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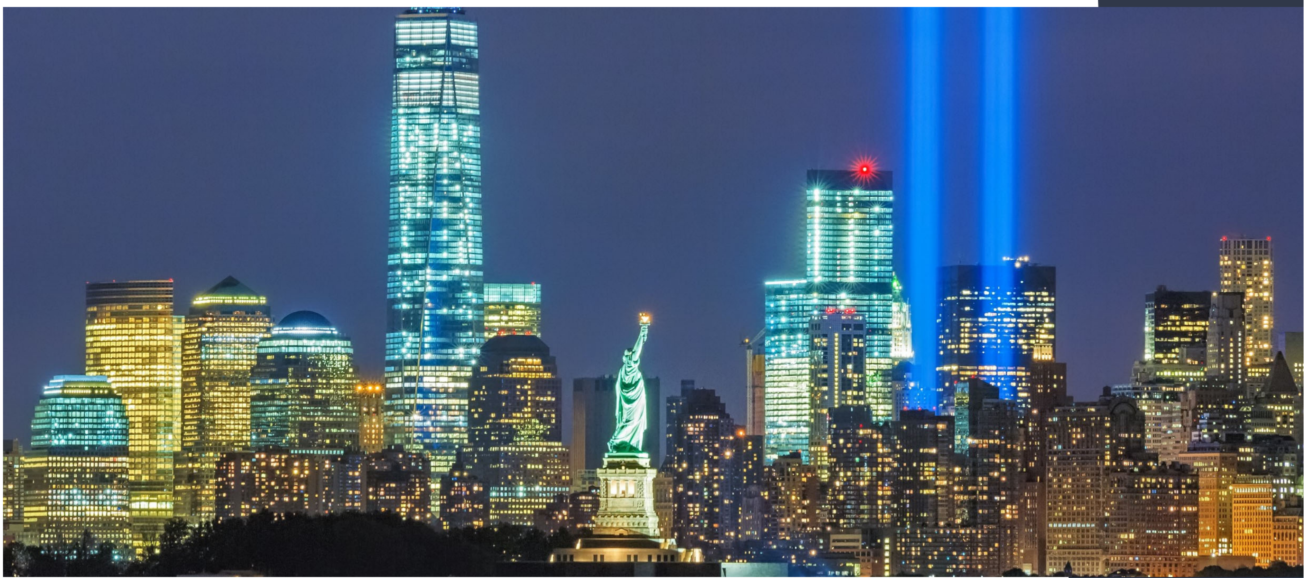
WEEKLY DIGEST | 17 September 2024

The Cycle Turns



John Wyn-Evans

Head of Investment Strategy

Sunday, 15 September was the sixteenth anniversary of the bankruptcy of Lehman Brothers, which just so happens to be where I was working at the time. I can recall the day very clearly, as well as the build up to it and the aftermath. Even so, it's hard to recreate the feeling of doom that enveloped the financial industry at the time, and I would not believe anyone who now claims to have predicted the extent to which financial wealth has been created since.

Sixteen years also elapsed between the end of the second world war and my arrival in the world. Given my recollections of 2008, just imagine how the events of 1945 and the preceding years would still have been imprinted on the minds of those who experienced them, not to mention the more recent years of deprivation which followed. I certainly did not appreciate that when growing up. The trouble is, the further we get away from such influential events, the more the collective or institutional memory of them fades. Is there any wonder that politics and markets are cyclical in their nature?

One important cycle that looks set to begin this week is the US Federal Reserve's (Fed) interest rate cutting cycle. Indeed, it's not a question of "if" but by "how much" the Fed Funds rate will be cut. A minimum of 0.25% is a racing certainty according to futures market pricing and it's edging towards 0.5% thanks to various "dovish" comments from Fed members and also what appears to be a timely hint to the Wall Street Journal at the end of last week. The Fed's ultimate decision, due to be published at 7pm UK time on Wednesday, along with the statement and commentary from the Chairman, should send important signals about the Fed's outlook for both employment and inflation, the key drivers of its policy.

Not all rate cutting cycles are alike. Much depends on the "why?". As I mentioned last week, cutting because you can is much better for markets than because you have to. A lot will also depend upon what other imbalances need to be corrected in the economy or financial markets. I cited the US rate cutting cycles which began in December 2000 and September 2007 as instances when, to borrow the phrase attributed to the economist John Maynard Keynes, the effect was no better than "pushing on a string".

But when I looked at them in more detail, I noticed that the initial reaction to the first interest rate cut was positive. There was a 7% bounce for the S&P 500 Index running into January 2001 and a 6% recovery in autumn 2007. These look like knee-jerk, business-as-usual reactions and an expectation that things would turn out positively, as they did when the Fed cut rates in 1995 and 1998. They certainly did not take into account the structural issues leading to the full-on Tech Bust in 2001/02 and the Global Financial Crisis in 2008/09. Nor could they have foreseen the destruction of the World Trade Center in September 2001, another event that I recall watching play out with increasing disbelief. And even had investors fully foreseen the problems that lay ahead of Lehman Brothers, they would not necessarily have predicted the financial authorities' mistake in allowing Lehman to go bankrupt in the way they did and the liquidity crisis that the event created.

But, as we keep saying, we don't think the current situation is analogous to 2000 or 2007. Yes, there is some sort of slowdown in train, but not a major drop in activity. There has not been excessive growth in bank lending and, for all the impressive gains in stock markets, the speculative behaviour just does not remind me of the madness of the Tech Boom that preceded the bust. If there was any similar period, it was with the boom in unprofitable "stay at home" stocks during the pandemic and then the explosion of "meme stocks" in early 2021. But these bubbles have been well and truly popped already.

