

WEEKLY DIGEST | 26 September 2023

Tactical Turning Points

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They always say that nobody rings a bell at the top of the market; it's something that you can only observe in retrospect. The same goes for troughs too. It can often pay to "leave something on the table" for the next buyer when markets are going up, but that comes with the caveat that bull markets can go on for a lot longer than one might expect and reach dizzying heights. If you're out of the market, the risk is that you never get those lost returns back, even when there is a setback or bear market at some future date.

As for bear markets, they can certainly destroy a lot of equity value, but (empirically) they always come to an end eventually. While individual stocks can go to zero, it's not really sensible to project that sort of outcome for the whole market. The biggest risk might be for leveraged investors who find that their liabilities end up being worth more than their assets. It is possible to ride this situation out as long as your debts or margin are not called in, but that could involve a lot of forbearance on the part of a lender (or regulator). Suffice to say that we do not employ leverage in client portfolios.

All of this suggests that, in the long run, an investor should remain pretty fully invested. Even so, there is always competitive pressure to beat benchmarks and, indeed, competitors. And so, investment managers employ Tactical Asset Allocation (as well as stock picking skills) to attempt to add returns over and above the benchmark (generating "alpha" in investment-speak). We have to be honest and say that, as this relies on a subjective judgement call, it doesn't always work. Indeed, you would rightly be suspicious if it did work all the time and under all market conditions. Nobody has perfect foresight, and the only people who appear to usually turn out to have been cooking the books or employing such risky strategies that they were only ever one small event away from total disaster.

How are equity market conditions now?

Right now, we are not negotiating a peak or a trough in broader equity markets. They rallied from cycle lows last autumn and, despite lots of excitement about a narrow range of US technology leaders, have ended up tracking sideways for most of this year. The MSCI All-Countries World Index (ACWI) is almost exactly where it was at the beginning of February, having kicked off the year with a near-10% gain. The FTSE 100 has gained just 2.5% in 2023.

Our own TAA process is patiently awaiting a better opportunity to increase equity weightings in portfolios, and we have had to be very patient. The last time we recommended increasing the weighting was at the beginning of October last year, right in the middle of the meltdown of the Gilts market triggered by the Truss/Kwarteng mini-Budget. It turned out to be correct to walk into that particular burning building. I commented at the time that we would probably be wrong in some respect, and it turns out our error was in not being even braver, especially as the ACWI is still 20% higher over the period since then, even if it has retreated by around 6% from July's most recent peak.

Like many, we continue to await a broader economic downturn (but not a crash by any means) as the effects of monetary policy tightening feed through. This has happened a lot faster in the UK and Europe, but not so much in the US, which is by far the largest component of the ACWI (62.6%). An inherent "home bias" in portfolios also means that most non-US investors have not fully benefitted from the gains of the "Magnificent Seven" US tech leaders (Apple, Microsoft, Amazon, Alphabet, Nvidia, Tesla, Meta). These seven companies now have a total market capitalisation greater than those of Japan, the UK, China and France combined (these are markets two to five in terms of market cap)!

However, cracks have started to appear in the market recently. There were a few events last week that might, in other times, have propelled equity markets higher. These included the retail release of the newest iPhone; Microsoft announcing the date for rolling out its new AI Co-pilot feature (26th September); Amazon investing up to \$4bn in an AI start-up; another decent sized IPO (Instacart) in the US; and chunky M&A in the US tech sector, with Cisco splashing out \$28bn for the equity of cyber security firm Splunk. But all of this seed fell on stony ground and equities had one of their worst weeks this year.

Central banks press pause

All fingers of blame are pointing at a combination of central banks (mainly the US Federal Reserve) and the bond market (mainly in the form of the US 10-year Treasury yield). Last week was a busy one for central bank announcements. Amongst the smaller ones, Norges Bank (Norway) raised rates by 0.25% against expectations of no change, while the Swiss National Bank held rates flat when the consensus forecast was for a quarter point rise. Following the ECB's "dovish raise" the previous week, the Bank of England delivered a "dovish pause" (which was also a bit of a surprise, and was a split decision, with members of the Monetary Policy Committee voting 5-4 in favour of doing nothing).

