QUARTERLY INVESTMENT OUTLOOK

JULY 2024

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

EXECUTIVE SUMMARY

- The global economy remains in a modest expansion following positive growth surprises in the US, Europe and China in the first half of the year.
- The consensus mood of investors has shifted away from a certainty of imminent US recession in 2023, to an assumption that it has been completely avoided.
- We are reluctant to draw the same conclusion, with signs that US growth is starting to wane. The combination of broadly sanguine investor sentiment and multiple layers of macro uncertainty inspire a preference for caution.
- The second half of the year is set to offer notable political and geopolitical shifts, culminating in the US presidential election in which former President Trump is now considered the front runner by many polls.
- As long-term investors we retain allocation to equities, which continue to be supported by lower inflation, central bank easing and impressive earnings growth.
- We reflect a cautious stance in our multi-asset strategy by tilting towards more defensive equity sectors and allocating to diversifying components of fixed income and alternative assets.
- The revenue conversion from AI advancements has, for a small number of large technology businesses, been huge. We are reassured that the significant share price gains delivered by AI enablers and early adopters are justified by operational performance, in contrast to the late 1990's dotcom bubble.
- We retain meaningful exposure to these trends, but seek to manage concentration risks and ensure a robust strategy by diversifying into other compelling opportunities. We highlight non-life insurance as an example.

INTRODUCTION

The global economy is in a modest expansion, characterised by falling inflation and consumer-led resilience. The World Bank[1] recently projected a global GDP growth rate of 2.6% for 2024, revised up from 2.4% in January, owing to positive growth surprises in the US, Europe and China. World trade is recovering and global manufacturing has stabilised. In the World Bank's words; *"Four years after the upheavals caused by the pandemic, conflicts, inflation, and monetary tightening, it appears that global economic growth is steadying."*

Investor enthusiasm remains high, propelling global equities to a 11.3% gain for this year so far (see chart 1[2]). Central banks are shifting to coordinated monetary easing, which is typically supportive for equity markets. The European Central Bank (**ECB**) and Bank of Canada (**BoC**) began their rate cutting cycles this quarter, and the Federal Reserve and Bank of England (**BoE**) are likely to follow suit in the coming months.

Earnings growth has also been impressive. In particular, the revenue conversion from AI advancements has, for a small number of large technology businesses, been huge. Nvidia, the US chip designer, has become a household name, growing revenues by 262% in the 12 months to April and briefly becoming the world's most valuable company with a market capitalisation of $3.3trillion (see chart 2[2]). The prospect of continued strong demand for AI services has also driven share price returns of other US tech giants, such as Microsoft, Meta and Alphabet, who are collectively set to invest hundreds of $billions into generative AI infrastructure over the coming years.

Chart 1: The US market has driven global equities higher

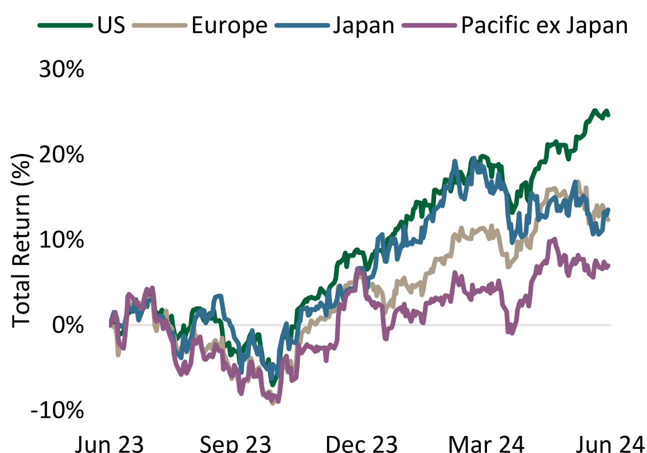
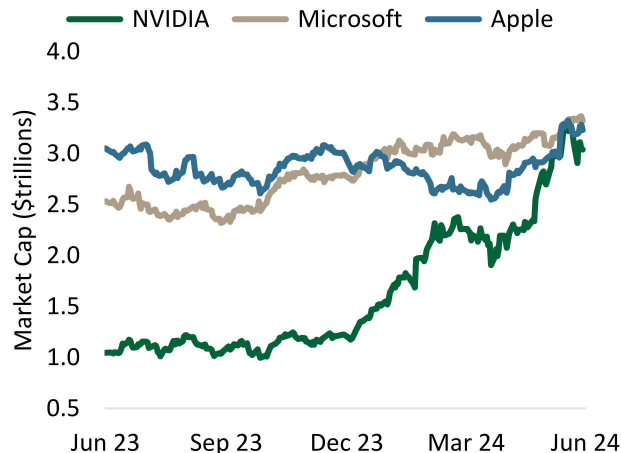


Chart 2: Demand for Nvidia's chips has surged



Yet this healthy picture of economic and corporate health should not be taken for granted. While global growth has accelerated this year, it remains well below pre-pandemic levels, and the signs are for a softer period in the second half of the year. Having been the driver of the global economic recovery since early 2021, the US economy may be the source of this weakness.

