



The past month summed up

The potential end of hostilities in the Middle East alongside ongoing AI euphoria is a heady cocktail for markets. Beware rising inflation though.

The rationale

Our core thesis has evolved over the past few weeks and months from one centred on a relatively benign inflation and interest rate outlook to one where the risks of higher inflation leading to interest rate hikes have become more pronounced. At the same time the stream of positive news of spending on artificial intelligence (AI) and technology continues, with markets quite happily absorbing the record IPO of SpaceX and enthusiasm for chip and memory stocks showing few signs of fatigue. However, with sentiment and positioning seeing the glass as half-full markets are vulnerable to any errant data causing a correction, as opposed to a nosedive.

The reason we start our view of rates and inflation is relatively straightforward – interest rates influence the relative attractions of all securities as against cash whilst inflation – for so long a non-issue – influences what the Bank of England or US Federal Reserve may do with interest rates. Interest rates and inflation impact the direction both of the economy and the economic prospects of companies and sectors. Higher and unanchored inflation can cause havoc when it prompts central banks to raise interest rates which in turn dampens economic activity, limiting the returns for companies and undermining share valuations.

Over? But not out of the woods.

As of now it seems that investors are giving more attention to a peace deal between US and Iran and the likely positives for the economy, the most important being the freeing up of oil capacity in the Middle East as the Iranians pull back from their blockade on the Straits of Hormuz. The signing of a deal is positive, and oil prices have fallen in anticipation (to below \$80 a barrel from highs of more than \$110) but, having been closed for four months, it will take some time for oil supply to return to pre-war levels. This means that although prices for crude oil are dropping quite rapidly those that consumers pay may take some time to readjust (US gasoline prices are still hovering around \$4 mark as compared to below \$3 before the war started).

Further upward pressure on prices can be found in food costs, which analysts fear will be sent higher due to the squeeze on oil, a key component in the production of agricultural fertiliser. A new additional burden on agriculture may arise from the El Niño climate effect, which is predicted to be particularly strong this year. And there's the colossal corporate investment into AI which Goldman Sachs has said is stoking prices for consumers, particularly as huge demand to run data centres pushes up the bills for energy whilst LLM's insatiable demand for chips and memory is feeding through into consumer electronics; Apple announced planned increases to iPhones this week. While the 172,000 jobs added in May, double what had been predicted, raises the prospect of future inflation in wages.

Inflation bubbling up

The end result of all of this is that US inflation hit 4.2% in May, its highest in three years. A global surge in prices has central bankers around the world reacting accordingly. The European Central Bank jacked up interest rates by a quarter point at its recent meeting – its first interest-rate hike since late in 2023. The Bank of Japan pushed up its interest rate to 1% earlier this month, the highest since 1995. Kevin Warsh, the new head of the Federal Reserve, has been a vocal proponent of the view that in the long-term AI efficiencies will drive down inflation. Yet recently, while electing not to raise rates, he was clear that the inflationary situation is of concern to the Fed. All of this is a major break from the viewpoint just a few months ago when inflation was at just 2.4% and analysts were debating how fast the Fed would be cutting rates through 2026.

As we have pointed out many times before, inflationary pressures are already gnawing away at consumers who feel they've been suffering from price rises for too long. As a result US consumer sentiment is still close to rock bottom and is lower than it was during the COVID pandemic, although this hasn't yet stopped them spending.

Still, markets for the moment seem unconcerned, dwelling instead on the positivity from AI investment and the ensuing efficiency the new technology may spur. Bank of America's fund manager survey showed that investors slashed their cash levels last month and any worries about global growth for them have dissipated.

To the Nasdaq and beyond

Market sentiment has been most vividly displayed in its approach to recent fund raising including the \$87.5 billion of money that was invested in Elon Musk's SpaceX. Post IPO gains helped the business become more highly valued than internet retailing behemoth Amazon and tech royalty Microsoft, despite extremely ambitious analyst predictions for its revenue in coming years (SpaceX, while ostensibly a play on interstellar exploration, has a significant chunk of its business focused on AI development). And there's more to come. Google's parent Alphabet is raising \$80 billion to fund further AI spending while AI-focused businesses Anthropic and OpenAI are both planning significant share sales for later in the year.