But it was the Fed that was central to the story, delivering a "hawkish pause" in the market's judgement. Although there was no change to the Fed Funds rate, the sting in the tail was further commitment to keeping the rate "higher for longer", which was transmitted through both the Dot Plot and comments from chair Powell. The Dots suggest one further quarter point increase before the cycle peaks, but only 50bps of reduction by the end of 2024, which is a good 0.7% above what the futures market is pricing in (even after continuing to reprice higher through the summer).

The key point to take away is that we are in the final throes of the cycle of rising policy rates, and that there is a turning point ahead. This means that investors can now focus more squarely on two other things. First, what will be the lagging effects of past increases, in terms of the dampening effects on both economic activity and inflation; second, how soon will rates be cut and then how fast. The Bank of England's economist, Hugh Pill, has introduced the "Table Mountain" metaphor to describe how he would like the base rate chart to look. This envisages no further spike up in response to surprisingly strong inflation, but also no swingeing cuts in response to an economic collapse. It might even take us back to the pre-financial crisis world of mid-single digit nominal rates and positive real rates, which, dare one say, could constitute some sort of return to normality.

What does this mean for bonds?

There was definitely a turn for the better in the Gilts markets last week, with the yield on the 10-year Gilt falling as low as 4.21% following better-than-expected news on inflation. That's down from an August peak of 4.74%.

Bond holders in the US are not as sanguine. There, the yield on the 10-year Treasury continues to make new highs (4.5%) as it digests the "higher for longer" Fed policy, the risk of a government shutdown if various spending bills are not voted through the Senate, and the burgeoning level of supply to fund the federal deficit. Despite loud calls from a few vocal bears, we remain inclined to believe that interest rates and bond yields are in a topping out process (with no bell!).

A very simple rule of thumb suggests that the 10-year bond yield should settle somewhere close to the growth rate of nominal GDP. If, say, the trend growth rate of US real GDP is between 1.5% and 2%, and inflation could settle between 2% (the Fed's target) and 3% (allowing for some slippage), that would suggest nominal growth in the range of 3.5% to 5%. A yield of 4.5% is heading towards the upper end of the range. The current yield and duration of the 10-year bond also mean that, on a nominal total return basis, the yield would have to rise to around 5.1% for a buyer today to lose money over the next year.

The good news about a peak in rates would be two-fold. First, it would relieve the pressure of the higher cost of money on the real economy. Second, it would put an end to the rise in the discount rate that has been such a headwind for financial asset valuations. Indeed, it is the latter factor that has been the biggest factor behind the poor performance of most equities (and other asset classes such as prime real estate) rather than any slippage in earnings per share.

Finally, and referring back to last week's introduction, this is Weekly Digest number 410. If the average word count has crept up over the last decade to around 1,200, then I have so far delivered 492,000. Tolstoy's War and Peace comes in at a count of 587,287 words. To reach that (at the current run rate of closer to 1,500 words) requires another sixty-three editions. Something to aim for. Then we can focus on Proust's A la Recherche du Temps Perdu which weighs in at more than 1.2 million!

Economic Commentary

FTSE 100 weekly winners

Hargreaves Lansdown plc	6.2%
JD Sports Fashion Plc	5.3%
Lloyds Banking Group plc	5.0%
International Distributions Services plc	4.7%
Land Securities Group PLC	2.5%
Persimmon Plc	2.3%
HSBC Holdings Plc	2.2%

FTSE 100 weekly losers

Ocado Group PLC	-9.5%
Halma plc	-9.2%
Entain PLC	-8.5%
Melrose Industries PLC	-7.4%
Burberry Group plc	-7.1%
Kingfisher Plc	-6.6%
Flutter Entertainment Plc	-6.1%

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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