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All's Well That Ends OK

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Sometimes, it's the things that don't happen that have the greatest influence on financial markets. If investors are positioned for certain outcomes, then those positions have to be reversed; if sentiment is extreme, it has to be subdued. This usually happens on several occasions during most years, and recently since the end of October, as we shall discuss in more detail later, but tends to get highlighted when reviewing performance over a calendar year.

If we cast our minds back twelve months, there are a few expectations from that time which stand out in my mind, none of which came to pass. The most glaring example was the almost unanimous call for an economic recession to develop in the United States during 2023. While it is not beyond the bounds of possibility that one might just have started and will only be confirmed in retrospect, that still appears highly improbable. Bloomberg's proprietary recession indicator was predicting a US recession within twelve months with a 100% probability. Why did we, as an industry, get it so wrong? I would point to two factors in particular, although these are by no means going to be the only ones when the financial history books are written: first is the aftermath of Covid, and what that has meant for supply chains, savings and spending habits, and fiscal policy, to name but a few; then there is the extent to which both companies and households termed out their debt at historically low interest rates in 2020, 2021 and 2022, thus dampening the effects of monetary policy tightening. Indeed, those with high cash balances are enjoying the returns offered by higher interest rates.

Here in the UK, no less an authority than the Bank of England was predicting a deep recession that would last for five quarters. Although the UK has not entered a technical recession (usually defined as two consecutive quarters of falling GDP), neither has it grown. Now that we have monthly GDP data in the UK, we can observe an economy that has spent the year consistently having a positive month followed by a negative month. But expectations were so poor that some of the best performing shares this year have been those reliant on a healthy consumer, with many retailers and travel companies trading at or close to their highs.

In Europe, the greatest fear at the end of 2022 was that the continent would run out of energy, after having natural gas supplies cut from Russia. This was another bullet dodged, thanks to the combination of a relatively warm winter, a shift in demand patterns and a concerted effort to secure alternative supplies. Matters look a lot better this year owing to storage facilities bursting at the seams, although a pessimist might point out that a prolonged cold snap could yet test the system, something which is not in the price.

These are all examples of potential negative outcomes that didn't occur. However, there was one widely expected positive development that failed to play out, namely the recovery of China's economy. The Chinese government's abrupt pivot away from its unpopular "zero Covid" policy in late 2022 promised a big "re-opening" of trade in 2023, especially if, again as expected, it was going to be accompanied by stimulus measures. And while there was some evidence of an initial spending spree, which helped French Luxury Goods company LVMH to become for a while the largest company in Europe by market capitalisation, the euphoria did not last. President Xi appears to be concerned about rekindling the flames of speculation in financial and real estate markets, and the real estate market itself remains encumbered by the enormous debts taken on by developers. Lacklustre property and stock markets have not helped consumer confidence, and those consumers are still bearing the scars of being effectively locked up for the better part of two years.

Of course, there were some other things that did occur which were not really on investors' radars at the start of this year. Perhaps the most influential, at least from a stock market perspective, was the breakthrough to the public conscience of what is broadly termed Artificial Intelligence. The launch of services such as Chat-GPT opened the door, but everyone rushed through it on the famous day in May when chip-designer Nvidia reported its exceptional first quarter results and upgraded future guidance. Indeed, you could say that it "blew the doors off" completely. It is still not clear exactly what the effects will be, either in terms of being beneficial to productivity or in terms of societal change (with the more gloomy predictions being about job losses, bad actors and even the end of civilisation as we know it), but we are minded to take the positive path. We suspect that all sorts of future applications for AI are things that we have not yet even thought about, much as

happened following the launch of the iPhone or, much earlier, broader access to electricity.

Another big development in 2023 has been the widespread launch of appetite suppressing drugs widely referred to by their classification as GLP-1s (glucagon-like peptide 1 agonists, for the technically minded). Developers including Eli Lilly and Novo Nordisk have had storming runs, with the latter replacing LVMH as the biggest company in Europe. Perhaps of greater interest, though, has been the negative effect that this has had on many Consumer Staple companies, the sort whose products (ranging from calorie-packed food to booze) would be consumed less by people taking the drugs. For hedge funds, especially, it seems that for every winner there had to be a loser. We doubt that matters are as clearcut as that.

From a market perspective, then, how did things play out relative to expectations? I noted this time last year that for the first time in the history of Bloomberg's annual poll of investment bank market strategists (dating back to 1998), the average forecast was for a fall in the S&P 500 index in 2023. At the close of play last week it had risen by 23%. Admittedly, the majority of that gain was generated by just a handful of companies, now collectively known as the "Magnificent 7" (Apple, Microsoft, Amazon, Alphabet, Meta, Tesla and Nvidia). These companies are deemed to be the primary beneficiaries of the adoption of AI.