When markets are in such exuberant mood – the S&P 500 index has risen almost 10% this year while the technology heavy NASDAQ is up almost 14% — it should always prompt serious questions. And yet it's difficult today to ignore the strength of both company earnings and the scale of investment which is underpinning the AI juggernaut and sustaining economic growth in the face of geopolitical shocks, particularly in the US.

While inflation is lurking and could force rates higher, the more immediate pause for thought may come from the next earnings season where expectations are already sky-high after a superlative first quarter. With the bar set high, any disappointment in the early weeks of July could be the spur for a readjustment in equity markets, most likely a pause for thought rather than any significant U-turn at this stage.

All that no longer glitters

We have talked before about gold, a long-term position of ours and one that has proven both a regular haven in the turbulence of this decade and more recently seen supercharged growth in value supported by central banks diversifying their assets away from the US and investors searching for an alternative to bonds.

There have been signs more recently that its price has begun to be more influenced by speculators than safety seekers. Prices had advanced considerably (from about \$2,000 an ounce in 2023 to more than \$5,000 recently), partly due to excess demand from central banks and from those producing jewellery but also as a speculative investment for those looking for growth in their portfolios. This has undermined its value as a portfolio diversifier, indeed it fell sharply in March following the bombing of Iran, a departure in behaviour for an asset which has been expected to retain value amid uncertain times such as conflict.

With its protective abilities undermined and signs of some countries being forced to slow purchases or turn sellers, we have decided to reduce our exposure having benefited from the multi-year uptick in its price. It is still 25% higher than a year ago.

Bond investments

The recent poster boy for securities that have morphed from those that perform more solidly in a downturn to those that more mimic the ups and downs of equities has been government bonds. US Treasuries and UK Gilts continue to be troubled by the swelling levels of public sector debt alongside fears of inflation mentioned above. According to the FT, borrowing costs on some US maturities recently reached their highest levels in 19 years, whilst the interest costs now exceed 14% of the total tax take.

Our continuing strategy in this important asset class remains to stay in those shorter-dated, more cash-like securities which are more inured against the more violent fluctuations in relation to fears about inflation and excess borrowing by governments.

Conclusion

The global economy has continued to grow but the risks remain balanced. Fears of an extended conflict in the Middle East hitting growth are now being replaced by concerns that inflationary pressures will force central banks to raise interest rates rather than cut them, which could raise borrowing costs and undermine market exuberance.

With fundamentals, particularly corporate profits, still on the march we are maintaining our equity exposure through a balanced portfolio of quality companies across a range of industries. There are areas that will be longer-term beneficiaries, not just of the AI revolution but also trends to reshoring, industrial renewal and energy security. We remain cautious however on businesses driven upwards by short-term euphoria, particularly those without any profits.

With more and more assets following the direction of equities, our more protective assets are increasingly focused on those we believe still offer some diversification: shorter-term fixed income securities, cash, and our portfolio of diversifying hedge fund strategies which have proven a reliable support in more difficult times. We are lightening our holdings in gold having enjoyed a very strong run in price far in excess of historic returns.

This document is a Financial Promotion for UK regulatory purposes and is directed only at investors resident in the United Kingdom.

This document does not constitute investment advice or a recommendation.

Past performance is not a reliable indicator of future performance. The value of investments, and the income from them, may go down as well as up, so you could get back less than you invested.

This material has been issued and approved in the UK by James Hambro & Partners LLP, which is authorised and regulated by the Financial Conduct Authority and is a registered investment adviser of the Securities and Exchange Commission. It is listed in the Financial Services Register with reference number 513246. James Hambro & Partners LLP is a limited liability partnership registered in England & Wales with number OC350134 and registered office at 45 Pall Mall, London SW1Y 5JG. A list of members is available on request. The registered mark James Hambro[®] is the property of Mr J D Hambro and is used under licence.