RATHBONES

WEEKLY DIGEST

A TRAIL OF DEBRIS
By John Wyn-Evans, Head of Market Strategy
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Economies, financial markets and celestial bodies all have their own cycles. As wealth managers, we take care not to get too caught up in the financial market variety.

The Comet Swift-Tuttle orbits the sun once every 133 (Earth) years, leaving behind particles of dust and ice. The Earth passes through this trail of debris. As it does so, the particles burn up in the Earth's atmosphere, creating streaks of light known as meteors. Owing to their apparent beginning in the constellation of Perseus, these meteors are known as the Perseid shower. The show tends to peak around my birthday in August, with the best time to see them around 2am. But I haven't ever actually observed them. For some reason I've been either not in the right place – too much light pollution – or in the right frame of mind: I've been more interested in sleeping. Maybe this year…

Economies and financial markets also have distinct cycles. Some are very long. One cyclical theory that has captured imaginations recently is 'The Fourth Turning', as invented by the American authors William Strauss and Neil Howe in the 1990s. They assert that over the course of four generations (or around eighty-five years), society shifts through four phases (or 'turnings'): High; Awakening; Unravelling; and Crisis.

You probably won't be too surprised to learn that they believe we're currently in the 'Crisis' part of the cycle, when long-established institutions are torn down, often accompanied by war or revolution. The good news is that the ultimate reaction to all this chaos is a rebooting of the cycle as everyone comes together to rebuild society; the bad news is that we have to endure the chaos first.

I'm not here to pass judgement on whether this is all hokum (many commentators think it is), but I don't think this should be dismissed out of hand. Not least, if enough people do subscribe to a sense that we're in an age of crisis, this notion can become self-fulfilling.

The half-century wave

Another well-known long-cycle theory is the Kondratieff Wave, invented by the Russian economist Nikolai Kondratieff in the 1920s. These waves, driven by technology, tend to last forty to sixty years, divided into three phases: expansion, stagnation and recession.

A less well-known but still interesting idea is the Coppock Indicator. This was developed in the 1960s by a US economist called Edwin Coppock, who addressed the 'period of mourning' that investors experience after a major market downturn. He asked members of the clergy how long the mourning period for an actual bereavement usually lasted. The answers clustered in the range of 11 to 14 months, though many people would say that mourning is in a sense a lifelong process. Armed with this information, he constructed the eponymous indicator, which generated buy signals. The latest of these was generated in April 2023 for the S&P 500; since then it has risen 56%.

All these theories exploit human nature: we, as a species, tend to look for patterns and narratives that neatly explain the world we experience. Obviously, it's easier to impose a narrative on past events than it is to make forecasts, but that doesn't stop people from trying.

Constructing portfolios should be a balance between riding long-term trends – whether we believe in any of the above or not – and navigating shorter-term periods of uncertainty. Some institutional fund managers are explicit about their objectives. They invite investors to accompany them on the ride in the knowledge of inevitable periods when the market environment doesn't suit their investment approach.

As wealth managers, we're somewhat more beholden to benchmarks, which help shape our investment strategies since we're aiming to achieve at least the same return as the benchmark. But at Rathbones, we do espouse certain investment philosophies. A key one is a preference for higher-quality equity investments: companies less at risk of inflicting on us a permanent loss of capital. There will almost certainly be periods when markets are more interested in buying 'trash' or in more speculative opportunities, but we're committed to the long game.

Return of the meme stock

And some forms of 'trash' are making a comeback. A bit like Earth passing through space debris, stock markets regularly encounter meteors that shine brightly for a brief period and then quickly fizzle out. Looking back through the Wyn-Evans archives, I see that in February 2021 I was writing about two such phenomena: 'meme' stocks and Spacs (Special Purpose Acquisition Companies). Both are back in the news as we reach a more speculative phase in the market cycle.

Source: FactSet. Stock prices rebased to 100 at beginning of period.

