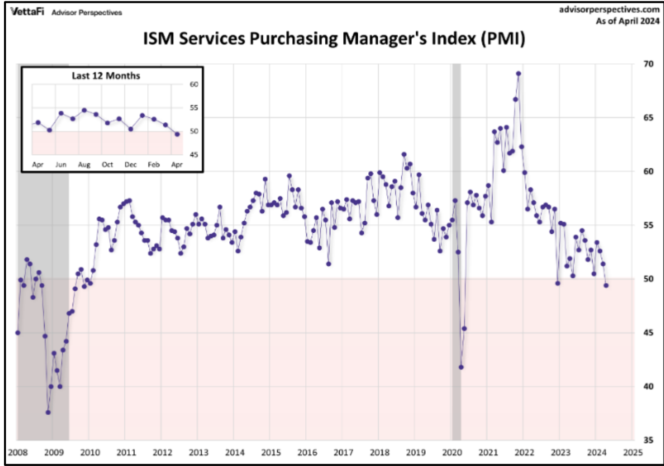
SRS
Strategic Retirement Solutions

Market View

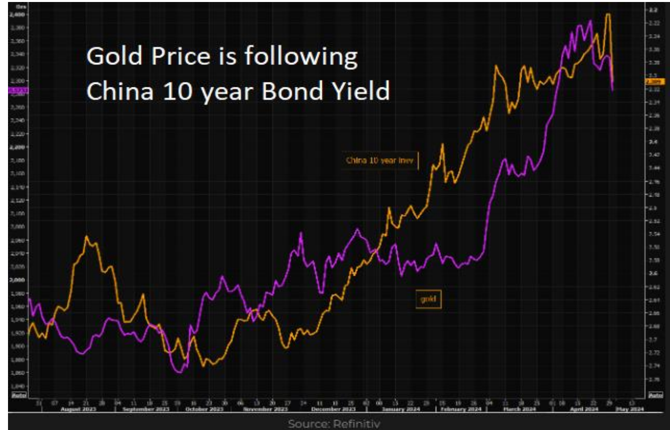
"Bull markets climb walls of fear and worry". This old market adage is once again very apt and in April there was lots to worry about. US inflation held at 0.4% month on month, higher than the US Federal Reserve Bank desires. The conflict in the Middle East expanded to a direct attack on Israel by Iran. Fears of further conflict boosted the oil price just when inflation appears to be stuck at too high a level. It thus became clear over the month that the Fed would not be able to cut interest rates as early as the markets hoped for. Three cuts, which until recently was priced into the Bond Futures market has been reduced to maybe one this year or even an increase! Recently, however, at the May FOMC meeting, Jay Powell quashed those fears, stating firmly that the next move will be down. The markets breathed a sigh of relief and once again the Wall of Worry was climbed. The fears of a broader conflict between Israel and Iran that would disrupt the flow of oil from the Middle East, appeared a real possibility. After Iran made its first ever direct attack on Israel, concerns about the inevitable response sent Crude Oil prices to c$90. Israel's response, when it came, caused minimal damage, but did demonstrate that it could hit a nearby nuclear facility if it wanted. Oil has since pulled back. Another worry, was the debate about whether the US would have a "hard" or "soft" or even no landing, this is when the economy keeps growing even with higher interest rates. Seemingly, the greatest danger to a market-friendly soft landing was that inflation would stay higher than wanted. The unemployment data for April, for once, suggested something healthier. Payroll growth decelerated, furthermore, growth in average hourly earnings fell below 4.0% (still too high) but does suggest that the US labor market is weakening and taking inflationary pressures with it. Crucially, we also had the April ISM Services PMI an important leading indicator of the fastest growing and inflationary part of the economy, the Services sector.

ISM US Services PMI



The US Institute of Supply Management produces the most accurate and widely used surveys of US companies. Most economic data is historic, few can be used as forecasting tools. The ISM surveys Purchasing Managers future intentions and has an accurate track record of pointing investors to the direction of the US economy. It is particularly important at this stage of the cycle as the inflation numbers are fractionally too high for the Fed to cut interest rates. They are too high because services inflation is distorting the numbers. Thus, when the ISM Services PMI moves below 50 (in May it was 49.6) it indicates contraction, which is deflationary, good news. For the Fed it seems that the US economy is finally "coming to them". Therefore despite inflation being marginally too high, if they hold their nerve, then economics might finally be proved right as the US economy slows as forecast and enough to reduce interest rates.

