Monthly Asset Allocation August 2023

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The past month summed up

Stock markets continued with their gains as more investors were persuaded that the only way was up, even against a background of continued mixed news and strong historical evidence for a more stinging decline.

Current positioning

Our positioning allows us to be poised to take a directional move once fundamental data indicates more solidly one way or another. We are neutral in our bond allocation with higher yields allowing us to rebalance away from real assets, while we remain slightly below benchmark in equities, ready to add to this as and when opportunities present themselves. We also retain holdings in diversified assets such as gold that should provide protection if economies and markets roll over.

The rationale

Our strategy for months has been to maintain balance in portfolios to allow us to adjust to both improving and deteriorating news. While the fundamental data remains mixed, particularly given the stage of the interest rate cycle, the upbeat behaviour of market participants might have run ahead of itself — just because things aren't as bad as they could have been, doesn't mean that everything is perfect.

In fact, the economic news seems to be mimicking classic British weather — sunny spells and scattered showers. That said, there's no doubt that the economy in the global driving seat, the US, has continued to provide better momentum than would be expected after more than a year of hikes, prompting research firm Yardeni to talk of the "Godot" recession.

The good

So what exactly are we waiting for? The main thing you'd expect when borrowing costs ramp up is that reduced spending will damp economic growth, possibly pushing the economy into recession. Instead, the US posted an expansion of 2.4% in the second quarter bolstered by consumer spending.

The US jobs market is also defying expectations, adding another 187,000 jobs in July. What about inflation, the entire reason why the Federal Reserve and other central banks have been pushing up their rates? US inflation was sitting at a respectable 3.2% in July, nearly 6% below a year ago, while core inflation is now at its lowest since October 2021. Company earnings again look positive, with CNN reporting in early August that 81% of the 292 S&P 500 companies that had reported Q2 earnings thus far were ahead of expectations. The New York Times is now musing whether at last good news can be good news again. With inflation seemingly declining and the economy still trundling along, is it time to put our worries to bed? Fed Chairman Jerome Powell acknowledged last month that inflation is falling without much economic damage.

The bad

But all is not rosy — US purchasing manager figures shows manufacturing contracted for an eighth month in July. Chinese growth has been remarkably slow, up just 0.8% quarter on quarter, down from a 2.2% rate in first quarter; both well below the 5% return that the Communist Party had commanded. And in Germany, a key measure of its manufacturing activity has slumped to its lowest level since May 2020. It's not as if the geopolitical environment is reassuring — Russia at war in Ukraine, an ongoing standoff between the US and China, and the US itself riven with culture wars. This dichotomy is reflected across the analyst community, where Yardeni says the chances of a soft landing have climbed to 85%, while others remain in the Isaac Newton School of economics – when interest rates go up, growth must go down.

And the greedy

To coin an American term, it seems that investors have drunk the Kool-Aid, with positions looking exceptionally positive across many measures. This matters because it's how the market interprets data that dictates the risk and reward potential of securities. CNN's Fear and Greed Index, an amalgamation of a range of measures designed to highlight market sentiment, was showing extreme greed in June. The American Association of Individual Investors' gauge of investor positioning earlier this month again showed a significant tilt towards ebullience – its bull-bear spread, the excess of positive positions over negative ones, climbed 6.9 percentage points to 27.7%, an unusually high level.

All of this has been feeding through to those continuing gains in equity markets, with the S&P index showing its best January-to-July gain in 26 years and posting its longest monthly series of wins since 2021. But those gains are not equally spread, being concentrated in large tech firms. 247 Wall Street, a financial web site, has asserted that just seven companies are responsible for 90% of the gains in the S&P, while the nine largest in the NASDAQ have provided all of its advances. JPMorgan pointed out last month how concentrations in the S&P were now at a 60-year high, encroaching into bubble territory.

The conclusion that sentiment may be ahead of reality is shown in the valuation data, the measure of how much we're paying for stocks. The trailing price / earnings ratio for the S&P has soared to almost 26 times now compared with just 22 times at the start of the year — an increase of about 20%. Relative to the valuations of the rest of the world, US equities are now more expensive than at any time in the last 25 years.

Do we fear a sudden reversal? Not imminently. However just as in a ship where the ballast tips to one side making the vessel unstable, so we find the biggest risk to be in expectations that could suddenly turn. The fundamental data is not so good and solidly directional that we could not get a surprise on the downside.

US debt woes

Because the US is the world's largest economy, a responsible and well-governed country that pays its debts, investors like ourselves are very happy to snap up US debt securities such as Treasuries, seen as among the safest investments in the world. But the deterioration of the US's internal workings amid an increasing zero-sum, winner-takes-all culture war has led Fitch, one of the world's main ratings agencies, to strip the US of its coveted AAA rating moving instead to a lower rank of AA+. As Gillian Tett has pointed out in the FT, its decision has less to do with the economic fundamentals than fiscal recklessness exemplified by a string of stand-offs over the debt ceiling in recent years. Tett notes that it's not so much whether the US can pay its debt, it's just whether it actually will.

Others argue, with which we agree, that this is less important than might appear at first glance. First, Fitch has been threatening this for some time after putting the government on negative watch, a precursor often to a rating change. Second, it's not as if this is new information – everyone is well aware, especially after this year's budget spat between an increasingly gung-ho Republican Caucus in Congress and President Biden, that the US faces internal ructions. Our view is that the bonds of the world's largest economy – a dynamic nation resilient (thus far) even to huge interest rate hikes, and one that, as the constant resolution of debt stand-offs show, is, as Churchill said, always prepared to do the right thing after exhausting every other option – remain the safest of the lot.

Conclusion

Our strategy as always is to follow the data and avoid getting pulled into sentiment-driven decisions. We are cognisant that many other investors are of the opinion that we are on a continuing upward trajectory, and we bear that in mind in our positioning, poised to move upwards with our equity holdings. However, the risk that the market may be moving too far ahead of the data leading to overpricing in certain areas, means we lean slightly towards caution.