What about other recent interest rate cutting cycles? In a perfect world, one would hope that we are replaying either 1995 or 2019. In both cases the Fed had successfully engineered a mid-cycle slowdown to take some heat out of the economy and inflation without crash landing. And as is the case today, the first rate cuts were made with equity markets already at all-time highs, somewhat in anticipations of the cuts. The rate increases of 1994, from 3% to 6%, had held equities in check for a year, but the worst drawdown was around 9%, which is about what you might expect on average in any single year. By the time of the first cut in June 1995, the S&P 500 was already +19% for the year-to-date and making new highs regularly. It ended the year +34%, to be followed by +20% in 1996 and +32% in 1997. Oh, how we would all like to see that replayed now!

The next “mid-cycle” cut following a period of tightening came in 2019. The initial reaction was a 5% sell-off (the sort of “travel and arrive” behaviour that investors often display) but the S&P 500 was +13% overall by the time the Covid pandemic hit the following year. If this does turn out to be a mid-cycle slowdown and the Fed does end up having threaded the needle perfectly, it looks as though further gains are ahead of us, at least based on past experience.

What if the outturn is a recession, albeit a shallow one rather than some sort of structural bust or crisis, as in 2000 and 2007? Unsurprisingly, history suggests a rather worse performance from equities, with the rate cutting cycle beginning in 1989 being the most recent example, which seems like a remarkably long time ago, but I distinctly remember that one too. Again, we will look at this through the lens of the US market, rather than the UK (which was adversely affected by joining the European Exchange Rate Mechanism in 1991), Europe (German reunification) or even Japan (which was just about to hit the top of its epic 1980s boom, from which the Nikkei Index has only recently fully recovered after thirty-four years!).

Inflation was creeping up in the US in the late 1980s and the Fed was highly aware of the risk of a rerun of the 1970s (which, again, would have been very fresh in the mind of policymakers). The Fed Funds rate had bottomed in 1986 at 6% and (apart from a small reversal in 1987 to respond to the stock market crash in October of that year) rose inexorably to 9.75% in early 1989. Again, the initial response to the first cut in May 1989 was positive, with equities rising 12% by October, but then the “long and variable” lagged effects of past rate increases kicked in, notably exacerbating the Savings & Loans crisis, with equities going nowhere for the best part of two years, including a near-20% drawdown along the way. A couple of years ago this looked to me as though it would be the result of the higher rates cycle which kicked off in 2022, and although there was a sharp drawdown in the equity market, that is itself becoming a distant memory. Of course, there has still been no US recession as there was between July 1990 and March 1991.

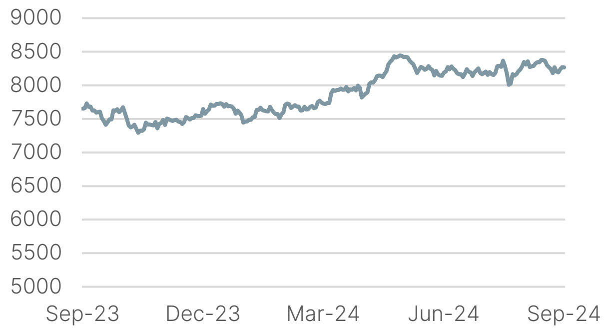
Which brings us to the unsatisfactory conclusion that in this forthcoming rate-cutting cycle, one can’t simply look back at past cycles and draw easy conclusions, at least not without a view on the probability of a recession still developing. We would still be inclined to rule out the sort of structural disasters of 2001 and 2008 and so the choice is between a shallow recession and a mid-cycle slowdown. Our central view is based on a 30% US recession probability, and so we are definitely leaning towards the more benign slowdown. That being the case, we would certainly remain fully invested at the current time, although retaining some insurance (mainly in the form of government bonds and higher quality equities) against something worse developing.

Economic Commentary

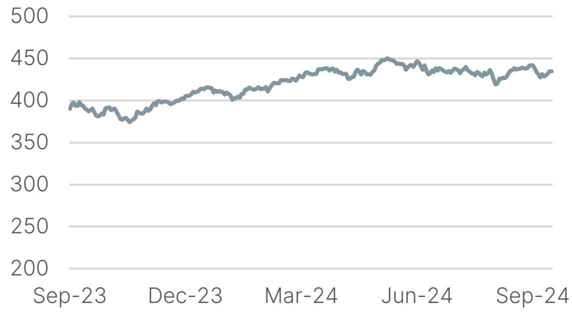
FTSE 100 weekly winners	
Entain PLC	14.9%
Intermediate Capital Group plc	11.8%
Fresnillo PLC	11.7%
JD Sports Fashion Plc	11.5%
Rolls-Royce Holdings plc	8.3%
Antofagasta plc	6.9%
Weir Group PLC	6.6%

FTSE 100 weekly losers	
Rentokil Initial plc	-19.1%
AstraZeneca PLC	-5.7%
J Sainsbury plc	-2.2%
Burberry Group plc	-2.0%
Ocado Group PLC	-1.5%
GSK plc	-1.1%
Pearson PLC	-1.0%

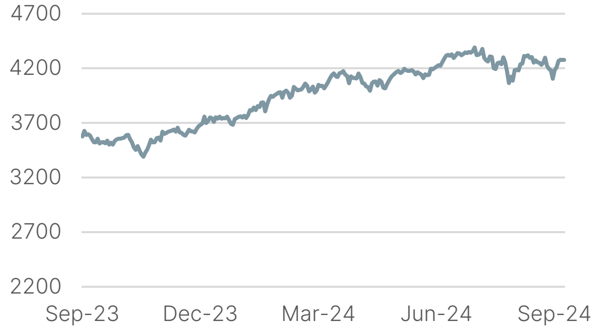
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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