RATHBONES

QUARTERLY INVESTMENT UPDATE

READY, SET, GO INTO THE NEW YEAR
Q1 2024

THE FITS AND STARTS MAY NOT BE OVER, BUT WE'RE LOOKING FORWARD TO A MORE SUSTAINABLE RECOVERY BEGINNING IN 2024.

Investors have much to cheer as we near the year's end. Following a terrible October, in which most of the year's gains were eradicated, global equities have rallied strongly. Returns through the year have been unusually concentrated, with the majority of companies underperforming the benchmark, but large technology leaders doing well.

We've been cautious through 2023, and remain so, but can look ahead to 2024 with a more confident hope. A fundamentally weak profit environment may challenge all but the highest-quality companies in the first half of 2024, and another one or two large dips wouldn't be surprising. However, the outlook for inflation – a huge source of uncertainty for investors last year – is much improved, especially outside of the US. With many market segments offering very attractively priced opportunities, there's much to look forward to.

Where have we come from?

This time last year we said that what happens in 2023 would be determined by the answer to two questions: will the world's major economies fall into recession? And how far will central banks continue to raise rates? That second question was, of course, conditional on a third, how quickly will inflation recede? Before looking ahead to 2024 and beyond, let's take stock of 2023.

Last January, interest rate futures were pricing in rate cuts for 2023, quite substantial ones in the US. We expected inflation pressures to recede enough to bring a halt to both US and UK rate hikes, but our research suggested that rate cuts were unlikely to come that soon, and we thought that the market was too optimistic about the path of inflation. That kept us cautious on bonds, and we saw particular risk for longer-dated debt, which is more sensitive to changes in interest rate expectations. As the year went on, the market came around to our way of thinking. As those rate cuts were priced out, bond yields soared: 10-year UK government bonds (gilts) peaked just shy of 4.7% in August; 10-year US Treasuries peaked just shy of 5% in October.

By September we had a more constructive view on longer-dated government bonds, particularly east of the Atlantic, and indeed bond markets have rallied strongly as they look ahead to rate cuts in 2024 following a plunge in key measures of inflation in the UK and Eurozone.

The three-month rate of change of both headline and service sector prices (usually a stickier category of prices) has turned negative in both regions – i.e. deflation. While we had flagged more heightened risks in the UK, weak demand has brought inflation tumbling down and concerns that inflation may linger at higher levels are now greater for the US.

Resilience underestimated

While we got those second and third deterministic questions correct, we were incorrect about economic growth. This time last year, the consensus forecast was for a developed-market recession to start in 2023, and we were part of that consensus. By the middle of the year the consensus had split, and many market participants now think that a recession will be avoided next year too.

With hindsight, we underestimated the potential for economic resilience in 2023, and we could have advocated taking more risk. We issued our *mea culpa* in August. We care about recessions because they are invariably accompanied by sizeable equity market falls. It is popular to dismiss economic cycles as irrelevant for market outcomes. At a national level this is often correct — a nation's GDP is often very different to the profits made by its companies who make many sales overseas. But at a global level — and we are global investors — this is completely wrong. There is a very strong correlation between global GDP and global profits.

And in 2023 global profits stagnated, alongside European economies, contracting global trade, and a significant slowdown in China. The US was an outlier among the largest economies, but even there profits weakened. With real interest rates (interest rates minus inflation) rising to a 14-year high, equity markets were largely driven by sentiment. Trying to time every ebb and flow of investor sentiment is not our business and we're sceptical of anyone's ability to do so consistently.

Instead, we set a strategic asset allocation, find companies that we can believe in over the long-term, preferably aligned to the major themes of a changing world, and tactically tilt towards or away from certain risk factors in response to the *major* turning points of the economic cycle — that's when the dispersion of returns both within and across asset classes are at their widest, presenting the greatest opportunities for active investors.