To concentrate on one of these phenomena, meme stocks are recommended by an individual or group on social media channels. They tend to be 'penny' stocks: low-priced shares in small companies. They also tend to have a lot of short interest. This means they've been sold by investors who don't actually own them because they think the stocks are worth less than the current price. The shorting process involves borrowing the stock in order to sell it, and then buying back the stock to give it back to the lender when it's (hopefully) cheaper. There's usually no underlying change in the fundamentals of the company to justify such buyer boosterism. The poster child for the genre in 2021 was the struggling retailer GameStop. The episode turned the cheerleader for the stock, 'Roaring Kitty', into a cult hero and forced a hedge fund, Melvin Capital, to close down. It's all captured in the entertaining film *Dumb Money*.

Last week saw several US companies' share prices rise dramatically on speculative tips, including well-known names such as GoPro, Krispy Kreme and Beyond Meat. Buying pressure was reinforced by the buying of out-of-the-money call options, which give the buyer the right to buy a share at a preset price (the 'strike price') that's above the current price. As the shares rose towards these strike prices, the sellers of those call options faced the risk that they'd have to buy a lot of shares of these companies, possibly at very high prices. They had to hedge their positions to avoid losing money, creating even more buying. It's all classic squeeze tactics. And then when the craze breaks, the shares tend to drop back to the levels they came from.

This is very much a US phenomenon, driven at least in part by the huge increase in retail activity in the stock market during the pandemic (when punting on speculative shares became a substitute for other, unavailable activities) and the ease of access to financial markets via online platforms and mobile apps. Moreover, some participants think the only way they'll ever accumulate enough wealth for a decent lifestyle is to speculate with what little they've got. And I wouldn't underestimate the 'gamification' effect, where betting on financial markets merges seamlessly with betting on, for example, sporting events.

I return to this subject because it reflects the belief in the eyes of some (and increasingly many, it seems) that investing in financial assets is some sort of 'get rich quick' scheme. While we might be skilful or lucky enough to catch the odd shooting star in our portfolio net once in a while, this is certainly not how we approach investing. It's tempting to succumb to Fomo (fear of missing out) at such times, but we regard adhering to a sound process as a key virtue.

And wasn't this all a welcome relief from reading about tariffs!

For this week's economic highlights, see below on page 3.

ECONOMIC HIGHLIGHTS

UK – The latest public borrowing figure made unwelcome reading for the Chancellor. Net borrowing of £20.7bn was £3.6bn higher than expected. Pay As You Earn (PAYE) income tax receipts were below forecast, perhaps because of a weaker employment market. Spending was higher than expected, partly owing to increased payments on index-linked bonds because of higher inflation. Capital Economics, a consultancy, calculates that taxes need raising by £15bn-£25bn in the Autumn Budget to keep the country's finances on an even keel. The torpid state of the economy was illustrated by the weak recovery in retail sales in June: monthly growth was just 0.9%, even after the 2.8% drop in May. This disappointment was amplified by the fall in the closely watched GfK measure of consumer confidence from -18 in June to -19 in July. At least this means that the Bank of England will almost certainly cut interest rates by another 0.25% at the 7 August meeting.

US – New data underlined the persistent weakness of the housing market, with new home sales, existing home sales and new building permits all coming in below expectations. With the 30-year mortgage rate stuck at 6.8%, there's little prospect of an immediate recovery. The latest S&P Global PMI survey data for the US was mixed. The services reading climbed from 52.9 to 55.2, while manufacturing fell from 52.9 to 49.5. Any number below 50 suggests a contraction in activity. No change is expected to the Fed Funds rate at this week's interest rate meeting on 30 July.

Europe – The market is saying that the European Central Bank (ECB) is just one 0.25% cut away from the bottom of the cycle – and that the final cut might come in December. The messaging from last week's ECB meeting (where the deposit rate remained unchanged at 2%) was that they could afford to remain in wait-and-see mode for the foreseeable future. The HCOB PMI survey for July saw small improvements for both manufacturing (49.8 vs 49.5) and services (51.2 vs 50.5). The Eurozone is still seeing economic data higher than consensus economists' forecasts. Momentum is showing signs of picking up a little thanks to lower interest rates and an increasing intent among governments and supranational bodies to remove barriers to growth and innovation.

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