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Reflections & Insights*

"In that direction," the Cat said, waving its right paw round, "lives a Hatter: and in that direction," waving the other paw, "lives a March Hare. Visit either you like: they're both mad."

"But I don't want to go among mad people," Alice remarked.

"Oh, you can't help that," said the Cat:

"we're all mad here. I'm mad. You're mad."

"How do you know I'm mad?" said Alice.

"You must be," said the Cat, "or you wouldn't have come here."

— ALICE IN WONDERLAND

And still, we wait. The economy in the developed world is not yet responding to its monetary medicine, the first dose of which was administered over a year ago. Markets are jittery, veering between optimism that everything will muddle through and pessimism that a recession is in the stars. This uncertainty tends to feed through to uncertain returns. There are reasons to be cheerful, just about equally offset by reasons to be miserable.

It is sometimes hard to understand why the transmission mechanism of higher interest rates takes so long to work. Consider a typical consumer: at the end of the pandemic, savings were very high because of the stimulus applied to stave off economic collapse; exposure to interest rates was limited because a fixed rate mortgage still had time to go before reset; and at work, wages were rising, even if not in inflation-adjusted terms. Things weren't all that bad. Now, though, the savings have been largely drawn down, the mortgage rate reset is happening (or soon will happen), and at work, the first ominous rumours of redundancies are beginning to appear. This is where the consumer decides to pull its horns in. Less of a bull and more of a mouse, spending less.

In the corporate cosmos, similar factors have been at work. Margins have remained high because prices have risen. Companies have been able to increase prices because the consumer has been willing to pay

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(for reasons we have already seen). Governments are also offering subsidies to facilitate the 'green transition' or to ease reshoring. Confidence has held up, so companies have awarded pay increases even though productivity is not rising. Now, though, the consumer is less willing to pay up, unit labour costs have risen and margins come under pressure. All this is before prices have actually fallen, which is very likely in some areas where inventories have built up. In real terms, revenues have not risen. The increase is an inflationary illusion. Companies in the conclave now consider what to do, and the classic response is to cut jobs. This reinforces the problems the consumer now faces.

This is a simple tale which is infinitely more complex in the real world, but it shows why cause and effect in economic matters are so unpredictable. The idea of applying a model to human behaviour is only ever approximately right.

Watching the signals

Looking at things from the point of view of a Central Bank, you watch the signals. You know interest rates have gone up. You know credit conditions are tighter, partly because you have (accidentally) engineered a mini-banking crisis and partly because banks see risk around every corner. The money supply is shrinking. What you don't know, though, is when the medicine will start to work; how high to push interest rates up and for how long. There is a supposition that a scientific process is underway here, but it isn't. Maybe monetary policy is less effective than it used to be. What we are witnessing is the guesswork of experienced, educated people, dressed up as science.

Over the past quarter, Central Banks have become somewhat more cautious. They see unit labour costs rising and service inflation, in particular, failing to behave; this itself is a result of the still robust labour markets. They worry about higher levels of inflation becoming ingrained and that real interest rates are lower than has been necessary to tame inflation in the past. All this translates into the likelihood of higher interest rates for longer than the market believed three months ago. Governments, of course, take a different view. The stage is set for a battle between the monetary purists and the fiscal profligates, particularly in countries facing elections over the next few years.

You might think that this would be bad for equity markets. Think again.

So far this year, the S&P 500 has risen by 16% or so, of which more than half has happened as the monetary weather has worsened. The increase is almost entirely caused by an increased market valuation – in other words, the price-to-earnings ratio has gone up. In Europe, the story is similar – total returns in local currency are above 11%, although valuation increases account for less of this than in the US. This outcome reflects the fact that markets are anticipatory. The worse the interest outlook appears, the more likely it is to run its course quickly, or so the theory goes. What is remarkable, though, is how easily markets have accommodated fresh bad news.

