RATHBONES

QUARTERLY INVESTMENT UPDATE

BROAD EARNINGS IMPROVEMENT BRINGS GOOD NEWS
Q3 2024

A widely expected change of government may bolster UK sentiment, while the US election is on a knife's edge.

Earlier this year, stock price gains had been broadening out from last year's very narrow list of winners, but substantial profit growth was still relatively rare and the average company's profit outlook was being downgraded by industry analysts. As we approach the end of the second quarter, we're pleased to report that profit expectations have also broadened out, in line with our more optimistic assessment of the wider global economy as some key risks have continued to fall away. Given the evidence that stronger and broader earnings momentum today tends to herald ongoing market gains tomorrow, this is encouraging.

US earnings breadth — more companies receiving upgrades than downgrades — is at a two year high. More notably, it's been negative for most of that period. Counterintuitively, stock price gains have narrowed again over the past six weeks even as profit expectations have improved more widely. In fact, the average US share price has fallen over this time. The standard US equity benchmark, which gives greater weight to larger companies, has outperformed the non-weighted average by more than it has in any six-week period in the recent past, bar the period that followed the launch of ChatGPT-4 in early 2023 — the game-changing moment that catalysed the market boom in AI-connected stocks. Indeed, the non-weighted average stock has fallen a touch in the last month and a half.

It may be that stock prices have reacted (or overreacted) to a slight soft patch in the economic data towards the end of this quarter. It takes time for fundamental analysts to update their earnings models and communicate their views, but stock prices react to new information nearly instantaneously (although not particularly efficiently, for all sorts of psychological biases that the behavioural economics revolution has taught us about over the last few decades).

Economic data have started to disappoint consensus expectations in China, the European Union, and, especially, the US. Although to be clear, disappointing consensus does not mean it is worryingly weak in Western economies. Ongoing weakness in China may have surprised the consensus (although only just), but we've been cautious about having large direct or indirect exposures to the Greater China region for some time. Loan growth at Chinese banks hit a record low in May but, more importantly for the outlook, People's Bank of China (PBOC) Governor Pan Gongsheng has argued that the PBOC isn't likely to provide stimulus in response to weak credit data. Pan argued instead for allocating China's ample stock of capital more effectively, without the stock necessarily needing to grow. We don't disagree, but sorting through the 'ineffectively' allocated credit (a euphemism if we ever heard one) takes time. Still, we think recent modest stimulus has already put a floor under the economy even if a significant rebound isn't likely to be forthcoming.

Political uncertainty on the Continent

European data has only just started to disappoint consensus expectations, largely due to surveys carried out in the wake of the surprise announcement of a French election. This sort of noise is common ahead of elections: it's rarely a signal.

Opinion polls suggest President Emmanuel Macron's centrist alliance will be unseated by enlarged left and right-wing opponents, which would lead to a new government led by one or the other (with Macron remaining as head of state). Polls have been famously wrong before, yet the prospect has spooked European markets. The parties-in-waiting, faced with debt greater than GDP and heavy spending, plan to increase spending, roll back modest pension reforms, while on the left they are talking of nationalisation. Prices for French government bonds and bank shares (a large cohort in the French stockmarket) have dropped sharply. Yet, our research on hundreds of elections across nine major countries over 40 years shows that they rarely divert an economy or its financial markets from the path they were already on. The outliers occur when properly radical governments are elected, particularly of the left.

The best example is Francois Mitterrand, who entered the Elysée Palace in 1981 and ushered in the first socialist government of the Fifth Republic. The French stock market welcomed Mitterrand with a 20% plunge and the franc dropped like a stone. And yet, after a couple of years, French stocks actually kept pace with other nations' after Mitterrand tacked slightly towards the centre. In other words, markets are very good at adjusting once, and moving on. Things happen quicker these days. The sizeable moves ahead of the election have already encouraged right-wing prime ministerial hopeful Jordan Bardella to row back on many promised splurges. Just as populist and secessionist governments in Italy and Greece did in the

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2010s, perhaps the 28-year-old has already grasped that the premiership is a poisoned chalice, recently saying he wouldn't form a government unless his National Rally party won an absolute majority (an unlikely prospect).

As for the US, there are a few signs that middle-class consumers are starting to come under pressure from past changes in interest rates. Inflation-adjusted retail sales have been stagnant in 2024, and now that restaurant sales are trending down this might be a precursor to weaker spending on services — which takes the lion's share of the US economy. However, US consumers are generally in reasonable health and not showing the excesses that can characterise the eve of a recession. The risk is that some (although not all) indicators of labour market health are suggesting rising job losses later this year. Personal income is the main determinant of spending, not wealth or household balance sheets, so jobs are the key risk to watch. We are optimistic, and we ascribe just a 25% probability to a US recession developing over the next year. That does stop us from being very overweight riskier assets, however. Accordingly, we prefer to lean away from consumer-oriented companies in favour industries that stand to benefit from investment spending on the long-term themes of a changing world, such as cloud computing, AI, government-mandated industrial policies or ageing societies.

