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BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY THINKING

LOOKING FORWARD

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Although stock markets started off the year on a positive note, of late, they have lost some of their sheen. In this article, Roy Leckie, Executive Director – Investment and Client Service, highlights some of the trends that might influence the equity landscape in the coming months, and, irrespective of any potential near-term challenges, retains his positive view on the prospects for world-leading companies at the forefront of long-term growth trends.

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Executive Director –
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Cast your mind back to this time last year. There had been a market sigh of relief that the terrible events of the Ukraine War had not caused the widespread disruption that was much feared. However, concerns abounded about the health of the global economy. Central banks remained on a tightening path given unconquered inflation, with rising prices squeezing the consumer. To compound matters, spring saw notable casualties of over-leverage and mistaken assumptions about the perpetuity of cheap money, with the saga of Silicon Valley Bank and Credit Suisse reminding investors that the monetary game had changed.

Fast forward to today, and despite 2023 not being a legion year for earnings, the upward progression of equities has reflected the easing of inflation across the globe, expectations of a change of course by the Federal Reserve and the European Central Bank, and hopes for middling, if not spectacular economic growth, and a modestly better year for earnings.

“The ‘bears’ on the US economy have been chased away by Goldilocks”

The dire forecasts of a plummet into recession have, in the main, not materialised, although parts of Europe and Japan have had a periodic dalliance with it. The ‘bears’ on the US economy have been chased away by Goldilocks, who has continued to spend (or borrow, judging by rising credit card debt). Unemployment has risen from lows, but the labour market remains tight-ish, while sentiment in the manufacturing sector has improved.

However, the narrative on prospective ‘Fed’ easing has changed. While mindful of the stickiness of inflation, the Fed will also have to take into account the relative vigour of the US economy in their interest rate considerations, and that alone might dampen the spirits of investors whose optimism has been founded on a plethora of cuts this year. Whatever the case, monetary policy has been reset and the cost of capital has risen, and we welcome this as an enforcer of capital discipline, as well as a differentiator between strong and feeble balance sheets.

In view of interest rate cut expectations and a more benign perception of economic prospects, ‘growth’, as a category, outperformed ‘value’ across most global markets although there has been a degree of broadening. The Magnificent Seven story has become more nuanced, with a number of its posse, including Apple and Tesla, not joining in the first-quarter party. Markets have travelled a long way since pandemic lows, and with equity valuations expanding, investors will be less tolerant of earnings under-delivery.

“Investors have been more focused on companies tied into long-term growth themes”

The current downbeat economic picture in Europe may change to a more optimistic hue as the year goes on. Rising real incomes as inflation ebbs, and the potential for a somewhat better exogenous environment, point to a slight improvement. The European Central Bank has been playing hard to get in terms of lowering interest rates given its vigilance over services inflation and wage growth, but equity markets are pricing in a sooner-rather-than-later *volte face* by the ECB. But rather than dwelling on Europe’s economic fortunes, investors have been more focused on companies tied into long-term growth themes in the fields of AI, luxury and obesity treatment. Lack of macroeconomic vigour does not translate into a blanket lack of enterprise, and our view on Europe is from the perspective of it being a habitat of global-facing companies with leading, proprietary products or services, which have prospered irrespective of the economic performance of their countries of domicile.

“Whatever the economic prognosis, [Japan] remains home to some excellent growth companies”

In our view, this is still true of Japan. The current enthusiasm for Japanese equities is vested in the prospect of an escape from the deflation, improvements in competitiveness thanks to yen weakness (although a weak yen is not good for domestic consumption), and moves to promote better corporate governance and returns to shareholders. Despite the recent ‘pivot’, monetary policy remains accommodative, and unless there is a concerted pickup in *real* wage growth, the Bank of Japan is not likely to be in a rush towards wholesale tightening. Whatever the economic prognosis, for us, it remains home to some of excellent growth companies that are the forefront of global technological and industrial trends. It is the case though, that it has been a market where last quarter, and indeed over a three-year period, growth has lagged value.

“China is likely to remain a deeply interconnected member of the world economy”

A few Japanese companies continue to suffer from ‘China-itis’, either through currently weak trends in

China, or wholly negative sentiment towards the Middle Kingdom. China itself is off the radar for many investors. The lingering problems of the property market and Sino-Western tensions have drawn a veil over some of the improvement seen in the economy of late. The Lunar New Year holiday season saw a pick-up in consumption, and industrial production rose 7% year on year in the first two months of this year. Several China-focused companies, such as AIA and Prudential, have been posting good results, but these have been ignored by investors. Markets seem to be reflecting the 'China-in-terminal-decline' rather than a 'China-in-transition' story, albeit the latter is about a lower-than-historical, but more value-added growth trajectory. The reset in Sino-Western economic and political relations is ongoing, but China is likely to remain a deeply interconnected member of the world economy as a major demander and supplier of the world's goods. On a geopolitical note, it is noteworthy that fractious global relations have not been in the markets' gaze, largely due to little disruption in energy markets and supply chains, but they remain a potential source of market disquiet, as highlighted by recent concerns over tensions in the Middle East.

After what has been a strong rally in global equities, and given lingering macroeconomic uncertainties and the current market fixation on interest rate moves, perhaps a degree of volatility lies ahead. But from our perspective, the 'outlook' remains highly encouraging. Our positive view of the longer-term prospects for many of the world's leading businesses is founded on their fundamental merits, rather than macro or market views. Thanks to their financial strength, market leadership, and the ability to adapt and innovate, these companies are tapped into an array of growth trends that in our view, augur well for long-term returns.

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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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