James Hambro & Partners

Monthly Asset Allocation June 2023

The past month summed up

An AI-driven rally in a narrow sector of US technology stocks belies the ongoing threat to equities from a rate-rising programme that has seen US levels advance from near zero to over 5% in just 15 months.

Current positioning

We are updating our portfolios to take account of where we are in the monetary cycle and as a result are adding to our bond allocation to complete the journey begun last year to bring exposure from underweight to neutral. This is being funded by a reduction in holdings of some real assets which are less attractive in a world where bonds yield 4% rather than zero. We remain poised below benchmark to add to our equity holdings as and when the opportunity is compelling and we retain holdings in diversifying assets of gold and cash.

The rationale

Our central thesis is that the economy-slowing attributes of higher interest rates are gradually taking effect, which will result in a downturn that prompts us to seek more defensive assets for the moment. We continue to test our thesis but the evidence still holds that some slowdown in economic activity is approaching that will dampen appetite for risk assets.

We commented previously on the giddiness of markets even amid what has been a relentless onslaught of rate increases as policymakers try to grapple with inflation. That exuberance has been most evident in returns from equities. Recently we have seen a rally in some technology stocks on the prospects of Artificial Intelligence led earnings increases. But this advance has been highly concentrated. The largest six technology companies have added around $3 trillion in value in anticipation of rising earnings in relation to their AI activities. These companies are so huge – the total market capitalisation of Apple is almost equal to the UK's annual GDP – that they can shift an otherwise rather moribund market. While the market is taking a rather scattergun approach to this – any company that has even a notional involvement in AI is benefiting from investor excitement – it's clear that there will be very significant returns to those who truly can tap this epochal shift in technology.

A dystopian future?

There is indeed something to be excited about in relation to AI. While science fiction writers might think it's all downhill from here, the market is at least correct in its assessment of the economic opportunities from this technology. True, as we noted in our previous asset allocation note, there will be significant disruption from a technology that seems to have powers that allow it to scan large data sets and then come to remarkably cogent conclusions in the form of documents, medical diagnoses, and legal advice, to name but a few applications. Much as the mechanisation of the last half century led to a decline in some blue-collar roles this may be a revolution that targets white-collar positions.

However it's worth noting that there are certain tasks that a computer cannot do – hospitality and critical care for example are surely rooted in people. It's also important to remember just how normal fears of human replacement are in history – the Luddites for example. But just as the printing press didn't stifle authorship but instead expanded writing and learning, so it's likely that AI will end up creating many more new jobs in the wake of its ground-breaking capabilities.

Meanwhile in the here and now...

The economy has proven more robust than would have been predicted given the severe bout of rate hikes. There are a number of reasons for this. As we've noted, employment in both the US and UK has remained remarkably healthy — should people start to lose their jobs, then the consumer, a key driver of the economy, will start to cut back on spending. There still does seem to be a remarkable amount of disposable income about – in part due to the hangover from the Covid lockdown where people saved considerable amounts and are now taking the opportunity to spend that cash. Witness the huge turnaround in international travel where it seems airlines can't put on enough flights and there are never enough hotel rooms. The mild winter in Europe also meant that consumers didn't have to plough so much into heating their homes, which gave them money to spend elsewhere.

However, the still small voice of calm continues to point towards recessionary tendencies that will dampen the earning power of most companies. A notable example is S&P Global US Manufacturing PMI data from May, which dropped for the first time in five months to a level that would indicate a contraction in the economy. This was due to a drop in new order inflows and declining demand, with continuing activity only held up by manufacturers working on back orders.

This has been followed by further signs of a cooling of the economy in the headline inflation rate. In the US this has slipped to 4%, which led the Fed this month to put a hold on a further interest rate increase. For us, this may well be an indication that, in the US at least, we are near the peak of interest rates which has informed our latest investment decision.

Bonds continue to burnish their credentials

In normal cycles, bonds have provided better protection against slowing growth than equities. The reason for this is straightforward – equities are valued on the earnings of companies and in a recessionary environment, the earnings of most companies decline. Bonds provide a fixed return, so no matter what happens in the economy, you receive your regular coupon payment along with the return of your capital at the end of the bond's life. That is unless the issuer goes bust – the reason why we prefer the security of high-quality government bonds.

Bonds had a terrible 2022 because the relative value of the fixed returns were devaluing rapidly as interest rates on cash surged. But as the interest rate and inflation environment steady, the longer-term attraction of their fixed, reliable payments has returned.

Given our view that the US economy will start to slow, meaning the end of its rate hike cycle is in sight, US government bonds again offer both a reasonable return and a buffer in the event of recession. We're funding the investment by selling infrastructure investments. These provided a useful income and diversification when interest rates were near zero but with rates nearer 5%, that attraction has now passed.

Conclusion

Our roadmap remains essentially the same: the interest rate hikes of the past year will slow the economy, and with it inflation; the data from the US shows signs of a successful reining in of inflationary pressures. Our move to fixed income neutrality allows us now to focus on where and how to increase our holdings of equities when the time is right. That will either be determined by signs that the economy is recovering after a dip, or by recessionary pressures reducing prices of stocks to levels that provide an opportunity irrespective of the economic landscape. Patience and resolve based on evidence remain the order of the day.

This is not advice and you should not act on the content of this comment without taking professional advice. Opinions and views expressed are personal and subject to change. No representation or warranty, express or implied, is made of given by or on behalf of the Firm or its partners or any other person as to the accuracy, completeness or fairness of the information or opinions contained in this document, and no responsibility or liability is accepted for any such information or opinions.

The value of an investment and the income from it can go down as well as up and investors may not get back the amount invested. This may be partly the result of exchange rate fluctuations in investments which have an exposure to foreign currencies. Fluctuations in interest rates may affect the value of your investment. The levels of taxations and tax reliefs depend on individual circumstances and may change. You should be aware that past performance is no guarantee of future performance.