Current Positioning September 2024

James Hambro & Partners

The past month summed up

The evidence still points towards a tapering of economic activity in the US though the debate continues as to whether this is the start of a deeper slowdown.

The rationale

Our central view remains as it has been all year: that higher interest rates have succeeded in slowing the economy in a managed fashion – the so-called soft landing – and that the reining in of inflationary tendencies will now allow the Federal Reserve to cut interest rates before the economy sinks into recession. Indeed, the Fed has just begun its interest rate reduction programme, cutting US rates by 0.5% with another 0.5% expected before the end of the year.

As we indicated in last month's report, the likelihood of prolonged inflation has now receded leaving us with two likely scenarios: the central soft landing theory outlined above and the harder recessionary outcome which a few analysts speculate is only months away from materialising. In both of these scenarios there has to be a slowing down of sorts and much data points to such a deceleration.

We pointed out before the importance of employment levels in the US as an indicator of the health of the general economy and a key bellwether of things growing too fast. Earlier in the year employment data continually pointed to an economy on the accelerated side, data which helped push back the pace of cuts in interest rates that markets had been expecting at the start of the year. In a significant change, data from the last two months has come in below expectations – in August 142,000 new jobs were created in the US, below the 160,000 forecast in a survey of economists. Figures for July were also revised lower to just 89,000.

The deceleration scenario has also been supported by the significant decline in inflation. The consumer price index dropped to an annual rate of 2.5% in August, less than the 2.9% in July and below the 2.6% expected by economists. With price growth now at its slowest pace since 2021, that's the green light for the Fed to cut interest rates for the first time in four years. Whilst core inflation (which removes more volatile food and energy prices) came in higher-than-expected Fed Chairman Jerome Powel has indicated the focus is now on employment.

Other snippets of information underline the slowing trend. The FT reported consulting firm Gallagher as saying that US pay increases are likely to decline over the coming year to an average of 3.6% in 2025, down from 4% in 2024. With fewer jobs on offer, as well as inflation slowing, it makes it easier for companies to reduce their labour spend.

The market seems to agree– according to Bank of America, defensive sectors throughout the world have outperformed recently, including industries such as healthcare, which rose 5.4% in August, telecoms rising 4.9% and consumer staples climbing 4.8%. Fund managers as well are showing a more defensive side in their activities, with cash levels climbing and overweight positions in stock markets sliding from 51% to 31%, according to a separate Bank of America survey.

Two outcomes, same origin

The problem for analysts is that the origins of both a soft landing and a recession look similar and it's challenging at this stage in a cycle to tell which way we are going. After all, as analysts at BCA (amongst the most vocal predictors of a downturn) point out, a recession begins with a slowdown from an economic highpoint – it's the depth and length of the slowdown that mark it out as being recessionary or not.

Our focus is on the accompanying data for clues as to whether things are slowing in a tempered or more profound way. Here we would argue the datasets point to the former. The number of jobs created in August was significantly above that of the July figure that spooked markets when it was announced. There are also signs that wage growth has increased marginally, while the unemployment rate reduced to 4.2% after four successive monthly increases. Consumer sentiment climbed to a four-month high in September amid the reduction in inflation and the likelihood of rate cuts by the Fed. Global earnings revisions rebounded in August, demonstrating continued corporate health.

The rosier scenario of a managed slowdown is supported by the majority of economists in a poll by the FT, where they anticipate the US is heading for a soft landing, with GDP expected to grow at 2.3% in 2024 and 2% in 2025. Equally important, those economists expect inflation to drift down to the Fed's 2% target. With interest rates falling, taking the cost of borrowing and funding with them, the chances of a benign slowdown are improving.

In summary then, the elevated interest rate environment of the past couple of years has succeeded in snuffing out the lion's share of inflationary tendencies in the economy and, and as would be expected, has also reduced economic activity as evidenced most significantly by slowing jobs data. Tonally, the market seems to have cottoned onto this environment and has shifted its emphasis in its investments accordingly to those sectors more attuned to steadier times. But very few analysts expect a recession to occur, with economic fundamentals supporting continued, but more moderate, expansion.

What this means for assets

The coming series of rate cuts by the Fed will, as stated, give an indication of where they think we are in the economic cycle – as time goes on the magnitude and pace of those cuts will indicate whether they're in the soft landing or recessionary camp. For now the cuts are in anticipation of a soft landing and have been taken favourably by equities, which have moved to new highs following the announcement, alongside bonds, which still provide a reasonable yield as interest rates decline. More aggressive rate cuts in anticipation of a recession would necessitate a reappraisal of equity holdings, which tend to do worse in a strong downturn as companies' profits contract, and suggest more reliance on those bond holdings, whose fixed payments are more valuable when all else slows.

Within our bond holdings we've talked before of the advantages of holding UK gilts over US Treasuries given the uncertainty in the US political environment compared with the relative stability of the UK as the Labour government reiterates its commitment to reducing government spending and balancing the books. A further boon to our shift to UK assets has been in the yield differential. US two-year yields are at 3.6% while those in the UK are 3.8% -- in essence US bonds seem to be pricing in a stronger downturn compared to a more measured outcome as predicted by UK gilts yields. Since the outbreak of recession in the US would likely cause a ripple effect across the Atlantic, we have sold out of US assets buying similar downturn protection at a cheaper price in the UK.

The US election matters for policy

Whatever you say about the US election and your position on the GOP versus the Dems, there's no denying the importance of the outcome. There are pluses and minuses to both candidates' economic policies and many in the financial community have pointed out the risks to US corporate earnings from Vice President Harris's suggestion that corporation tax be increased to 28% (former President Trump, who reduced the tax to 21% from 35% during his term, has now said he wants to slash it to 15%).

While this risk to earnings from a tax hike is identifiable and potentially measurable, the impact of a Trump victory is more intangible but could be even more disturbing for financial markets. The US system has always emphasised a division of power between different parts of government, and in economic terms there is no more important division than the power of Fed policymakers to set interest rates independent of any government interference. Trump has strongly asserted that the president ought to be allowed to influence the Fed in setting interest rates, making monetary policy a much more politicised activity.

Even amid all this uncertainty and the heightened debt levels that we have highlighted in the past, US Treasuries remain as among the safest investments in the world because of the traditional stability of the American economic and financial system. A fundamental change to that system could undermine that perception and reinforce demand for gold which, on global geopolitical uncertainty, has already reached record prices.

Conclusion

The gradual transformation in market sentiment to one more accepting of a realistic but slower growth rate means that we continue to review our equities to consider adding weight to those stocks that display more defensive growth opportunities, but with the high-quality characteristics that imbue that companies that we traditionally invest in. Our bond portfolio is primed for a slower market environment, but we remain ready to shift our stance to one more defensively inclined should the data start to point towards a more serious slowdown in economic activity.
