INVESTMENT UPDATE

MARCH 2024

FOR PROFESSIONAL INVESTORS ONLY

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Portfolio performance proved positive again in February. The hyperbolic nature of artificial intelligence inspired technology companies pushed equities higher such that valuations are now, in some cases, stretched. Our forecast for an economic slowdown in selected developed economies has proven accurate – with a good number, except the United States tipping into technical recession. We will investigate the key drivers and likely path ahead in the update that follows.

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A stronger than expected CPI inflation print and a robust press conference from Federal Reserve chairman Jerome Powell upset markets mid-month. We should remember the trend is more important than individual data plots and markets, just like inflation, tend not to perform in straight lines. Inflation has fallen quickly in US from 8% down to 3.1% and a reversion closer to the 2% target is likely to be a grind and take time. Despite interest rates at 5.25% the giant US economy remains in decent shape.

Consumer spending makes up around 70% of GDP and persists in robust fashion. The key being a strong labour market. Against this backdrop, the US yield curve has steepened, with the 10-year Treasury yield back around 4.3% from its recent low of 3.78% at the end of December.

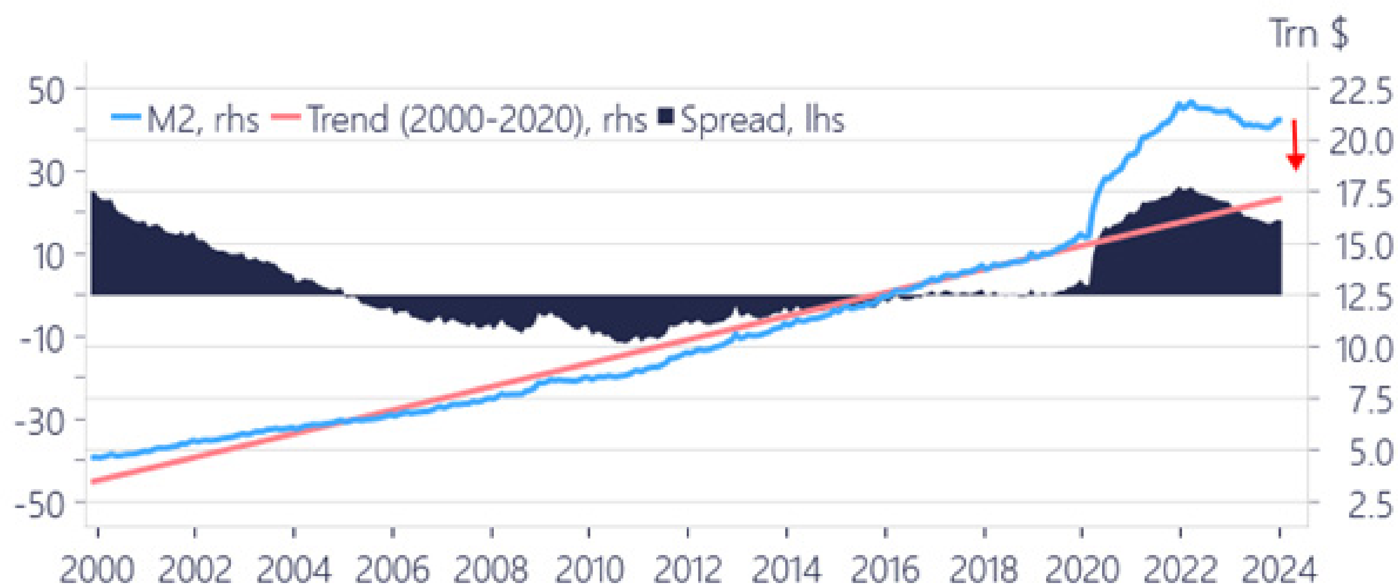
The US economy has remained resilient in the face of much higher interest rates and has not yet succumbed to technical recession for some key reasons. Mortgage holders have, by and large, sensibly refinanced and fixed their costs when interest rates were lower. Many US mortgages are 30-year fixed rate offerings.

To an extent some corporations have been able to do likewise, although the refinancing cycle is approaching. During the short post Covid period so far, multiples of experienced workers "of a certain age" have chosen to retire from the day job – persuading employers to retain staff wherever they can and reward them favourably. By the close of 2028 the last Baby Boomer will have already become a "senior" in American parlance as the post war population bulge moves into retirement. Finding qualified and experienced workers is not easy. Inflation has caused some issues for sure, although this has been skewed to certain states – Texas and Florida in particular. Cost rises on essentials have impacted blue collar workers more than the middle class and affluent, who have continued spending unabated.

The final Q4 2023 earnings results for corporate America were delivered during February. Overall results proved positive and only slightly weaker than the longer run average, despite the headwinds of higher borrowing costs. It's worth remembering the largest technology firms in America carry huge net cash surpluses on balance sheet – meaning interest rates at 5.25% have seen decent returns. Artificial intelligence related stocks, notably Nvidia, delivered powerful results, driving their share prices markedly higher. Nvidia's share price is valued at 40x sales and its market capitalisation standing more than $1 trillion is greater than the entire German stock market. This is quite astonishing for a company founded as recently as the 1990s.

