RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

It makes a pleasant change to be able to look back on a month during which both bond and equity investors prospered. We will investigate the reasons for that in a moment, but first it should be noted how quickly the market's mood changed. We have long counselled that trying to time turn points in markets is almost impossible, and there are plenty of studies illustrating how much of the compounding benefit of investing can be lost by missing out on just a few of the more positive days. It is one reason why we have recommended maintaining only a marginally underweight position in equities even when there seemed to be a dearth of good news. After two years of lacklustre returns, while markets readjusted to a higher interest rate environment, (which also required a lot of froth to be blown off the top of more speculative valuations), we continue to believe that we are much closer to the end of this cleansing process than to the beginning. It's time to look ahead, not back.

Market historians had a field day with the November data. Amongst some of the statistics that we saw were the following: the S&P 500 index enjoyed its eighteenth best month since 1950, which might not sound that impressive until you work out that there have been 886 months over that period, putting that gain at around the ninety-ninth percentile. That sounds more impressive. For the record, the index gained 8.9%.

Bonds also had rip-roaring time. US Treasuries had their best month since May 1985, whilst global bonds had not experienced a better month since 2008. The US 10-year yield fell from 4.93%% to 4.32%. The UK 10-year Gilt also delivered a nice capital gain as the yield fell from 4.51% to 4.17%.

Unsurprisingly, then, balanced portfolios also did well. Michael Hartnett, the Chief Investment Strategist at Bank of America, pointed out that a US 60:40 portfolio (60% equities; 40% bonds) gained 9.6%, the best month since December 1991, a month which saw the collapse of the Soviet Union. While it might be tempting to see that event as the primary catalyst for such a strong rally thirty-two years ago, we would point that the month also featured two interest rate cuts delivered by the Federal Reserve, the first being 0.25% at the beginning of the month and the second being a punchier 0.5% just five days before Christmas. Such an aggressive move appears to have signalled that the central bank was satisfied that it had tamed a nasty outbreak of inflation and was willing to unleash animal spirits once more. For the record again, and to emphasise once more the potential benefits of a patient long-term investment strategy, the S&P 500 Index ended 1991 at 417 versus the current level of 4567. Indeed, with dividends reinvested, the total return of the index over the period is a noteworthy 1,955% (or an annualised return of 9.93%).

And what links the performance of December 1991 with November 2023 most strongly is interest rates. In the former case it was actual cuts; in the present day it is more about expectations of future cuts, the horizon for which shortened dramatically during the month. Not long ago, investors were worried that interest rates would continue to rise, a view that was supported by a hawkish tone from central banks. At September's meeting of the Federal Open Market Committee, for example, members indicated in their quarterly Dot Plot that they had not yet finished tightening monetary policy, with the message being reinforced during chairman Jerome Powell's post-meeting press conference. Andrew Bailey, Governor of the Bank of England, and Christine Lagarde, President of the European Central Bank, adopted the same stance. The commitment to fighting inflation was unanimous.

And what changed? We would observe two key factors. The first is that the central banks started to soften their tone. At the last Fed meeting, Powell conceded that tighter financial conditions (a function of rising bond yields, wider credit spreads, a stronger dollar and weaker equity markets) had been doing some of the Fed's work for it and that it might be appropriate to pause at current interest rate levels and assess the economic outcomes. Secondly, and perhaps even more importantly, inflation levels continue to subside, and somewhat faster than expected. The last data we have is for October, and this showed the US headline Consumer Price Index (CPI) to be +3.2% over a year, the lowest reading since March 2021 and well down from the June 2022 peak of 9.1%. Eurozone inflation similarly fell below expectations to 2.4%. Even the UK, a country that tends to have a more stubborn inflation problem than many, reported a fall from 6.7% to 4.6%. And while none of these figures are yet close enough to the central banks' 2% target, all of them are trending down in an encouraging fashion.

There has also been an unforeseen helping hand from energy prices. Despite concerns that hostilities in the Middle East could escalate to bring Iran into the fray, thus threatening both oil production and vital crude oil shipping lanes. The oil price is lower not only than it was before Hamas's attacks on Israel, but also than it was before Russia invaded Ukraine in February 2022. Analysts seem to be struggling to pin down a single reason for the weakness. Indeed, there are several candidates, some cyclical, some more structural: a weak global economy is not good for demand; the OPEC+ cartel is struggling to find unity on production policy; oil continues to be exported from

sanctioned countries; and the transition away from fossil fuels is curtailing demand at least to some degree. Even so, while welcoming the effects, we would not be complacent on this front. Experience shows that it can take only a small shift in the balance between supply and demand to have a big influence on the oil price.

