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Weekly Digest

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Pulling teeth: markets stuck in the waiting room

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Markets are still waiting to be called, with bonds offering more cushion than before and investors rotating away from tech rather than heading for the exits.

Quick take:

- Markets are short of direction, with bonds offering more padding than before, but they're still vulnerable to inflation and fiscal nerves.
- Tech leadership has faded, but banks are helping keep broader markets steadier than the headlines suggest.
- Investors are waiting for clearer signals on AI, geopolitics, inflation, and the US mid-term elections – any of which could jolt markets out of their current holding pattern.

Most weeks, when it comes to writing the Weekly Digest, it's just a case of letting the words flow. Every so often, though, it feels like pulling teeth. This seems to be one of those weeks. Plenty is happening, but the storylines are stuck on repeat – and there's only so much juice left in them. There's the familiar escalation and de-escalation Middle East cycle; whether the AI-related capital spending will pay off; endless speculation over the UK government's meeting its fiscal targets; and, this week, attempts to second-guess the policy decisions of central banks. All while navigating the quarterly company earnings season.

Bonds: going nowhere... slowly

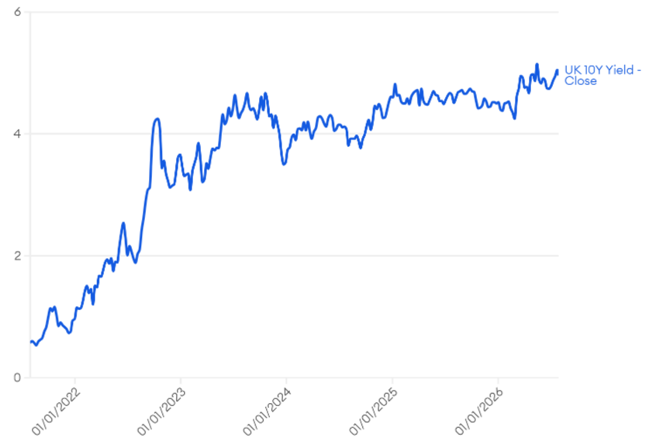
A typical medium-risk, balanced portfolio has gone nowhere for the past couple of months (using the FTSE Private Balanced Index as an objective reference point). In an age of instant results, that's pretty boring. Especially after three years of persistent growth, interrupted by the odd gut-wrenching decline.

Bonds have been flat for longer, at least in total return terms. When checking the year-to-date performance of the sterling-hedged version of the Bloomberg Global Aggregate Bond Index on Friday, it was +/-0.00%! That means the loss of capital so far this year, as yields have risen, has neutralised any income received (at least across the global bond market as a whole). But there is a silver lining: the current yield on bonds can help offset capital losses.

That was not the case when yields were close to zero. My colleague and bond guru Bryn Jones, Head of Fixed Income, points out that the redemption yield (the yearly return expected if the gilt is held to maturity) on a 10-year gilt would have to rise from around 5% today to 6.8% in three years' time to wipe out the accumulated income. We haven't seen that sort of yield since November 1997. It looks unlikely, provided bond investors keep pressure on the new Chancellor and the Bank of England remains alert to inflation threats.

Gilts have their cushion back

After five years of rising yields, 10-year gilts now offer more income to absorb shocks, though inflation and fiscal nerves still matter.



Source: FactSet, Rathbones

This is not a recommendation to pile savings into government bonds, but rather an observation that the starting point for bonds is more favourable than five years ago. Bonds remain vulnerable to inflation and fiscal mistakes. They also compete with equities and alternative assets for their place in a portfolio. Our long-term models continue to project better returns for equities.

There's also the vexing problem of whether government bonds can still help steady a portfolio when share markets fall. In a world of higher and more volatile inflation, they'll continue to struggle, compared with other assets, as central banks may have to keep interest rates higher, pushing bond yields up and prices down. They could come into their own again if the economy weakened sharply and inflation fell – provided that shock doesn't pull the rug out from beneath the government's finances.

Equities: going nowhere… fast

Equity markets' recent flat performance continues to mask a much more volatile atmosphere below the surface. Around late May, many leading technology stocks started falling, as doubts grew over whether their heavy AI spending would pay off.

There has been another source of pressure too: although investors expect inflation to be lower over the long term, longer-term bond yields have risen. This suggests a higher 'term premium', the extra yield demanded by investors to allow for increasing uncertainty over, say, fiscal responsibility – how prepared governments are to limit the gap between income and spending. Rising real yields increase the real cost of capital. That depresses the present value of future earnings, or, more simply, lowers the near-term price/earnings ratio (how much investors are willing to pay for each pound of a company's current earnings).

The effect is greater for companies with a higher proportion of their current value derived from future expectations. Technology companies are prime examples. A basket of hyperscalers (the companies funding the drive to carpet the world with data centres) peaked on 29 May and has since fallen 18%. The 'Magnificent 7' leading technology shares have shed 10%. The tech-heavy Nasdaq 100 Index has fallen 8% over the same period.

