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Grinding It Out

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Having taken a diversion into the world of "social capital" and auction houses last week, I promised that it would be back to "business as usual" this week, with the focus returning to more market-related matters. Indeed, since the previous week was the Monthly Digest, it is now three weeks since the last market-related Weekly Digest, and there has been plenty going on. Unfortunately, the net result of everything is that greater doubt has crept into investors' minds about how this year is going to play out.

The main drivers of market activity have been company earnings and economic data, which is not unusual. First, the good news. Companies continue to prosper. Starting in the US, where almost 80% of the members of the S&P 500 Index have reported, earnings for the fourth quarter of 2023 are running at +9.6% year-on-year, or +13% if one excludes the Energy sector, which had supernormal earnings in 2022. Eighty per cent of the companies that have reported so far have beaten expectations, and it seems to be reasonably widespread, with more than half of all companies in every sector beating forecasts by an average of 7%. This is important because the US now comprises around 63% of global equity indices, which is a record level.

The strength of the US economy plays a strong part in this resilience. We have seen a number of investment banks and independent forecasters abandoning their recession calls, or at least pushing them out into 2025. The Bloomberg consensus forecast for US GDP growth in 2024 is now 1.6%, and that has risen from a trough of 0.6% last summer. Additionally, companies have been deploying a bit of self-help, as the threat of recession encouraged business leaders to control costs. After all, if the "most anticipated recession in history" arrived and you had taken no evasive action, shareholders would not have looked kindly upon you.

In Europe, we are about halfway through the reporting season and the outcome has been more mixed; even so, the aggregate beat is coming in at around 1%. And just to prove that technology leadership is not confined to the United States, the biggest positive earnings surprises have come from the Technology sector (SAP and ASML were notable winners).

UK Plc is a bit slower out of the blocks, with only around a quarter of companies reporting so far, and so it's harder to reach a firm conclusion. So far, at least, Energy and Financials have been better than expected, whilst, Communications, Consumer Staples and Consumer Discretionary have disappointed. Net net, it seems to add up to around a 1% positive surprise.

Despite the positive earnings momentum, the corporate crystal ball is a bit clouded, and many companies have been rather more circumspect when it comes to giving guidance for the year ahead. They cite the uncertainty over interest rates and the economy (more on which in a moment), the US Presidential election and geopolitical risks (notably current events in the Middle East) as their primary concerns. And although there has been a notable increase in the number of companies citing Generative Artificial Intelligence as the "Next Big Thing", it's not entirely clear how this opportunity is going to be monetised or feed through to productivity gains.

And so, what about economies? It's very much a tale of the United States versus the rest (at least in terms of the main influential economies). The US economy shows no great signs of slowing down appreciably, and government spending remains supportive for now, although there are concerns about how sustainable this can be, given the extent of the federal deficit. "Reshoring" trends continue to boost capital expenditure. Mortgage and corporate debt have been termed out, meaning little risk of a major refinancing cliff at the moment, although this is looming in 2025, especially in sectors such as commercial real estate. Household wealth is at record highs along with the stock market, and the combined $23 trillion sitting in deposit and money market accounts are now earning interest.

But it is also fair to say that (a bit like the future, as the author William Gibson once observed), the bounty is not being evenly distributed. Lower income and wealth demographic groups are feeling more economic pain, and smaller companies, which tend to be more highly leveraged, are lagging behind large cap peers. They both really need interest rates to fall, and that is looking less of a given than it was just a few weeks ago.

At the start of the year, I posed the question; "Will central banks cut interest rates because they can (thanks to lower inflation), or because they have to (owing to weak economic activity)?" While interest rate cuts are still on the cards for this year, the expected date of the first cuts is being pushed out. In the US, a March cut seemed to be a done deal just a few weeks ago, and now it could be June. The Federal Reserve certainly does not have to cut rates because the economy is weak, but the window provided by falling inflation has started to close too. Last week saw upside surprises to both Consumer and Producer Prices and economists are starting to question how quickly inflation can fall from 3% to 2% (which is the Fed's target). Not fast enough for comfort seems to be the conclusion. This is not exactly a disaster if overall growth is resilient, but it reduces the possible boost to valuations from lower rates.

