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Here We Go Again

John Wyn-Evans
Head of Investment Strategy

In the last Weekly Digest of 2023, I looked back at some of the highlights of the year. To get my brain into gear for the first one of 2024, I returned to what I wrote a year ago, and, once of you have read this, there might be a sense of déjà-vu. It's remarkable how similar the main themes are, with the US economic, interest rate and earnings outlook still dominating the conversation, alongside perpetual concerns about the state of the UK and European economies. The recovery potential for China's economy continues to be widely debated. Last

year's financial "exogenous shock" risk emanated from a potential shortage of natural gas; this year's relates to shipping disruption in the Red Sea.

Perhaps the main difference is that the opening salvo of 2023 contained no mention of politics. That subject will be very hard to avoid this year, especially in terms of the US Presidential election in November and a highly probable UK General Election. Some commentary suggests that more people in the world will be voting this year than ever before.

I am going to stick my neck out early and say that the result of the UK election could be one of the least impactful (barring some short term uncertainty in the event of a hung Parliament, which is not currently suggested by the opinion polls). For all the tribalism and polarisation on view in global politics today, the main parties facing off in the UK are virtually indistinguishable compared to rivals elsewhere, and it's not as though the winner is going to be blessed with either the economic or fiscal strength to implement radical change. Yes, there will be dramatic headlines and the usual media hype, but, from a financial market perspective, it will probably be something of a non-event for which we should be grateful!

Equity markets came out of the blocks quickly in 2023, with the MSCI All-Countries World Index gaining around 9% by early February. There was an element of "flattering to deceive" in that, because it failed to break sustainably beyond that level until early November. Even so, proponents of the "January Effect", which maintains that markets tend to follow the path of the first month for the full year, could still claim victory, with the index ending the year +20%.

Bearing that in mind, the first couple of weeks of 2024 have been lacklustre. The majority of major indices are around or slightly below their end-December levels, taking a breather after a very strong run during the last nine weeks of 2023. Short positions have been well squeezed, momentum-driven funds have filled their boots and retail investors have swung from maximum bearishness to close to maximum bullishness.

The main influence so far this year has come from the bond and interest rate markets. The final bout of euphoria in December was triggered by the Federal Reserve's meeting in which it acknowledged the peak in the interest rate cycle and opened the door to cutting rates in 2024. This sent the 10-year Treasury yield to a low of 3.79%, which is remarkable when one considers that it brushed 5% in mid-October. The expectation for the level of the Federal Funds (base) rate also tumbled, with the December 2024 projection falling from 4.8% to a current 3.7%.

Given that the current effective Fed Funds rate is 5.33%, that implies six-and-a-half 25 basis point cuts this year, and, as I have commented before, this looks a bit aggressive without further weakness in the economy. Of course, the conspiracy theorists are out in force, claiming that the Fed is going to cut rates at the behest of the Biden administration to help him get re-elected as President. And because the Fed cannot be seen to be doing much as we get closer to the election, it will "go early and go big". I guess anything is possible. But the New Year hangover does suggest some scepticism creeping in, and this has been reflected in the probability of the first cut coming as soon as March being reined back from close to 100% to around 70%. The 10-year Treasury yield has backed up to 3.94%.

There is also a glut of supply to reckon with. The US Treasury will have to issue around $8 trillion of new paper this year. Even allowing for the replacement of maturing debt, that means over a trillion dollars' worth of net new supply. Remember, it was the prospect of such a wall of issuance that so upset bond investors in October. The Treasury managed that risk quite astutely by issuing more short-dated Treasury Bills than expected to mop up cash during the final quarter of the year, but that could be a harder trick to pull off a second time, and certainly not in perpetuity.

As for interest rate futures markets, they are notoriously poor predictive tools. At the beginning of 2022, the futures curve suggested that US interest rates would be around 1% today. It predicted much the same for the Bank of England Base Rate (now 5.25%), and, even more remarkably, had European rates still in negative territory (now 4%). Our current feeling is that markets will have to give back some of that rates optimism in the short term if economic data and corporate earnings remain resilient. That's not an outcome to worry about by any means, but it does mean having to exercise a degree of patience regarding further capital appreciation.

The "failure to relaunch" of China's economy was a feature of 2023, especially given the burst of optimism that followed October 2022's National Party Congress, at which President Xi confirmed his third term in office, and the subsequent abolition of its "zero-Covid" policy, following which the MSCI China Index rose an incredible 59% to its January 2023 peak. It has fallen 29% since then and sentiment is as weak as ever. I mentioned four companies with strong links to China's economy that had rallied aggressively, but they have really struggled since. From a year ago, they are UK-listed Burberry (-42%) and Prudential (-37%) and French Luxury Goods giant LVMH (-14%). The only one to buck the trend was HSBC (+10%), which benefitted from higher interest rates and a steepening yield curve.

That big squeeze in China's equity market is indicative of what can happen should sentiment shift for the better, but there is no sign of that happening today. The economy continues to labour under the shadow of the deleveraging of the real estate sector and the demographic headwind of a rapidly ageing population. The government appears to be in no hurry to apply stimulus.

I should mention that this weekend's election in Taiwan was seen as a potential geopolitical flashpoint. So far, so calm. The ruling Democratic Progressive party prevailed, as expected, but with a reduced share of the vote and the loss of its legislative majority. China, which has ambitions to reintegrate Taiwan, has declared its satisfaction that the DPP (which supports independence) no longer represents the majority of voters. That would seem to reduce any threat of conflict in the shorter term, although this is a situation that remains far from resolved.