Gold v China 10 year Government Bond



One of the surprising features of global markets this year is the strength of Gold. Gold is not technically an investment. It doesn't pay a coupon like a bond or a dividend like an equity. The price is usually driven by dollar declines as dealers hedge weakness in the key reserve currency. But this time the dollar has been strong and US Treasury Bond yields are high compared to inflation, thus Gold should be weak? The answer for the strength lies in China. It is easy to forget there are other major economies than the US. In China, the currency is weak and bond yields are low and falling, hence it is entirely rational that Chinese investors and traders would buy Gold. Interestingly, this comes as the main Chinese equity indices are suddenly springing back to life. Both the mainland China and Hong Kong equity markets are deeply oversold and despite the political risk, very cheap.

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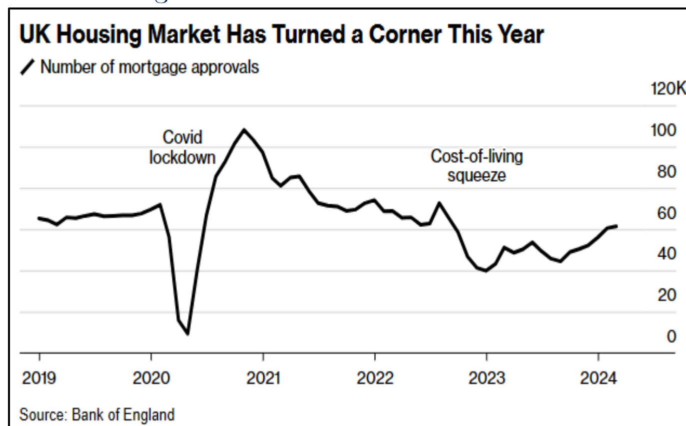
US Corporate Earnings

Up until now global market returns have been driven by the Magnificent 7 or more recently the Magnificent 2. These are the big US technology companies Apple, Amazon, Alphabet. Meta , Microsoft, Nvidia and Tesla. Given their size they are easy for the large institutions to buy and thanks to the Artificial Intelligence boom their performance has been justified by high levels of earnings growth. “The rest” meanwhile, as this chart shows, have been in recession. Profits have fallen by c15%. More if Oil companies are excluded, indeed close to the levels seen in the Great Financial Crisis of 2008/09. Critically, this last earning season has seen earnings growth from “the rest” match growth from the Magnificent 7 for the first time since the Ukrainian invasion. If interest rates are indeed coming down then it is likely this catchup will continue. Everything in investment, eventually, returns to the mean.

UK Housing Market



For the UK economy house prices are everything. We are a post manufacturing economy that relies on the recycling and growth of existing wealth. We have an inverse population pyramid, where older, wealthier, mortgage low or free, individuals are the main influences on major consumer expenditure. Since the invasion of the Ukraine consumer spending has been constrained by utility price rises and increased taxation. As inflation has moderated and mortgage lenders become more commercial for the younger, first and second time buyers (30 plus year terms rather than 25), together with the dramatic shortage of rented properties (thanks to government policies) housing markets are returning to life. It is early days but if interest rates come down as the Bank of England clearly desires then this recovery should continue.

Markets

If we return to our 4 broad scenarios number 1. remains the dominant theme but was under threat from 4. in April.

1. The Goldilocks i.e. Inflation keeps falling and yet recession is avoided.
2. Economics is right i.e. the US will join the UK and Europe in recession during 2024.
3. The Fed has done too much i.e. a major financial crisis arrives as banks see a wave of defaults.
4. Inflation returns i.e. inflation isn’t beaten and comes back with a vengeance.

Furthermore, the ISM Services data could indicate that both 2. and even maybe 3. remain live options for future market direction. This is the classic “Wall of Worry”, nobody is at all confident of the trend and what is driving it. This is not unusual, it always happens at this stage of a new Bull Market’s development. Stockbrokers such as Morgan Stanley, Bank of America and Citigroup are sticking to their negative market views, they are trapped by prior forecasts and refuse admit that they might be wrong. Again this is entirely typical at this point in the cycle. Based on history, we are due the “Double Dip recession” narrative fairly soon! If we stick to the historic patterns, what we can say is that Inflation is falling and indications are pointing to it going lower still, positive for markets. Interest rates have peaked and the next move is down, again positive for markets. Corporate earning growth for the broad market has fallen by historic recessionary norms (c15%) and is starting to pick up, again positive for markets. So we are at a very rare point where all three markets drivers are giving positive signals. Timing is always difficult but at some stage the broader, non-technology, equity markets will begin to reflect the new reality of these key drivers. Why, because, based on history, they always do.

May 2024

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