MONTHLY UPDATE

Latest views from the investment team

Summer calm

July was a quiet month in markets with global stocks and bonds performing relatively well across the board. A softer economic landing in the US feels more likely as disinflation progresses alongside a resilient economy. Things even seem a bit rosier at home as we reported in our flash update with softer inflation. As we are now halfway through summer, typically the quietest point for markets, we thought it would be opportune to take stock of market sentiment and weigh up our own positioning.

Starting with the US, prior to July the sentiment suggested that a recession was on the horizon (albeit with an uncertain start date), however, recent developments hint this may not materialise. Bank of America, Goldman Sachs, and the Fed all lowered their prediction of the likelihood of US recession. This comes as the job market and output remain resilient and stronger than expected while inflation softens. This goldilocks scenario where inflation slows with minimal damage to the economy is still far from certain; it takes time for the now higher interest rates to have their full impact. While a US recession remains the consensus view, the narrative has shifted from viewing strong economic news as negative due to subsequent potential interest rate hikes, to embracing it as positive news. In other words, good news is once again seen as good news. This has bolstered US markets beyond just tech stocks. We remain wary; with so much good news being priced in we are concerned that markets might be trading at elevated levels and valuations when a recession still seems likely.

The mood at home in the UK and in Europe feels quiet and more downbeat. The month brought no big surprises; inflation in the UK slowed quicker than expected and is trending downward in Europe. Germany exited its recession, but the Eurozone remains stagnant with little growth. Political events like the Dutch government's fall and a Spanish election had limited market impact. Our stance is to be cautious on Europe due to growth concerns and its higher exposure to the struggling Chinese market. The UK market's defensive attributes keep us neutral on it.

More eventful news seems to be taking place in Asia. The Chinese economic reopening remains disappointing with floods of economic data coming in below consensus, but Chinese markets had their best month in several. Despite sounding counterintuitive, this is driven by the resulting likelihood of increased policy support and stimulus from the Chinese government. In Japan (the best performing region year to date) markets underperformed, but notably the usually cryptic Bank of Japan surprised markets by taking steps towards eventually allowing higher interest rates. In our view this should support a stronger currency, and so boost sterling returns on Japanese stocks. We remain bullish on both Japan and Emerging Markets.

Bottom Line

Overall, our positioning remains moderately defensive, with a tactical overweight to fixed income assets in portfolios, which offer attractive yields. Within equities, we favour Emerging Markets and Japan, over the US and Europe. Our equity style preferences are for lower volatility and quality stocks.

Month by numbers

Change in various markets over the month:

Asset	Direction	Change	Value
Equities			
UK	↑	2.21%	
Europe	↑	1.88%	
US	↑	3.41%	
Emerging Markets	↑	5.30%	
Japan	↑	1.27%	
Bonds / Rates (* Absolute change (%))			
UK Base Rates	–	0.00%	5%
Fed Funds Rate	↑	0.25%	5.5%
UK 10-Year Yield	↓	-0.07%	4.31%
US 10-Year Yield	↑	0.14%	3.95%
Currencies			
GBP / USD	↑	1.17%	$1.29
GBP / EUR	↑	0.11%	$1.17
DXY (USD Index)	↓	-1.03%	101.86
Commodities			
Gold	↑	2.35%	$1965.07
Oil (Brent)	↑	14.23%	$85.56
Noteworthy			
Rolls-Royce	↑	22.20%	

Q&A

What's on your mind?

Why has the US been downgraded and what are the implications?

After month end, on Tuesday, the creditworthiness of the US Government was downgraded by one of the three major rating agencies, Fitch. This reduced the credit rating of the most important economy in the world by one notch from the highest possible rating of AAA to AA+. The rationale given was that Fitch expect to see the US debt burden worsen over the coming years as higher interest rates make it more expensive for the government to repay its increased debt. Fitch also noted that the 'Erosion of Governance' that has caused several debt limit stand offs as well as the political polarization (reflected partly by the Jan. 6 insurrection) continues to cause concern. It should be stressed that this downgrade does not signal Fitch's expectation that the US will imminently default and that this downgrade is not unprecedented given S&P's rating downgrade in 2011. Market reaction was therefore muted.

What is the case for fixed income?

After one of the worst years on record for bonds in 2022, returns this year have been somewhat muted. As interest rates have continued to rise this year, although not at the same pace as in 2022 – total returns on bonds have broadly been flat. At this juncture, one can reasonably believe we are closer to the end of the rate hiking cycle than the beginning and that interest rates in the UK and the US at the 5-6% level is likely to be close to their ceiling. Given that bonds are broadly priced off current interest rates and longer-term interest rate expectations – there are some attractive yields on offer, ranging from 5% for short-term government bonds, to 10% on higher yielding corporate bonds. This makes bonds a very investable asset class once again and a core reason why we have increased allocations steadily over the last 9 months.

Are technology earnings sustainable?

So far this year, equity market performance has largely been driven by the tech sector, capitalising on the current AI hype-wave and resilient business models. But despite impressive performance, Q2 earnings struggle to match and investors may find themselves indecisive whether to hold or sell these stocks. For example, semiconductor manufacturer AMD surprised with better-than-expected earnings and its share price subsequently fell 8%, perhaps suggesting investors are nervous or doubtful of a continued outperformance. In Europe, semiconductor manufacturer Infineon narrowly missed earnings expectations and their share price fall 10% in a day. Stellar performance and recession threats still looming over the market might encourage some to 'quit while they're ahead' and crystallise their gains. Equally, the adoption of AI is in its infancy, and those who believe in its potential may feel comfortable in continuing to hold these stocks.

For more information, please contact your adviser.

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