In the US, returns have been generated by a small handful of stocks. Seven companies have produced 11.6% of the 16% return. The next thirteen or so produced the rest. The remaining 480 stocks on balance contributed nothing. The 'Magnificent Seven,' as they are called, are all companies in the technology sector (Apple, Microsoft, NVIDIA, Amazon, Meta, Alphabet and Tesla), turbo-charged by an adrenalin shot of artificial intelligence (AI). This is hardly a vote of confidence for the general health of the economy, but rather a recognition that the growth of the digital economy continues to be unaffected by broader trends.

Europe, too, has had skewed returns, albeit less extremely so, as the Information Technology sector accounts for a much smaller part of the market. Nevertheless, year-to-date returns in the EU Information Technology sector have been above 25%, and the market has also benefited from resilient spending on luxury goods, which are heavily represented in benchmarks, especially in Italy and France. Commodity and real estate-heavy countries, like the UK or Norway, have lagged.

Given the likelihood of an economic slowdown and pressure on margins, market behaviour suggests that some sectors are immune from economic reality. Of course, valuations of these icons have risen sharply even as earnings have sometimes disappointed. This reflects investor faith in the transformation to a more digital economy and that most of the major companies are set to be the main beneficiaries of the breathtakingly rapid development of AI opportunities.

A revolution unfolding

It is worth a digression into how the AI revolution is unfolding. Apologists believe that the rollout of AI

tools will achieve in one year what it took the iPhone seven years to achieve. The pace is electrifying. At this stage, the longer-term winners have yet to emerge, as it often takes a couple of years before a 'killer app' becomes dominant in a particular sector. When a significant new technology appears, the losers tend to become visible before the winners – for example, horse-related industries (when the internal combustion engine became popular) struggled long before car brands were established – what happened to the Cunningham Steam Wagon Co?

The losers in AI are likely those companies in sectors such as Health Care that could benefit from AI (in drug discoveries, for example) but fail to adopt the technology. In particular, it is easy to see the potential productivity enhancements in software development, healthcare (especially drug discovery) and customer-facing businesses (e.g., call centres). In financial services, many activities requiring judgement can be replaced with machines with access to much larger datasets than mere humans – asset managers had better watch out. AI may allow smaller companies to benefit from their natural agility compared to larger ones. Uncertainties remain, of course. In particular, the role of regulators in ensuring that technology causes no significant harm is an evolving area that could slow down adoption. The very speed of development is also a potential political issue, particularly if it causes frictional job losses.

The main issue, though, is that we cannot uninvent the technology, and so we will have to adapt to the opportunities and challenges which AI will pose. In the meantime, the market is in the early stages of an AI bubble, which will become more extreme as time passes. While today's major companies will be in the mix – and they are not strangers to anti-competitive behaviour – new winners are likely to emerge out of the venture world. US companies dominate this transformation, but all investors will need some exposure to the phenomenon. In the short term, avoiding the losers is at least as important as embracing the sunlit uplands.

Nothing much to do with the economy

All this is to say that the reasons equity markets have been fairly robust, in the light of mediocre economic news, is nothing much to do with the economy.

Bond markets, on the other hand, do reflect the fact that interest rates have been rising. After many years where cash generated no return, and longer bonds were miserly at best, we are now in a world where prices have fallen and prospective returns are more attractive. The point at which rates have risen and held high for long enough to stick the inflationary genie back in the bottle will be the moment to revisit the appropriate equity to fixed income balance in portfolios. Many investors are heavily skewed in favour of equities and against bonds. There will inevitably be flows into fixed income assets from investors who see equities as being too risky and, because of demographics, those who would like a stable income. This could be another headwind for broad equity markets, even if some sectors are able to buck the trend.

Stock markets may struggle from here to generate significant returns for all the reasons outlined, but that does not mean that all stocks will tread water. In the US, valuations are stretched, but the economy there is set to emerge from the rate cycle in robust health. It is well positioned to take advantage of emerging trends in technology and healthcare, and should be in the vanguard of the transformation to a more sustainable world, even in the absence of political will. It is hard to see how it will not be essential to any investor's equity weighting. Selective equity exposure elsewhere is also justifiable, even if the geopolitics are more volatile. The big shift is that investors are likely to move back over the next year or two to more balanced portfolios, looking to equities to provide zip and bonds for stability and income.

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