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Knife-Edges

John Wyn-Evans
Head of Investment Strategy

The last Weekly Digest I wrote was at the end of July, and since then, an awful lot of water has flowed under the bridge. I covered a lot of that in the latest Monthly Commentaries, but it's worth a quick recap. In a nutshell, investors first started to question the returns likely to be generated on the huge amount of capital expenditure related to generative artificial intelligence (AI), which undermined the leadership of mega-cap technology stocks. Although there were initial signs of a healthy rotation into other areas of the market, this was cut short by increasing concerns over a slowdown in the US economy (on which the jury remains out, and more later). The situation was exacerbated by an unexpectedly large increase in Japanese interest rates which forced a reversal of the "yen carry trade". A persistently weak Chinese economy is offering no counterbalance and Europe is also only firing on one cylinder. And although there is a general expectation that central banks will provide a monetary safety net if required, which helped to trigger a strong risk asset rally in the last three weeks of August, there is a

lingering lack of confidence in what happens next. This carried over into a poor first week of September, which, statistically, is the weakest month of the year for stock market returns.

It feels as though the fate of financial markets rests squarely on the US economy at the moment. With China's recovery still failing to gain traction, Europe barely in positive growth territory and the UK, sadly, too small to make a difference (although we are doing relatively better than most), the global economy needs the US to keep towing it along.

On the face of it, things don't look too bad. US consumption grew at an annualised pace of 2.9% in the second quarter and the consensus forecast for GDP growth this year is 2.5%, with 1.7% for 2025. The number of people in work continues to rise, even if the unemployment rate has ticked up, mainly owing to more people entering the workforce (notably a lot of immigrants as well as a few people reversing their retirement plans).

But some of the heat has come out of the job market, with fewer new jobs available. There is a very persuasive school of thought that all of the current slack in the labour market has been taken up by companies reducing new employment and that it is only a matter of time before this shifts to reducing employment (i.e. laying people off). Indeed, on average going back to 1945, new jobs have continued to be created right up until a recession started, and so payroll data and the unemployment rate appear to have limited predictive powers.

Data is still under the influence of the Covid pandemic. The latest revisions to US payroll growth saw 818,000 jobs evaporate as the Bureau of Labor Statistics adjusted for the number of companies formed and dissolved (the Birth-Death model). That doesn't necessarily change reported GDP or the profits already generated by companies, but it raises some concern that the Federal Reserve has held interest rates too high for too long. Economists also continue to grapple with the concept of "excess savings", the extra savings piled up by households during the pandemic which have since been released and which contributed to the strong recovery and the inflation that accompanied it. Are they all spent or not? And even if the current savings rate is low, is that just a function of retiring baby boomers running down their nest eggs? Add to that the fact that the US government is running what should be an unsustainable fiscal deficit that amounts to 7% of GDP, then this remains a very tricky cycle to call.

Still, we can't just ignore it. Our central view is that there will not be a US recession, but neither one is completely off the cards. Our subjective probability of one developing is 30%, based on analysis of the data and proprietary models, but there is no 100% reliable predictive tool, whether it be the shape of the yield curve or the Sahm Rule, which plots the pace of the increase in the unemployment rate relative to past cycles.

Some solace lies in the fact that inflation does appear to be receding (although prices are still going up), which allows central banks a freer hand to cut interest rates as appropriate. Even then, though, past data for what happens to the stock market after the cutting cycle begins is highly dependent upon the central banks' motives. In the event that the Federal Reserve is cutting rates proactively in response to benign inflation, the 12-month forward returns are positive on average. But if the cuts are reactive to a weak economy the returns tend to be negative. And so, you can see that the fate of the US economy is crucial now.

There have been two particular instances in recent times when cutting rates really was no more effective than pushing on a string. The first was in 2001 and the second in 2007. Both cycles were associated with huge excesses, those being the Telecom, Media & Technology boom that ran over the turn of the millennium and then the real estate bubble that sowed the seeds for the Global Financial Crisis. Such excesses are not apparent to us in western economies today, even accounting for the concerns about AI-related capex. If they are apparent, they are in China as a result of its epic real estate boom (and now bust).

That all leaves us relatively neutral on risk but with a continued preference for higher quality equities and a recommendation to overweight government bonds as insurance against a recession. One notable shift this year has been the return to negative price correlation between equities and bonds. This has been enabled by the fall in inflation and appears set to continue unless we run into some sort of inflation scare. Even so, we would be wary about being lulled into the sort of "set and forget" 60:40 equity/bond portfolio which served investors so well for the two decades before 2022 when the world was enjoying structurally and cyclically low inflation. Forces have been unleashed in the last few years, ranging from (geo)politics to climate change, which suggest a more volatile inflation environment lies ahead of us. We expect to have to be more agile in our choice of assets to diversify equity risk in future.

If the US economy appears to be balancing on a knife-edge, so does the outcome of the US Presidential election, where the result could come down to just the odd district in two or three states. I will be coming back to this subject in more detail, especially after the second Presidential debate which takes place this week (even if the two candidates are not the same as they were for the first one!). Suffice to say that for now the US provides a perfect example of the current trend of polarisation in politics, and that victory for one side or the other could have very different implications for financial assets, at least in the short term. Longer term data suggest minimal difference between the average returns generated for investors under Republican or Democrat leadership. We are not expressing a strong view either way in portfolios today.

Finally, a couple of quick observations from my summer holidays. The first concerns the weather, or possibly more accurately, climate. In Canada I experienced a biblical rainstorm which raised the water level in our lake by two feet and even opened a sink hole in the garden. It was described locally as a "once in a hundred years" storm. However, that assertion disregarded the fact that there had been another "once in a hundred years" downpour only two months earlier in June! I am of the belief that there are material changes in the climate unfolding and that they will require large amounts of mitigation and adaptation as well as measures to help reverse them (although I also think that the current momentum means that things will inevitably get worse before they get better). There are necessary costs involved and they will divert funds from other investment. There will be all sorts of disruption to supply chains. These are potentially inflationary factors. And much as I was happy to make my contribution to Canadian GDP by ordering a few tons of gravel to fill in the sink hole, I'm not exactly sure it is the sort of productivity-enhancing investment they would prefer!

The second observation comes from reading Ben Macintyre's excellent history of Colditz Castle during World War II. For any Brit of a certain age, the exploits of British prisoners of war in Colditz are the stuff of legend, captured in books, films, a BBC series and even a board game. I mentioned it to a friend of mine of a similar age who was born and brought up in Germany and he looked at me blankly and said he had never even heard of it! (And it's fair to say that, when challenged by my editor, I could not name any camps for captive Germans in the UK either) It's just a reminder of something that I have observed in the past (with reference to the opposing supporters at football matches) that perceptions of events and even the emphasis of recorded history can be very different depending upon which side you are on. That's worth remembering in these politically divisive times.

Economic Commentary

FTSE 100 weekly winners

Rightmove plc	17.7%
British Land Company PLC	7.5%
Severn Trent Plc	5.4%
United Utilities Group PLC	4.8%
SSE plc	4.6%
Land Securities Group PLC	4.4%
Reckitt Benckiser Group plc	3.9%

FTSE 100 weekly losers

Antofagasta plc	-11.6%
Associated British Foods plc	-11.5%
Burberry Group plc	-9.5%
Glencore plc	-8.4%
Anglo American plc	-8.4%
Rolls-Royce Holdings plc	-6.8%
Pershing Square Holdings, Ltd. Public Class USD Accum.Shs	-6.5%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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