Investment*Update*

28 September 2022

Staying defensive as risks continue to build

We can see a path to better returns, but there are substantial dangers to be guarded against

The end of this quarter has been dominated by the fallout from Chancellor Kwasi Kwarteng's so-called 'mini-budget' – which revealed the largest tax cuts since the early 1970s, despite the backdrop of the Bank of England (BoE) already struggling to bring inflation down. The timing of such a large fiscal boost is very hard to defend, and the UK looks like an outlier internationally. The government's unusual decision not to publish the independent forecasts from the UK's fiscal watchdog didn't help either. The pound fell to $1.035, which hadn't been reached since the currency was floated in the modern system in 1971. It has since recovered some of its losses to trade between $1.07 and $1.08, but the currency shakiness is rattling for everyone in the UK. So far in September, the pound has fallen 7% against the dollar and 3% against the euro; year to date, it's dropped 20% against the dollar and 6% against the euro. It's not just the currency either. UK 10-year government bond yields have risen by 131 basis points so far in September – more than any other month on record (going back to 1957).

Enough fuel for growth?

If you're looking for positives, the mini-budget's stimulatory effects, combined with the previously announced energy bill freeze, should reduce the likelihood of a very deep recession in the near term, something that had previously seemed very possible. However, markets have understandably focused far more on the significant increase in uncertainty around the outlook further ahead. The mini-budget and energy measures together amount to a loosening of fiscal policy worth perhaps 6% of GDP – very large by any standards. Much looser fiscal policy means that demand will remain far stronger than it would otherwise have been, significantly increasing the likelihood of inflation staying uncomfortably high for a long time. That in turn raises the prospect of a much longer cycle of interest rate hikes from the BoE, with significant implications for the housing market in particular.

The government appears to be counting on its tax cuts and regulatory reform agenda significantly boosting long-term growth via improvements in the supply side of the economy. The Chancellor is targeting faster trend growth of 2.5% annually, compared with the 1.5% average since 2000. If that were achieved, it would ultimately help to reduce the size of the national debt relative to GDP, assuaging worries about increased borrowing today. However, there are plenty of reasons to be sceptical that it will actually happen. There's little evidence that low corporate taxes boost investment and trend growth – the UK already has the lowest corporate tax rate in the G7, but the least private investment as a share of GDP. And Britain is already significantly less regulated than the average high-income economy in both labour and product markets, so it's not clear that a deregulation drive will help much either.

Meanwhile, the package doesn't address some of the specific constraints on long-term GDP growth in the UK, like sluggish growth in the labour force and persistent uncertainty over trade policy. Global investors seem to agree that the plan to make up for large tax cuts today via faster long-term growth is flawed. Gilts have been dumped in a hurry: the yield on five-year gilts ballooned from roughly 3.00% a couple of weeks ago to 4.50% because their price has plummeted. This means the government will have to pay much more to borrow much more, squeezing its ability to spend on infrastructure and public services.

Concerning inflation

The UK's underlying inflation problem has been getting worse recently, even before the Chancellor's announcement. Core inflation still hasn't peaked, driven upward by prior weakness in the pound (the imported content of the UK's inflation basket is higher than most countries') and higher wages as service industries grapple with less immigrant labour. It's also concerning that inflation expectations have been rising. In August, the Citigroup/YouGov Inflation Tracker found households' long-run expectations (5-10 years ahead) jumped to 4.8% – a new record and well above the c.3.5% rate that has prevailed for 15 years. Data collected by the BoE shows that firms' expectations for future price increases have also risen recently.

One bit of good news is that the government's decision to freeze energy bills from October should reduce the prospective peak in headline CPI by four to five percentage points. Inflation is now likely to plateau at the current 10-11% level rather than rising to 15% in January as many feared. But beyond that, the key risk is that inflation falls back only very slowly. The energy bill freeze – plus the tax cuts announced in the mini-budget – will support demand, keeping inflationary pressure in non-energy goods and services stronger for

Rathbones
Look forward

longer. Inflation could conceivably remain well above the BoE's 2% target throughout next year.

Since the summer, the BoE has stressed its desire to bring inflation down regardless of the possible costs to growth further ahead. In the words of Governor Andrew Bailey, it wants to reduce inflation "no ifs, no buts". As a result, it's likely to respond to recent fiscal loosening with a longer cycle of interest rate increases than previously seemed likely, even if it resists market pressure for an emergency rate hike before its next scheduled meeting in November. The Bank's Chief Economist, Huw Pill, has suggested that "a significant monetary policy response" is needed. Markets are now discounting interest rates rising above 5% early next year and continuing to climb thereafter. Even if market pricing has gone too far, the bigger picture is that large rate rises are highly likely.

Value is out there

At the time of our update in early August, the global equity market was very close to the completion of a substantial rally from its June lows. We said then that the "facts had changed" and pointed to a marked deterioration in the outlook for economic growth, the likelihood that inflation would fade less quickly than investors expected, and a widespread underestimation of central bankers' resolve to stamp down on prices. Accordingly, we were unimpressed by the rally and reiterated our view, held since the middle of last year, that it makes sense to take an increasingly defensive position.

