Current Positioning
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James Hambro &Partners

The past month summed up

US inflation is looking stickier than previously thought as the economy continues to boom, but the good news is that this growth seems to be spreading to more parts of the globe.

The rationale

Our core position remains that US inflation is decelerating as supply constraints ease and higher interest rates bite. However, we also believe that economic growth will continue, potentially keeping inflation above target for longer. This may delay some of the rate cuts that had been planned (Federal Reserve Chairman Jay Powell said recently the Federal Reserve may hold rates higher for longer) though at this moment it's unlikely that rates could be pushed higher – inflation would have to accelerate for this to change.

That said, there are a few signals that inflation is yet to be tamed. One of the most important expenses in any personal budget is accommodation – in the US the three-month annualised inflation rate for rents was at 5% in March while the owner's equivalent rent inflation figure (what homeowners would pay if they leased their homes) stood at 5.9%. Given that the Fed's target for inflation overall is 2%, this is a considerable gap. Another area of concern in terms of rising prices has been in the cost of insurance for cars. According to S&P Global, between February 2023 and the same month this year, the average cost of motor vehicle insurance climbed 20.6% – talk about sticker shock! The problem of course is that higher costs in one area can push up prices in another with the only solution for most people to seek higher wages.

Eat, drink and be merry

We've talked before about tightness in the US labour market on the back of surging demand for workers. One of the biggest drivers would seem to be the behaviour of the baby boomers who not only have been retiring in their droves but have been dipping into their personal savings, spending on high labour component services such as restaurants, travel, entertainment and healthcare. Fear of an overheating economy has played on investors' minds of late – the threat that an economy growing too fast means higher inflation which means delayed interest rate cuts. As a consequence, the S&P 500 index slipped 4.2% in April.

However, on the jobs front there was some relatively good news last month in that the US added only 175,000 jobs in April whereas 241,000 had been the prediction in a Bloomberg poll, representing the smallest gain in six months. US markets posted their best day in more than two months on the news. Relief about the state of the labour market may also be bolstered by data that shows the underlying cost of labour has been declining. Unit labour cost (compensation divided by productivity) inflation, slipped by an annual 1.8% in the first quarter. Excess heat coming out of the labour market gives us some comfort that inflation could be about to fall to more reasonable levels. Overall inflation slipped marginally to 3.4% in April, from 3.5%.

Going global

Which all goes to underline why there remains a great deal of positivity in markets. The widely held belief holds that we have exited the higher inflation epoch without an economic lapse. The S&P 500 index is up more than 10% year-to-date. Encouragingly, economic growth seems to be spreading to the rest of the world and consequently equity gains are becoming more broadly distributed. The UK, where growth had been lagging, has now exited a recession, growing faster than both the US and EU in Q1. The FTSE 100 index itself has climbed 9.1% so far this year. Bloomberg is reporting that Eurozone economic growth will accelerate this year to 0.7%, against a previously forecast 0.5%. The Stoxx 600 European benchmark index has climbed 8.8% in the year to date.

Corporate data is also supportive, with the Bank of America global earnings revision ratio climbing from 0.76 to 0.81 in April. Its global fund manager survey shows that investors are the most bullish since January 2022 while there's been the biggest jump in global growth optimism since May 2020. Investors are saying, for the first time since the end of 2021, that they expect the global growth to accelerate.

Could expectations be getting ahead of themselves? The cyclically adjusted price earnings ratio (CAPE) for the US would indicate that equity valuations are looking fairly full, suggesting that real returns could be modest for the next 10 years. However, with the prospects for earnings improving across a range of industries, not least tech, then the true 'E' in the future could be much higher than the estimated 'E' in the CAPE.

The Monarch of Microsoft?

It's difficult to fathom just how large our biggest companies have become. They could almost be seen as more akin to the city states of history than simple companies: incredibly rich and powerful, and able to hold their own in an uncertain world. Microsoft, the world's largest company, has a towering market cap of $3.1 trillion – not that much smaller than the $3.5 trillion that makes up the GDP of the UK, itself the world's sixth largest economy. And these companies are sitting on vast amounts of cash for them to invest, even if it is in themselves! Recently Alphabet, the parent company of Google, proposed a new $70 billion share repurchase programme, bigger than the UK's annual defence budget. They are even matching countries in terms of policy decisions, with reports that large companies such as Meta are planning to spend vast amounts on building or acquiring clean energy parts to guarantee their energy security.

This poses interesting comparisons – most investors consider, quite rightly, that US debt is about the safest investment in the world. However, with many western nations' budget deficits swollen by the response to the pandemic, it is not impossible that the financial might of the biggest tech giants could mean they are viewed as more secure than many sovereign nations. After all, it is not much more than a decade since we worried about the solvency of Greece, Italy, Portugal and Spain.

Conclusion

There remains an element of uncertainty about the trajectory of the economy, although it is still most likely that inflation is slowing, paving the way for interest rate cuts later in the year. Our decision to shift our fixed income into shorter-dated bonds has been vindicated by recent rises in yields as interest rate cut expectations moved further out. The next step may be to increase our equity weighting should the outlook for the economy and inflation become more benign over coming months.

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