The speed of market moves was exaggerated by a big swing in sentiment and positioning. At the end of October, there seemed to be maximum pessimism, especially in bond markets. Fear of burgeoning supply was rife, especially in the US as the government's large fiscal deficit needed to be financed. But there seems to be a price for everything, and buyers were finally enticed by 10-year and 30-year yields rising above 5%, a level that we believe offers decent long-term value. Matters were further improved when the quarterly US Treasury auctions concentrated supply in short-dated Treasury Bills, thus taking pressure off longer-dated issues. Meanwhile in equity markets, bearish sentiment, indicated by the AAII Bull/Bear balance falling to a low -51, swung back up to -2.5 (it rarely strays into positive territory and never stays there for long). Not only were long positions added to, but short positions were aggressively squeezed. Momentum-following hedge funds were net buyers of $225bn of shares during the month, the fastest ever such accumulation according to traders at Goldman Sachs. They have now largely spent their ammunition.

And so can this rally be extended? Maybe. Seasonal factors remain supportive, but there is some concern that interest rate expectations have become overoptimistic. In the US, the futures market is suggesting as many as five cuts of 0.25% during 2024, with the first one being in May. In Europe the corresponding number and month are five and March. In the UK they are three and June. We have been here before: as many as seven times during the current rate increase cycle, according to Deutsche Bank, with hopes dashed on every occasion. The cuts will probably only be made as expected in two central circumstances. The first and best would be the scenario that saw inflation fall to around 2% and remain there without the effects of past interest rate increases having too detrimental an effect on the economy – the so called "immaculate disinflation". We still deem this to be a low probability outcome, almost in the realm of wishful thinking. The second would be a much weaker economy, possibly falling into recession in the key regions of the US, Europe and the UK, which would undermine corporate earnings. This remains our most probable scenario and informs our tilt towards more defensive companies and our overweight position in fixed income.

In a nutshell, the big question is this: will central banks cut interest rates because they can or because they must? The first reason would certainly be preferred by all, while the second offers a bumpier ride. However, we would emphasise that we are still discussing potential interest rate cuts in both scenarios, and they usually end up providing the fuel for better investment outcomes.

Markets – US

We spotted an intriguing article in a recent edition of the Financial Times. The FT commissioned its own survey of more than 2,000 adults in the US to see how greatly their opinions of various economic indicators differed from the facts. The results were eye-opening. For example, 90% of people thought that prices had risen faster than wages over the last year, when the opposite is true. 73% thought that the rate of inflation was above where it was a year ago, when it is, in fact, a lot lower – 3.2% vs 7.7% to be precise. Only 13% thought that the median American household was wealthier than before the pandemic, which turns out to be the case. Maybe they would rather see Bill Clinton back in the White House. On a similar range of questions comparing the present to thirty years ago, there was the same level of faulty perception. For example, just over half of the respondents reckoned that unemployment was higher today than in 1993. The unemployment print for December 1993 was 6.6% vs 3.7% today, and the rate was never below 4% during the whole decade – indeed it was above 5% more most of it. Given that the Federal Reserve will be looking at such anomalies, it makes for an interesting job in terms of managing monetary policy. It also highlights the difficult task that Joe Biden has in convincing the US electorate that he is the right man to occupy the White House for another four years. It could also help to explain why US consumers continue to spend

so much despite appearing to be so miserable, at least in terms of consumer confidence surveys. Let's just say this is the most challenging economic cycle that most of us have ever experienced given the lingering effects of Covid and the massive fiscal and monetary response, not to mention geopolitical issues ranging from trade wars to ground wars.

