RATHBONES

QUARTERLY INVESTMENT UPDATE

ENTERING THE MIDNIGHT ZONE
Q4 2023

As we set out in a recent video, it's now been a year since we first said a recession in the developed world was more likely than not within the subsequent 12 months. As a result we were investing cautiously, favouring the quality companies (think highly profitable with low levels of debt) and defensive industries that are likely to produce steadier returns as markets get hit by a slowdown in the broader economy.

Yet no recession has arrived. In this quarter's update we address head on why – after rigorous debate – we haven't changed our outlook. There's a little more detail in the video.

With hindsight, we underestimated the probability of economic resilience in 2023, and we could have advocated taking more risk. Still, global earnings have been falling since January and with real interest rates (interest rates minus inflation) rising to a 14-year high, equity markets have been 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 tilt towards or away from certain risk factors tactically in response to the major turning points of the economic cycle.

At best, one could say that there are conflicting signals about the outlook for corporate profits over the next few quarters. And yet, despite that uncertain context, the VIX index of volatility – often referred to colloquially as the market's fear gauge – has been near a three and a half year low. Despite corporate bankruptcies alreadyreaching a 13-year high, US corporate bonds are more expensivethan they have been over almost three quarters of their availablehistory (although European credit is still offering more value).

US equity markets are more expensive than they have been over 90% of their history on many metrics, as we'll discuss below. In other words, investors shouldn't need to fully subscribe to our view that a recession is more likely than not to think that there is an air of complacency in financial markets. While long-term return potential keeps us invested, the short-term threats to risky assets aren't being compensated for adequately. These concerns come at a time when rather substantial returns are available from relatively risk-free government bonds.

Still, companies with the quality and defensive characteristics have generally done better than the overall market this year. This is typical in the late stages of the economic cycle and as central banks near the end of their interest rate increases, we continue to favour these kinds of companies. Our research has shown that expensiveness does not preclude defensiveness at this stage of the cycle. In other words, investors will remain willing to pay a premium for quality and defensiveness.

To frame the way ahead, it's worth revisiting the checklist we have for turning more positive on the outlook for financial markets in general. Historically, new bull markets have required at least two of the following five conditions to be met:

1. US rate increases come to an end

This is the only of our five condition that has now probably been fulfilled, given the significant progress the US Federal Reserve (Fed) has made so far in bringing inflation down. Shelter (cost of housing for primary residences) is the largest part of the 'basket' used to measure core services inflation (excluding energy services), and this has started to fall. It's a very lagging measure of conditions in the housing market, and more timely ones suggest that a steep fall is on its way. The monthly pace of core services inflation excluding shelter, which the Fed has fixated on, has slowed to around pre-pandemic levels.

The median price rise and various other gauges of underlying inflation among all the many goods and services in the inflation basket have been falling sharply. Meanwhile, wage growth has begun to slow. The measures with the best track record of leading wage growth indicate that the pace will continue to decline. However, the jury is still out on whether wage growth will fall enough to keep it consistent with the Fed's inflation target. And with petrol prices starting to rise again, this does present some lingering risk given they have been found to drive consumers' inflation expectations and therefore wage-bargaining behaviours. This is likely to prevent the US and other major Western central banks from cutting ratesin the immediate future, but we expect most of them to follow the European Central Bank's lead and signal a long pause withinthe next one or two meetings.

2. Economic signals bottom out

Since 1965, there have been five episodes where high inflation in both US wages and prices were tamed successfully by rate increases: all five were accompanied by recession. Now five is not a large sample, and it could be different this time. Yet if the peak impact of a rate change is felt after nine to 18 months, then

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

it's important to note that 18 months ago US rates were still 0.5% and nine months ago they were 4% compared to 5.5% today. There are some reasons to think the lags may operate at the longer end of the historical range today - for example, the average maturity of corporate debt is longer than it has been and there are fewer variable-rate mortgages (although these were never dominant in America). So we are only now really entering what you might call the midnight zone — the nadir has probably not yet been reached for leading economic indicators.

We've also had a major tightening of bank lending conditions, the effects of which tend to lag by about nine months. Our analysis suggests that the reduction we've seen in the availability of consumer finance would be consistent with a 10-percentage-point or higher contraction in retail sales by the end of the year. For as far back as the data goes, there's never been a 'soft landing' (where recession is avoided) after rates have surged and bank lending standards have tightened as well. Again, that doesn't mean it can't happen, but it's important information to note.

Admittedly, the US housing sector has been a bright spot so far this year, stabilising after clear weakness in 2022. And it has had a good track record of leading the overall economic cycle. However, its stabilisation reflects some very unusual dynamics. Given the way the US system works, mortgage holders who had locked in fixed rates far below current levels have a strong disincentive to move (which would mean an expensive new mortgage). This has effectively frozen the existing homes market. And since some people always need to move, new home sales have risen in response. This doesn't look like fertile ground for a strong recovery. Housing affordability remains the worst since the mid-1980s at current mortgage rates, and the latest surveys of homebuilders have turned down again.

