



The past month summed up

Markets don't always look on the bright side of life. Despite strong earnings and falling rates, fears of AI exuberance and a soft patch in the US economy means we are vulnerable to a reset.

The rationale

Our core view is unchanged from the month before: the US economy continues to lead the world with healthy corporate earnings and continued, albeit increasingly nervous, optimism about an artificial intelligence-led future. But with US stock valuations at very high levels we are looking for opportunities in other parts of the world where the news may be improving and markets less stretched.

As regards the US, it's doing an extremely good job swithering between optimism, especially as to where we are in the here and now, and pessimism about where we might be going. Supporting this general assumption are the exceptionally good reports from companies. Recent data on third-quarter earnings indicate that more than four fifths of businesses that reported had posted earnings that had beaten expectations – not a bad result given that optimism about corporate America was already very high. Earnings overall are up more than 13% in the last 12 months while revenue is 8% higher.

AI bounty

Underpinning a significant portion of that corporate bounty is the search for advanced AI solutions by some of the world's largest companies who, as we reported before, have been spending billions on the project. Data from September indicated that spending on building US data centres reached a seasonally adjusted annualised all-time high of \$40 billion in June, according to a report from Reuters citing Bank of America Institute. The Financial Times has reported that Morgan Stanley analysts estimate building data centres and AI infrastructure could cost over \$5 trillion.

The benefits of money swirling around the economy are appearing in other data reports. The Institute for Supply Management showed that the US services sector advanced in October to its healthiest level since February. Looking to the future, a significant fillip to the US economy should arrive next year in the form of President Trump's signature economic legislation which some analysts reckon could send \$150 billion of tax refunds to US citizens between January and April, providing a boost to consumers.

Under the bonnet

The problem with so much optimism on excesses from corporate spending through to company valuations, means that it magnifies the impact of anything that looks to undermine the AI-infused economic edifice. Ticking away in the background are fears that the US labour market might be slowing. Until recently, the US shutdown meant that many of the data sources that analysts normally use weren't available and instead they had to rely on proxies. For jobs, payroll processor ADP provided indications of what was happening in the market – October's data was relatively positive with private employers adding 42,000 jobs, more than the number predicted by analysts, but that came after two months of downward facing numbers.

Analysts are attempting to look under the bonnet, to find any indicators that can give more colour and detail to the relatively benign picture that optimists are focused on. The most newsworthy element here is in relation to the US consumer, a highly important factor given that it accounts for about two thirds of the overall US economy. A University of Michigan survey suggested that US consumer sentiment fell to a three-and-a-half year low in November – retail sales figures, while still positive, are also slowing.

Unhappy meals

Signs of distress are appearing to show the burden that has fallen on the lowest income earners in the US, accentuated by the travails in surviving the recent US government shutdown. So while better-off consumers are kept happy watching their stock portfolios continue to rise, the poorest are cutting back on their spending. US news network ABC reported that burger behemoth McDonald's and Mexican fast-food outlet Chipotle have expressed concern about reduced spending by less well-off customers. Chipotle referenced large cuts from customers earning below \$100,000 a year, those low to middle income families which make up about 40% of the company sales.

Overarching all of this is the 44-day hiatus in US government activity which, given the fact that little data was produced during the period, meant we were blind as to how this had actually affected the economy. Of course turning off the taps for the income of federal employees, a slowdown in travel as unpaid air traffic controllers stepped away from their duties, as well as cutting back on welfare programmes during the period for those that rely on government money, must have some damping effect on the economy – the question is how deep. Earlier this month, a White House adviser said it had been far worse than expected but also predicted it would recover quickly.

But again, this implies that there is some binary nature to the world – that it is either good or bad. Instead, of course everything is relative and the real test is whether people are overpaying in their investments for what the US economy is presenting currently. With stock prices looking historically high at the moment that's the Achilles' heel in the story. Headline news last week was that Michael Burry, the enigmatic hedge fund manager who found fame for his role in exposing the sub-prime mortgage collapse (and played by actor Christian Bale in *The Big Short*), said he was exiting the market essentially due to his belief that assets were significantly overvalued. We understand the sentiment which is why we have been looking for better value both in other sectors and outside the US in recent months.

Eastern promise

That relativity of course implies that if US stocks are overly expensive then others elsewhere might be offering better relative value. The case for looking closely at emerging market companies is compelling as their economies, the spending of their consumers and the vitality of their companies, look to be improving. This trend is reflected in economies from Latin America right through to Asia.

In Latin America for example, Trump's support of the Argentinian government may well help embed policies there that should contribute to sustainable growth in the economy. In neighbouring Brazil, things are looking particularly positive – an August report from Deloitte suggested that GDP growth advanced strongly in the first quarter of 2025, whilst inflation and interest rates have been falling.

Most impressive of all is perhaps the growth in India. The Economist predicted that the country will overtake Japan in early 2026 to become the world's fourth largest economy, after passing Brazil, Canada, the UK and several other European countries in recent years. And while its main stock market has trailed those of its US counterparts this year, the Sensex at the time of writing is still up a very handsome 9% year-to-date.

Defensives could become the next form of attack

Sector-wise, while technology shares have been the dominant story in the past few years, this has left a number of industries feeling unloved by the market. With parts of the economy and markets increasingly priced for a goldilocks outcome, there are others that have been somewhat shunned. This might well be the time now to look for so-called defensive stocks that tend to prove reliable in more challenging economic conditions and where valuations are more reasonable in absolute and relative terms. Pharmaceutical and healthcare companies are an obvious choice because healthcare is rarely a discretionary spend but instead continues even when the economy slows down. Likewise so-called consumer staple stocks are looking cheap

after a difficult period and may still prove resilient even when consumers pull back on buying the latest smart phone or computer accessory.

It's also worth mentioning when bad news can be good news. We don't think it would be politically partisan to suggest the UK government hasn't covered itself in glory in recent weeks with its dithering on how to fill the black hole in the country's finances. The UK economy itself seems to be sputtering with the unemployment rate climbing to 5% (this is not just a UK problem but a European one – France's unemployment rate climbed to 7.7% in the third quarter, the highest since 2021). However, weaker conditions will allow the Bank of England to cut interest rates faster. A soft patch in the US could also free the Federal Reserve to cut rates in December providing a boost to more interest rate sensitive areas of the market and those consumers we highlighted as struggling.

Conclusion

Data and news reports over the past month, presenting a smattering of future risks for the US economy and markets, have bolstered confidence in our recent moves to broaden diversification beyond the US. At the same time improving news from emerging markets is emboldening our search for opportunities in these high-growth areas, while we are looking to increase resilience through broadening the balance of stocks that both are undervalued and can perform even should the economy slow. We are expecting a soft patch in the US economy, but in that event our bond portfolio continues to offer some protection, especially as the prospect of interest rate cuts increases in the UK and US. Our continued holding of diversified assets such as gold and hedge funds means we're prepared should shocks come our way in the months ahead.

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