Monthly Asset Allocation July 2023

The past month summed up

Mixed messages in markets continue to give succour to those who believe an economic downturn is unlikely, with an attendant climb in some equity markets. While a deceleration of some sort is still the most likely outcome for us, there's sufficient evidence to suggest that it may not be as severe, at least in the short term, as data and previous experience would have indicated.

Current positioning

We continue to hold a position that allows us to adapt to a market that could go either way — defensive against the still likely downturn but ready to turn and take advantage of better market indicators. Our recent addition to bonds means we are now neutral in this regard, having sold off some real assets. We remain poised below benchmark to add to equity portfolios as and when better value is available, and we retain holdings in diversifying assets that should provide protection in tougher markets.

The rationale

Our central thesis is that monetary tightening in the form of the fastest stream of rate increases in decades must at some stage have a dampening effect on economic growth. However, continuing robustness in some sectors of the economy means that the outcome is not as clear cut as the historical statistics would indicate.

One thing we should always avoid in investment commentary and decisions is the notion that markets work in a binary manner — that it's either one thing or the other. True, a recession is a clearly defined two successive quarters of negative growth, but even if that threshold is not reached, it's clear that an economy can be growing faster or slower or shrinking at an accelerated or marginal pace. In other words, perception of how things are doing is relative rather than absolute.

Another factor that frames how we should view the economic situation is around expectations of market participants. Fund managers in recent surveys seem to have become less bearish and there hasn't been any significant exit from equities, a move that one would expect in advance of recessionary times. In fact, US markets continued to climb in June, with the S&P 500 up 6.5% and the NASDAQ climbing 6.7% (albeit with gains driven strongly by a few technology giants). Economically, there is no immediate sign of a contraction, with the US set to expand at annual rate of 1.1 % in the second quarter (from 0.6% a year before), according to the Conference Board, a research group.

Supporting factors

There may well be one-off time-specific factors keeping a recession at bay. One key element has been continued consumer spending even in the face of higher borrowing costs. One of the effects of the Covid pandemic was a build-up in savings, as the ability to spend was curtailed by lockdowns — estimates suggest that Americans set aside a total of $2.4 trillion during the pandemic, money that's now being spent bolstering consumption (although some anticipate that this money may run out later this year).

But aren't people worried about their mortgages, often their biggest outgoing, amid rising interest rates? Evidence, again in the US where many mortgages have fixed longer-term rates, would suggest that in the ultra-low-rate environment of the pandemic people were enticed to take out new mortgages and refinance older ones at low fixed rates, which means they're protected for the moment from soaring costs.

Another unusual element is the amount of money that the US government under President Biden is pumping into the economy. Under the auspices of legislation such as the Infrastructure Investment and Jobs Act there's a further $2 trillion of government cash supporting economic growth — some analysts have suggested the difference between this and other tightening cycles is that the fiscal support has come sufficiently early to soften an otherwise hard landing.

Pointing both ways… still

The data is contradictory. The June S&P Global US Manufacturing PMI, a measure of manufacturing activity, slid for a second month in June — its sharpest decline this year. Yet other data suggests that we may have passed the nadir for companies, with the earnings revision ratio, which shows the relationship between financial analysts' upgrades and downgrades of expected company earnings, climbing to 0.85 from 0.77 — a trend Bank of America says in the past has seen markets rising 10% in the subsequent 12 months (although it's worth noting that much of that gain came in technology stocks, reflecting that narrowness that we observed above). Even jobs data cannot provide a clear picture — while the number of jobs added in the US last month was below expectations, the unemployment rate continued to fall. One area of more certain figures is in US inflation which fell to 3% in June from an eye-watering 9.1% a year before, indicating that just maybe policy makers have got away with raising rates without killing the economy.

Bringing this all together, it's obvious that while rate increases of recent magnitude should slow the economy, there are special factors that are interfering with the normal course of events. The evidence and the logic dictate there still should be a slowdown at some time — it took New Zealand until now to enter recession even after starting its rate hike programme 20 months ago. Policy makers of course have an obligation to keep boosting rates until inflation is at an acceptable level, so those hikes won't stop until rising prices are brought fully under control. However, the depth of any slowdown — whether severe or a mere speed bump — seems to define this debate now.

Conclusion

With data proving inconclusive and an immediate downturn looking remote, we remain positioned to take advantage of both a hard and soft landing. Our priority remains to be cautious and not get drawn into narrow equity market advances that may prove fleeting. When we do decide to push our holding of equities further, it will be into those specific businesses that we believe show the right characteristics of long-term potential at a price that is reasonable.
