

The past month summed up

The oil shock of the Iranian war vies with the Artificial Intelligence (AI) technology boom to be the dominant theme of the market – at present AI driven positivity is keeping markets higher.

The rationale

Our central view remains that the AI-led boom alongside the structural shift in global trade and international political dynamics is driving a renewed period of industrial and capital investment. This will percolate throughout economies spurring a more generalised expansion (already evident in manufacturing) in the US and across the wider world. Fears that the Trump administration's policy of increased tariffs would stoke inflation and undo this process receded in the early part of the year, setting up the prospect of a Goldilocks scenario of increased economic activity alongside tamed inflation and moderating interest rates.

Then the Iranian war came along.

The fear of war and a spread of hostilities can generate excessive stress about what might happen to the global economy. Looking through the headlines, we try to be dispassionate, despite the tragic humanitarian loss; to focus on the impacts and assess how they translate to our clients' portfolios. As we have mentioned previously the supply and price of oil have the potential to impact both inflation and economic activity, much as the energy squeeze amid the Ukrainian war did in 2022. Whilst markets and the world have cheered a ceasefire, it's not quite as simple as some might hope as still high energy prices could cause a whole host of problems for the economy, markets and investors if they persist.

Kremlinology

It's worth noting that stock markets are not about the here and now but are in fact attempts to anticipate the future – the prices that we are paying for securities at present are predictions of the future income streams that will come out of those securities, and that in turn is based on how investors see the politics and economics of the world unfolding in the months and years ahead. But there are limitations on the abilities of fund managers to make balanced judgements on the current situation; they are neither political pundits nor US-focused "Kremlinologists". In more orthodox periods anticipating US government activity has probably been an easier task as global strategists within organisations would have had enough political information to make informed predictions about policy. Just like one of the principles of central-bank management is never to move precipitously outside of your idiom, so politicians have in the past tended to outline, perhaps roughly, what they want to achieve and the path to get there.

With the present US administration this is not so, with policy and facts on the ground changing by the minute. Our job is not to judge this approach – President Trump's supporters would likely say this is a negotiating tactic whilst detractors would probably say that the flip-flopping is a sign of mental disintegration. Whatever, it is a struggle to make binary judgements about the extent and likely conclusion of a war where solid information and insight is thin on the ground and the rhetoric changes overnight. However, as has previously been the case it does seem that President Trump backs down from his more serious threats before catastrophe strikes America. That is the hope today.

This leads us to where markets are at the moment. Given the potential significance of a war in the tinderbox that is the Middle East, markets have been willing to look through the disruption, with the S&P 500 having recovered all its March losses and now retesting record highs. The technology-heavy NASDAQ recently recorded its longest streak of gains since 1992 on the back of renewed enthusiasm for the AI bonanza, a mega-trend that continues seemingly immune from the energy impact. Overall investors seem to be confident of a relatively swift resolution of the conflict with limited permanent economic damage. They are likely

extrapolating Trump's tendency to act ultimately in a way that belies the bellicosity of his rhetoric alongside the facts we asserted in our previous paper, where in the 21 US airstrike campaigns in the Middle East over the past four decades, on 95% of occasions the S&P had been higher eight weeks later.

Robust earnings

While the market might not have the ability to read President Trump's intentions, it does have other valuable information. Corporate earnings have continued to improve significantly even amid the ructions caused by the war. Earnings revisions as expressed in Bank of America's Global index have climbed over the past month from 0.97 to 0.98; significantly the figure for the US remains above one, which means that revisions are still on balance more likely to be positive than negative. Energy companies have understandably been boosted by the rise in oil prices but technology companies have also been seeing upgrades to profit forecasts. As evidence, both TSMC and ASML, two of the most important companies in chip manufacturing, reported strong earnings this month.

Thus far the market believes the war has managed to neither snuff out the prospects for growth given the amount of money being poured into building data centres nor hopes that AI will revolutionise the way our economy works. To reiterate this narrative, the FT reported recently that the head of Northern Trust's asset management business believes that AI will set in place huge gains in productivity. And, as we have said, this boom has extended further into the economy with signs that industrial production is expanding with factory output in the US in the euro area advancing.

On the downside

Still there is another side to the story— while rising oil prices may not yet have damped economic enthusiasm, they are likely already stoking inflationary pressures (we noted at the start of the year that the biggest threat to our central thesis was inflation coming in higher than had been predicted). US inflation bumped to 3.3% in March, the highest it had been for two years, while the International Monetary Fund increased its estimates for US inflation to be at 3.2% this year compared to the 2.5% it had predicted before the war. Forward pricing in markets at present indicates that inflation expectations are more focused on a spike in the shorter term than any longer-term increase in prices.

Consumers, already nervous about daily costs, are becoming much more bearish amid the inflationary resurgence – the University of Michigan's consumer sentiment index slid to a record low of 47.6 in April from 53.3 in March as Americans saw the price of petrol shoot from under \$3 a gallon before the war to more than \$4 now. Fund managers themselves are becoming more glum with a Bank of America survey showing that the optimism about global growth has slid to a net positive of just 7% from 39% previously while inflation expectations have jumped from a net 9% to a net 45%.

So, what does this indicate with stock markets still edging higher? It means that on balance investors still favour the positive story that has sustained markets for the past number of years i.e. huge investments in relation to AI technology spreading through the economy, which also unleash productivity gains again across the market. With the world less oil dependent (but still pretty reliant!) disruptions can be absorbed as long as they don't last too long.

Therein lies the rub. This positivity is inevitably tinged with uncertainty about the war. Given our relative informational opacity, the solidity and validity of the stock market sounding the all clear is questionable and things could change rapidly as events unfold.

Conclusion

While stock markets remain positive it's clear that the risks have receded rather than disappeared. The uncertainties engendered by the war with Iran remain and the economic impact of the closure of the Strait of Hormuz continues even if the intensity of battle has subsided. The longer that continues the greater the

likelihood of these uncertainties wreaking more damage to the economic prospects of the world and knocking the AI-led growth story off kilter. This balance of risks and opportunity means that we want to retain a balanced approach and focus on the individual prospects for the companies we own while ensuring the resilience of the industries in which we invest. Equities look well supported today but that could change.

Our move into shorter dated bonds on the risks of higher inflation has been vindicated by rising energy costs and increasing consumer prices in major economies – while bonds overall have shown a reduced ability in recent years to offset declines in equities, those at the shorter end have acted as a better hedge than longer bonds against inflationary tendencies and economic risk. Finally, we are maintaining our investments in gold and hedge fund assets as reliable instruments to help keep the portfolio robust as the uncertainty of the Iran war continues.

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