Current Positioning
July 2024

James Hambro & Partners

The past month summed up

Strengthening signals that the economy is cooling will bolster the likelihood of policy makers being able to bring down interest rates before inducing a recession, while the UK now looks like a relatively safe fiscal haven.

The rationale

Our core view remains unchanged that a gradual cooling of inflation and a managed slowdown in the US economy — the world's powerhouse — will allow interest rates to be lowered before the higher rates have forced the economy into recession. This scenario is essentially the most likely middle way between two outlying scenarios at different ends of the economic spectrum and with very different investment implications.

At the one extreme, the view is that multi-decade highs in interest rates have failed to stall runaway inflation that may in the end require interest rates to rise even further rather than being lowered. At the other end of thought is that those rate hikes have been working their way through the economy relatively unnoticed and almost by stealth the economy will suddenly sink into recession before central banks have had time to ease monetary policy.

The Middle Way

In favour of the former theory is the fact that until recently the US has had an extremely active labour market, a significant ingredient in driving prices higher. If job openings are plentiful but labour is in short supply, that gives the power to employees to demand higher wages, which pervades the entire economy through pushing up corporate costs and potentially leads to a vicious circle of spiralling prices. Data recently has pointed to that risk receding — while the number of new jobs created was roughly in line with predictions in June, figures for April and May were recast downwards. More significant, the jobless rate rose to 4.1%, the highest since late 2021 when we were still recovering from the Covid pandemic. Overall, we see diminishing evidence of the continued overheating scenario at the moment, but we retain some caution given that, as we saw in 2022, any shock to energy prices can have a rapid impact on inflation.

At the other end of the scale is the view that the economy is slipping into recession. As we have noted before the most prominent advocates of this theory are the analysts at BCA, who now predict a recession is due either late 2024 or early 2025. The essence of the argument is that the labour market has effectively turned and that this phenomenon in earlier instances has preceded a downturn. Not only that, this unexpected recession means that the Fed won't react quickly enough with an aggressive lowering of rates. Data may well suggest that the economic direction of travel is indeed slowing — first quarter US growth was recorded down from 1.6% to 1.3% last month — but isn't a managed slowdown in the economy what we have been seeking all along? Up until recently the surprise has been the strength of the US economy in the face of higher rates. The IMF, which is not infallible but has at its disposal unsurpassed information and analysis, said in April the US would return growth double that of any other G7 nation this year, rising 2.7%, 0.6% higher than the previous forecast.

Consequently, the data, whilst choppy, corresponds with our assertion of a managed slowdown that will allow interest rates to be reduced this year. The most significant supportive data point in this field was that the US posted inflation of 3% in June, down from 3.3% in May and lower than the 3.1% forecast by analysts in advance. Markets responded positively, with declines in yields on US bonds indicating now that investors expect two rate cuts for the second half of the year, beginning as early as September.

Dangerous consensus?

Does this leave us dangerously near a consensus that all is rosy? Not when it comes to the nuance underneath our beliefs. While we do favour the continued steady slowdown theory, we've laced it with a healthy dose of circumspection. First, we think that pessimists such as BCA have precedent for their viewpoint (namely that interest rate hikes tend to induce recessionary trends) and therefore their assertion is definitely within the scope of a reasonable probability. Second, the investment world does on the surface seem worryingly complacent, given that we have had such high interest rates for a prolonged period and the world is in such a state of political upheaval. The Bank of America fund manager survey shows that investors continue to be the most positive since November 2021, expecting growth to remain unchanged over the next year; just shy of three quarters say they aren't expecting a recession. Our nuanced viewpoint is that while the steady, managed slowdown scenario is where we are at now, there is a reasonable risk of things taking a turn for the worse at any stage along this trajectory. This is why we have not been adding further to stocks, which tend to underperform other asset classes in a stronger downturn.

So what of stock markets? For those who wonder whether their continued march higher is indicative of unfettered exuberance in a world clearly challenged economically and geopolitically, it's worth noting that Bank of America earnings revision data are now at a 29-month high, climbing globally from 0.82 to 0.95 in June. It isn't just the US at the forefront here, with the biggest improvement last month in the Asia Pacific ex Japan region. As share prices are a reflection of expected dividend and earnings growth, higher stock prices can be justified against a background of higher expected earnings.

However, by historical measures valuations are becoming stretched, particularly in the US and specifically in those hot parts of technology which have captured the enthusiasm around artificial intelligence. Whilst not beyond the realms of the possible, particularly if lofty expectations are met or exceeded, these valuations do leave parts of the market vulnerable in the event of disappointment or should a growth slowdown become a bona fide contraction.

Feeling gilty?

It's never a good idea to let your political biases infect your economic thinking which is why we remain healthily sceptical of the power of any political party being able to build utopia — there are far too many variables outwith government control to allow them to claim all the accolades for a successful economic and corporate environment. There are however a few key principles that underscore a successful economic management programme and in the UK with the election of the Labour government we seem to have bagged a couple of these after some years of turbulence.

The first element of stability is the simple good housekeeping that involves not spending vast amounts more that you can afford. The Labour Party has been at pains to stress that it is sticking to the fiscal framework of Rishi Sunak (for contrast note the economic ructions that accompanied the fiscally lax Truss/Kwarteng budget). Where the UK benefits next is in terms of stability — Sunak's fiscal caution meant little if he was at the mercy of the whims of his disparate group of backbenchers, some of whom disagreed strongly with his aversion to unfunded tax cuts. New Prime Minister Starmer however stands with a whopping majority and the sheen of victory that assures the loyalty of the vast majority of his backbenchers, at least for a time. So not only are our national finances looking unlikely to become untethered (as opposed to economic performance which is another matter altogether), the situation looks relatively stable for the next few years.

For contrast just look across the channel. France has done little to fix its stretched budget — its deficit to GDP ratio came in at 5.5% in 2023, 0.6% above what was forecast. It's overall debt to GDP ratio stands at 110% compared to 66% in Germany and 43% in Ireland. Combine this with President Macron's decision to peer into the political abyss by calling parliamentary elections amid a resurgence in support for the right wing National Rally and it's no surprise that bond markets went into a flutter. Amid the political uncertainty the yield spread over German debt has climbed from about 0.4% to 0.8%, showing that investors now demand more money for holding French bonds over what they consider relatively safe German securities.

At the crossroads stands the US, already irking the sensibilities of the so-called bond vigilantes by racking up a record $34 trillion of debt. We've already suggested that a Trump victory could be even worse for US finances, with a likelihood of tax cuts without any pretence to rein in spending. There are also suggestions that an emboldened Trump could upend even more norms — in the economic space this could include undermining the independence of the Fed, which at present operates at an arm's length from the federal government. With increased concerns about President Biden's ability to beat Trump in November these fears will likely increase as we move towards the election day. Whilst this risk might be in the tail of distributions, for traditional safe haven assets such as US treasuries it could seriously undermine their stability and attractions.

Conclusion

Our portfolios are closely aligned with our central economic views — that a managed slowdown of the economy will hasten rate cuts, avoiding the onset of a recession – but tempered by our experience that circumstances can change quickly. Our neutral equity holding respects both this scenario and that of the outlying, but not inconceivable, possibility that a recession may occur. Most important still, our bond portfolios have been altered to minimize our exposure to the tail risks in the US market and to benefit from the stability which we will likely witness in UK markets amid the more settled political environment.

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