Current Positioning December 2023

James Hambro &Partners

The past month summed up

After declines earlier in the quarter, both bonds and equities posted healthy gains over November as the market consensus settled on the likelihood of a softer landing for the US economy. This sentiment was bolstered by the Federal Reserve's more dovish stance on interest rates for 2024.

Current positioning

Our diversified portfolios were rewarded with solid advances for both equity and bond holdings over November. Bond portfolios continue to provide support as both inflation and growth cool. In equities we are well balanced with a portfolio invested across a range of sectors and end markets, but with a focus on quality, robust cashflows and companies with balance-sheet strength. With the downside in mind, we retain investment in diversified assets such as gold to protect against predictable and unpredictable risks; these assets also contributed positively over the month.

The rationale

Our central view has evolved through the year and while there has been a slowdown in the economy due to the higher interest rates of the past two years, this is not proving as severe as previously anticipated — we may have seen off the scourge of inflation with a managed slowdown rather than a recession after all. However, whilst the consensus is coalescing around "Goldilocks" – everything just right – there is still a meaningful risk that a slowdown evolves into a recession for the global economy next year that would impact the prospects of investment assets.

Still, had you suggested a year ago that we would be where we are today, with inflation falling, interest rates over 5% and no sign of a significant downturn we would have said that this meant a significant break with historical precedent. Previous experience of economic cycles was that the speed and scale of interest rate rises would inevitably lead to a more severe downturn. This time, the trend has been mitigated by one-off factors: excess savings held over from the Covid pandemic have kept consumers spending whilst the vast infrastructure spending undertaken by the US government has charged industry.

Soft-landing relief was palpable in markets over November with the US benchmark S&P 500 index posting an 8.9% gain, one of its 20 biggest monthly advances ever. More broadly the MSCI World index climbed 11.5%, its second biggest monthly advance of 2023. Europe's Stoxx 600 index gained 6.4%. The FTSE 100 index returned a more sluggish 1.8% as oil prices slumped, holding back the energy-heavy UK benchmark. The gains were underwritten by the feeling that the major global economies may be at peak interest rates, a view which also helped send the yield on benchmark government bonds lower, which in turn sends their value higher. The yield on the benchmark 10-year US Treasury and equivalent UK gilt now sits under 4% after flirting with 5% in October.

Goldilocks and the ECB/BOE bears

Evidence that we are touching down softly comes with an institutional hallmark – the Fed in its December meeting gave the clearest indication yet that it believed it had dodged a recessionary shock from the interest rate splurge.

Central bankers tend to speak in moderated tones and therefore Chairman Jerome Powell's assertion that rate setters within the Fed thought it unlikely that they'll have to raise rates further can be read that, as of now, the only way is down. The Goldilocks stats keep flowing, with US inflation slipping to 3.1% in November from 3.2% a month before, down drastically from the 9.1% of June 2022. At the same time the US economy seems perfectly fine with retail sales unexpectedly rising by 0.3% in November; US employers added 199,000 jobs in November while the unemployment rate slid to 3.7%.

The confidence of the Fed announcement was somewhat missing on the other side of the Atlantic with the European Central Bank indicating it was still watchful over inflationary pressures and the Bank of England strongly suggesting it may need to hold rates higher for longer, even as the UK economy contracted in October. In the wider world, the prospect of deflation in China provides evidence of an increasingly de-synchronised world.

Given its pre-eminence, the US remains in the driving seat for global economic prospects, which at present are looking better than expected given our position in the interest rate cycle. With market watchers having all but declared victory over inflation and holding a settled view of where interest rates will go, attention now turns to the great variable of US employment as a bellwether of how the economy is progressing.

To reiterate, we are mindful of the continuing risks – just because the road ahead looks clear doesn't mean we are taking our hands off the steering wheel. Those risks include the ongoing chance that this proves a case of downturn delayed rather than averted, that any reversal in the employment trend could be rapid, and that there remain two significant wars taking place at present, both of which could have a major impact on global energy prices. Recent restrictions on trade through the Red Sea may be a portent of things to come.

Discerning in large cap, warming up to small cap?

One theme that has dominated investment markets over 2023 has been the seeming invulnerability of global tech titans who have driven most of the gains in the US stock market. We do not question the potential of an AI-driven technological revolution, but that does not mean that each of the so called "Magnificent Seven" will benefit equally. We take seriously our stock-specific approach, involving the assessment of the specific prospects for individual companies and their value both now and into the future – separating what may be a great company from what will prove a great investment. We have exposure to several of the leading tech companies, but while acknowledging the sheer power of a business such as Apple, we believe it does not provide value into the future for our clients at present price levels. The winners of yesterday may not be the best investments for tomorrow.

At the other end of the capitalisation range lie mid- and smaller-cap companies. They have been largely overlooked amid the mega-cap rally, not without reason as smaller companies tend to be more susceptible to the higher interest rate environment, borrowing for shorter periods with more sporadic financing needs that may occur at inopportune times. To demonstrate this divergence in outlook, the Russell 2000 index of smaller US companies lagged the S&P 500 by nearly 14% for the year up to the day before the Fed announcement last week. With the chance of a pivot in the direction of interest rates, the prospects for smaller companies may be about to improve, prompting the Russell 2000 to climb 6.3% in just two days after the Powell speech. A more benign monetary environment alongside economic stability would give us greater confidence to look at smaller companies in the new year.

Cop-out 28

Whatever your thoughts on the transition to a more sustainable energy future, it's reasonable to expect that when governments get together to deal with a global challenge that something might come out of it. Cop 28 served to confound that rational expectation – it has hardly marked any significant change at all. The first iteration of its communiqué neglected to mention the phasing out of fossil fuels, surely a prerequisite for changing our global carbon footprint. Even the more robust later statements from the meeting are unlikely to move the needle for those companies involved in developing alternative energies. Until governments become bolder in their steps, progress will be driven by companies driven by commercial opportunities more than environmental principles. Thus we continue with our strategy of looking for companies a step back from the frontline of the Green Revolution, those who can benefit from the transition independent of what governments globally decide to do, if indeed they decide to do anything significant at all.

Conclusion

The consensus is increasingly confident that inflation has been tempered without serious damage to the global motor that is the US economy. Our measured approach has made absolute sense in the face of a rapidly evolving cycle where the reverberations of Covid continue to be felt. However, with the Fed more firmly

optimistic than before, this does open the prospect of 2024 offering a clearer directional emphasis for markets. This may provide the opportunity for us to incorporate bolder themes without throwing caution to the wind.

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