This is a particularly important development since the second half of the year is set to offer notable political and geopolitical shifts. Anti-incumbent voting has been a central theme to high profile elections so far this year. In June, Indian Prime Minister Modi won a third consecutive term, but with a much smaller majority than in 2019. High inflation and unemployment were cited as key concerns amongst voters. The UK's Labour Party has just claimed a substantial win, with voters rejecting the Conservative Party after 14 years leading the government. In France, President Macron's centrist coalition has lost substantial support, with notable gains made by left and right leaning parties in the recent snap parliamentary election.

In isolation, these election outcomes are unlikely to have a meaningful impact for globally diversified investors. But a trend of political upheaval is emerging, and may culminate with the US presidential election in November.

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[1] Source: World Bank Group, "Global Economic Prospects", June 2024
[2] Source: Bloomberg, MSCI indices, USD, June 2024

In that case, the incumbent is failing to fill the American population with confidence that the economy can remain strong, or that he is fit for office. Former President Trump is now considered the front runner by many polls, and such an outcome is likely to spell more uncertainty and volatility for the economic and market cycle.

Signs of weaker US growth are far from alarming, and lack the kind of excess that accompanied the lead up to the 2008 crisis. Yet, particularly when combined with political uncertainty, they warrant constant investigation and review. In this quarter's Investment Outlook, we offer our assessment of the US economy for the next year, with particular reference to early signs of a weakening labour market, and the implications for investment strategy. Having assessed the potential investment implications of a second Trump presidency in our April letter, we today review the common investor concern of whether rising US debt could have financial ramifications in the long term.

Section 1. Assessing the Global Economy

1.1 The US has powered the global economy – its ability to do so is waning

The global economy has been surprisingly firm this year so far. US employment growth has remained strong, China has steadied, and Europe has somewhat recovered. Indicators of economic momentum have broadened, raising expectations for future growth. This is neatly captured in the Sentix Global Economic Expectations Index (chart 3[3]), which measures broad investor sentiment and has a close relationship with the market cycle:

Chart 3: Broader global growth has strengthened economic expectations

The consensus mood of investors has shifted away from a certainty of imminent US recession to an assumption that it has been completely avoided. We are reluctant to draw the same conclusion; the combination of broadly sanguine investor sentiment and multiple layers of macro uncertainty imply a preference for caution.

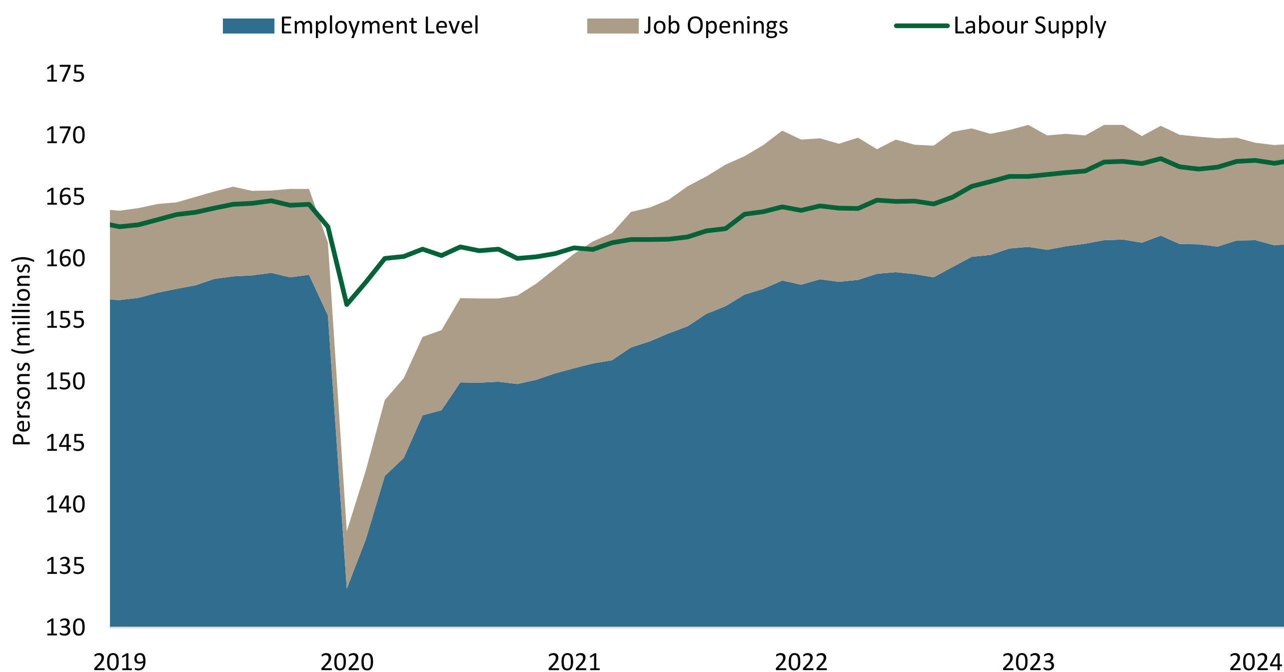
> The US economy is not infallible. We noted last quarter how falling labour demand, currently an asset in the fight against inflation, could become a growth concern, should unemployment rise meaningfully. Current evidence is unalarming, but there are good reasons to remain alert to this trend.

