RATHBONES | Incorporating Investec Wealth & Investment (UK)

WEEKLY DIGEST | 30 July 2024

The chips are down

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With the Paris Olympics in full swing, it's remarkable to think that twelve years have swiftly elapsed since they took place in London. I managed to get tickets for loads of events then, including synchronised swimming, which turned out to be surprisingly brilliant. The run-up to those games were characterised by all sorts of media coverage speculating about what a disaster they were going to be (poor organisation, security problems, unsold tickets, etc.) and yet they were a great success. Funnily enough, the coverage ahead of the Paris games seems to have been very similar, and yet I suspect the post-games reviews will be glowing (with the possible exception of what happens to the plan for swimming events in the Seine). It's a reminder that news media in all spheres is compelled to attract one's attention, and it's well documented that bad news "sells" better than good news. The same seems to apply to coverage of financial markets!

Although there is often talk of a summer lull in markets, there is absolutely no evidence of one currently. We're right in the middle of the mid-year company earnings season, there has been a profound shift in sentiment below the surface of the market, and, of course, there have been some interesting developments on the political front.

In the very long term, as we often emphasise, earnings are the main driver of investors' returns, and so it's not unreasonable that there is a lot of attention paid to them. But the fact that many companies (especially the big, important ones) report earnings on a quarterly basis means that they can be subject to short-term influences ranging from consumer fads to the weather which don't necessarily represent longer term trends.

There are a couple of themes that are developing during the current season. The first is that technology-driven growth stocks are going through a bit of a "show me the money" phase. The second is that consumers seem to be reining in their spending, and it is not just in the lower income brackets. Several luxury goods companies have reported weakening demand, and while Chinese consumption has been conspicuously disappointing, there is also evidence of buyer fatigue in Europe and the US. At the cheaper end of the market, Ryanair pointed to having to reduce fares dramatically to sell seats (although easyJet was less bothered). Another interesting example is a lesser known American company called Lamb Weston, which supplies frozen potato products (e.g. fries/chips/roasties) to fast food outlets. Its shares fell by a third last week as it cited declining demand which is being driven, at least partially, by consumers finally rebelling against rising prices (chips down #1).

In the US, there is also an element of concern about the underlying economy. Although second quarter GDP beat expectations by rising 2.8% (quarter-on-quarter annualised), the rising unemployment rate, now at 4.1%, is worrying to some because its increase is very close to triggering levels of change which in the past have always led to a recession (the so called Sahm Rule). There is also a school of thought which suggests that any rise in unemployment has been mitigated so far by a reduction in the number of jobs being offered, but that we are about to hit a tipping point at which more layoffs will become inevitable. Bearing that in mind, we are closely monitoring US employment trends. While a US recession is not our central case (and we think that one would invite a swift and aggressive response from the Federal Reserve), we do recommend some recession insurance in the form of government bonds, whose attractions have been enhanced as yields have risen.

Indeed, the odds of central banks cutting interest rates sooner have shortened recently, and not just because of bad news. The latest US inflation print for the month of June came in below expectations, taking some pressure off the Fed and potentially allowing it to focus more on the part of its mandate that is to underpin employment. The Fed has a dual mandate – to maintain employment and to keep inflation at its 2% target – there is also an implied third mandate to maintain financial stability, which is why it often intervenes in markets when things go wrong. The narrative on diminishing pricing power from the companies mentioned above as well as from some of the Consumer Staples giants tends to support a more optimistic view on inflation too.

This shift in interest rate sentiment has been the catalyst for a remarkable shift in fortunes within the market. Suddenly, small and medium-sized US companies have swung back into favour owing to their greater sensitivity to the cost of funding (they tend to have more borrowing than the large caps – indeed, the mega-cap technology companies have surplus cash on which they have been earning more as interest rates have risen). If we look at performance since the night before the inflation data, the Russell 2000 (US small cap) index is up 10.2%, while the S&P 500 index is down 3.1%. At a more extreme level, the much-vaunted Magnificent 7 stocks are down 12%, delivering a rarely experienced swing in relative performance in such a short time.

While we had been warming up to the recovery prospects for small companies based on attractive relative valuations, the speed of the rotation seems to have taken everyone by surprise, and this is because it is not a one-sided story. I mentioned earlier the "show me the money" aspect of technology companies, and this pertains specifically to the huge amount of capital expenditure on everything relating to Artificial Intelligence. Within the last few weeks a couple of influential investment houses, Goldman Sachs and Sequoia Capital, published research questioning whether the returns generated by deploying AI would be sufficient to justify the cost of buying all the semiconductor chips and constructing the data centres. While neither had a definitive answer, enough doubt was sown to mean that the slightest excuse to take profits on the high-fliers was accepted gratefully (chips down #2).

Just to exacerbate matters, the increase in equity market volatility associated with the rotation begat more selling, as investors whose position sizes are influenced by the level of volatility became, essentially, forced sellers. And this was not confined to equities. It has even shown up in a squeeze higher in the Japanese yen, which has rallied sharply as leveraged "carry trades" have been unwound. This is where one sells a low-yielding currency to buy a higher-yielding one, effectively creating "free" returns, although they can be wiped out very quickly if the currency pair moves the wrong way.

Suffice to say that we have not felt compelled to react to these developments. Our longer-term view that there is potential relative value in smaller companies remains the same, but the economic uncertainty suggests that it's not a moment to be chasing them. And we continue to hold the opinion that we are only at the beginning of discovering the full powers of AI and associated technologies, although cognisant of the fact that the path to greater adoption will not be a straight one.

Finally, the US election promises to be constant source of noise over the coming months. That's not to say that theatre surrounding it is anything other than incredibly entertaining, especially with the elevation of Vice President Kamala Harris to become the Democrats' Presidential candidate (subject to what looks like an inevitable "rubber stamp" at the party's convention in August). The very tight polling and the fact that the result will, in all probability, depend on what happens in just seven states, makes it difficult to position a portfolio to reflect either outcome, although we are acutely aware that there are some big differences between the two main parties' policies. One of the biggest swing factors pertains to corporate taxes, with the Democrats threatening to let previous cuts expire (taking the headline rate up from 21% to 28%), while the Republicans are promising more cuts (to as low as 15%). The swing factor for US corporate earnings could be as much as 17%, and that compares to long-term average earnings per share growth of 7%!

Another key element of difference revolves around foreign policy, and there could be very different outcomes in Ukraine and the Middle East depending upon who wins. Then there is Trump's trade policy, which, if fully applied, would see a 60% tariff imposed on all imports from China, as well as 10% on goods from the rest of the world. Aggregate tariffs would reach levels not seen since the 1940s, potentially reversing decades of financial benefits from increased global trade (although we are not unaware of the social impact and note the effects this has had on politics in general).

In the long run, though, there is no firm evidence that either US party is worse or better for shareholders. There will always be bigger secular influences than the current President, and, for all the fear of dysfunction, the "system" generally seems to find a way to restore equilibrium. And so, at this stage at least, we have not put any chips down on the outcome of the US election.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	17.9%
Intertek Group plc	8.1%
NatWest Group Plc	7.9%
Compass Group PLC	7.6%
Burberry Group plc	7.1%
British American Tobacco p.l.c.	6.4%
Anglo American plc	6.0%

FTSE 100 weekly losers

Pershing Square Holdings, Ltd. Public Class USD Accum.Shs	-10.4%
Fresnillo PLC	-6.0%
ITV PLC	-3.9%
InterContinental Hotels Group PLC	-2.8%
Prudential plc	-2.3%
Rightmove plc	-2.1%
Glencore plc	-1.9%

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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