UK

Chancellor Jeremy Hunt presented his Autumn Statement to Parliament in November under much more calm circumstances than a year earlier when his debut in the role came in the aftermath of the disastrous Truss/Kwarteng "mini" budget. Even so, he had limited room for manoeuvre. October's fiscal deficit came in a little higher than expected owing to the increasing cost of servicing the country's debts, but that damage was limited by higher-than-forecast tax revenues. One positive fiscal side-effect of higher inflation is that nominal profits and wages tend to rise too, leading to higher nominal tax payments. The benefit to the government has been amplified by last year's decision to freeze income tax bands, meaning that more people have been dragged into a higher tax bracket, so called "fiscal drag". We would observe that the key initiatives fell into two categories: what's good for the long-term health of the economy; and what grabs votes. In the first bucket came a commitment to extend and make permanent the £9bn-a-year tax break for business. It is directed at spending on IT equipment, plant and machinery and allows for immediate deductibility against taxable profits. We applaud such a pledge. One of the greatest weaknesses of the UK economy in recent years has been the lack of productivity growth. That has been blamed variously on the extended fallout from the financial crisis to the effects of Brexit and the chaos within government, all of which, no doubt, have contributed. This tax break is intended to kick start the much-needed investment in the country's technology capital stock. Crucially, if it is, as currently intended, a permanent feature of the fiscal landscape, it will encourage companies to take a longer-term view of their investments in this key sector. On the more voter-friendly personal taxation front, the Chancellor opted for a reduction of 2% in the rate of National Insurance paid by employees which used up pretty much all his existing fiscal headroom. Nevertheless, it is already being suggested that an income tax reduction will be announced during the March Budget. Market reaction was limited. This is probably a good thing, as markets have tended to react negatively in recent times to fiscal developments.

Europe

The day after a former MP delivered a speech to an assembly of investors declaring that populist politics was in retreat in Europe, Geert Wilders' Party for Freedom gained the highest number of seats in Dutch Parliamentary elections, although far from a majority. We await the outcome of what could be protracted negotiations over a coalition government – it took 208 days in 2017. Recent regional gains for the right-wing AfD party in Germany are another sign of rising discontent (again) on the Continent. Even so, and much against the expectations of many, Giorgia Meloni's far-right (in the eyes of some observers) regime in Italy has so far governed with a reasonable degree of responsibility, a fact that has been recognised in the shrinking interest rate premium of Italian bonds over German Bunds. And yet we also recognise that voting for change can deliver unexpected and disruptive consequences. For now, the electoral calendar in Europe threatens limited risks to investors, but it is as well to monitor popular sentiment and how it will respond to management of the economy.

Emerging Markets

China remains firmly in the doghouse from an investment perspective. Much of the pain stems from the ongoing unwinding of years of excess in the property sector. The developers are encumbered with liabilities greater than their assets; individual homeowners, many of whom are reliant upon house price appreciation for their investment returns, are faced with stagnant prices at best. Financials and Real Estate account for 70% of the market capitalisation of the Hong Kong stock market, which is the home of many Chinese companies via their H-share listings. As one might imagine, it is struggling this year, having fallen 14%. The Real Estate sector is -33%. It is hard to see a durable recovery without the real estate sector's mess being cleaned up, despite the fact that shares in the region are ostensibly cheap.

Fixed Income

The Bloomberg Global Aggregate Dollar Index of investment grade bonds has finally broken into positive return territory for the year, increasing the prospect of avoiding a third year of negative total returns (unprecedented since its inception in 1990). We continue to emphasise the fact that selected short-dated Gilts offer risk-free yields of close to 5% with tax benefits even when not held within tax-exempt wrappers such as SIPPs or ISAs. Low coupons mean that the taxable income is negligible. But the “pull to par” on maturity delivers a tax-free capital gain. They remain an attractive home for surplus cash savings, especially for higher rate taxpayers.

UK Gilts have delivered a total return of +1.6% over the last three months and -5.7% over the last year. Index-Linked Gilts returned -1.25% and -10.6% over the same respective periods. Emerging Market sovereign bonds produced a total return of +1.44% in sterling over the three months to end October (+4.07% over 12m). Global High Yield bonds delivered +2.4% (+8.4% over 12m) in sterling.

Conclusion and Outlook

Patience finally paid off in November, although investors might yet need more of it to see them through the final stages of the current economic and interest rate cycles. In homage to the recently departed Charlie Munger, the long-time associate of legendary investor Warren Buffett, it seems a fitting time to include one of the many investment-focused aphorisms attributed to him. And while our periods of waiting for better opportunities do not extend to the lengths that he was able to tolerate while running a business, the mindset is a useful one to have during periods when markets are uncertain and volatile: “You have to be very patient, you have to wait until something comes along, which, at the price you’re paying, is easy. That’s contrary to human nature, just to sit there all day long doing nothing, waiting. It's easy for us, we have lots of other things to do. But for an ordinary person, can you imagine just sitting for five years doing nothing? You don’t feel active, you don’t feel useful, so you do something stupid.”

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