A simple review of the labour market is useful in this analysis. The total demand for labour can be estimated by the sum of those in employment and the number of job openings at any time. Labour demand (jobs occupied plus vacancies unoccupied) can be seen below in the overall shaded area, and is compared to labour supply (those in employment plus those seeking employment) in chart 4[4].

[3] Source: Bloomberg, June 2024
[4] Source: Federal Reserve Bank of St Louis, June 2024

As the chart shows, labour demand recovered sharply following the pandemic, as economic reopening spurred a surge in activity. Yet the supply of labour has grown more gradually, creating a distinct shortage of workers for the past three years. This imbalance is unusual; in fact, it was the late 1960's when we last saw a similar labour deficit, which also resulted in explosive inflation.

Chart 4: A rebalanced US labour market reduces inflation concerns, but raises recession risks



As the business cycle has matured, abundant job vacancies have been filled and far fewer vacancies are now being posted. This has rebalanced the labour market back to pre-pandemic levels – a process which has resulted in much lower inflation, with only a negligible increase in unemployment.

> This economic 'soft landing', driven by analysis of the labour market, has been central to our investment strategy over the past two years. Consequently, we have remained engaged with equities.

As we argued in our January 2023 Investment Outlook, "*with such a disrupted cycle in mind, the economy could continue to follow an unconventional path… inflation could fall further and faster than expected, and without the requisite recession*." As shown in chart 5[5], the core PCE inflation rate has declined from 4.9% at that time to 2.6% today, while US GDP growth accelerated.

Our focus today is how the economy may evolve with the rebalancing of pandemic distortions largely complete. Indications are that businesses are still slowing their pace of hiring (see chart 6[5]), whilst there are some early signs of rising layoffs. Unemployment, whilst still historically low, is trending up and has already reached the Federal Reserve's central expectation of 4% for 2024 overall. Business uncertainty has also picked up, which is common in presidential election years, and no surprise considering profound geopolitical tensions and political polarisation.

Furthermore, higher interest rates matter. The Federal Reserve has held interest rates at 5.50% since mid-2023, having been at 0.25% at the start of 2022. Usually, such a dramatic tightening of financial conditions would trigger a recession. However, the US corporate and consumer sectors have remained resilient during this period, convincing many investors that the economy has already cleared this hurdle.