Meanwhile, the US consumer arguably faces a perfect storm later this year. Slowing growth in wages and employment combined with rising energy prices suggest that growth in real income will slow. After adjusting for inflation, the extra savings accumulated during the pandemic have now been depleted for all bar the 10% richest households. And a couple of specific headwinds will kick in during October. Student loan repayments, which have been suspended since March 2020, are due to resume, subtracting an estimated 0.4 of a percentage point from disposable incomes. And tax relief related to severe storms in California earlier this year will expire. Most residents of the state - which accounts for one in every seven dollars of US GDP - have been able to delay personal and business tax payments originally due in March and April.

Consumption doesn't have to contract outright for the economy to experience a downturn. (It has continued to rise in four US recessions since the Second World War.) Investment is usually the swing factor. It's hard to have much confidence in the outlook for investment currently, given the weakness we've already seen, plus the backdrop of rapidly rising interest rates and tightening bank lending standards.

Finally, away from the US, China is still struggling from a deep downturn in its housing market. Policymakers there have now begun to provide more support, notably cutting deposit payments on houses and reducing mortgage rates (including for many existing mortgage holders). Yet the overall scale of new support appears far smaller than we saw ahead of the big cyclical rebounds in China's economy after the global financial crisis and around 2016. Officials are still concerned about doing too much and reinflating the prior housing bubble, and about the wastefulness of previous stimulus spending.

3. Profit forecasts and economic outlook aligned
The consensus is still for strong earnings growth in 2024, particularly outside commodities sectors. Even mild recessions in the past have typically been associated with double-digit declines in earnings. Simple top-down models of earnings revisions (based on broader macroeconomic trends) continue to point to downward revisions to come.

4. Historically cheap valuations
This condition hasn't been fulfilled. Although valuations are only around the 20th percentile (bottom fifth) of their historical range in the UK on our composite measure, they are higher in Europe (40th percentile), the developing markets (40th) and Japan (48th), and a lot higher in the US (87th). Measures that look at value relative to cash flow or sales, which are less distorted by accounting conventions, are just as bad and in some cases worse. One such measure, the ratio of the S&P 500's enterprise value to its sales is nearly the highest it's ever been, in its 97th percentile. Equity valuations in the US also now look even more stretched when you compare them to government bonds. The measure of the additional return on offer from equities over government bonds, known as the equity risk premium, has now declined to its lowest level since the late 1990s-early 2000s dotcom era.

5. Investors capitulate
This is harder to measure than most of the other triggers, but certainly doesn't appear to have been fulfilled recently either. In the US, retail investors' allocation to equities has increased recently and is not low at all by the standards of the past. On the institutional side, Bank of America's latest global fund manager survey was the most optimistic in a year and a half, with cash allocation dropping to the lowest in 21 months and three quarters of participants anticipating a 'soft landing' or 'no landing' (i.e. not even a noticeable slowing) scenario.

The bright spots
While we wait for another one or two items on our list to be checked, there are plenty of bright spots to focus on.

Our view on government bonds is more positive than at any point in the last decade. The UK 2-year government bond (gilt) now yields about 5.0%, compared to an average of 0.9% over the past 10 years. And the 10-year gilt yield is 4.3%, versus its average of 1.6%. Furthermore, yields are now higher than what we think are plausible estimates of their long-term 'fair values', based on our analysis of long-term trends in UK growth and inflation. The Bank of England is probably now at the end of its rate-increasing cycle too. Although interest rates are not about to be reduced imminently, they could plausibly fall in 2024, with inflation on course to keep falling and the UK economy struggling. Government bonds have historically performed well in the months ahead of rate cuts, so adding now makes sense. Even if lingering inflation does result in a couple more rate rises or a longer pause, the higher yield to maturity is very likely to offset the potential capital loss and result in a positive total return.

Japan's stock market has reached a 13-year high, as the country has been somewhat dislocated from the global slowdown. It has lower inflation and thus has uniquely been able to keep interest rates ultra-low, while it was also the last developed economy to reopen from the pandemic. Its economy should still benefit as it gains traction, especially as tourism from China returns.

Moreover, Japan's equity market continues to be a beneficiary of improving governance and, in turn, valuation multiples (such as prices relative to earnings) on the back of Tokyo Stock Exchange initiatives. Having lagged for decades in the past, measures of return on equity (net income accruing to shareholders) for Japanese companies are catching up with the developed market average. Japan looks attractively priced, with more than half of companies having more cash than debt – no bad thing in a higher rate world, and the pace of Japanese companies buying back their shares with surplus cash is accelerating (thus increasing the value of the shares still outstanding). Against this backdrop, renowned investor Warren Buffett has poured money in and Japan is now his biggest holding outside of America. Unlike us, foreign investors have been cautious on Japan for years, but inflows have shot up this year could increase further.

While we remain cautious on equities and other riskier assets overall, there are some great companies out there that we think can generate market-beating returns over the long term. In particular, we are always on the lookout for companies that will benefit from underlying structural shifts in their sectors and the wider economy.

Our two latest research reports have explored some of these thematic opportunities across a spectrum of industries: from big tech to the buildings and construction sectors. You can read more in *The cloud revolution* and *Building a more sustainable future*. Last quarter's *Investment Insights* publication led with the risks and opportunities for investors from the latest technology craze – generative AI. In our next Insights publication due out next week, we'll follow this up with a look whether AI can change the world, at least in terms of GDP growth.

ADDITIONAL INFORMATION

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