RATHBONES

QUARTERLY INVESTMENT UPDATE

THE DESCENT OF MONETARY POLICY
Q4 2024

Subsiding inflation has allowed interest rates to fall – but are bond markets factoring in too much?

We've seen a significant development since our last quarterly update: the UK and US central banks have both started to cut interest rates. We anticipated this, as did many other market participants: **in July we presented five key pieces of evidence** to suggest a US rate cut was highly likely in August or September. The stage is set for rates to keep falling in the fourth quarter and beyond, but there's still much uncertainty about how fast and ultimately how far. In the US in particular, expectations of substantial further cuts all the way through 2025 may now be excessive.

The US Federal Reserve (Fed) didn't move in August, but it did cut rates by 0.5% in September, more than the more common 0.25% rate of change – a double cut, if you like. The commentariat tends to overemphasise the implication of each decision at each individual meeting of its rate-cutting committee; longer-term investors like us are much more interested in the path of interest rates over the next year or more. We don't think this outsized cut was the starting gun for an accelerated cutting cycle. We find evidence for this view in the combined projections of the future Fed rate by the committee's members. We can also cite the statements made by Fed Chair Jay Powell following the September meeting.

To some extent the Fed was playing catch up in September. The Bank of England (BoE) has already cut once, the European Central Bank and various northern European central banks twice, the Bank of Canada three times. Moreover, looking at the Fed's 10 interest rate cycles since the 1970s, there was an average of five months between the last rate increase and the first cut. This time it was 14. In other words, the Fed has kept rates at the peak longer than it usually does. It did this because of the grave consequences of assuming that inflation was tamed from such high levels before it actually was.

Employment: the new focus

Increasing confidence in more stable prices ahead means that the Fed can now focus on jobs – it has a dual mandate to pursue both stable prices and maximum employment. The double-strength cut alters its focus decisively onto employment.

In the US, price stability and full employment are given equal importance over the long-term; however, in the UK a strong economy is an objective of the central bank, but subordinate to price stability. The Bank of England cut rates by 0.25% in August but held them steady in September. While we expect another quarter-point cut in November, the BoE is right to proceed more cautiously. At 3.6% in August, UK core inflation is much higher than the US's 2.6% (using the Fed's preferred measure). In the UK services inflation, which can be hard to suppress once it's taken hold, popped back up to 5.6% in August, well above its long-run average of 3.5%. A shorter-run measure of core services, which strips out more volatile components, rose back to 5.3%, in contrast with an easing to 2.5% in the US.

The labour market also remains tighter in the UK than in the US, as far as we can judge, though the quality of the labour market data has deteriorated significantly – the Office for National Statistics needs to hurry up and fix that problem. Meanwhile, the BoE is putting more emphasis on the surveys conducted by its agents. These point to a retreat from high wage growth to something approaching normality. This makes us confident that UK rate cuts will resume, though at a relatively slow tempo for now.

Over time, we expect interest rates in the UK and the US to settle at around 3-4%, still some way below the current rates of 5% and 4.75 to 5% respectively. As late as July, we said markets were likely underestimating the pace of rate cuts over the following year. For that reason, we tactically preferred bonds with longer duration – those whose price rises more than shorter-duration bonds when interest rates fall. However, markets have since priced in an extra 0.5% of UK rate cuts between now and July 2025, while in the US they have priced in an extra 1%.

The UK repricing matches our assessment of the balance of risks. Uncertainties about government spending, higher minimum wages and the effect of public sector pay rises on inflation do warrant caution.

But the US repricing is arguably an overreaction – something bond markets have been prone to in both directions over the last two years, as we've pointed out repeatedly. Market interest rate expectations are at odds with those of the Fed rate-setting committee. They're also at variance with commonly used rules of thumb for monetary policy rules that trade off damping inflation and maintaining a strong economy. These ready reckoners have been good guides to Fed policy in the past. We therefore no longer advocate overweighting those more rate-sensitive bonds.

Interest rates could fall further than we expect if there's a deflationary recession. We discussed weaker job growth in our last video, and the risk of this has grown. That said, we still think there's a 70% chance that the US economy will keep growing. That's a slight downward revision from the 75% probability we estimated three months ago because some – though by no means all – indicators of labour market health have weakened.

Some analysts dismiss the rising unemployment rate as simply down to higher supply (particularly because of surging immigration). They argue that it shouldn't be read as the end of demand growth and the prelude to recession. These analyses can cite low initial jobless claims. But on the other hand, some labour market gauges that are affected little by changes in supply have also weakened, suggesting faltering demand for workers. These include a rise in the native-born unemployment rate and a significant increase in 'job losers' in the unemployment numbers. Moreover, business bankruptcies are up 200% to their highest level in a decade.

None of these statistics are sending clear signals of recession, and consumer spending remains robust. Meanwhile, corporate profit growth remains fine, even if we strip out the earnings of the technology giants. But we're in the 'late cycle stage', a time when equity markets tend to produce positive returns but with increased volatility. In other words, more pull-backs, even though the direction of travel is upwards.

Unstressed by systemic stress

On that note, we saw a sharp sell-off in the first week in August, caused by weak US economic data, a rate hike in Japan that caught investors by surprise, and some repositioning away from trades that had become rather overcrowded. At these moments – and there will be more – long-term investors like us must return to fundamentals and ask, are there signs of 'systemic stress' that could prevent a swift recovery?

We like to break down systemic stress into four categories: banking, debt market, macroeconomic and corporate profit stress. There have been no clear signs of any of these (outside of China), so we weren't surprised when global equities started reaching new highs again within a fortnight.

