Monthly Asset Allocation September 2023

James Hambro & Partners

The past month summed up

Stock markets dipped slightly over August, digesting the gains of the year during a notoriously quiet period for market volumes. Uncertainty still bedevils the outlook for the global economy, where tensions remain between a more benign and a more recessionary outcome.

Current positioning

Our positioning continues to lean towards caution, though this is tempered by the economic resilience this year amid a plethora of mixed signals. Our focus remains on agility and holding a diversified balance of assets that can weather a mild downturn. We are neutral in our bond allocation while we are beginning to see some individual stock opportunities in companies left behind by this year's AI driven markets. We retain holdings in diversifying assets that should provide protection if economies and markets unravel more severely.

The rationale

Our expectation remains that the economic outlook will deteriorate into next year as higher interest rates begin to bite. However, the chance that weakness leads to a so-called soft landing rather than a more severe recession has increased.

The present cycle hasn't chimed with historical patterns, and the rapid acceleration in rates over the past 18 months hasn't led to the demand destruction that would normally have been expected. Rather, there has been a series of rolling slowdowns, hiccups and speed bumps spread across industries and regions but without any of these uniting into a coordinated contraction in the global economy.

Leaving aside the sputtering S&P 500 index last month – down 1.8% – major stock markets have advanced over the year, but the gains have been anything but uniform. A few large tech companies have been responsible for much of the momentum in the US market—their dominance maybe giving a false sense of wider market health. In addition, this year's advances come fast on the heels of significant declines last year – Meta sliding 64% in 2022, Tesla 65% and Amazon 50%.

Mixed signals

There are mixed signals as to the outlook for safety baked into equities. Certain measures of the equity risk premium, which is the excess yield that equity holders get over that of safer bond investments, are extremely narrow at present, suggesting that stocks are over-valued (or alternatively that bond yields are too high!). Yet there are signs that companies' operating performance is improving, a potential positive for share prices. The global earnings revision ratio, the difference between upgraded and downgraded analyst expectations for future earnings, climbed from 0.77 to 0.9, its most optimistic in 18 months – in the US it reached a firmly expansionary 1.37. Stats like these are lifting spirits. The Bank of America Global Fund Managers survey reported that institutional investors are the least bearish they've been since February 2022. Cash reserves, which tend to be higher when people are fearful, have fallen to a 21-month low. Three quarters of those surveyed expected some variation of the soft landing rather than an economic rout.

The economic environment has indeed improved, with the US economy growing 2.2% from April to June – not a blistering pace but what economists might have overlooked has been the effect of the consumer in the US, still flush with savings made in the Covid lockdown, in sustaining growth. Alongside the consumer, President Biden has pumped billions of dollars into the economy, potentially offsetting some of the efforts of the Fed to limit demand.

Jury out

Debate remains as to the nature of any prospective downturn given that central banks are still looking to stem inflation – a prospect more likely to continue after US consumer prices climbed from 3.2% to 3.7% in August (an uptick in part caused by rising oil prices on the back of Saudi efforts to limit supply). Fed Chairman Jerome Powell reiterated in his speech in Jackson Hole last month that he would keep rates at a “restrictive level" until inflation moved down further.

Analysts such as Ed Yardeni note that the labour market is a key component in determining the future activities of the Fed, a measure that had been stubbornly strong throughout the year. But maybe, just maybe, things might be changing, with the unemployment rate nudging up to 3.8% in August from 3.5% the month before. Gavekal research notes that job openings slid from 9.2 million to 8.8 million in August while the number of those quitting jobs to move elsewhere fell by 300,000.

Is this the sign that the Fed might be having some success? It is too early to tell, leaving open the question of the ultimate end result: for some, a soft landing; for others, it means the US moving into recession next year.

Equity potential

A market stuck in seemingly perpetual indecision doesn't mean we need to do the same. In fact, the sectoral ups and downs have opened the door to opportunities. Many good businesses, offering exciting long-term growth potential whatever the economic journey in the next year, have been largely shunned by the market given their lack of obvious exposure to the current AI zeitgeist. They now look to offer real value for investors willing to look through the fog.

The Covid pandemic supercharged some elements of the healthcare industry, while its end has led some shorter-term investors to lose interest, ignoring the huge potential that this sector possesses harvesting data and technological innovation. There are clear long-term beneficiaries in this space, and these include dominant companies in the life sciences and diagnostics space such as Thermo Fisher Scientific and Danaher. Leaders in the provision of equipment that drugmakers use to create ever-more complex medicines, they have both grown organically and through being astute acquirers of other businesses – at present Danaher is seeking to subsume UK life sciences business Abcam.

This sector also includes a number of companies harnessing cutting edge technology, even if it involves augmenting rather than replacing human intelligence and skill. Intuitive Surgical, a leader in the ground-breaking use of robots in surgery, has been in the news recently. The BBC reported that one of its surgical “Da Vinci” robots has recently completed its 10,000th procedure after 20 years’ use at Guys and St Thomas’s NHS trust in London. The report outlined how the use of robots had improved patient outcomes, reduced complications and sped up the recovery of patients, ultimately saving money for the NHS.

Conclusion

It remains unclear whether the impact of higher interest rates proves different this time or whether a recession is just a matter of time; economies have proven more robust than anyone expected. For that reason we remain close to neutral in portfolios. However, neutrality does not necessitate a lack of conviction at a stock level and our research continues to identify opportunities that will support returns for our clients in the years ahead.

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