



The past month summed up

Did someone mention inflation?

The rationale

Our core view remains that the US economy is in a relatively healthy state and could strengthen next year, while corporate profits continue to grow, meaning that there are few signs of an economic reversal. And yet, even with this benign backdrop fears are increasing that the artificial intelligence-led stock surge may come undone as overambitious projections meet more realistic assessments about the costs and benefits of a step change in global technology.

Another blot on the seemingly rosy landscape is that the economic situation can change quickly – in fact faster US growth could lead to a resurgence in inflationary pressures. The most recent figure suggests that inflation is not getting worse but rather is stuck near 3%, one whole percentage point above the Federal Reserve's 2% target. It was against that background that there was a tension at the Fed's December meeting – whilst policymakers did indeed cut interest rates by a quarter percentage point to the lowest in three years, the list of attendees was split between those who thought it was foolhardy to cut rates with inflation where it is, those who backed the small change, and a Trump supporter who called for an even bigger reduction.

Job losses

Trump himself has made no secret of his support for a much more aggressive rate cutting programme – what self-respecting former real estate magnate wouldn't want cheaper borrowing? For those worried that our politics are too short-term, of course one of the main drivers for Trump to encourage faster rate cuts is that this will put more money in consumers' pockets in the run-up to the mid-term elections next year.

Still, it's not as if those eager to cut rates don't have more than a political incentive. One of the bigger concerns in the US at the moment is a slowing labour market – ADP, a commercial payroll processor whose data became a proxy for labour market statistics during the recent government shutdown, said that private employers cut 32,000 jobs in November, against predictions of a 10,000 rise. The losses were mainly concentrated in smaller companies, ADP said. Yardeni Research noted recently that for young adults aged between 20 and 24, the unemployment rate has risen from 6% in January to 9.2% in September.

Yet elsewhere, there is no sign of a slowdown in US growth with the Federal Reserve of Atlanta predicting that GDP growth for the third quarter will be at 3.5% – not exactly recession territory. Together with rate cuts and the prospect of an increased fiscal injection into the economy next year as Trump's signature Big Beautiful Bill comes into effect, this increases the risk that prices might rise even faster in coming months. Lest we forget, inflation matters because of the turbulence it causes – continually rising prices eventually mean that interest rates have to move upwards which then puts a brake on sought after economic growth.

Tech tectonics

Of course, we don't invest in the economy – we invest in securities. But that doesn't mean that the economy isn't intimately entwined in the valuation of all of the assets on our radar. Indeed, part of the high valuations that have been placed on the US market over recent years, and on technology shares in particular, is derived from the continued good health of the world's largest economy. What this means then is that anything that affects central assumptions about broad levels of inflation and interest rates should have a significant bearing on the prices people are paying in the stock market.

It's also worth noting how share valuations are strongly linked to the prospective individual earnings of companies – analysts use analysis of future growth in profits to forecast how future earnings will affect the worth of a company. A significant change on the upside or downside on those estimates can trigger a rally or a sell-off in shares. Recently we have seen that manifest across the technology sector as changes in expectations as to which AI assistant will dominate the future have influenced the fortunes of the companies behind Gemini, ChatGPT and Grok, and the providers of the chips to train them.

Knowing the eventual beneficiaries of the AI buildout is not immediately obvious – we commented before on how, following the tech bubble of the late 1990s, many companies who had been predicted to benefit now reside solely in the annals of history. A reminder that the leader of today might not be the leader tomorrow has come in the form of Google's Gemini AI platform, whose recent success has shaken expectations around AI poster boy ChatGPT. Google's use of its own chips in the project has also knocked confidence in market leader Nvidia, which has been supplying ChatGPT.

Quality street

The market in recent years has heavily rewarded those companies willing to spend billions on winning the AI race, a trend that has now attracted firms with a tangential relation to advanced technology. Caterpillar Inc, the famous maker of engineering equipment (which also spawned a brand of footwear), has sidled into the AI show by aiming to provide the infrastructure needed to power the proposed explosion in data centres. The point here is that there remains a range of companies that have been largely ignored through not being involved in the AI race and which might be undervalued as a result.

We've noted before how we've slowly begun to pivot our investments in recent months away from the frenetic US technology arena, seeking balance through those companies where market fashion means they're out of the limelight and potentially undervalued. We have, as a company, always had respect for so-called quality businesses – those that provide high returns but with stable growth and that don't overload their balance sheets with high levels of debt.

If we combine these attributes with the defensive qualities that we've mentioned in previous reports – those companies whose business models tend to thrive whatever the economic conditions – then these firms look attractive should the technology bubble market retreat and the economy show more turbulence. For example, healthcare companies look to offer interesting opportunities. Demand for healthcare solutions is unlikely to shift with the tides, especially with an ageing population, whilst the recent political noise – criticism over high prices for drugs – leaves some looking attractively valued.

At the same time, we're continuing our investigations into emerging markets where a number of positive factors are coalescing. We've noted before how exports are buoyant because many of them use the dollar for the international trade which has been falling in value. Second, inflationary pressures have mainly been kept under control because of strong pre-emptive action by central banks over the past few years. Third, local company profits are predicted by market strategists to grow by as much as 18% in 2026, well ahead of estimates for developed markets. With emerging markets making up nearly half of global GDP and more than two thirds of the global population but only 10% of global equity markets, there is plenty of room for this to increase, particularly should economic and profit growth exceed that in the US, UK and EU.

Conclusion

It's all very well being able to identify when prices might be overvalued but it's another thing knowing when they might reverse. Our strategy therefore has been to acknowledge the fundamental shift that the AI revolution will bring while using the imbalances that it has caused to construct a robust portfolio that should thrive in a range of scenarios. As investors we see growing opportunities in quality companies in those sectors that have been left behind of late as the market has proven pre-occupied with AI-related participants. Likewise, we continue our investigations of the best potential in emerging markets.

Whilst not high on many investors' bingo card currently, any tangible signs that inflation might be resurging could perturb markets with 2022's surging prices fresh in the memory. This means we are continuing to hold bond investments of shorter duration, which are less sensitive to rising prices and interest rates and more insulated from government profligacy. At the same time, we continue to hold gold and hedge funds as a diversified safety net balancing against more risky and volatile stock markets.

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