Current Positioning
June 2024

The past month summed up

The market and economic outlook continue to be positive, but some analysts are worrying that a slowdown is coming soon – still in the optimistic camp, we are ever watchful for any change in direction.

The rationale

Our central view remains that the global driver that is the US economy has settled into a reasonable equilibrium: inflation has fallen but is proving sticky at present levels; the economy is trundling along nicely; and interest rate reductions, while probably delayed relative to what had been expected at the start of the year, should come eventually when the inflation outlook improves. However – and there is always a however in investing – some analysts are highlighting specific data points they believe imply that the higher interest rates of the last couple of years are now biting at the US economy.

New York Times columnist Paul Krugman, a Nobel Laureate, noted recently it was time for policymakers to leave aside their concerns about inflation and worry more about a slowdown, citing an April decline in some measures of consumer spending and weakness in the manufacturing sector. BCA, currently a cautious outlier amongst strategists, say there are markers that might augur a sputtering economy: increased US corporate bond defaults and Chapter 11 bankruptcies, and gains in the number of people unable to pay off credit card or automobile loans.

While we still believe that the majority of information points to the positive, these concerns are useful in highlighting several important considerations as to how the economy reacts to higher interest rates. First, there is the length of time it takes for interest rates to bite – bearing in mind that under normal circumstances, making it more expensive for people to borrow should slow spending and demand in the economy. We've mused in the past that this lag has previously been anything up to 18 months – we are well past that now with interest rate hikes first increased in early 2022. BCA, with the catchy slogan "this time is not different: this time is longer" reckon the lag since 1970 has actually been closer to 29 months, which would mean any pain being felt in earnest around August.

Ice ice baby

If that seems a bit like trying to read the runes to predict the second coming, this is because of the observation that economies lapsing into recession often resemble the phase transition in relation to freezing water. Water gets colder and colder, but remains in liquid form, until it suddenly turns to ice. In other words, when the downturn comes, it will be sudden. Historically the US economy has on average grown at a rate of 2.5% in the three months immediately preceding a recession. There is a fine line between slowdown and recession.

In the analysis of how a slowdown impacts markets, we need to consider whether a downturn is taken as good news or bad news. Slowing growth in recent months has been good news for equity markets because it's made it more likely that interest rates will be cut whilst aggregate growth is still positive, keeping us in a glidepath to a soft landing. BCA analysts believe that if those signals become all too pervasive, then slowing growth becomes just bad news.

Whilst we are not in the BCA camp today, part of our responsibility is to consider tail-end risks and less-likely scenarios and how they might impact our clients. This means that we are ready to act in the event that economies do take a turn for the worse.

Our central view of calm conditions remains supported by recent core statistics. Job openings in May far exceeded expectations, with the US labour market adding another 272,000 jobs in the month well above the 180,000 predicted in a Bloomberg poll. The FT cited president Biden's excitement at the news, with his claim that unemployment has been at or below 4% for the longest time in 50 years.

Quick quick, slow slow, quick

Some felt that strength in the labour market, and with it wages, would prove a precursor to further signs of overheating, yet May's inflation statistics were more reassuring, coming in at 3.3% for the headline CPI against a 3.4% prediction by analysts polled by Reuters. With inflation showing neither signs of climbing again, nor any marked slowdown, the Federal Reserve said this month it was likely to cut interest rates just once this year. This does indeed mark a significant change from the start of the year when analysts were pencilling in as many as seven cuts. Even in Europe, where the ECB took the plunge of cutting rates by a quarter percentage point earlier this month, central bank President Christine Lagarde said there is no guarantee that the reduction in rates will be linear.

Overall conditions are supportive of a healthy corporate environment. World markets are up as much as 11% year-to-date, driven in large part by gains from technology companies, where investors are betting that the advent of generative artificial intelligence will bring in an epoch-changing shift in inefficiencies and revenue opportunities. While some may fear that the asymmetric gains by a small number of companies is making the US market overly concentrated (as they grow faster, they take up an increasing portion of the stock market) there have been several times in the 20th century when stock markets were more concentrated than they are now.

We do not see the gains by tech companies as a threat, but see opportunities across a range of sectors, as the benefits from this technological shift diffuse across an ever-wider number of companies. Even utility-type businesses, traditionally seen as reliable, if unexciting, investments for leaner times, are witnessing increased interest on the basis that they will supply the power and basic materials needed to power the data centres vital to the technology boom.

Positive company reports mean that the Bank of America earnings revision ratio in the US climbed from 0.93 to a nine-month high of 1.28 – more companies earnings expectations are being revised higher than lower. Fund managers continue to be ebullient, at the most bullish since in November 2021. For the moment, the optimists outrank and outgun the doomsayers.

Trading places

Take a trip down memory lane to the end of 2022 and any suggestion that the UK was a more stable fiscal bet than the US would have seemed ridiculous – after all, this was the period when Liz Truss and Kwasi Kwarteng introduced a budget that, whether you liked it or not, sent bond markets into a flurry over fears the UK was giving up on any pretence of balancing its books. Over that period, we'd held that US Treasuries were a safer haven than UK gilts, but now that isn't so clear. Whatever happens after this election, there is a general agreement that the Labour Party, the likely winner, will stick broadly to the current fiscal framework, with no overt plans for a spending spree that would place an additional burden on government finances.

Over in the US however it's a different story – we've talked before about the massive increase in US indebtedness over the last few years with US government borrowings now standing at an all-time high of $34 trillion. Under normal circumstances you'd expect the prospect of a Republican win in November's election as the precursor to more fiscal discipline. However, Donald Trump is no fiscal Conservative in the mould of previous Republican presidential contenders. His inclination is to lower the tax burden but also to maintain spending. In fact, well-known bond investor Bill Gross, a Wall Street fixture over several decades, told the FT recently that Trump would be more negative and disruptive for bond markets than Joe Biden.

Our response has been to reduce the riskiness of our US Treasury portfolio by reining in the maturity of the bonds that we own. Overall, our holdings of gilts exceed those we own in Treasuries, giving us the benefits of fixed income should the economy take a turn downward while holding bonds currently less susceptible to government and policy risks. We are keeping this under review and may take further steps once the outcome of the UK election is confirmed and before the US elections in November.

Conclusion

We continue to consider the weight of positive and negative signals from the economic and corporate environment with the clear balance of data points at present pointing to a continuation in the positive conditions. However, we are not blind to those indicators that might suggest a slowing of the economy. Should these coalesce into a more aggregated directional trend, then we may have to reassess our core position. By retaining balance and diversification in portfolios built around a basket of high-quality companies, operating in a range of industries, alongside a robust fixed income portfolio and diversifying investments in alternatives such as gold, we should prove resilient in the event of any unexpected or sudden downturn.