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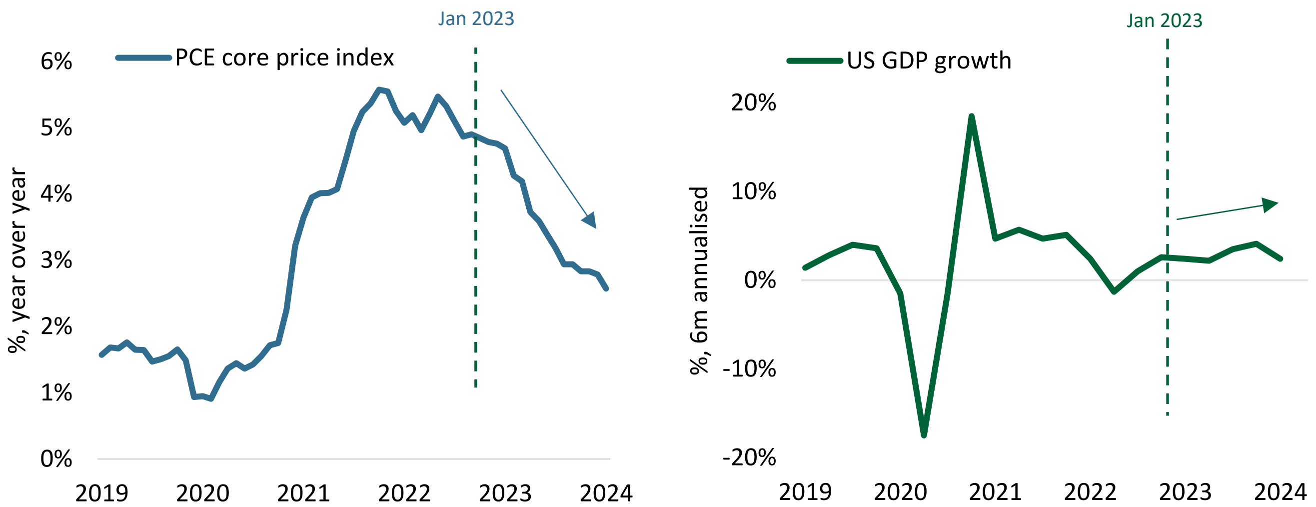
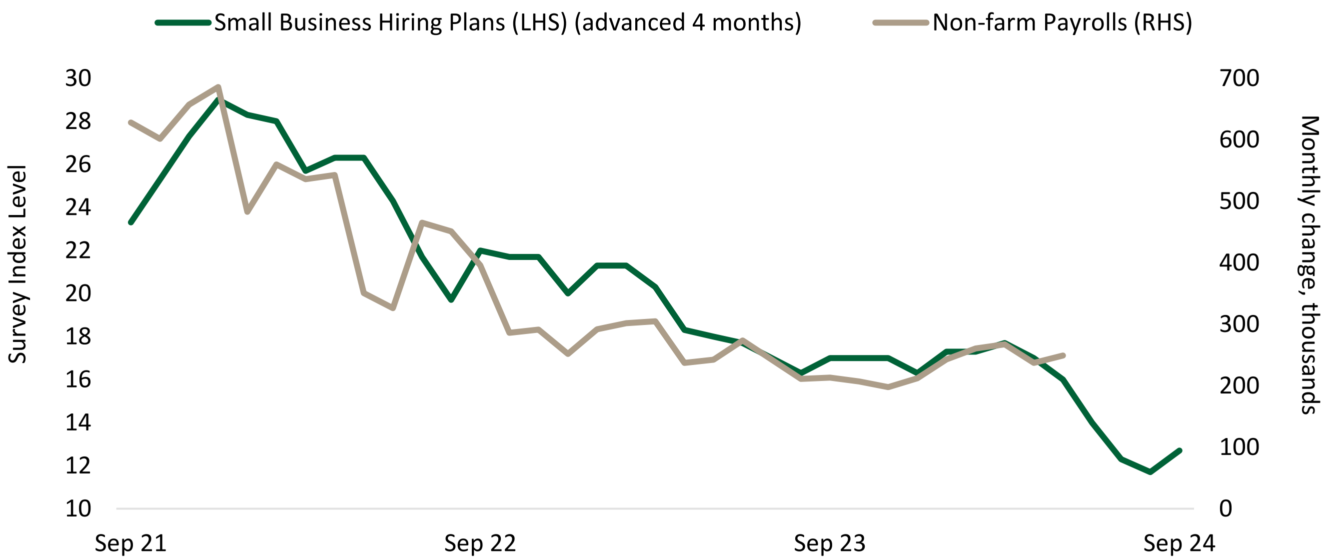
[5] Source: Bloomberg, May 2024

Chart 5: Inflation has fallen without the need for economic pain



This assumption may reflect an element of short-termism. It is well known that higher interest rates impact economic growth slowly. This is particularly so in this case, as consumers have been able to reinforce spending with savings accumulated during the pandemic. As these savings have been run down, their ability to do so will soon come to an end - if it has not already.

Chart 6: Demand for US labour is softening and could lead to weaker economic growth



Our analysis tells us that the US labour market has rebalanced following pandemic distortions, just as a refinancing squeeze for consumers and businesses is building. This is likely to cause the US economy, the engine of post-pandemic global growth, to slow over the coming year, if not contract.

If a recession does come, it is likely to be mild. The kind of excessive corporate and household leverage that preceded the financial crisis in 2007-08 is absent today. Furthermore, equity markets remain well supported by strong mega-cap earnings momentum, falling inflation and central bank monetary easing. These trends do not appear exhausted yet. But the range of possible outcomes is wide and warrants close attention and a cautious approach.