Since the mid-August peak, the global equity benchmark has fallen by 15% (in dollar terms). After some unsightly US inflation data was released in early September, US equities, which account for almost 70% of that benchmark, suffered the steepest one-day fall since the pandemic-induced shock of March 2020. Two and a half years ago, all concerns focused on deflationary forces. Today, inflation is the primary scourge, and the uncertainty it is generating regarding future interest rates, profits and jobs is profound.

The good news is that a considerable amount of that uncertainty is compensated for in the valuations of many companies that we favour. As we explained in a recent video, US stock valuations are today at levels that in the past have been associated with decent – albeit not spectacular – long-term returns, and non-US markets look even more attractive. It may not feel like it, but when you are paying less for those future earnings, that tends to be an auspicious time to have new money to invest. That being said, investing is always risky and there's a chance that lower prices go even lower.

Valuations tell you very little about the next year. Furthermore, when we take a few dozen individual investments with compelling long-term prospects into a single portfolio, a considerable amount of that individuality is (intentionally) diversified away. Much of the risk comes from exposures to systemic, macroeconomic factors, such as growth, interest rates, the price of energy, and so on. A key part of our job is to ensure that we do not expose you to an unsuitable amount of total risk at any given time. As such, we are continuing to favour defensive positions.

Fading growth

Over the last seven weeks, leading indicators of economic output have continued to deteriorate. Eurozone and British consumer confidence have hit all-time lows. A much-watched measure of German business confidence, the Ifo survey, which has proved a very accurate predictor of business investment, has also fallen beyond the lows seen in the financial crisis and subsequent European debt crisis. To be very clear, the predictive power of many of these survey-based indicators has weakened considerably since the pandemic, and a contraction deeper than that experienced during the financial crisis is not the scenario we deem most likely, especially now there is widespread government intervention in energy costs. What interests us most is the direction of travel, and until we see compelling reasons to expect a substantial bounce in these indicators, we remain defensive.

China's economy is also struggling, and a major revival in growth there soon does not look likely. Coronavirus cases there are rising again after a summer lull. This has already resulted in some new lockdowns as the country persists with its zero-COVID policy. In early September, parts of the country responsible for producing more than a third of China's GDP are experiencing new outbreaks. At the same time, China is suffering its deepest housing downturn in decades of data, caused by policymakers' attempts to rein in overleveraged developers and years of overbuilding that created an unsustainable market. New starts and sales continue to slump. Three things are necessary to restore our confidence in China: a refocus on economic growth (Beijing has quietly abandoned its growth target for this year); a clear path out of zero-COVID; and either a bolder, more holistic approach to fix property sector problems, or, in its absence, a trough in construction activity.

The US economy, by contrast, has so far held up much better. But it faces challenges of its own. The interest-rate-sensitive parts of the economy are suffering as the cost of borrowing has risen. Existing home sales have already fallen by more than a quarter from their January peak. New building permits are more than 10% off their highs. And the forward-looking components of key housing market surveys suggest more weakness is coming over the next six months. The housing market matters a lot, because it has a long track record of leading the economic cycle in the US. It is a key input into our quantitative models of US recession risk, and it's one of many reasons why the implied probabilities of recession from these models are still high (well above 50% at every time horizon) despite some improvement in other leading economic data, like the ISM manufacturing new orders survey or initial claims for unemployment benefits. Outside of the immediately interest-rate-sensitive sectors, we have seen little slowing even after the huge increase in interest rates this year. In combatting inflation, the US Federal Reserve (Fed) may need to do more to entrench the economy in below-potential growth, but raising rates this quickly carries its own risks.

The inflation fight continues
Lower jobless claims are a double-edged sword: fewer people out of work means better growth, but it also means that labour markets are remaining very tight after all and that will keep pressure on wages and service-sector inflation. Leading indicators of wages have stopped rising for some months, but they remain stuck at levels far above where they need to be for inflation to return to target.

The latest data for US inflation in August was shocking. Bar another unforeseen shock, inflation has almost certainly peaked, but the pace at which it is falling is meagre. Moreover, the prices of core goods and services, excluding transport and energy, are still rising at a rapid clip. The median consumer price index, calculated by the Cleveland Fed, ranks the price changes of all the many goods and services that are in the consumer 'basket' used to calculate inflation. It then looks at the change in the median item. That, along with some other alternative measures of core inflation, is still rising at the strongest monthly rate on record (the median CPI measure goes back to 1983).

As we have noted for some time, the theoretical and empirical evidence is quite clear: the longer inflation stays high, the longer it is likely to remain high. We still believe that inflation is likely to fade rapidly next year, but an awful lot has to go right for inflation to fade as quickly as the market expects, and we see this as a key reason to remain defensively positioned.

Still, the impact on inflation from supply disruptions is easing substantially. Citi's global supply chain indicator stands at its best level since late 2020. Gauges of input costs, supplier delivery times and order backlogs are back to normal levels in the US. But there is a risk that disruption may not be completely behind us, given the ongoing war in Ukraine, lockdowns in China, worker shortages and labour disputes (like the narrowly circumvented American railway strike this month) that can all have a sclerotic impact on the flow of goods.