But there has been a sign of market leadership broadening in recent weeks. Sentiment started to shift abruptly at the beginning of November, when investors called time on the punishing bond bear market and started to price in the increasing probability that we had passed the peak in the interest rate cycle. The equal-weighted S&P 500 Index started to outperform the more normally quoted market capitalisation-weighted version, and small-cap shares, always beneficiaries of lower interest rates, started to motor. The Russell 2000 Index of US small and mid-caps went from its fifty-two week low to its fifty-two week high in 48 days, the fastest such move in its history (inception was in 1984). We have also seen a decent recovery in similar types of shares in the UK and Europe as investors anticipate the first interest rate cuts next year from the Bank of England and the European Central Bank.

And it is this change of direction in the interest rate cycle that I would highlight as the key factor today. My most recent webinar was entitled "Patience will be rewarded", and the key point of optimism was that we had judged that interest rates were going no higher: it was now a question of when they would start to fall and then how fast and by how much. Even now, though, there is a degree of uncertainty. Will central banks cut interest rates because they can (owing to inflation heading towards target) or because they have to (as economies do finally stumble into recession)? We remain a little wary because we believe that the effects of higher interest rates are still working their way through the system. But history has also shown us that it's right not to be too negative when interest rates are starting to fall. The main exception to that rule was in the run up to the Great Financial Crisis, but we are sticking to our guns in saying that current circumstances do not suggest a rerun of that event.

In terms of tactical asset allocation, what would I say have been the best decisions this year? Slightly surprisingly, perhaps, the answer is "doing nothing". There have been two occasions when the temptation to reduce equity weightings was high and investor sentiment was extremely poor. The first was when Silicon Valley Bank (and others) went bust in March. Our detailed analysis at the time suggested that this was a problem largely confined to a handful of US regional banks and we also judged that the Federal Reserve and related regulatory institutions would step in to backstop the financial system, which they did.

The second moment came at the end of October, with bond yields soaring. Again, we took the view that positioning had become extreme and that some value was on offer. We were also of the opinion that a trend of falling inflation would persist, allowing central banks some eventual leeway.

In retrospect, it's easy to say that we could have taken on more equity risk, but the key message on both occasions was not to be shaken out of long-term investment positions by short-term stress. I have observed on many occasions in the past that market returns tend to be supernormal in the initial phase of a recovery, and that in the great game of compounding returns, it is very hard to claw one's way back to parity if one misses those early gains. Thus, while the allure of 5% plus cash deposits is strong, one also needs to take into account future reinvestment risk as interest rates fall as well as the opportunity cost of missing out on rallies.

I see that the subtitle of last year's final Weekly Digest was "Reasons to be cheerful". While 2023 has not turned out to be a banner year by any means at the overall balanced portfolio level, neither has it been the disaster that many predicted. Markets, in aggregate, have been going nowhere for two years. That means that we have already worked through a lot of the valuation adjustments that were required to account for a world of higher interest rates and bond yields. The US Federal Reserve is finally happy to admit that the path of interest rates will be downward in 2024, and we suspect the BoE and ECB will not be far behind.

The sell-side community seems to be rather more divided in its opinions heading into 2024. For example, the lowest December 2024 forecast I have seen for the FTSE 100 Index is 6550 (-14% from current levels) while the highest is 8800 (+16%). There is about a 1000 point range for forecasts for the S&P 500 in the US, with top-of-the range forecasts surpassing 5200, which would take us well into all-time high territory. No doubt there will be plenty of fun and games along the way, not least when it comes to the US Presidential election in November.

As always at this time of year, I thank you for your readership and support. I wish you all a restive and restorative festive season. The next publication will be the Monthly Digest on January 9th.

Economic Commentary

FTSE 100 weekly winners

Entain PLC	16.9%
Ocado Group PLC	15.2%
International Distributions Services plc	14.9%
Land Securities Group PLC	10.7%
British Land Company PLC	8.8%
Spirax-Sarco Engineering PLC	8.7%
Ashtead Group plc	7.9%

FTSE 100 weekly losers

B&M European Value Retail SA	-7.9%
Vodafone Group Plc	-6.5%
Auto Trader Group PLC	-5.5%
BT Group plc	-5.4%
Admiral Group plc	-5.2%
Weir Group PLC	-4.6%
Rightmove plc	-4.0%

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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