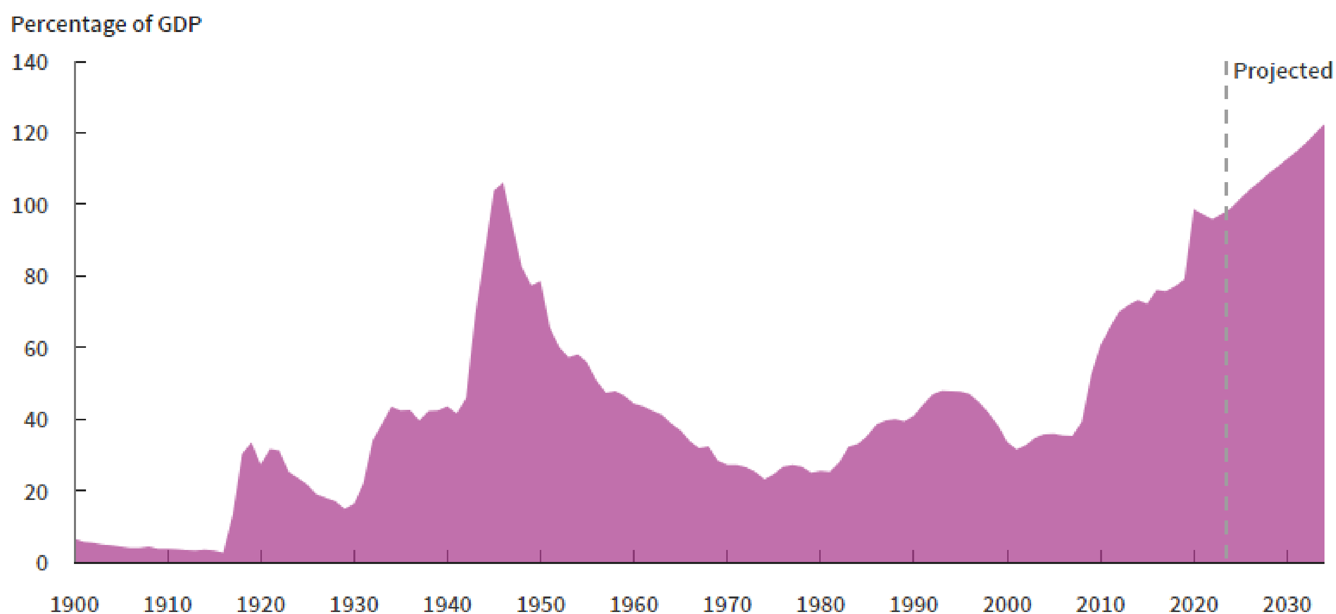
We cover the implications for multi-asset strategy in more detail in section 2, with particular reference to corporate earnings trends, the impact of US technology, and how we are reflecting a cautious stance.

1.2 Rising US national debt is a reason for broad risk diversification, but not for alarm

In addition to the possibility of a US recession, the ballooning US national debt has become a focal point for investors and voters alike. A 2023 survey revealed that 57% of Americans cited reducing the budget deficit as a top priority for the upcoming administration, up from 45% in the prior year[6].

Following years of fiscal deficit spending, which has undoubtedly contributed to America's economic leadership, US public debt is estimated at c. 100% of GDP, rising to 116% of GDP by the end of 2034 (chart 7[7]).

Chart 7: US debt projections have alarmed some investors



The concern of some investors is that, with the annual fiscal deficit averaging 9% over the past 5 years and both presidential candidates advocating continued fiscal laxity, a day of reckoning is coming. Such concerns are not unfounded, but arguments for an imminent financial crisis appear overblown.

With all of its debts denominated in its own currency, the US can avoid the most extreme scenario of a sovereign default. The Federal Reserve, who are the largest single holder of national debt at c. 20%, can act as a lender of last resort, printing money if necessary. Furthermore, whilst interest rates have risen, the average rate on federal public debt remains low by historical standards. Debt servicing is an increasing federal expense that will compete with other spending over time, but it is not currently unmanageable as a proportion of total outlays.

Global comparisons also demonstrate that high levels of national debt are not intolerable for a large economy. As the Economist[8] recently highlighted, *"Japan's net debt is about 155% of GDP, yet it has no trouble issuing new bonds. America may have extra latitude given the dollar's role as the pre-eminent global currency, which ensures a healthy foreign appetite for its debt."*

So, what is the risk? Primarily, it is that an extended period of fiscal profligacy, particularly under a second term for President Trump, could lead to a bond investor revolt. In similar fashion to the UK mini-budget crisis of 2022, when Prime Minister Truss spooked bond markets with unfunded spending plans, investors could shun US Treasuries. A rapid spike in US Treasury Yields, and decline in the value of the US Dollar, could have much wider financial and economic repercussions.

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[6] Source: Pew Research Centre, February 2023
[7] Source: US Congressional Budget Office, June 2024
[8] Source: The Economist, "America's fiscal outlook is disastrous, but forgotten", May 2024

The timing of any such crisis, or if it will happen at all, is extremely hard to judge. A combination of tighter fiscal control and strong economic growth, driven by AI-led productivity, could keep total debt at a sustainable level for the foreseeable future. But an environment of higher bond market volatility is certainly possible – something we are already seeing some evidence of today.

The right investment strategy avoids disengaging with long term investment objectives, and looks beyond traditional equity and bond '60/40' asset allocations. Broader risk diversification is needed in a world of such complexity and uncertainty; which includes allocating to physical gold, insurance-linked bonds and other alternative assets, complementing traditional government bonds.

Section 2. Multi Asset Investment Strategy

2.1 Invest according to recession forecasts at your peril

Many investors expected a US economic recession over the past two years, and kept capital on the sidelines as the stock market soared to all-time highs.

Even the most sophisticated economists and investors struggle to time the business cycle accurately. Today, there are a particularly wide range of variables that could impact the timing and severity of such a slowdown, and its impact on financial markets. This means we need to be flexible and consider the balance of probable outcomes.

