term was blighted by the oil embargo in 1973, had the misfortune to see the stock market's Nifty Fifty Bubble deflate rapidly on his watch. George W. Bush's presidency was punctuated by the attack on the Twin Towers and the "war on terror" but it was the fact that his presidency began close to the peak of the early noughties Technology boom and ended during the depths of the Financial Crisis, neither of which were of his doing, that marks him down as a "loser" in terms of stock market returns.

And so, for all the noise that is going to be generated around this election, and there will be a lot of it, we're not going to let it define our current long-term investment outlook.

Markets – US

The S&P 500 Index marked the end of the quarter by registering its forty-third new all-time high of the year. Although it suffered an 8.5% drawdown during August, it was buoyed again by the expectation of falling interest rates and resilient economic data. The Atlanta Fed's GDPNow forecast for third quarter GDP suggests around 3% growth. There was a distinct change in market leadership below the surface once investors became more confident that the Fed was going to start the rate-cutting cycle. The dominance of Technology stocks faded, with interest rate-sensitive sectors and cyclicals coming to the fore. That is the sort of rotation that one might expect at this stage in the rate cycle and represented a healthy and welcome broadening out of performance. The best performing sector was Utilities (+18.5%). Not only are utilities sensitive to interest rates as they tend to be heavily debt-financed and big dividend payers, but they are also considered to be a play on the adoption of generative Artificial Intelligence owing to the need for increased electricity generation and distribution – Large Language Models consume a lot of power. Real Estate (+16.3%), another classic interest rate play, returned 16.2% in the quarter, followed by Industrials (+11.2%). The Technology sector managed to generate just 1.4%. But it still pipped Energy (-3.1%), which was restrained by a lower oil price as concerns about oversupply and lack of demand outweighed geopolitical worries.

UK

The installation of the new Labour government was expected to sound a rallying call for UK domestic assets thanks to the potential for a pro-growth and more business-friendly agenda. That may yet materialise, but the new team, led by Prime Minister Sir Keir Starmer and Chancellor of the Exchequer Rachel Reeves, chose first to emphasise the negatives, notably the "£22 billion black hole" in the country's finances. Using this as justification for planned tax increases in the forthcoming Budget (30th October), they have only succeeded in reducing business and consumer confidence. Even so, the FTSE Small (+4.6%) and Mid Cap (+3.1%) Indices generated positive returns across the quarter, although initial strong gains made during the euphoric immediate post-election period have not been built upon. In light of the poor reception given to some of the tax plans (which, nowadays, tend to be aired in advance to test the water), the Chancellor may take advantage of the remaining time to reconsider her options, although the country's 100% debt-to-GDP ratio, reached again for the first time since 1962, when it was falling rather than rising, cannot be ignored. We continue to advise clients to make full use of (y)our financial planning resources to ensure that incomes and assets are managed in the most tax-efficient manner.

Europe

Europe remains in the doldrums in aggregate, with stronger showings from the Southernmost countries (which are benefitting from a strong tourism season) offset by weakness in the core. France's political disarray is not helping its fortunes, and the new cobbled-together government has its work cut out to reach the EU's 3% fiscal deficit ceiling target from the current 6%. The new Prime Minister has already had to announce tax increases and spending cuts. Germany, meanwhile, is under the cosh owing to the lack of momentum in its export markets, primarily China. Its important automative manufacturing industry is struggling, with profit warnings emanating from Mercedes, BMW and VW. As in other countries, including France and Austria, a far-right party, the AfD, has fared well in regional elections, highlighting the social unrest lurking not far below the surface. If there is any good news, it is in the fact that headline inflation across the eurozone has dropped below 2%, leaving the door wide open for the ECB to cut interest rates to support the economy.

Emerging Markets

There really was only one big story in EM during the last quarter, and that was the multi-pronged stimulus package unveiled by China's central bank and government at the end of September. The initial measures included the usual interest rate cuts and freeing up of bank capital to make loans, although these sorts of supply-side policies had not helped to ignite an economic recovery on previous attempts. There is limited demand to take out new loans. Cuts to mortgage rates, including the ability to refinance existing mortgages, were a stronger signal of intent, as they put money into consumers' pockets, although the propensity to save any windfall remains high. It was the second round of fiscal measures which caught the market's imagination, delivered as they were from a Politburo meeting chaired by President Xi himself. Even though, at around 0.8% of GDP, the incentives offered to consumers to trade in old appliances for new (think "cash for clunkers") pales by comparison to the 12.5% of GDP that the government promised to spend in 2008, at least it was a step in the right direction – investors have been crying out for fiscal rather than monetary stimulus as it has greater power to persuade consumers to spend more. Pledges of funds to be made available to purchase shares was the icing on the cake. The CSI 300 Index went from being one of the worst performers in the world this year (-8% at its worst on September 13th) to one of the best (+17%), recording a stunning 27% turnaround in just nine trading days, a performance unmatched by any major share index in data going back to 1980 according to Deutsche Bank. Is this the beginning of something even better? While we believe that the "left tail risk" of further economic and stock market weakness has been cut off for now, pricing in a strong "right tail" economic boom feels like a bit of a stretch given the country's structural problems (poor demographics, bursting of the real estate bubble) and the difficult geopolitical situation, especially ahead of the US election. Even so, there seems to be less reason to bet against China's stock market for now.

