Current Positioning
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James Hambro & Partners

The past month summed up

The final push on lowering inflation is proving more of a challenge, prompting a slight change in our bond allocation. And while stock markets continue to be buoyant on the back of AI expectations, there's too much froth and exuberance at present to see clearly who the ultimate beneficiaries will be.

The rationale

Our core position remains that surging interest rates over the past two years have essentially brought rampant inflation to more reasonable levels without damaging the economy. The US is in rude health, but the final leg of inflation poses the biggest challenge. Getting inflation back down to the Federal Reserve's 2% target might be more difficult amid a thriving economy, resilient jobs market and rising wages. Questions remain as to if and when interest rate cuts are likely.

We continue to view the evolving situation through the lens of the scenarios outlined in previous papers. First, and still most likely, is that inflation declines at a slower pace from here but falls sufficiently to let central banks ease back on interest rates later in the year, leaving economic growth undimmed; the so-called "soft landing" scenario. Second, is the possibility that higher interest rates do ultimately bite harder than expected, or that their impact has simply taken longer to filter through, so that the economy and employment starts to sputter. The third option is that inflation remains stubbornly at present levels, or even rises, undermining the prospects of, and market expectations for, interest rate cuts.

We continue to review these outcomes on a weighted basis. We think the first the most likely, the second – delayed recession – scenario the least likely, while the chances of the third scenario have increased – rate cuts may not be quite as forthcoming as people expected.

At the start of 2024 markets and some commentators were predicting as many as five or six US rate cuts this year, beginning this month. We felt these market expectations were inconsistent with the stable economic picture and so we were expecting fewer. These expectations have now shifted, with investors consolidating around the Federal Reserve's guidance of three rate cuts in 2024. However, a recent Financial Times poll of economists showed they believed there'd be even fewer cuts than anticipated by the market, and that these may take longer to be actioned. Fed Chairman Jerome Powell just this month reiterated that policy makers were being "careful".

The reason for pushing out those expectations is the clear difficulty in squeezing out the last of inflation. In February US inflation climbed to 3.2 percent, higher than the 3.1 percent predicted. Perhaps not surprising given that the US added another 275,000 jobs in February, faster than the 198,000 that was anticipated.

Any change in interest rate expectations will have a direct bearing on the prospects for bonds, but there's another significant issue that may influence US Treasuries.

Things can only get debtor

A recent article in the FT noted the relative lack of concern in markets about the vast issuance of US debt and the huge amount of spending the US has undertaken in recent years. The so-called bond vigilantes, who managed to raise a storm in the autumn over their concerns about the oversupply of US bonds, sending 10-year yields above 5%, have been quiet of late, the report noted.

On face value, the US has been taking itself deeper and deeper into debt and spending more and more. Total debt now stands at more than $34 trillion, almost three times the figure from 15 years ago at the height of the Tea Party Movement's crusade against what they saw as President Barack Obama's unsustainable level of US borrowing.

As we've noted before, one of the factors sustaining US growth has been the considerable amount of investment undertaken by the federal government through programmes such as the Inflation Reduction Act, which will pump hundreds of billions of dollars into the economy. For those who believe a change in the administration will reverse or rein in debt levels, think again. The former, and possibly future, President Trump, along with his supporters, bear little resemblance economically to the Republican Party of yesteryear, with little aversion to fiscal expansion. In contrast to the Democrats, they are more likely to emphasise tax cuts rather than spending, but both will put a further strain on US purse strings. Their belligerence towards China and others might reduce overseas demand for Treasuries just as supply is picking up (Reuters reported in January that Chinese Treasury holdings are already at their lowest in 15 years). Simple supply and demand factors point to downward pressure on US Treasury values.

This is not the time for panic – previous concerns about US debt levels have proven premature, the US remains the world's largest economy, and US Treasuries are the benchmark for how every other security on earth is measured in terms of safety. US credit ratings are still strong and people lend the US government money in the full expectation of being repaid.

However, combine the slightly larger lag on interest rate cuts with potential questions about debt levels and we have decided to modify our investments in US securities from those at the longer end to those at the shorter end, where they are less susceptible to interest rate and inflation concerns and the implications of rising government deficits.

Bubblicious

What with a global pandemic of recent years and the highest interest rates seen in decades there's still a suspicion that equities are a bit ahead of themselves, with US and other markets breaching all-time highs.

While much of the US gain can be ascribed to the rise of the so-called magnificent seven technology titans, the story hasn't been so simple recently. Apple has shed about 3.8% of its value and Tesla a whopping 29% since the start of the year. Instead, it has been the likes of AI chipmaker Nvidia which has soared more than 85% over the same period, harnessing the escalating expectation that AI will drive a paradigm shift in the economy and in our lives.

There are fears that with gains such as Nvidia's a bubble might be building similar to that of the dotcom surge at the turn of the millennium. That, we think, is jumping the gun. As The Economist reported citing Goldman Sachs, forward price earnings figures for the larger tech firms stand at a weighty 25 times earnings, but that's nowhere near the 43 times earnings at the height of the tech boom.

There's also a strong qualitative difference in the discourse. Today while some might consider the price of these tech companies over-inflated, these are serious businesses involved in selling real products. Wind back to 2000 and people were paying money for companies that were based around a good idea, with, in the worst cases, brokers selling shares to clients that they privately considered worthless.

Instead, it's clear that AI will bring demonstrable efficiencies. Consider, for example, buy-now-pay-later pioneer Klarna, which put out a statement last month saying its AI assistant was doing the work of 700 full time agents and doing the job better. That announcement underlines for us the fact that AI will have transformative impacts – it's just not quite clear yet exactly who it will be transformative for, and what the impacts will be for productivity and profitability. There is great potential in the application of AI across a range of businesses but our experience of previous cycles reminds us that bubbles initially build on sound fundamentals and good ideas and so we need to be rigorous in distinguishing the opportunity from the hype.

Conclusion

We are happy with the balance between equities, bonds and our other diversifying positions given the prevailing economic winds and asset valuations, which on the whole look reasonable. This allows us to monitor the changing environment and to shift assets to where they may be better deployed should the interest rate and economic outlook diverge from our central scenario. For the moment we continue to modify our specific holdings within each class where new information and opportunities arise.