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&Partners

Current Positioning
April 2024

The past month summed up

The economy in the US is roaring ahead. But is the price for this buoyancy a delay to, or even an abandonment of, planned interest rate cuts?

The rationale

Our core position remains that higher interest rates in the US are having the desired effect of reducing inflation without sinking the economy, and that will allow rates to be gradually reduced. Economic activity, however, seems to be on a faster footing than expected.

Of the scenarios that we previously outlined, two are now looking more likely. Most probable is that, while inflation is proving difficult to bring down to target levels, the challenge isn't insurmountable and eventually this year we will see rate cuts commence. The other is that the US economy is in overdrive, leaving inflation too hot to handle, and forcing central banks to rethink the planned interest rate cuts due this year.

A cool-headed assessment of the state of the interest rate cycle doesn't give enough credit to how robust the US economy continues to be. One key task for any government is to keep its people in employment and the US is certainly doing that, with employers adding another 303,000 jobs in March, 50% more than the 200,000 job gains predicted. The flipside is that a tight jobs market means workers can demand more wages, maintaining inflationary pressure. Whatever the underlying cause, consumer prices advanced an annual 3.5% in March, with gains accelerating for the last three months.

The factors driving the US economy are oft cited – savings held over from the global pandemic now being spent, massive US infrastructure investment and largesse on the part of the baby boomer generation, with consumption per household near an all-time high. An economy that is powering ahead is good news for many types of investors, but particularly those in equities. More money going through the economy means higher profits, yielding better returns for shareholders. Stubborn inflation driven by a thriving economy is a different proposition to unchecked inflation driven by higher energy costs.

A concern over the past year has been that rising stock markets were driven by a few, very large technology firms. Not a problem the last month – the economic glow is spreading to a host of other sectors, with energy companies, materials companies, industrials and banks amongst the top performing global sectors, easily beating returns from telecoms, technology hardware and software companies. The diffusion of performance has also been geographical, with equity returns spread throughout the world rather than just focused in the US. In the UK, whose stock market has been relatively moribund until recently, the FTSE 100 posted a 4.2% gain in March and, as of writing this document, was hovering close to an all-time high – as was Europe's Stoxx 600 index.

Chocoholic challenges

These are all reasons to be cheerful: those equity gains are founded on economic fortitude along with the prospect of a more benign interest rate environment. However, the risks of shocks to supply have not evaporated in a de-globalising world, where some inputs are rising in cost. It should be noted the price of oil has climbed from $70 to $85 a barrel this year. While some have pondered that instability in the Middle East is pushing prices higher, the simple answer could be a healthier economy driving greater demand for energy, particularly as the manufacturing sector emerges from the doldrums.

An off-beat trend, but of interest to chocolate lovers, has been a surge in the price of cocoa, with prices more than tripling over the past year to close to $10,000 a tonne (Easter eggs did seem rather pricey). According to Bloomberg, rising prices come on the back of a global shortage that in turn was prompted by crop failures due to bad weather and a lack of fertiliser.

Which brings us back to our original concerns about inflation and then interest rates. Opinions from analysts span the entire range of scenarios that we have talked about in earlier missives. From those who believe that rate cuts will indeed come this year along with continued economic growth, to those who think rates may even have to rise again or those who resolutely believe that we are ultimately heading into a recession. Policymakers are trying to hold the line, with Federal Reserve of New York head John Williams claiming that US inflation was still on the way to the 2% target. The trendline though does now look to have shifted: inflation isn't slowing as much as expected. The FT reports that the market is pricing in just a couple of quarter-point rate cuts this year, down from the six that were expected in January. Bloomberg reports that both Deutsche Bank and Bank of America are now saying there'll be no rate cuts until December.

Gilts

As we noted last month, we've taken action to protect our bond portfolio amid these ructions, moving investments into shorter-dated bonds which are less susceptible to inflation and interest rate concerns. Furthermore, it's worth noting that two thirds of our bond portfolio is held in UK gilts. While we've been sceptical to a degree of the UK's prospects in relation to a US that's firing on all cylinders, the inflationary situation in Britain has at least been pointing in the right direction, with the Consumer Prices Index at 3.4% in February, down from 4% the previous month.

Treasuries or Tiffany

We often remind clients that we hold gold in our portfolio as a protection against unforeseen economic and market volatility. Gold has been seen as a haven and store of wealth for centuries irrespective of where in the world you sit.

However, the precious metal has recently been outperforming with growth accelerating. Demand for physical gold has been rising, particularly in emerging markets, supported by stronger demand from both central banks, wealthy individuals and family offices.

Central banks' motivation is bubbling geopolitical tensions, with countries such as Turkey, India and China unwilling to have all their reserves hostage to US foreign policy. As was seen with Russian assets after the invasion of Ukraine, the US is not averse to stopping the repatriation of foreign money, using its place at the centre of global trade to influence the behaviour of other nations. A holding of gold however has no such risk. This thinking has also been followed by wealthy individuals and families in these nations who may either face similar penalties for holding US assets, or be worried about the kleptocratic tendencies of their own authoritarian leaders.

Conclusion

Market perceptions of the interest rate outlook have been changing. The action we have taken recently in relation to US Treasuries will protect portfolios should expectations for rate cuts be pushed further out. Given this is likely due to the healthy state of the US economy it should still be supportive for our equity portfolio.

Gains are spreading rapidly across the economy but particularly in those stocks more sensitive to economic growth, such as those in finance, infrastructure construction or consumer spending. We are seeing growth opportunities across a broader range of our quality companies.

However, with growth in fashion, more defensive areas such as healthcare and consumer staple businesses – those stocks that tend to do well in slower economic times because their goods are bought no matter what the outlook – are lagging. This may throw up some interesting opportunities in what are undoubtedly good businesses but which are out of the limelight. Quality always comes back into style.

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