In the UK and Europe, too much growth is definitely not the problem. The UK entered a technical recession in the final quarter of 2023, while the eurozone continued to avoid one only by the skin of its teeth. Neither have we seen the upside inflation surprises. But central bank chiefs remain paranoid about prematurely declaring victory over inflation and would appear to wish to err on the side of caution by keeping rates higher for a bit longer.

China, meanwhile, remains stuck in a rut and with apparently limited will amongst the leadership to apply a big stimulus for fear of reigniting speculative behaviour, especially in the housing market. China reported its second consecutive year of falling population in 2023, and so it is also facing a strong demographic headwind. And then there is the threat of the return of Donald Trump to the White House. His victories in the Iowa caucus and New Hampshire primary triggered further market declines in China as investors feared another round of punitive trade barriers.

Where does this leave us at a market level? Probably having to exercise a little more patience, but far from despondent and still looking for gains in line with earnings growth as well as picking up our dividends (which, in the long run, is what investing is all about).

At the simplest level, the price/earnings ratio is a function of the discount rate and the equity risk premium (or the excess return demanded by investors over some sort of risk free rate). Unfortunately, the former pair do not appear to have a strictly linear relationship and the latter can often only be measured in retrospect. But if one is to expect markets to rise faster than earnings, then we need to see at least one of the following things happen: either a benign reduction in interest rates and bond yields, most probably driven by inflation surprising to the downside, and even better if this is driven by productivity gains; or a further fall in the equity risk premium, although this would be storing up potential trouble if it was driven by investors driving valuations to extreme levels. Neither option looks sufficiently attractive to put a big bet on at the moment.

Economic Commentary

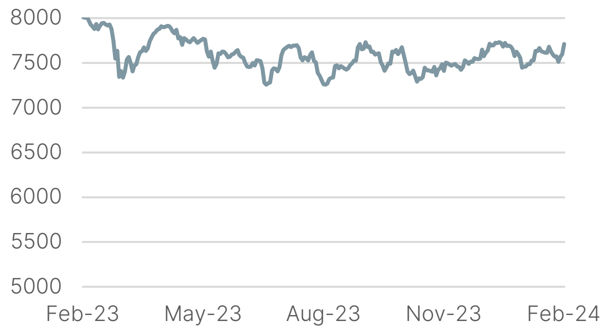
FTSE 100 weekly winners

Coca-Cola HBC AG	12.4%
NatWest Group Plc	8.9%
Antofagasta plc	8.7%
Rentokil Initial plc	7.9%
JD Sports Fashion Plc	7.8%
Anglo American plc	5.8%
Burberry Group plc	5.3%

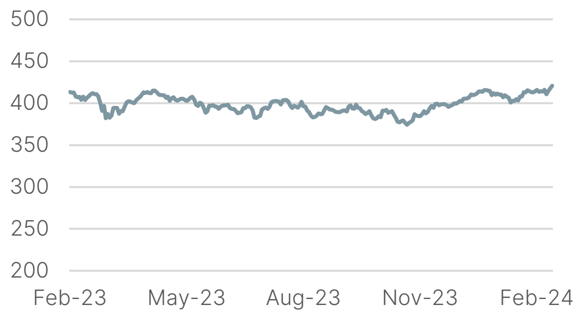
FTSE 100 weekly losers

Entain PLC	-7.6%
Imperial Brands PLC	-2.0%
Barratt Developments PLC	-1.9%
Pershing Square Holdings, Ltd. Public Class USD Accum.Shs	-1.8%
Compass Group PLC	-1.6%
BP p.l.c.	-1.3%
Sage Group plc	-1.1%

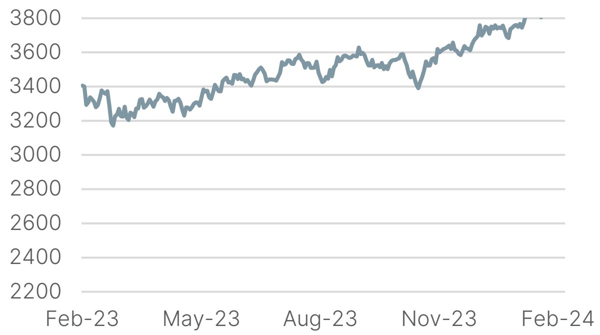
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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