The best news relates to inflation expectations, which can become something of a self-fulfilling prophecy (as we've explained before when contrasting today with the very different 1970s). The latest New York Fed survey shows that consumers' 5-year expectations have receded to below the level that prevailed before the pandemic. Their expected inflation rate in three years fell to a reasonable 2.8%, down from 3.2% in July. In another survey by the University of Michigan, which has a five-decade history, median inflation expectations over the next 5-10 years declined to their lowest level since July 2021 and remain well anchored to their range of the last 30 years.

Is there a Fed 'call'?
However, central bankers have been extremely clear since the summer: their focus is now firmly on reducing inflation, even if there's a cost in terms of growth. Fed Chair Jerome Powell's rhetoric over the last three months has moved from suggesting a so-called 'soft landing' was a reasonable assumption, with inflation brought back down without derailing economic growth, to making it clear that a mild contraction is a small price to pay for preventing an inflation spiral. Almost all Fed policymakers are saying the same. Only Vice Chair Lael Brainard is warning that hiking at this historic pace may be too quick, given monetary policy operates with a substantial lag. Yet even she's not calling for a slower pace of tightening today.

While some investors still cling to the concept of a Fed 'put' – a hypothetical level that the Fed would prevent US equities from falling through – there may actually be an implicit Fed 'call' – a theoretical level it would prevent the market from *rising* through. This is because monetary policy works by influencing broader financial conditions – in short, the average cost of capital for firms. Strong equity markets, all other things equal, mean looser financial conditions (cheaper money) and until inflation appears beaten, policymakers are likely to talk tough if they think the providers of capital are contradicting them. That doesn't mean there's no room for markets to rise in the near term, but it could mean a limit on the extent of any possible upside for now – as we saw in late August.

For investors, there are substantial risks of Fed-induced upset. Back off and let inflation get the better of us today and interest rates may need to be hiked even further tomorrow, which could mean even lower equity valuations. Hike too quickly and sharply increase the prospect of falling revenues next year. The path to a market-friendly outcome is narrow, again keeping us cautious. Although, unlike some doomsayers, we do not think it implausible.

As interest rates rise, an important development to keep in mind is that households and corporate sectors are less sensitive to rising rates today than the mid-2000s. In stark contrast to the financial crisis era, 90% of household debt in the US today is fixed rate, according to Morgan Stanley analysis. Despite the sharp increases already, higher interest rates are not yet showing up in weaker corporate balance sheet metrics. In fact, the dollar amount of interest costs paid by companies with investment grade bonds actually fell in the second quarter. In Europe, interest coverage (earnings divided by interest paid) has never been better in the index of investment grade companies – same for the US. Net leverage has only been lower 2% of the time (although in the US net leverage is still reasonably high compared to history).

Higher rates yet to bite profits
From an investment strategy perspective, one silver lining is that UK investors with substantial overseas investments are protected somewhat from the pound's weakness. This includes large British companies, which together earn around 70-75% of their earnings overseas. The UK stock market has held up better than other geographies, even excluding its outsized oil and gas sector, due to its large defensive cohort. It is also trading at an historically extreme valuation discount, even adjusting for growth prospects.

Globally, we do expect growing pressure on corporate profitability. When financial conditions have tightened in the past, investors have typically rewarded companies with 'quality' attributes, according to analysis by Goldman Sachs. Since 1990, periods of tightening have been correlated with the outperformance of companies with high returns on capital, strong balance sheets, and low volatility, all relative to lower-quality peers in their sector. Today, firms with high returns on capital carry a valuation premium close to historical averages, leading us to favour some blue-chip names in the US, even in technology sectors that have been under pressure this year.

European equities look very cheap and have de-rated so much that they may no longer be at the mercy of large swings in real (inflation-adjusted) bond yields. They remain very out of favour according to investor surveys and fund flows. Yet with earnings expectations still too high (around 4% growth next year when flat to negative growth is much more likely), we don't see investors rushing back to Europe until a significant turnaround in its outlook.

We continue to favour Japan. Structural reform has helped return on equity reach a 40-year high, which could continue given this measure of profitability still lags developed markets as a whole. Japanese earnings have been surprisingly resilient for an historically more cyclical market, even before the very large decline in the value of the yen, which still hasn't fed through fully.

In currency-hedged terms, the yield on Japanese equities relative to US counterparts is the highest in two decades. The risk here is the supply-chain linkages to China and the possibility that new Prime Minister Fumio Kishida could do something less than market-friendly.

To sum up, we see long-term value and a path to better returns. Yet while we think financial crises are very unlikely, there are substantial macroeconomic risks that need to be guarded against and so we believe it makes sense to remain positioned defensively.

Important information

The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

Contact us

If you would like further information or to arrange an initial meeting, please contact us on 020 7399 0000

Head Office
8 Finsbury Circus, London, EC2M 7AZ

For ethical investment services:
Rathbone Greenbank Investments
0117 930 3000
rathbonegreenbank.com

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

@Rathbones1742
Rathbones Group Plc
Rathbones Group Plc