RATHBONES

A PSYCHOLOGY TEST FOR INVESTORS

INVESTMENT VIEW
JULY 2023

MIXED MESSAGES FROM MARKET PERFORMANCE AND ECONOMIC DATA HAVE CREATED A SORT OF RORSCHACH INK-BLOT TEST, WHERE INTERPRETATION DEPENDS ON AN INVESTOR'S PERSPECTIVE.

While a few large US tech stocks drove America's benchmark S&P 500 stock index higher over the second quarter, the rest of the market has languished, held back by a decline in aggregate profits since late last year. There have been significant signs of weakness in manufacturing around the world, but services industries have displayed resilience in the face of aggressive interest-rate increases from central banks.

Despite this continued belt-tightening by central bankers, equity markets appear to be signalling a 'soft landing' in the US – where economic growth slows but outright recession is avoided. Bond markets, meanwhile, are pointing in the opposition direction, towards recession, as they continue to be roiled by these rate increases.

The conflicting signals have created a kind of investors' Rorschach ink-blot test, where patients are asked to interpret what they see in the blots. Given how wide-open to interpretation market and economic signals seem to be at the moment, it's crucial to take a comprehensive and systematic view of the evidence; to focus on the more forward-looking data to determine the direction of travel rather than being swayed by headline-grabbing developments.

Looking beyond the US to the largest advanced economies in general, our analysis suggests that mild recessions are likely later this year, reinforcing the importance of our current cautious investment approach.

Four factors contribute to our view. Firstly, interest rates have risen significantly, and various economic models suggest it takes from a year to 18 months for their effects to be truly felt. Secondly, banks are making it harder for people and businesses to borrow, especially as they turn more cautious after the recent run of banking collapses. Thirdly, the savings that households accumulated during lockdowns are diminishing, leading to reduced consumer spending. Finally, China's post-lockdown recovery is faltering so it can't be relied upon to give a booster to the slowing global economy. Our head of asset allocation Oliver Jones warned about in his April report, China past its peak.

Still, though recessions loom, they shouldn't be anywhere near the scale of the Global Financial Crisis. Even 15 years later, that cataclysm it still fresh enough to skew people's expectations of recessions – they are usually much milder than that and there are no indications that the coming downturn will evolve into something more dangerous. Inflation should continue to fall further throughout this year across advanced economies, despite recent stubbornness in the UK. Global shipping snarl-ups and energy and food price spikes caused by COVID-19 and the war in Ukraine are now fading. There are also tentative signs that wage pressures, which are responsible for much of the persistent strength in services inflation, should ebb later this year.

With inflation past its peak, major Western central banks are probably approaching the end of their rate increases. The Bank of England likely has a few final solid increases ahead of it, but it should be done lifting interest rates later this year, as will most other big central banks. When a peak in rates approaches, the outlook for government bonds tends to improve, as falling inflation and rates boost their prices. We have started to turn to a more favourable view on UK government bonds – which also now offer much more attractive yields than they have done for years – for this reason.

As we noted at the start, the recent strength of the largest US tech stocks (helped by AI hype) has overshadowed weakness elsewhere. Company profits in aggregate have been declining across developed markets since late 2022, showing that there are still fundamental reasons for caution. Last year we tilted our preference toward companies that were less sensitive to the economic cycle and which had profits that should be less affected by recession. We've also been turning more positive on corporate bonds issued by companies with strong credit ratings, as they now offer attractive rates of return (reflecting the much higher prevailing interest rates). They are also typically less volatile than stocks.

There is a notable outlier among global equity markets today: Japan. Typically dismissed as a sunset nation of declining clout, the Land of the Rising Sun has enjoyed a quiet renaissance this year, driven by improving corporate governance and growing profits. Japan is the only major advanced economy that isn't raising interest rates to contain inflation, and it has exposure to the vibrant growth of Asia without the geopolitical risks associated with China.

With a longer-term view, patience and prudence, investors should be able to ride out a bumpy year or so ahead for markets, and still find some interesting opportunities along the way.

Important information. This document is published by Rathbones Investment Management Limited and does not constitute a solicitation, nor a personal recommendation for the purchase or sale of any investment; investments or investment services referred to may not be suitable for all investors. No consideration has been given to the particular investment objectives, financial situations or particular needs of any recipient and you should take appropriate professional advice before acting. The price or value of investments, and the income derived from them, can go down as well as up and an investor may get back less than the amount invested. Rathbones Investment Management Limited will not, by virtue of distribution of this document, be responsible to any other person for providing the protections afforded to customers or for advising on any investment. Rathbones Investment Management International is the registered business name of Rathbones Investment Management International Limited which is regulated by the Jersey Financial Services Commission. Registered office: 26 Esplanade, St Helier, Jersey JE1 2RB. Company Registration No. 50503.

Rathbones Group Plc is independently owned, is the sole shareholder in each of its subsidiary businesses and is listed on the London Stock Exchange. Rathbones is the trading name of Rathbones Investment Management Limited, which is authorised by the Prudential Regulation Authority and regulated by the Financial Regulation Authority and the Prudential Regulation Authority. Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW. The information and opinions expressed herein are considered valid at publication, but are subject to change without notice and their accuracy and completeness cannot be guaranteed. No part of this document may be reproduced in any manner without prior permission.

Any views and opinions are those of the author, and coverage of any assets in no way reflects an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Fluctuations in exchange rates may increase or decrease the return on investments denominated in a foreign currency.