Such is the allure of AI and its intrinsic promise of higher productivity in the not-too-distant future. We should guard against irrational exuberance, and we note the proprietary ABP Momentum Indicator is close to signalling an over-bought position in the S&P 500. However, the prospect of lower rates later this year remains present, and the Federal Reserve will be seeking the appropriate date and quantum to ease policy – finding the optimal level for interest rates is a fine art indeed.

The chart that follows shows the trend and current flow of liquidity, which is supportive for risk asset performance.



Source: Steno Research, Bloomberg and Macrobond

There are several positive factors continuing to drive US share prices higher, despite lofty valuations. Principally the oxygen of liquidity in the form of a drained Reverse Repo facility, lower corporate borrowing rates courtesy of bond markets, and the US Treasury issuance of Bills are all drivers. Tapering quantitative tightening, and a Federal Reserve inspired programme to back-stop regional banks whose exposure to commercial real estate has brought issues all supports a positive mood amongst investors. The next Quarterly Refunding Announcement (QRA) due by the end of March will be eagerly anticipated. Lower interest rates when they finally come will be welcomed by many. The US election due in November will also play a role – in 80% of election years in America the stock market ended the year higher than it began.

The world's second largest economy, China is fairing less favourably. A failure to show a meaningful recovery post Covid lockdowns has been exacerbated by a dominant real estate sector which is insolvent. Real estate once a sparkling investment has witnessed values collapsing by at least 40%. The behemoth property developer Evergrande slid into bankruptcy owing a mind boggling $300+ billion.

Chinese GDP numbers have been strong for many years underpinned by a centrally planned and funded economy building extensive infrastructure still yet to be utilised by a shrinking population. Understandably in such circumstances equity values have not prospered particularly. China does not empathise with equity investment in the same way as the United States, rather she appears to offer greater support for bond holders, many of whom could benefit from a state sponsored back stop for their support of the real estate sector.

The economy was delivered state support in the guise of an interest rate cut from the People's Bank of China during February. We expect to see further monetary and fiscal support (not yet witnessed) and perhaps a gradual weakening of the Yuan to stimulate a renewed manufacturing-led export drive – something the Chinese know how to do. Equity values have flicked upwards positively during February stimulating a broader positive from emerging economies overall, despite a US dollar yet to fall appreciably. However, against a backdrop of steep western tariffs and a trend away from favouring China's manufacturing base in support of more localised onshoring / near shoring it may not be so straightforward this time. The potential for Mr Trump in the White House may focus minds further. Modest inflation has turned to deflation in China, and we expect a flood of cheap goods to make their way west as time goes by. The current 91 Chinese battery electric vehicle manufacturers are likely to consolidate to a more focused number. The promise of BEVs at a starting price (before tariffs and taxes) of $11,000 will make manufacturers in western markets wince. Manufacturers are supported by commodities trading at their lowest point since 2021.

Japan's newfound period of prosperity was signified by the Nikkei index reaching a new all-time high during February, the first time this has happened since 1989! We are pleased portfolios have participated in the equity market success. Inflation nudged higher to 2.1% but is barely troubling compared with western countries. The economy continues to do well, but again we note this month the potential for the rally to begin fading before too long.

Closer to home major economies in Europe have succumbed to recession. To some extent Germany in particular is undergoing quite a change in its industrial fabric – temporary or permanent, perhaps too early to tell. However, despite the headline difficulties the German DAX equity index hit new all-time highs during February. A reflection of earnings being derived more globally than domestically.

Across the continent, economies are slowing in response to higher interest rates and inflation is falling in convincing fashion, yet the European Central Bank are reluctant to cut rates. Mrs Lagarde, head of the ECB, seems timid to cut rates ahead of the US Federal Reserve which would break with the traditional hierarchy of policy implementation.

The chart shows decarbonisation across Europe and suggests some deindustrialisation – in Germany in particular.

Source: ICE Futures Europe, Bloomberg, via Twitter

The UK also slipped into recession during February and likewise would benefit from interest rate cuts to stimulate growth. Our economy is much smaller than that of America and does not benefit from "giant tech" companies meaning cheaper borrowing costs would assist growth potentially more quickly. Inflation, a particular problem domestically, has continued to fall away with food costs dropping back, according to most recent data.

We are pleased with progress at portfolio level and the recent pick up in emerging market equities has improved risk adjusted performance for higher risk profiles. We do expect the US dollar to weaken further which will be stimulative to risk assets on a broader footing but emerging markets particularly.

Technology and AI have driven performance higher across our equity selection. Our holdings are derived principally at index level rather than taking specific positions within individual stocks or specific focused funds. This diversified approach has enabled portfolios to capture upside performance whilst anchoring risk at appropriate levels. Whilst we are enjoying the market ride so far, we are not blind to the risks and are ready to respond. We look forward to updating you further next month.

We sign-off this month by offering a short extract from one of the most iconic investment tombs ever written.

An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative. The distinction between investment and speculation in common stocks has always been a useful one and its disappearance is a cause for concern. In most periods the investor must recognize the existence of a speculative factor in his common stock holdings. It is his task to keep this component within minor limits, and to be prepared financially and psychologically for adverse results that may be of short or long duration.

There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: (1) speculating when you think you are investing; (2) speculating seriously instead of as a pastime, when you lack proper knowledge and skill for it; and (3) risking more money in speculation than you can afford to lose.

– Benjamin Graham, The Intelligent Investor.

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All sources Bloomberg unless otherwise stated.

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