A good get-out clause for any strategist who wishes not to offer hostages to fortune is to maintain that "market outcomes are path dependent". And, at the risk of appearing cowardly, I am going to offer that now. The important thing in terms of managing balanced portfolios is that we assess the probability of various possible outcomes and then construct the portfolios accordingly. There are times to swing the bat hard when valuations and market drivers such as interest rates and corporate profits align favourably. This does not look like such a moment to us, at least in terms of moving our tactical asset allocation far from the benchmark. But that still means one should remain fully invested in accordance with one's risk tolerance. Not taking a strong view does not mean hiding in cash. And, as we saw towards the end of last year, markets can move very quickly and return much more than years' worth of interest in just a few weeks when they get the bit between their teeth.

Question of the week:

Last week's question: Who sailed Gipsy Moth IV single-handed around the world in 1966/7?
Sir Francis Chichester

This week's question: Which member of the Cabinet is currently MP for Chichester?

Economic Commentary

This Week's Forthcoming Events

US	Empire State Index SA
US	Export Price Index NSA M/M
US	Import Price Index NSA M/M
US	Industrial Production SA M/M
US	Business Inventories SA M/M
US	Housing Starts SAAR
UK	ILO Unemployment Rate 3-M
UK	CPI Core NSA Y/Y
UK	CPI EU Harmonized NSA Y/Y
UK	PPI Output NSA Y/Y
EU	CPI EU Harmonized Y/Y (Final)
EU	Industrial Production SA M/M

UK – Monthly GDP figures from the UK for November revealed that activity fully reversed its October fall in November, recording a 0.3% month-on-month increase in output. Even so, it remains touch-and-go whether the economy tipped into a technical recession in the second half of 2023: assuming no revisions to back data, any monthly rise in output in December would prevent this, but any decline would bring it about. Even so, recession is an emotive word and even if one is confirmed, it will have been as mild as they come. Output gains were broad-based among the major sectors. Services saw a 0.4% gain. Strong volume growth in retail spending in November, on the back of substantial discounting around Black Friday, played a role. A further factor was the reduced level of industrial action compared with previous months; there were fewer strikes in the health sector (notably, there were no NHS strikes after the double whammy of junior and senior doctors in October), transport (rail and bus) and TV and film production. Industrial production posted a 0.3% rise, with manufacturing +0.4% following four consecutive monthly declines. Construction contracted a little (-0.2%), seemingly affected by stormy weather.

US – The largest event of last week was the release of the US December Consumer Price Index data, which broadly came in line with expectations. On the headline front, the annual CPI came in at 3.4%, against a consensus forecast figure of 3.2% and a print of 3.1% in the previous month. Looking at the core CPI figure, the print came in at 3.9%, again slightly ahead of the consensus figure of 3.8% but below the previous month's print of 4%. Fed officials highlight the importance of the so call "super core" inflation print, which measures service sector prices excluding housing, with the figure at 0.4% month-on-month, the same as the previous month and 3.9% higher on an annualised basis. Alongside the inflation data, US weekly jobs data also came out, with the initial jobless claims at 202K against a consensus figure of 210K. US employment remains very resilient, although the number of jobs on offer continues to decline steadily, which is a factor worth keeping an eye on.

Europe – Eurozone rate cut expectations were tempered by robust labour market data, during the past week. Unemployment in the bloc declined to 6.4%, marking an all-time low in unemployment since the creation of the single currency. Although the Eurozone economy continues to bump along, with growth hovering around 0%, the labour market has been tight. For now, this shows little sign of weakening, as shown in Germany's unemployment levels, which would be as low as 2.9% of the working population, based on a comparable measurement basis as used for US data. A tight labour market highlights ongoing risks to wage inflation, and, in this context, Isabel Schnabel made comments suggesting that the European Central Bank only sees a modest decline in wages as likely in 2024. These comments were taken in a relatively hawkish light in comparison to her comments prior to Christmas, which had been quick to emphasise the progress in bringing inflation down during the fourth quarter last year. Consequently, enthusiasm for a rate cut in March has cooled. Thanks to not registering two consecutive negative quarters, Germany managed to avoid a technical recession even though its economy shrank by 0.3% during 2023 from 2022 levels.

China – The latest inflation data showed consumer prices falling 0.3% year-on-year. Although economic weakness is a contributor, the main driver remains falling pork prices as past supply shortages are alleviated. That should put more money into consumers' pockets. A pickup in Exports (+3.8% year-on-year) is a welcome sign of potential recovery and it might have been helped by the fact that a lot of customers have finally dealt with surplus inventory. The latest figures for total lending to the economy (growth of close to 40% from a year ago in terms of the amount lent) also suggest potential for future economic growth. The one lever that the government is still not pulling is monetary policy. The 1-year lending rate was held at 2.5% this week when the market was expecting a 0.1% cut. We know that the government is concerned about squeezing banks' net interest margins even lower, but they will probably have no choice but to cut rates if GDP growth does not pick up soon.

Economic Commentary

FTSE 100 weekly winners

Company	Change
Melrose Industries PLC	4.8%
B&M European Value Retail SA	4.1%
RELX PLC	4.1%
Halma plc	3.9%
Hikma Pharmaceuticals Plc	3.8%
Pershing Square Holdings, Ltd. Public Class USD Accum.Shs	3.4%
Just Eat Takeaway.com N.V.	3.4%

FTSE 100 weekly losers

Company	Change
Ocado Group PLC	-9.6%
International Distributions Services plc	-7.6%
J Sainsbury plc	-7.2%
Burberry Group plc	-6.7%
Barclays PLC	-6.5%
Standard Chartered PLC	-5.8%
Standard Life Aberdeen	-5.4%

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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