Japan

Japan's currency and stock markets were the epicentre of a shock which rippled through global financial markets at the beginning of July. We covered this in some detail in last month's commentary, but, to recap, a combination of weak US economic data and a surprise increase in interest rates by the Bank of Japan combined to ignite buying of the yen, which in turn triggered the unwinding of various yen-based "carry trades" which had relied on a weak yen and low borrowing costs. The enforced unwinding of leveraged positions put even more upward pressure on the yen, which in turn undermined the stock market, which tends to be negatively correlated to the currency owing to its high exposure to overseas currencies either through exports or remitted profits. On August 5th, the flagship TOPIX Index fell 14%, although to overseas investors that fall was mitigated by the yen's rise. However, it quickly recovered as the forced selling dried up and investors acknowledged that the positive underlying trends of improving profitability and corporate governance remained intact. There was another small sell-off at the end of September when the LDP elected its new leader, who is considered to favour tighter monetary policy and he also called a general election on October 27th, in which his premiership should be backed by a popular mandate. For us, the increased volatility has taken some of the gloss off a still relatively attractive long-term story and we would be happy to book some profits and await another entry point once the dust has settled.

Commodities

There are three principal pools of commodities that we monitor closely and which we can invest in either directly or indirectly – industrial metals, precious metals and oil. Soft (food) commodities have always represented more of a challenge and can be extremely volatile owing to short-term supply factors, for example the weather, and do not lend themselves to our process. However, we are always alive to what influence they might have on inflation. Metals prices, primarily iron ore and copper, were boosted by the China stimulus news, although we are not convinced that there will be a return to booming construction. The two metals that would appear to have strong secular tailwinds are copper and uranium. The former is key to the "electrification of everything", while the latter shares some of that characteristic whilst also being the key fuel for nuclear energy production. Nuclear energy's reputation is undergoing a strong rehabilitation owing to its ability to produce reliable baseload electricity with no carbon emissions. We gain our exposure to metals cycles through the shares of the producers, and the London Stock Exchange is host to several of the world's leading miners, all of whom are in rude financial health and tend to pay generous dividends. Our main focus in terms of precious metals is Gold, which continues to perform well, recently making new all-time highs in both dollar and sterling terms (in which it is +21% this year). Although often seen primarily as a hedge against either inflation or geopolitical risk, much of the demand of late has been from central banks looking to diversify their foreign exchange reserves away from dollars (or dollar bonds). The sanctions placed on Russia following its invasion of Ukraine were unnerving to some. We continue to view Gold as a valuable risk diversifier. In a world of no geopolitical conflict, there would be limited upside potential for oil as underlying supply remains plentiful and demand continues to be dampened by the switch to cleaner fuels (although we are a long way from a zero carbon world). The main threat to oil supplies is evident in the Middle East and would rise should Iran get drawn deeper into the conflict. Iran is still a major producer (accounting for around 4% of global production) and effectively controls the Strait of Hormuz (through which around 20% of crude oil passes in tankers). Our stance here, to hedge the risk, is to recommend using structured products which have a leveraged exposure to a big spike in the oil price with capital protection in the event that oil remains unaffected.

Fixed Income

Global bonds had a good quarter as inflation prints were generally benign, paving the way for central banks to cut interest rates. The Bloomberg Global Aggregate Index of investment grade bonds gained 6.5% (or 4.2% in the sterling hedged version). Bonds also proved to be a good counterweight to falling equities in early August. Now that inflation has subsided, the negative price correlation between bonds and equities is being re-established. However, in the absence of much weaker economic data, we see limited further downside for government bond yields. The same is true for both investment grade and high yield corporate bonds, where the yield spreads over government bonds are towards the bottom of historical ranges. But the income is reasonably attractive.
All UK Gilts have delivered a total return of +2.3% over the last three months and +7.9% over the last year. Index-Linked Gilts returned +1.2% and +5.2% over the same respective periods. Emerging Market bonds produced a total return of +3.5% in sterling over the three months to end September (+17.4% over 12m). Global High Yield bonds delivered +4.6% (+14.6% over 12m) in sterling.

Conclusion and Outlook

Despite a catalogue of things that could go wrong, global bond and equity markets have sidestepped most of the potential obstacles so far this year, with even August's technically exaggerated equity market sell-off being short-lived. One of the lessons of that event is that episodic moments of increased volatility are an integral part of the investment landscape today. A key skill is to evaluate whether they will evolve into something more serious. There have been several occasions in the last couple of years when it was tempting to hide in cash-like instruments, but that would have left a lot of gains on the table. While we will evaluate all such moments on their merits, we would also observe that those with a long-term investment horizon tend to be best served by remaining committed to their portfolios.

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