We have favoured equities over bonds since the pandemic, reflecting the relatively low likelihood of an economic downturn over this period. That likelihood is higher today, but still estimated at c. 40% over the next 12 months and exceeded by our expectation for a more benign growth moderation at c. 50%.

The question that follows is how a more cautious stance should be reflected in capital allocation, considering the uncertainty that surrounds the next phase of the economic cycle. Is it prudent to invest a smaller proportion of multi-asset portfolios in equity markets today?

As long-term investors we set a high hurdle for reducing equity allocations to low levels. Equities are the engine for long term portfolio growth, driven by real earnings growth and the creation of shareholder value, and clear evidence of economic deterioration is needed to justify a heavily defensive strategy.

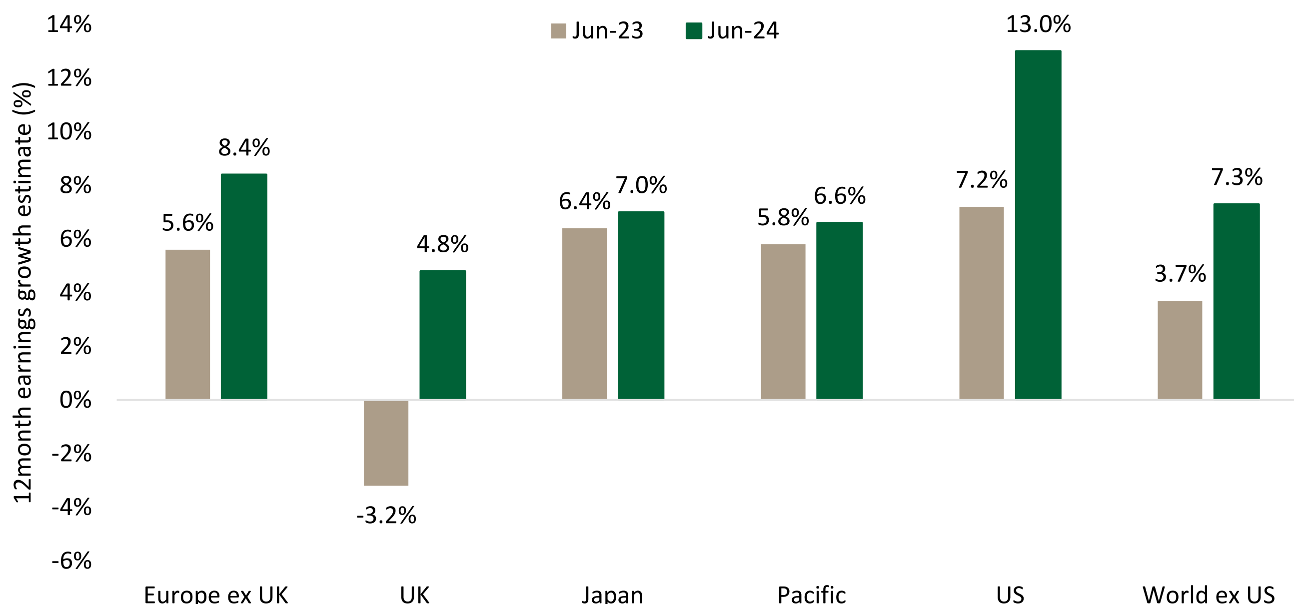
Our assessment of the US economy today reflects a moderation in growth and rising risks, but recognises continued resilience in the corporate sector that is underpinning equity market momentum. In particular, the recovery in earnings has been robust, following earnings pressure in 2022-23.

This is true on a global scale. As shown in chart 8, earnings expectations are accelerating across regional markets, with the percentage of global companies reporting positive earnings revisions reaching 77%[9]. Equities typically advance on such earnings optimism and analyst upgrades.

The weight of evidence continues to support equity engagement. Whilst the US economy is showing signs of moderating, raising recession risks, the combination of falling inflation, central bank easing and earnings growth momentum remain positive factors for continued equity market gains.

[9] Source: NDR, July 2024. Based on MSCI AC World index

Chart 8: Earnings momentum is a supportive factor for equity markets



Yet an element of caution is warranted, which we reflect in four main ways today:

- By gradually evolving our fixed income allocation to emphasise high quality government bonds (i.e. US Treasuries and/or UK Gilts) over more economically sensitive credit markets (such as sub-investment grade debt and Emerging Market debt). Should bond yields fall during a period of economic turbulence, these investments will provide important balance.
- Through disciplined rebalancing of portfolio asset allocations where required, capitalising on strong market returns and pursuing a broadly 'neutral' equity weight.
- In the composition of our core equity strategy, which has a higher weight to traditional defensive components such as the US, healthcare, non-life insurance and larger companies, than in recent years (please see section 2.3 for more detail on the non-life insurance sector).
- By investing in diversifying alternative investments, such as physical gold, catastrophe bonds and carefully risk managed long / short equity strategies, which in aggregate offer a vital source of uncorrelated returns in the event of higher equity market volatility.

