RATHBONES

AN OLD-FASHIONED SANTA RALLY

REVIEW OF THE WEEK
8 JANUARY 2024

A GRUELLING YEAR FOR INVESTORS ACTUALLY DELIVERED DECENT RETURNS. BUT HOW MUCH OF THAT STRONG PERFORMANCE IS IN ANTICIPATION OF 2024?

Last year was a tough year for markets, yet it turned out to be a great year for returns. Most major stock markets (UK, unfortunately excepted) roared higher, while corporate bonds gained handsomely as well. Even government bonds made positive returns in a year of central bank tightening.

Towards the end of the year, the driver was a large fall in prevailing bond yields as investors first hoped for, and then pre-emptively celebrated, a 2024 of falling central bank interest rates, muted inflation and absent recession. It was an old-fashioned Santa rally: the returns came before the presents were handed out.

The US economy stayed strong into the close of the year and continues to create a slew of jobs. But everyone is wondering when it will run out of steam. Large US lenders are reporting fourth-quarter results this week and some people are wondering how much of their profits will have been curtailed by loan losses. It's almost two years since interest rates first started ramping up for Americans and they're yet to substantially slow them down. Unpaid credit card bills and loans did start to rise in 2023, but from historically low levels and they remain well below what they averaged in the years before the Global Financial Crisis. Still, this will be an interesting metric to track.

The heady years of zero-percent interest encouraged many people to take on more debt, whether it be to buy a house, a car or some new threads. While multi-decade fixes on mortgage rates shelter the US from big rises in those payments, credit cards could be a growing source of pain. According to the St Louis Fed, the average credit card interest rate has been above 20% for almost a year now – it hadn't breached 16% since at least 1995. And American credit card debts have never been higher; they are roughly 20% higher than on the eve of the pandemic.

The giant US banks' earnings report could provide a window into how many people are struggling with their debts. The banks will report how much debt is behind in payments, and some analysts are expecting this to increasingly cut into banks' profits. No one told the banks, though, as in the previous quarter most of them were cutting their allowances for bad loans.

Questions like these and many more besides have come more to the fore in the early days of 2024. After a whiplash-inducing jump in late 2023, markets have been wobblier and slightly down. Maybe some reality is creeping back in – an acknowledgement that there's still a lot of uncertainty about some important pillars for a healthy stock market.

Broadly, there are three things that influence stock prices: changes in profits, changes in how you value those profits, and changes in how certain those profits are. Last year, while the S&P 500 US stock market index gained 24%, the underlying companies' profits didn't rise at all (using estimates for the final quarter). So profits didn't influence the return. Meanwhile, the 10-year US Treasury yield ended the year almost exactly where it started. This bond yield is the world's 'risk-free rate', the benchmark for valuing profits, so that means there was no boost to stock market returns from how we value any future profits. Therefore, the big gains of 2023 were driven entirely by that third factor: increased certainty in the arrival of future earnings (we would call this the 'equity risk premium').

This equity risk premium is now at a low not seen since 2007, which is wonk speak for investors in US stocks are more certain about the next few years of company profits than at any time since the eve of the Global Financial Crisis. Not a fantastic augur! Now, we will say that we don't expect any huge downdraughts or catastrophic crises like that terrible time. We've said often that the world is different, regulation has tightened and the stressors are elsewhere. But we think it shows investors have become much too focused on the upside and less inclined to worry about the risk of disappointment.

That could make sense! It's been a tough few years where everyone and his dog has expected a recession, yet one hasn't materialised. While markets have been rocky and brutal at times, they have repeatedly bounced back strongly. Maybe people are starting to feel like being cautious doesn't pay, so they're marginally more inclined to jump back on the bandwagon. That fear of missing out does tend to reign supreme before a market slump.

This is why we've been cautiously positioned on stocks for some time. Timing markets is infamously hard, which is why we advise staying in the market throughout, as long as you have many years to ride out any shorter-term losses. Yet tilting towards stocks that should fare better than most in a falling market or in a recession makes sense to us and we're maintaining this stance as we move into 2024.

Paradox stocks

You could argue that stock markets are forward looking, so the big gains in late 2023 are simply anticipating favourable changes to the investment environment that should arrive in 2024.

However, one paradox facing investors is that, for the roughly 11% profit growth forecast, the economy will need to remain relatively strong. Yet if the economy is strong, will the US Federal Reserve (Fed) be in a position to make the five to six 25-basis-point rate cuts that are priced into fixed income markets and implied in stock prices? Not while we still aren't decisively out of the woods on inflation. We know, we've all had quite enough of inflation chat. Yet there're some signs that inflation – particularly US inflation – may get stuck in the final mile.

Advanced economy inflation has fallen back as quickly as it rose. When we average the 38 OECD member nations, it shows that it took 14 months for headline inflation to peak after it broke above the historic norm in 2021. It's taken 13 months for it to fall within spitting distance of that same threshold. Yet when you look at core inflation (which strips out volatile energy and food costs), it took 17 months to peak and has been falling for only nine months. At 5%, the global average of core inflation still has quite a way to go.

A rapid fall in bond yields, which helps ease borrowing costs for businesses and households, could help create a resurgence in inflation. And depending on which inflation measures you use, you can get some very different pictures! As the Fed all but declared victory over inflation just before Christmas, investors rejoiced. But we think it makes sense to be careful and remember that no one knows the future. Not even the Fed.

We're braced for some significant volatility as the paradoxical outlooks for the economy, monetary policy and company earnings gets straightened out in the first half of the year.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you. For more on how we see the world and our views on 2024, **sign up for our next Investment Insights webinar** on 16 January.