Current Positioning October 2023

James Hambro & Partners

The past month summed up

Bonds made the headlines with US benchmark yields rising to levels not seen for more than 15 years. The horrific terror attack in Israel and subsequent bombardment of Gaza risks escalating into a wider regional conflict with ramifications for the global economy.

Current positioning

The strong movement in bond yields underlines why we have adopted a balanced approach to managing asset allocation in a world where future economic trends aren't yet clear. We are neutral in our bond allocation and approaching neutral in equities where there continue to be individual stock opportunities at attractive prices. Our portfolio is buttressed by diversifying assets such as gold, which tend to outperform when risk increases.

The rationale

Our expectation is for continued uncertainty in global markets as the effects of the extraordinary monetary tightening of the last 18 months continue to bite, even while certain sectors of the economy and the stocks they represent outperform. This uncertainty has been supercharged by the attack on Israel by Hamas terrorists and the subsequent response of Israel in the Gaza Strip.

While we abhor any loss of life, our professional focus is on the economic and market ramifications of these events. Thus far markets have largely absorbed these attacks, with the US benchmark S&P 500 climbing slightly over October at the time of writing following a 4.9% decline in September.

The current calm in equities however doesn't mean that things could not get worse – in response gold prices have risen to their highest in a month as nervous investors seek the safest assets. Many fear the powder-keg effect that could turn this conflict into a more significant conflagration in one of the most politically volatile regions of the world. The chief concern for financial markets is that the Middle East is a centre for oil extraction – according to OPEC statistics two thirds of its oil reserves are in the region. Even just a relatively minor increase in tensions, such as those that might limit the movement of tankers, could send the price of oil soaring.

Why does this matter right now? The major theme in economic management over the past two years has been the taming of inflation, with energy costs one of the most volatile contributors – rising prices will almost certainly reinvigorate inflationary pressures. However, the prospect is of a different kind of inflationary situation from what we have seen this year, where prices have remained sticky on the back of an economy growing faster than expected, as demonstrated by continued strong employment figures in the US. Instead, this may lead to what economists refer to as stagflation – inflation coupled with a sputtering economy as higher oil and energy prices limit spending elsewhere causing a wider slowdown.

Where do you want to be in such a situation? As we saw in 2022, a stagflationary shock reminded us of the protective qualities of oil and energy-related companies – their profits tend to increase with rising energy prices. At the same time gold has historically been one of the best stores of value when military conflict and financial stress rear their heads. We think both have a place in portfolios on the basis of their ability to protect in difficult times and yet earn a solid return when the economic outlook is more benign.

Bond woes

The value of government bonds at any one time will reflect the collective view of markets on the financial strength of countries and their ability to repay their debt – in effect, global markets act as agents assessing the credit score of the nations of the world. Recently markets have taken a rather dim view of the situation in the US, as demonstrated in soaring yields and declining prices, the two being inversely related. In fact the US 10-year yield has hit 4.9% – the highest since

2007. BlackRock, the world's biggest investment business, said recently those yields could rise yet further.

What might be causing this? We've noted how the economy has been more resilient, which is keeping interest rates higher for longer – higher interest rate expectations out into the future damp the value of the fixed returns that bonds pay as investors demand higher yields from all assets.

In addition, there's been a significant increase in supply — according to analyst Ed Yardeni the amount of Treasury securities held by the public ballooned by $1.4 trillion from June through August. The eleventh hour agreement in June between Congress and the White House on government spending may have led to expectations of a surge in issuance just at the point that the biggest buyers of the last decade, the US Federal Reserve, turned off the quantitative easing taps. Whether individual or nation, the more you borrow the more difficult it is for you to pay it back and so markets are extracting a higher rate for this debt. Nor can we ignore the fact that ratings agency Fitch downgraded US debt in August, nor the gridlock in Congress that was sparked by a spat over government spending.

Whilst these are valid concerns, particularly over the long term, we don't hold US debt for the transitory verdict of markets on the US's ability to sustain its borrowing. We buy Treasuries because they're a solid investment backed by the world's largest economy that should provide protection if troubling times lead to a recession.

Obesity drugs – the losers?

While government bonds move largely on broad economic data, equity shifts can be much more specific. But that doesn't mean that what companies are doing can't be a harbinger of wider trends and disrupt sectors and regions seemingly only tenuously linked.

One such area is the development of new treatments for diabetes with drugs known as GLP-1s, which are increasingly replacing traditional insulin-based methods. Potentially exciting for those companies that are producing them, they've also been proven an effective treatment for obesity, a hugely significant malady with a range of associated issues such as heart disease and organ damage. This is particularly pertinent in the US where it affects about 42% of the population. Thus, there is a real opportunity for any intervention that can challenge this.

And that's where the indirect effect comes in – Morgan Stanley (a bank) recently issued a report that claimed the drugs can affect behaviour significantly, especially in relation to high-sugar and high-fat foods such as confectionary and sugary drinks. Not surprisingly that's dented the prospects for food companies – the S&P Food and Beverage Select Industry Index has slipped by about 10% over the past six months. However, as is often the case, the market is prone to shoot first and ask questions later rather than considering the specifics and resilience of individual firms. Whilst GLP-1s have huge medical potential that could disrupt a range of industries and businesses, this ignores the ability of companies to respond and adapt. Businesses such as Coca Cola and Nestle have faced existential challenges but the quality of these companies, their structures and leadership has enabled them to embrace corporate Darwinism in the past, to adapt and survive.

Conclusion

What was a challenging environment, albeit one showing some signs of economic positivity, is now facing a host of uncertainty amid a conflict that risks getting out of control. The only solution in times like these is to hold a broad range of high quality assets that diversify a portfolio and ensure that risk is well spread throughout providing resilience however this crisis unfolds. Our holding of gold, often considered the safest of assets, should prove particularly useful during this uncertain time.

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