2.2 Artificial Intelligence is driving US markets – should this worry investors?

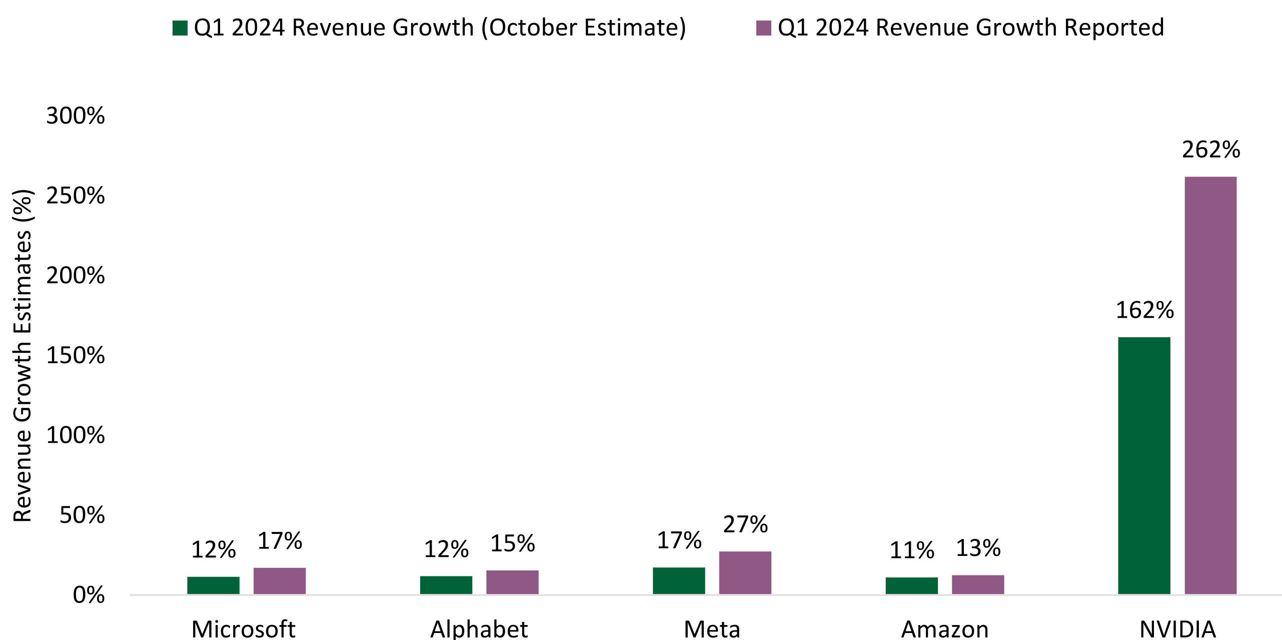
Revenue and earnings growth for a small number of AI-linked US technology companies has been substantial, driving the market higher. Chart 9[10] shows the impressive 12 month sales growth of AI enablers and early adopters, particularly chipmaker Nvidia, whose data centre processing capability is under high demand.

One consequence of this leadership is high market concentration. Whilst such narrow leadership is reminiscent of the late 1990's technology bubble, market concentration does not represent a threat in itself if it is justified by financial results, as we are seeing today. US companies are returning more cash to shareholders and continuously outperforming competitors.

It is important to consider the differences between the economic and investment landscape today and that of the late 1990's. The dotcom bubble was fuelled by the rapid adoption of the internet causing many companies to flood the equity market. Easy access to capital at low interest rates made the emergence of small companies easier, while the collective excitement of the era pushed investors to ignore profitability realities, pushing valuations ever higher.

[10] Source: Factset, June 2024

Chart 9: AI enablers are delivering impressive revenue growth



This is not the same environment today. Interest rates remain in restrictive territory, curtailing market excess, while valuations are considerably lower than the peak of the dotcom bubble. Investors are today still rewarding companies that can generate returns, whilst maintaining strong balance sheets. This is reassuring.

AI excitement is driving the largest companies in the US to ever higher market capitalisations. Our strategy ensures we retain access to this structural growth trend. However, other components of the market also offer interesting and diversifying opportunities. One example is non-life insurance, a specialist industry within the financial sector, which typically performs well in periods of economic softening. The below section offers an insight into why we favour these companies through a specialist active manager, and continue to hold conviction in the allocation.

