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MARKET INSIGHT – ‘GOLDILOCKS’ REVISITED?

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In this article, Roy Leckie, Executive Director – Investment and Client Service, discusses some of the current trends in markets, and highlights the need to focus on strong company fundamentals in what remains a testing backdrop.

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Equity markets resumed their upward path in June, despite the somewhat mixed picture of global economic health and ongoing geopolitical tensions. Back in May, US GDP data for the first quarter showed the economy growing at a tepid annualised rate of 1.3%, but a subsequent revision saw this figure revised to 2%. Aside from highlighting the foibles of economic data gathering, let alone the fickleness of economic forecasting, the more-positive data reflected the ongoing resilience of the American consumer and better-than-expected export growth. Inflation has continued to abate and is now running at 3% on an annualised basis, representing a marked decline from the 9% peak of one year ago. Having pressed the pause button at its last meeting in June, there is increasing speculation that the Federal Reserve may soon bring an end to further interest rate hikes, although actual reversal seems a distant prospect.

Of particular note this year has been the strength of the information

technology sector. The "Magnificent Seven", as the select cohort at the forefront of the market's gains has been dubbed, are members of the FANG+ club, and the share price surge in several of them was propelled by the rapidly evolving AI story. Chipmaker Nvidia's share price has tripled and Apple's market capitalisation has breached the $3 trillion mark.

The Walter Scott Research team are continuing to analyse how the shifting AI landscape might present opportunities or indeed create threats for companies held and potential portfolio candidates, and this is work that is being led by fundamentals rather than hype. Our investment approach focuses on innovative businesses with a defensible market leadership, financial strength, and strong operational track records. In the case of the portfolio's technology holdings, many sit at the forefront of diverse and enduring industry growth trends, of which AI is but one, that will be long-term drivers of their earnings.

"Recent data revisions have highlighted the corrosive effect of inflation"

If markets were heartened by the resilience of the US, economic data in Europe has given them less to shout about. With energy prices ebbing, thanks in part to the not inconsiderable fiscal support programmes, consumption had been holding better than expected in Europe, but recent data revisions have highlighted the corrosive effect of inflation, with euro-zone GDP tipping slightly into negative territory in the first quarter of 2023, at least on a quarter-on-quarter basis. The S&P Euro-zone Composite Purchasing Managers Index slipped below the 50 level in June, pointing to the sluggishness of economies. As with the US, inflation has been falling, although with it running at an estimated 5.5% on annualised basis, it is still too high and the ECB duly increased deposit rates to 3.5%, with further hikes expected, despite some dissenting voices. In the UK, there are hopes that pace of inflation will ease from the current 8.7%, although not to the extent it would allow the Bank of England to take its foot off the monetary brakes.

Hong Kong and Chinese equities have shown a whiff of recovery recently, with investors mulling the prospect of economic stimulus. The international media has focused on the muted pace of the post-lockdown recovery in China, with private consumption and industrial production not rebounding as vigorously as expected. The woes of the property market, a major component of the economy, continue to dampen activity and the government is reluctant to revert to its old policy playbook of reinvigorating the sector to propel growth.

"China remains an important supplier and demander of the world's goods"

The growing Sino-Western political rift and offshoring trends have taken the sheen off the China reopening story. However, a recent Walter Scott Research team trip highlighted that while the West is 'de-risking' its supply chain exposure, the depth and complexity of interconnection with China will limit the extent of any decoupling. For all its current travails and acknowledging the likelihood of a lower growth trajectory, it remains an important supplier and demander of world goods, and a continued source of opportunity for global and domestic companies alike.

Japan has continued to find investor favour. Economic data has been supportive, despite a fall in exports, with GDP growing a revised 2.7% on an annualised basis in the first quarter of this year thanks to a post-Covid recovery in consumer and corporate spending. The external environment remains uncertain given slower global growth, but the generally more upbeat economic prognosis and the view that the market is optically cheap has provided a positive backdrop for Japanese equities. There are signs that the multi-decade deflationary environment is losing its economy-stifling grip on the country. Some of this inflationary pressure is imported, but wages are also rising. For now, the Bank of Japan (BoJ) is sticking to its loose monetary policy, and corporate Japan has not been too vexed by the weak yen trend this year, which has helped competitiveness and profitability in yen terms. However, it is possible that at least some modification of the BoJ's policy of putting a trading band on bond yields (yield curve control) will be necessary if current economic trends continue.

"Investors have been encouraged by the resilience and indeed growth shown by the world's 'quality' companies"

Not that discerning market moods and direction forms any component of our investment approach, but investor sentiment has arguably reflected a nascent 'goldilocks' scenario, founded on hopes of peaking interest rates, and economic growth proving more resilient than expected. The latter has certainly been the case, considering the dire forecasts for global economies of early last year. However, inflation has not been completely conquered and its lag effect on consumer behaviour may yet be fully felt, while there is a danger that central banks go too far in their attempts to rein in inflation. Aside from the still-uncertain demand environment, we've gone through a cost-of-capital

reset which should be (healthily) purgative, but will certainly continue to cast a spotlight on weaker, highly levered enterprises with vulnerable business models, and highlight the merits of strong balance sheets.

Geopolitics remain fractious. With Russia seemingly neutralised as a potential disruptor in the energy market, the war in Ukraine appears off the market radar, but it could still be a source of volatility should the balance of the conflict change. However, although China 'de-risking' has become part of the market narrative, we remain of the view that the re-opening of its economy is a positive for the world.

So, while many markets appear flush with optimism, we are not yet out of the woods in terms of the broad economic challenges. However, our optimism is based on the fundamental merits of the companies we hold. In the face of this mixed macroeconomic climate, we have been encouraged by the resilience and indeed growth shown by the world's 'quality' companies – businesses that benefit from market leadership, financial strength, good management and their adaptability in challenging times. Such attributes are always vital, in our view, whatever the economic or market backdrop.

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STOCK EXAMPLES

The information provided in this article relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

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