Where are we going from here?
The various goldilocks scenarios, to which many investors subscribe, could be summed up as "it's different this time." For sure, we only have eleven US business cycles to analyse since the Second World War, and even if we multiply that by building a panel of other region's business cycles, our dataset is not that much richer because of the degree of interconnection between Western countries' cycles. Statistically, it is important to acknowledge that it *could* be different this time and that's why our investment committees consider the probabilities of a range of scenarios.

But the aggressive rise in interest rates, tighter bank lending conditions, falling real sales and profit growth, an inverted yield curve (yields for longer-dated bonds being lower than shorter dated ones due to expectations of weaker future growth), contracting money supply and rising unemployment have almost invariably signalled a recession in the past. When they are *all* flashing at the same time, it is bold to say definitively that they can be ignored. So-called 'soft landings' – whereby central banks calm inflation without derailing economic growth and corporate profits – have never occurred when all of these gauges are flashing warning signs.

Of course, much like the effects of monetary policy, the lags between these warning signals and the start of a downturn are long and variable. US recessions have tended to arrive 18–27 months after the first Federal Reserve (Fed) rate hike. That covers most of 2024. Similarly, recessions tend to arrive 14–24 months following the inversion of the yield curve (bond investors demanding more compensation for short term debt than long-term debt). That too covers most of 2024. We could go on.

Tighter financing is already weighing on businesses. Company bankruptcy filings are on the rise (they've never been higher since data began in 1996, outside of the global financial crisis period). It isn't surprising that business investment intentions are on the floor and spending on equipment is contracting year over year, even in the US, with borrowing costs for companies having surpassed revenue growth. This is particularly true when you strip out the supercharged profits of the so-called Magnificent Seven (watch out for the lead article on these tech titans in our next *Investment Insights* publication in early January. Firms' interest expense is also likely to grow in 2024 and 2025, with lots of debt maturing that was taken out at ultra-low rates during the pandemic.

America's CHIPS and Inflation Reduction Acts, focused on microelectronics and the green transition respectively, may have provided some offsetting support to investment in manufacturing facilities, but this has been small compared to the overall size of US investment. And there are growing anecdotal reports of associated projects, especially in the renewable energy sector, now being delayed or renegotiated due to higher interest rates. Moreover, fiscal policy, burdened with high government borrowing expenses, is likely to shave some 0.6 percentage points off headline US real GDP growth, according to a Brookings Institution measure, in stark contrast to 2023.

Recessionary foreshocks are often felt first among smaller companies, which collectively employ half the US workforce and the most people per unit of sales. In the latest survey by the NFIB small business association, the proportion of smaller companies with shrinking revenues in the prior three months outweighed those enjoying gains by 17 percentage points. This level of deterioration has only been exceeded twice in the survey's 49-year history: during the financial crisis and COVID. The forward-looking gauge of sales expectations in this survey is similarly poor.

Household spending has stagnated across much of Europe, but it still strong in the US. It is certainly possible that US households continue to spend next year. Investment spending tends to be the key swing factor for business cycles, and it tends to correlate with corporate profits. In five of the 11 US recessions since the Second World War, household consumption didn't contract at all.

Tying it all together, the long leading indicators, such as the yield curve, change in rates, or bank lending conditions have continued to signal recession. Some of the shorter-term indicators such as housebuilder confidence or business surveys have stabilised, though at levels consistent with stagnation, if not recession, while some indicators are dropping significantly again.

Investing in 2024
On many measures 2023 was the narrowest year in equity markets since the late 1980s, as far back as we have records for, with returns concentrated in the hands of a few tech titans. One of those measures is the proportion of companies in the S&P 500 rising by more than the US equity index. It's around 25%. Until this year the low was just under 35% during the dot com bubble. In Europe, there's been more breadth, and the largest 10 stocks have actually underperformed. But, like 2022, leadership has still been very concentrated, and it is also the narrowest two years in Europe apart from the late 1990s dot com era.

While the economic environment is weak, we expect leadership to continue to be narrow, with large companies that have a track record of sector-beating profitability and plenty of cash to cover their interest payments likely to do well. These factors have been outperforming since the summer in all geographies except the UK. In the UK, sector laggards have outperformed their stronger peers, something that is highly unusual and not something we expect to continue.