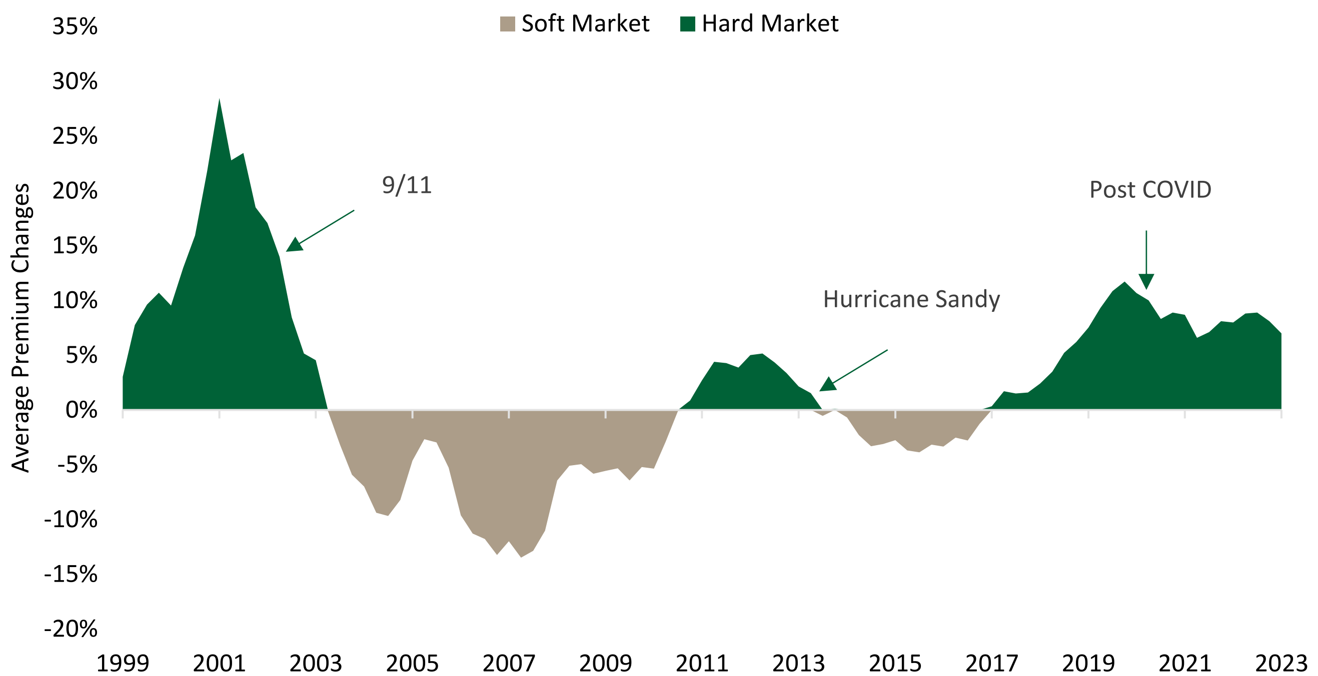
2.3 The 'Age of Risk' is driving growth for the non-life insurance sector

In many ways, we are living in an 'Age of Risk' – extreme weather events, pandemics, wars, acts of terrorism all capture public attention. Though these risks are numerous, they all have one thing in common – they increase the complexity of the challenges faced by businesses, governments and individuals. The result is that the long-term growth trajectory for insurance companies is being enhanced as awareness of risk and the demand for protection grows. In recent years the industry has shifted to a 'hard market', featuring rising insurance rates, restricted underwriting, and less availability of coverage (see chart 10[11]). It's a trend that looks set to continue.

Furthermore, new avenues for growth and change in the insurance sector are emerging. Rising geopolitical tensions are creating more uncertainty, which is driving the development of new products. Cyber Insurance, for instance, is a potentially fast-growing market as incidents of data hacks and cyber fraud continue to rise. Trends such as 'reshoring' and the build-out of renewable energy and data centre infrastructure for AI is resulting in new physical assets to insure. Meanwhile, although regulatory and legislative pressures are certainly not new for companies, the scope and complexity of incoming regulations does create new risks, such as the risks of not looking after personal data properly under the EU's GDPR rules, or falling foul of US sanctions on Russia or China.

[11] Source: The Council of Insurance Agents & Brokers, Q4 Commercial P&C 2023 report

Chart 10: Non-life insurance is witnessing strong premium growth



The insurance industry is not immune to risk and indeed is facing disruption due to technology and more complicated risk management requirements. However, opportunities arise as systems are modernised and companies leverage their customer data and adopt new technologies. Generative AI can price risk more effectively, gain new insights and improve productivity. There are also opportunities for insurers to expand into faster-growing international markets, such as China or India, where insurance penetration remains low.

> Amidst this strong structural backdrop, insurers find themselves in the best underwriting environment for a decade. Both insurance premiums and volumes are rising, while elevated bond yields are enhancing insurers' investment portfolios.

Against a backdrop of rising recession risks, the insurance industry offers valuable diversification properties to multi-asset portfolios. Insurance companies are the beneficiaries of higher investment yields. They are also less impacted by economic slowdowns due to stable demand for the product, often mandated by law. And finally, they boast strong balance sheets and regulatory oversight, making the sector an attractive investment theme for the long term.

Stonehage Fleming Investment Management
Chief Investment Officer Group
July 2024

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