This underlines the importance of keeping a clear head. Panic selling can greatly harm long-term performance. Over the last 40 years, there have been 73 days when global equities have notched up a rolling one-month loss greater than 7.5%. A sharp pullback over a short period of time starts to make investors' palms sweaty and the ill-advised investor may sell in a panic. But in seven out of every 10 times, equities went on to beat cash over the following year – and by a median of 16%. What about slightly slower but more persistent falls over two months? We look at the 161 days when the two-month loss is greater than 5% (and things haven't turned around over the previous month). Two-thirds of the time, equities still beat cash.

US equities: from large to small

Another striking feature of markets since our previous quarterly update has been the outperformance of smaller stocks. In that time, the US's fifty largest stocks have been roughly flat, while the Russell 2000 index of small stocks has gained more than 8%. This is in marked contrast to the typical pattern of the past couple of years.

We recommended adding to smaller stocks in the first quarter of this year. Their previous struggles, while larger stocks powered ahead, had left valuations looking very attractive in relative terms. On most conventional measures of valuation, the gap between small and large stocks had become about as large as it at the peak of the dot com bubble in 2000. This period was followed by substantial outperformance from smaller stocks when the bubble burst. That suggests a significant long-term investment opportunity.

However, we always allocate to smaller stocks with a couple of caveats. First, broad indices of smaller stocks typically contain a higher share of companies with weak balance sheets or profitability. So it pays to be selective, rather than investing passively. Fund and stock selection is a crucial part of our approach here. Second, smaller stocks are typically more volatile and exposed to the economic cycle than their larger peers. In other words, they might be expected to suffer more if the economy contracts.

Japan: it pays to be cautious

While the central banks of most advanced economies have cut interest rates, there's been one notable exception: Japan. On 31 July, the Bank of Japan (BoJ) shocked markets when it raised interest rates, pledged to halve its bond purchases, and suggested that more tightening was on the way – an aggressive move away from ultra-loose monetary policy by the central bank that had pioneered it. The fallout briefly convulsed Japanese (and some other) markets, appearing to trigger the rapid unwind of some crowded trades. Japan's Topix stock market index plunged by 20% in just three days, before reclaiming nearly all the lost ground over the next three weeks.

Rapid 'flash crash' events, where markets fall sharply and then recover in a matter of days, have been a feature of markets in recent years. And sterling-based investors in Japanese equities have lost nothing over the past quarter. Yet such volatility is concerning. It's prudent to trim our exposure in response, reallocating to highly profitable Western companies that increase the marginal risk to our portfolios in a more predictable way.

But there are still several fundamental structural reasons to favour Japanese equities. Corporate governance, once an Achilles heel, has steadily improved – but this has yet to be fully recognised in valuations. By international standards, Japanese firms also generally enjoy very low leverage, and many have lots of idle cash; there's now evidence that firms are starting to return some of this cash to shareholders with increased buybacks. And Japan offers investors an opportunity to diversify away from the US and Europe, without the geopolitical and regulatory uncertainty associated with China.

However, it makes sense to be cautious because of high uncertainty about the BoJ's policy. Although the case for continued tightening appears weak, with underlying inflation already low and clearly on a downward trajectory, monetary policymakers seem more focused on backward-looking measures of wage growth. They're also under political pressure about recent yen weakness – albeit somewhat undone by the BoJ's recent moves. With markets discounting little further tightening, the prospect of another hawkish surprise – and the possibility of an unpredictable reaction in equity markets – makes us concerned that volatility in Japanese stocks could stay high.

UK Budget: investment is vital

October brings us the new UK government's first Budget.

The Chancellor has to ensure the health of the public finances. But Rachel Reeves also has a chance to revive investment – the weak investment numbers largely explain the UK economy's long record of slow growth over 40 years. We'd like to see three responses to this problem.

The first is preserving public sector investment. Reeves inherits spending plans that show it falling over the next five years.
The second is avoiding tax changes that discourage private investment. Some Labour MPs want much higher rates of capital gains tax. But this may bring in scant additional revenue because people can control when they sell assets, crystallising capital gains. HMRC analysis suggests large rate increases could even reduce the total tax take. Higher rates can also discourage entrepreneurship and investment in small firms.

The third is supporting a broader pro-investment agenda. That includes reforming the sclerotic planning system, to boost housebuilding and investment in infrastructure. Changes to the pensions system, such as tax incentives, could help with the latter. The Chancellor could also sharpen the incentives for businesses to invest. That could include expanding 'full expensing' – where the full value of investments can be written off against tax – to include things like training and software.

Finally, in industrial policy, we need both consistency and humility. By one count, the UK has had 11 strategies since 2010. And decentralisation, working with business and with local and devolved government, has a greater chance of success than the usual top-down model.

US election: special report

Finally, in the run-up to America's presidential election, we're publishing a detailed report exploring the differences between the two parties' platforms on eight policy areas that could affect our clients' investments. These include corporate tax, geopolitics, and industrial and energy policy.

Wealth Management Festival webinar series
7 to 11 October 2024 — 12:00 to 12:30
If you'd like to join our investment experts at any of our five webinars in October on the rise of activist monetary policy, the economic outlook, financial planning for a Labour government, America's uncertain election and keeping your finances in order, you can register at https://registration.duuzra.com/form/Rathboneswealthmanagementfestival2024.

The value of investments and the income generated by them can go down as well as up.

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rathbones.com

Email
enquiries@rathbones.com

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Greenbank
0117 930 3000
enquiries@greenbankinvestments.com
greenbankinvestments.com

For offshore investment management services
Rathbones Investment Management International
01534 740 500
rathboneimi.com

@RathbonesPlc

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