The race for the White House

With a potentially very significant and uncertain US election approaching, some investors are nervous about the prospect of Donald Trump returning to the White House. In contrast with the foregone conclusion of the UK election, the race for the White House is on a knife edge, and the contests for the Senate and House are almost as tight. There are also big differences between the Republicans and Democrats in the consequential policy areas of corporate taxation and trade, and no clear view on which outcome markets would prefer — that's likely to vary from issue to issue. In this context, it doesn't make sense to premise investment decisions on any single outcome — we need to be prepared for a range of possibilities.

There are some risks. Though our research suggests that elections rarely tend to matter, this is based on 40 years' of history over which inflation had been on a downward path. This was driven by institutional changes, such as independent central banks or changes in labour contracts, and by economic and social trends, like expanding globalisation, and ample workers relative to retirees. We think that structural trend is reversing slowly. Rather than, say, inflation between 1% and 3%, it may move to a range between 2% and 4% — but there are risks that this range could head higher still because of policy mistakes or unforeseen shocks.

We think the US election does present some risks to inflation, by way of a very carefree attitude to government spending, as well as the potential to undermine some of the domestic and global institutions which have played an important role in anchoring inflation since the mid-1980s.

This may be an oversimplification, but in general deficit spending that is directed to household tax cuts or spending on day-to-day government items is inflationary. Spending on infrastructure or tax cuts that may incentivise private investment is less so. Republican deficit spending may be more about the latter, but there are some risks, particularly if it is enacted at a time of existing inflation pressures. Undermining free trade by way of a 60% tariff on Chinese imports and 10% on everything else would also be serious if enacted at a time of existing inflation pressures too (although the imported content of US consumption is 10% and about 20% of imports are from China, and so this wouldn't be as inflationary as perhaps you might first think, especially given how adept companies are at redirecting supply chains and how much lobbying for exemptions will occur).

The real doozy, to borrow an American phrase, would be mooted proposals by some Trump loyalists to take away some of the Federal Reserve's (Fed's) independence. But any such proposal would face a long Congressional battle, and currently doesn't have the support of Trump's top economic advisor, Robert Lighthizer. We don't dismiss this grave risk to central bank independence, but it is likely to be a last resort if other policies intended to devalue the dollar and/or decrease the trade deficit fail.

Importantly, we think lingering US inflation stresses will continue to wane throughout 2024. Inflation was stronger than expected in March and April. However, the US Consumer Price Index didn't rise at all in May and non-housing services prices, which Fed officials are paying particularly close attention to, even fell slightly on the month. Admittedly, Fed policymakers will want to see the positive news in May continue over the coming months. But we think there are good reasons to believe this is likely to happen.

For one, US wages (a key input cost for service sector firms) are growing at a much slower pace than they were a year or so ago, and a number of metrics suggest that will continue. The rate of vacancies to workers has fallen back to where it was before the pandemic, as has the proportion of workers voluntarily leaving their jobs for new opportunities. Meanwhile, growth in salaries advertised via online job boards has also slowed to where it was before inflation took off. Elsewhere, some firms seem to be having a tougher time passing on any rise in costs to customers, as more households on lower and middle incomes are feeling the financial strain from higher interest rates.

Finally, you may be reading this after the result of the UK election. We'll be publishing a special election edition of our quarterly Investment Insights magazine following the UK

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vote, including an article with some more on the US election, which you can find on the Insights page of our website at www.rathbones.com/knowledge-and-insight. In the run-up to America's presidential election, we'll also be publishing a full report exploring the differences between the two parties' economic platforms in much more detail.

Amid the contrasting uncertainty surrounding the US versus the UK election, it's worth remembering that the outperformance of US equities over global peers that we've become accustomed to over the past decade or so is not a permanent state of affairs. We suspect it will come as a surprise to many that the UK equity market has delivered almost the same return as the US market over the three years to 14 June. In fact, over the three years to mid-June, the UK's FTSE 100 index has delivered double the return of the *average company* in the main US equity index, the S&P 500. For sure, we believe in making the most of a global opportunity set and America is abundant with opportunities, but investment flows have been coming back to the UK to take advantage of valuations that our analysis suggests are inexplicably cheap. As we've discussed previously, we believe UK equities warrant a higher allocation than the 4% or so in the global equity benchmark. When our fundamental analysis no longer suggests that, we will trim UK equities accordingly.

Investment Insights webinar
2 July 2024 — 12:00 to 12:30
If you'd like to join our investment experts at our next Investment Insights webinar on Tuesday 2 July to hear more about the outlook for the global economy and markets, you can register at www.rathbones.com/about-us/events

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ADDITIONAL INFORMATION

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