James Hambro & Partners

Current Positioning January 2024

The past month summed up

Positive sentiment helped propel both equities and bonds higher during December, with the market coalescing around the view that inflation had been tamed, leaving relatively little impact on the economy. The question therefore is what could challenge this upbeat scenario.

Current positioning

We have in recent weeks rebalanced our minor shortfall in equities up to full strategic value, so are now neutral across the board in equities and bonds, reflecting the relatively benign state of markets and the economy at present. We still see the need to maintain overall resilience to shocks and so remain vigilant for anything that might threaten this state of affairs and so retain investments in diversified assets such as gold to protect against predictable and unpredictable risks.

The rationale

There are no signs on the ground that cause us to strongly disagree with the current consensus that central banks have managed to tame inflation with less disruption to the underlying economy than was thought possible a year ago – and has normally been the case during other periods of rapid rate increases. We are conscious though that significant threats remain that could alter the current trajectory of smoothly declining rates and a reasonable economic outlook.

Market consensus is an interesting phenomenon: just because a majority of market participants believe something to be the case, or in a particular outcome, does not make it a foregone conclusion. This seems to be particularly marked at the start of the year. The geopolitical and economic order of early 2020 had turned on its head by March when Covid forced the world into lockdown. At the start of 2022, few were expecting the Russian advance into Ukraine and associated chaos in energy markets.

Indeed, the market consensus a year ago was that the rapid interest rate increases in Europe and the US would stifle economic growth leading to a downturn that could threaten company profits and therefore the returns on equities. The consensus now is that the period of rampant inflation, which prompted those rate increases, is now generally behind us, that interest rates can start coming down this year and that the economy seems to have survived relatively intact from the burden of higher borrowing rates.

The evidence for the consensus is in some ways compelling. Inflation does generally seem to have slid, albeit with bumps along the way – the US posted inflation of 3.4% in December, slightly higher than a month before but not enough to rattle nerves significantly. In the UK, wages have been rising faster than inflation, taming the differential that had caused a cost-of-living crisis. Market indicators still suggest it likely the Fed will cut interest rates in March, beckoning the end of a severe bout of rate increases and lessening the burden on companies and individuals. US economic growth is strong: 4.9% in Q3, underpinning support for equities. Even a significant and spreading conflagration in the Middle East doesn't seem to have dented economic prospects, with the price of oil surprisingly falling during the conflict.

With this background, the S&P 500 recorded growth of 4.4% in December, while the technology heavy Nasdaq climbed 5.6%. An indicator of bullishness was the growth of 12.2% for the Russell 2000 index in the US, a measure of the performance of medium-sized companies who tend to be more susceptible to the interest rate cycle and economic ups and downs. Likewise in the UK, the FTSE 250 index of small and mid-sized companies climbed 8.2%. Bonds also advanced with the yield on the US 10-year Treasury falling from 4.33% to 3.88% on the expectation of declining interest rates. Investors have strongly bought into this bullishness with the Bank of America Global Fund Manager survey showing the highest positivity in almost two years, and money managers holding an overweight position in stock markets.

All well and good? Perhaps. But best not get ahead of our skis.

Watch out!

While we still believe a continuation of this trend is the most likely outcome, we differ from consensus in the weight we would give to a series of counter narratives that may come into play. There is a long list of data points that may go awry and prompt a series of alternative outcomes.

On the more positive side, inflation could slip to the Fed's 2% target sooner than expected, allowing interest rates to fall sharply, boosting the prospects of economic growth. This outcome would suggest shifting to an overweight position in equities. It would also drive bond prices higher.

On the downside though, there remains the possibility that the downturn has only been delayed by the impact of Covid savings and President Biden's assertive government spending programme. A late arrival recession might lead to the Fed rapidly cutting interest rates – bonds would be boosted by this, but equities might be threatened by the economic downturn and its impact on profits.

Somewhere in the limbo between economic good fortune and bad luck is the scenario where the US economy remains so strong, bordering on overheated, that the Fed decides to postpone those interest rate cuts that it heralded at the end of last year. This outcome could threaten both equities, because of the perceived chance of a squeezed economy from the higher interest rates, and bonds, whose fixed returns would seem relatively low to what might become available on deposits.

Election year, election fear?

More interesting again is the increasingly jaundiced relationship that markets have with the US government in relation to its burgeoning borrowing. Those downturn-busting investment programmes of the Biden administration have got to be paid for somehow. It's not as if debt levels haven't been a factor already and many will remember how US yields shot up beyond 5% in October on these concerns. Throw in an election year where both parties might seem to eke out advantage by promising to spend more (the Republicans under Donald Trump seem to have eschewed their position as a party of fiscal restraint), whilst the fractious relations between the Democrat White House and Republican-led House of Representatives could pave the way for a budgetary crisis which would again put fear into investors that the US may not honour its debts. An outcome such as this would deeply unsettle investment markets globally.

While we don't think that any of these represent the most likely outcomes, and the final scenario is most definitely an outlier, we still think these are reasonable possibilities that engender caution in our approach and preparation in case things change. It’s not time to relax yet.

What goes up must go down?

Another important facet of the way markets are operating at the moment is the highly correlated movements of both bond and stock valuations. In recent decades these two asset classes had typically moved in opposite directions, with more risky equities doing better in times of economic health and bonds outperforming in a downturn. Unusually, the recent prospect of rates declining has benefited both – equities on the basis of more benign economic conditions and bonds because falling rates mean existing fixed income streams are more valuable than beforehand. It is therefore even more important to ensure a good spread of assets within each asset class – in our equities we invest in quality companies across the board, with a good number of leading technology businesses but without relying on a single sector alone to drive returns. In our bond portfolios, whatever the short-term concerns about the US deficit, we feel that the bonds of the world's largest economy have been shown to be dependable investments over many decades and will continue to behave as such in the coming months.

Conclusion

The New Year brings the prospect of a turn in the interest rate cycle, a belief widely shared across the investment community. We agree that the outlook today is positive but the vulnerability of markets to shocks is writ large in recent market history. There remain plenty of opportunities for the central scenario to be challenged and there will be plenty of the unexpected in the year to come. We will continue to manage our clients’ portfolios to take advantage of the positive but

not at the expense of overall portfolio balance
and resilience.

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