There was a time when the loss of such leadership would have sounded a death knell for the market. But the broader S&P 500 Index has declined just 2.5%, while the 493 companies previously deemed not so 'magnificent' have posted a marginal gain.

Our own FTSE 100 Index has gained 4%, and not because of the oil majors. Of the 400-odd index points gained, a third can be attributed to the HSBC banking group, with almost as much to fellow banks: Barclays, Lloyds, and NatWest. Banks have been performing well globally. They're generating significant cash in a higher-interest-rate environment, with limited loan losses. Those with capital markets operations are enjoying the boom in trading volumes and a healthy M&A and IPO environment (i.e. dealmaking and new stock market listings). More of the former than the latter in the UK, it's fair to say.

It's usually wrong to get too pessimistic if banks' shares are faring well, as banks tend to be useful barometers of the wider economy, and the MSCI World Banks Index has hit a series of record highs. Investors began to smell a rat a good 18 months before the global financial crisis hit in late 2008.

Still in the doldrums

The perfect scenario for investors today would be a conclusive resolution of the US–Iran war, as it would open shipping lanes in the Gulf and allow the free flow of critical commodities. Inflation-related concerns would melt away, and the risk of further increases in central bank interest rates would diminish. This verges on wishful thinking.

We could also hope for definitive proof that the productive adoption of AI tools is accelerating, along with the willingness and wherewithal to pay for them. It's too early to declare this outcome, and patience is required, even though our research suggests computing power demand will continue to grow.

A final consideration is that US equities have historically been range-bound (moving up and down within a fairly narrow band) in the months leading up to the US mid-term Congressional elections on 3 November. They tend to be weaker than usual in mid-term election years: over the decades, the S&P 500's median return from early August to Election Day has been 0%. The good news is that returns have usually improved once the vote is out of the way, with a median gain of 6% over the following three months. For now, then, markets may have to sit tight a little longer – uncomfortable, perhaps, but not necessarily in need of emergency treatment.

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Regional highlights

UK. The annual inflation rate declined from 2.8% in May to 2.6% in June, a 14-month low. The main driver was lower fuel costs thanks to the Memorandum of Understanding between the US and Iran. The fact that this has since been ripped up suggests a potential bounce ahead, especially as Ofgem's new, higher utility price cap takes effect in July. More encouragingly, there seemed to be little evidence that businesses were passing on higher energy costs to consumers, although that in itself might indicate a weak underlying economy.

Even so, these pressures can take a while to make their way through the system, and so the Bank of England will not relax its vigilance. Retail sales increased by 1% in June, another strong performance after a 1.2% rise in May. Growth was particularly marked among non-store and clothing retailers, with businesses reporting a notable increase in demand in response to deeper-than-usual discounts. Again, a sign that underlying demand might not be as strong as headlines suggest.

US. Perhaps the most remarkable number in the US last week was the Weekly Jobless Claims data. The fact that 187k individuals 'signed on' might not sound special, but it was the lowest print since September 1969! There aren't any special factors behind this, although summer data can be more volatile than normal. More evidence of what has been dubbed the "no hire, no fire" labour market. Certainly, no signs of incipient weakness. Stronger growth was evident in the latest S&P Global Purchasing Manager Index (PMI) data. With the services reading increasing from 51.2 to 53.6 in July, and manufacturing little changed at 53.8, the composite reading climbed from 51.2 to 53.6 (consensus forecast was 52.2). There's no evidence that this was driven by the World Cup.

Europe. Data in Europe remains very strong relative to expectations, as seen in Citigroup's Economic Surprise Index, which rose from -82 in May to +43. The depths of despair following the initial fighting in the Middle East have moved close to the heights of optimism. Sadly, this might revert lower again in the coming months following the re-escalation and volatility in oil prices. Even so, it speaks to some sort of increase in animal spirits on the Continent. This was also evident in the latest PMI and consumer confidence data, as well as in the latest Ifo business sentiment survey.

At the Eurozone level, the composite PMI hit a five-month high of 51.9, supported by both subcomponents. In Germany, it climbed back to 51.2, while in France, it rose to 49.8 despite a fall in manufacturing output. But that might be as good as it gets over the short term.

China. Industrial profits rose 18.7% year-to-date in June, stronger than the 15.5% recorded in Q1. Overall, profit growth continued to exhibit the K-shaped nature of the recovery, with upstream sectors such as mining and manufacturing recording 23.2% growth, much stronger than the 11.1% seen in downstream industries. By industry, electronics-related sectors, such as computers and communication equipment, saw profits surge 96.9%, accounting for 45% of total profit growth, although that moderated from 124.5% in Q1. AI demand has lifted factory gate prices for many electronics products.

The superb performance of the high-tech sector stood in sharp contrast to that of the old economy, particularly consumer goods industries. Profits in clothing, footwear, wine and beverages, arts and recreational products, and furniture manufacturing fell by -28.0% in aggregate, thanks to a soft labour market and the ongoing deleveraging of the property sector. The authorities may announce targeted support measures in the coming days following the conclusion of July's economy-focused Politburo meeting, more probably an acceleration in budgeted fiscal disbursement rather than any ‘bazooka’ stimulus.

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