Current Positioning
November 2023

James Hambro & Partners

The past month summed up

US bond yields climbed higher, temporarily breaching 5% for the first time in 16 years, before moderating in late October and early November. The surge in yields raised concerns around borrowing costs and, coupled with an uncertain earnings season, held back stock prices.

Current positioning

With yields at their most attractive levels in more than a decade, we retain a neutral position in bonds, while we continue to review and optimise the balance of our underlying holdings. We remain close to neutral in equities although lean towards caution, focussing our investment on more resilient companies and sectors, given expectations that interest rates will succeed in slowing growth. Diversifying assets, such as gold, remain a key component to provide protection against geopolitical shocks and surprises that currently present a heightened but unpredictable risk.

The rationale

Our core expectation remains that there will be some deterioration in economic prospects given the rapid ratcheting in interest rates that has taken place since early 2022. The fallout from the Covid pandemic, with its rolling impact across sectors, continues to provide mixed signals and means this cycle is following a very different trajectory to those in the past.

This lack of clarity has been evident in some big swings in assets over the past few weeks. The US 10-year yield climbed to over 5% in October, a 16-year high, before falling back to levels closer to 4.5% by the start of November. The move in yields has been laid at several doors, including jitters over the scale of US debts, but seems mainly driven by the simplest of economic calculations related to supply and demand – in this case investors are worried that the US is issuing way too much, with almost $1 trillion of bonds sold over three months. Lurking in the background though is the ever-present fear that interest rates will have to stay higher for longer as the economy seemingly refuses to bow to being curtailed. Indeed, Federal Reserve Chairman Jerome Powell said earlier this month the bank wouldn't hesitate to increase rates further.

Hokey Cokey

The nervousness in bonds spread to equity markets prompting the benchmark S&P 500 index to drop 2.2% over October after a 4.9% slide in September. Fittingly for the one-step-in-one-step-out times we live in, the market flipped direction at the end of October when US stocks recorded their best weekly return in a year. That came after the US posted a lower-than-forecast 150,000 new jobs in October, fuelling expectations that interest rate policy was starting to work, decelerating the economy without crashing it into a brick wall – bad news for growth being seen as good news for markets.

Company earnings, normally a significant bellwether for the state of the economy, have also failed to provide clear direction. While Factset data suggest Q3 earnings in the US for most companies were above estimates, the Bank of America Global Earnings Revision ratio, which measures the ratio of improvements to deterioration in earnings, slipped slightly back in October from 0.78 to 0.74. Expectations for growth in the final three months of the year are now being nudged lower.

The ghost of Covid past

Into the heart of all of this back-and-forth is the lingering effect of Covid, not surprising considering the once-in-a-century upending of natural economic activity that took place. Consumer spending has been prolonged, even as interest rates tightened, sustained by the savings that households had built up when they'd nothing to do apart from watch Netflix during lockdown. That helped propel US GDP annual growth to a very respectable 4.9% in the third-quarter. Bloomberg reported last month that revised government figures show that US consumers have billions of dollars more in savings than previously thought; there may be even more fuel in the tank.

The ricochet of the pandemic can also be seen in particular sectors. For example, parts of the healthcare sector have suffered of late because assumptions of demand that were built in during the height of the pandemic, particularly related to their ability to make money from an enduring need for vaccines, have retreated, as Covid for the majority of people has become less deadly. The patchy effects of this will be felt keenly in Ireland where Pfizer is amongst the biggest taxpayers; the fall in vaccine sales will put a not insubstantial hole in Dublin's coffers.

The lack of traditional cause and effect stretches even beyond Covid. In Gaza, on the political and humanitarian front, the news seems to get worse day in, day out. And yet, where conflict in the Middle East would normally prompt a spike in the oil price over fears of dwindling supplies, this has yet to materialise in any significant way. In fact, oil prices have already shed gains that happened since the start of the conflict.

The price of energy is still one of the most important ingredients in an economy, and in the longer term, changing sources of energy are going to increasingly influence which sectors and companies succeed.

The energy transition

With the exception of the extreme wing of the Republican Party there are very few people who now deny the existence of man-made climate change, nor the need to alter our collective behaviour to modify this threat, nor that this shift will provide huge opportunities for companies. Of course, this potential has been recognised for some time, but events of the last year mean it is time to reappraise the best way to ride this particular wave.

The simplistic notion has been that companies at the coalface of green energy are most likely potential winners. One risk with this approach is that governments can be fickle and arbitrary depending on what way the political winds are blowing. Thus, consider the recent decision to rein back the lion's share of the HS2 project, which only a few years back was the UK's flagship infrastructure development.

In fact, the shift to a more sustainable energy future isn't going to be quite as linear as previously thought, particularly after Russia's invasion of Ukraine prompted many governments to reappraise their energy policies, with security of supply prioritised over cleanliness of generation. With interest rates much higher, projects that a few years back might have been viable now look unpalatably expensive. Another element bearing down is that the price of raw materials needed for some of these projects has rocketed — copper prices for example now sit comfortably above their pre-pandemic levels. By way of example, Danish renewable-energy company Orsted said earlier this month it had cancelled two major offshore windfarm projects in the US, citing rising interest rates and a squeeze on supply chains.

There are parallels in the transition to renewable energy with what happened during the great Internet bubble of the early noughties. Then, many companies expected to be winners in the building of the Internet failed to deliver, at least for shareholders. Instead, it was those companies at a slightly more distant remove from the fray who benefited most; the technology titans of the present – Amazon, Google, Meta, weren't involved in building out Internet infrastructure but spectacularly harnessed the technological shift. For the same reason, we're attracted to companies that will benefit from a wide range of consequences of the energy transition but whose fortunes are independent of the balance of technologies that ultimately fuels the electric revolution. Companies such as Ashtead, which rents out industrial and construction equipment, Amphenol which makes electronic connectors and sensors, and critical resource mining companies like Rio Tinto are key enablers of the energy transition which should succeed whoever ultimately wins.

Conclusion

Looking closely, market data is hinting at elements of an interest-rate induced slowdown, but the picture is increasingly different depending on your vantage point; the outlook is beginning to diverge by country and industry. Over 50% of central banks around the world are now cutting rates.

With few strong signals and many investors having been wrong-footed by the economic resilience to rate rises, there has been enough optimism helping sustain activity and as a result buoying investor appetite. Despite a rollercoaster month, there has been insufficient new information or shifts in valuations over the past few weeks to prompt us to make any significant change to the balance of assets in our portfolios.
