The past month summed up

The US economy is humming and the new administration could heat it up further, making expected interest rate cuts less likely. Heightened uncertainty can reveal investment opportunities, especially for active investors.

The rationale

Our central view is that the US economy is in a healthy state but that there are a number of risks that challenge the continued growth of the world's economic motor, which could cause turbulence for bonds and equity markets which are hovering around peak levels. Most significantly for those who thought that we were escaping from the higher rate cycle relatively intact, inflation is showing signs of refusing to go quietly in the US. This could mean interest rates fail to fall or could even go higher.

As regards the economy there is plenty of evidence that in the world's biggest, the US, things are motoring along very nicely, with veteran commentator and Nobel Laureate Paul Krugman stating that Donald Trump is inheriting a very healthy economic environment. But there is a balance to be struck. Low growth dulls prospects for companies, the mainstay of any portfolio looking to capture economic expansion and innovation in its returns. However, if an economy runs too hot it can lead to spiralling costs, stoking inflation which distorts and inhibits economic activity. That's the origin of the Goldilocks economic target – just the right amount of growth.

Rewind back to the latter half of last year and it seemed like we had achieved just that: inflation had cooled and growth had tempered enough to let the Federal Reserve (the Fed) begin its interest rate cutting programme. However, that view has begun to be questioned as inflation has stopped falling and the growth has remained hot; the most recent labour statistics in the US shattered expectations on the upside with the creation of an additional 256,000 jobs in December. Labour costs are one of the key drivers of inflationary pressures. More hirings means there are fewer workers out there to fill existing roles, giving them bargaining power over wages which find their way into prices. Markets immediately sensed the significance of this data with yields on US 20-year debt climbing to close to 4.8%, the highest in about 14 months, while expectations for further rate cuts this year slid significantly. Some analysts even predicted that the Fed might start raising rates again to contain inflation.

Then there's the Donald

While the inflationary pressures on their own would be a concern, another headache for investors is the prospect of the return of Donald Trump to the presidency in just a few days. We have highlighted in the past the positives that are attributed to Trump's policy agenda, including tax cuts to stimulate the economy and a reduction in regulation that can help companies to generate higher profits and increase innovation through the removal of costly burdens and restrictions. Does an economy already firing need any further stimulus?

Elsewhere in his arsenal, the prospect of tariffs – his favourite word according to the man himself – cannot but interfere in the workings of an economy, even a relatively self-sufficient one such as the US. They make things made elsewhere more expensive to incorporate into US production lines and redirect production from potentially higher value areas. Retaliatory tariffs that others may impose on US goods, making it more difficult for global brands based in the US to sell elsewhere, threaten further damage. Is the market paying enough heed to the prospect of a tit-for-tat trade war? Trump's Greenland and Panama trash talk coming even before he takes office doesn't indicate he's out there to build alliances, political or economic.

It's the price, stupid

All of this is moot if it's properly discounted in the prices of equities and other securities. If markets were tepid, or not showing any great direction, we could shrug off some of the concern outlined above. However they are not – from the analyst community right through to the FT and The Economist, financially interested commentators are questioning whether US stocks are overvalued. Again, the answer is not a simple yes or no – traditional measures of market valuation, do indeed indicate that markets are at exceptionally high levels. On the other hand, should the benefits of technological advances, particularly in artificial intelligence, accrue widely to companies and across the economy, then these valuations look more realistic, forecasting stronger growth ahead. There are also sectors and industries both within and outside the US where prices look much fairer.

Our continued strategy is to navigate these balances, mindful that it is not a binary world and that two competing narratives can exist at the same time. Thus, the US economy is in a very strong state, and this may well continue under the Trump presidency. Corporations should continue to generate healthier profits – the Bank of America global earnings revision ratio vaulted from 0.68 to 0.81 in December with gains across the board in regions and sectors. Stock markets, particularly in the US have performed extremely well, with the S&P 500 climbing more than 20% in each of the last two years. Investors remain bullish, according to Bank of America's global fund manager survey. And yet that economic excess can also sow the seeds of a damaging inflation and rate cycle, expectations for corporate earnings may be misplaced, and US stock markets are indeed high.

The UK in turmoil

Remember our misgivings about expanding US debt levels potentially exacerbated by Trump's fiscal policies? That, you may recall, has sent yields on US debt, already rising on the inflationary issues mentioned earlier, higher still as investors charge more for the risks of lending money to a country seemingly unable to slow its borrowing. Where the US goes, the rest of the world follows and for the UK that's been a challenge. That's because whilst bond yields across the world are tracking US rates higher, this has coincided with declining confidence in the UK's own fortunes.

Not only is there a fear that Labour is reverting to its old caricature of taxing and spending – whatever your political views, the management of this message has been less than exemplary, with aspects of last year's budget seen as punitive. No amount of blaming the fiscal situation on the previous Conservative government can overcome this perception. Furthermore, it's likely that some Labour policies are not only potentially inflationary, particularly those that have upped wage costs, but also seem to be undermining business confidence and slowing growth. With recent auctions of UK debt not quite attracting the interest that had been expected that's pushed yields on long-term UK debt to the highest this century; pared back expectations for UK Inc. have also sent the pound to its lowest level in more than a year.

This has prompted us to build on decisions taken last year to reduce sensitivity to the UK's budgetary strains in light of our evolving assessment of the risks and opportunities that the present global uncertainty presents. Thus we have added to our specialist interest rate and currency trading funds. They have proven increasingly adept at profiting from the rising dispersion in global economic trends. The present uncertain environment, stoked by the advent of Trump's second presidency, will provide plenty of opportunities for these funds, which can benefit from falling as well as rising prices.

Conclusion

Any asset allocation has to balance both growth and portfolio protection in the context of our views around the current fabric of risks and opportunities for economies and assets. Equities will most often be the engine of growth and we're always looking for new opportunities. Some of these may well arise outside of the present highly valued US technology sector, or be potential beneficiaries from a changing economic environment as President Trump takes the reins. The shifting sands have meant that our specialist funds are offering incrementally better balance to portfolios than fixed income, where a combination of spending profligacy and economic overperformance in the US, and underperformance in the UK, have increased the risks for these assets, particularly those bonds not due for repayment for many years.