On their own, valuations are a terrible market timing tool – when something is cheap it tells you nothing about the likelihood of it getting cheaper over the next year. But there is a strong link between valuations and longer-term returns, and as long-term investors we are looking at the valuations in many areas of the market with great excitement, particularly among smaller and mid-market companies. In a forthcoming article in *Investment Insights* we'll set out some of the more cyclical and higher beta investments (i.e. investments that tend to rise by more than the broader market when the broader market is going up and vice versa) that are on our buy lists ready for when the economic environment becomes a little more certain and these factors tend to do well. Inflation uncertainty is much reduced, which brings us much closer to that point compared to last year. We just need a surer outlook for corporate profits.

UK equities: cheap for a reason, or good value?

Long gone are the days when UK equities made up the majority of the average UK wealth management portfolio. We firmly believe that a global mindset is important for delivering superior risk-adjusted returns. In 2022 the UK equity market had its best year relative to the global benchmark since the early 1990s, but the FTSE 100 has underperformed for most of the last ten years. Some commentators suggest UK equities should be ignored entirely. There are certainly some stocks that deserve to be cast aside. But is that right for the market as a whole?

When the gap between the valuations of UK relative to global equities (which is wider on some measures than it has been since the 1970s) is mentioned, we often hear the rejoinder that the UK market deserves to trade at a significant discount, because it is weighted towards old-economy sectors and has fewer fast-growing and high-quality firms than the US. There's certainly an element of truth to that view. The UK clearly has no direct equivalent to the US tech giants. But what it doesn't tell us is how much of the valuation gap is due to the composition of the UK market, and *how much* (if any) is a genuine discount. Or in other words, cheap for a reason or good value.

Using regression analysis allows us to control for all kinds of relevant characteristics which can affect valuations. Doing so means we can account for differences in composition between markets, helping us compare valuations on an apples-to-apples basis. We've done just that, using a universe of more than 1,000 global stocks (of which 140 are listed in the UK).

In this universe, the price/earnings ratio of the average UK stock is 32% lower than that of the average US stock (and 16% lower than the average stock listed elsewhere in Europe). If we control for sectoral composition, the gap narrows only marginally – to 28% versus the US –meaning UK stocks trade at a discount to their US counterparts within the same sector. When we also control for various other factors (including sales growth, profitability and balance sheet strength), the gap once more remains large, at about 22%. Essentially, this means that firms in the same sector with identical growth and quality characteristics trade at a lower multiple if they're listed in the UK rather than the US. That's very hard to justify.

The UK discount emerged after the 2016 Brexit referendum. There's no evidence of any gap whatsoever when we repeat the exercise with 2015 data. The vote to leave the EU arguably increased the uncertainty around the UK's long-term economic outlook. However, even if you're very pessimistic about the economic consequences of Brexit, the discount described above still doesn't look logical. UK-listed firms trade at a discount regardless of whether they generate much revenue in the UK. We found that multinationals face the same discount as purely domestic plays. Again, that doesn't really make sense, suggesting that an investment opportunity exists. There's little reason for high quality global firms to have been penalised just because they are UK-listed.

A year of elections, and opportunity

One risk that we that expect will get over exaggerated next year is the general election. Indeed, more than half of the world's population is set to go to the ballot box in 76 elections around the world in 2024, which will make it the biggest election year in history according to *The Economist*.

Our analysis suggests that elections rarely change pre-existing market trends, which are typically determined by factors outside of a government's direct control, unless they bring in a radically different economic model, which is not something we see happening in major economies next year. In other words, we shouldn't lose sight of the bigger picture. We'll have much more to say as elections approach and we learn more about policy plans, and we make a few preliminary observations in another forthcoming article in *Investment Insights*.

To sum up, after taking a sober look at the challenges that still lie ahead, we believe investors do have good reasons to ring in the New Year with a toast to the opportunities it will bring.

ADDITIONAL INFORMATION

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