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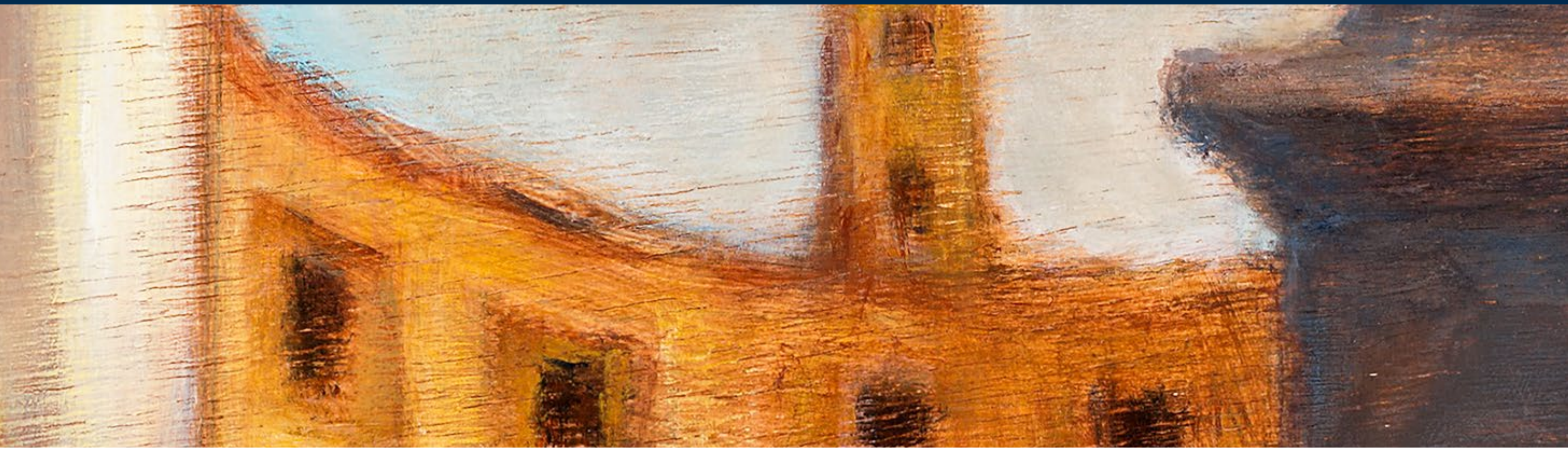

QUARTERLY THINKING

EQUITY NIRVANA?

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Is it better to travel than to arrive? Now that the Federal Reserve and the European Central Bank have turned the monetary corner, investors may well be asking what happens next in view of a lengthy period of strong equity returns, with a few markets at or near new highs. In this article, Roy Leckie, Executive Director – Investment and Client Service, outlines some of the events and developments that might affect equities over the coming months.

ROY LECKIE
Executive Director –
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For nigh on two years, expectations of interest rate cuts and the resilience of the global economy have helped bolster equity market risk appetites, albeit the market focus over the period has been quite narrow. Over the next few months, a recipe of middling economic growth plus lower interest rates may continue to equal equity market nirvana. However, from our perspective, a considerably more nuanced view is required.

A MIXED PICTURE

The Federal Reserve's hefty 50 basis-point interest rate cut in September, reflected the bank's view that while inflation is above its 2% target, it is sufficiently near it to warrant a change in policy. The Fed's US economic outlook remains fairly benign, but it is not without blemishes. Main Street's resilience has been a key driver of the post-Covid economy. However, US consumers have become more price sensitive, as the cumulative effect of inflation weighs on their spending behaviour, although lower interest rates may improve sentiment over time.

Aside from weakness in certain segments of the US consumer sector, manufacturing activity has now spent a lengthy period in the doldrums. According to the latest ISM Purchasing Managers' Index (PMI), the US manufacturing sector contracted in September for the sixth consecutive month and for the 22nd time in the last 23 months. A similar trend has been evident in Europe, where manufacturing activity has been in a contractionary phase for over two years. Germany has been the poster child of this torpor, reflecting the lingering effect of post-pandemic cost rises, and increased competition from China. The case for lower interest rates in Europe has therefore been clearer cut, with economies remaining in a tepid state, and inflation now below target. Lower inflation, wage growth, and low unemployment, by European standards at least, are expected to boost consumer spending, although recent service sector PMIs have shown some renewed weakness.

These various macro trends have been evident in various calls and meetings we've had with companies over the last year or so, although it is important not to generalise. In the retail arena, McDonalds has highlighted how price sensitivity has become more evident in middle-income groups. Consequently, the company has had to put a bigger emphasis on value menus. By contrast, other retail businesses have fared well in this environment. Costco, with its store membership model, and Spanish fast-fashion retailer Inditex have seen solid growth despite the macro challenges.

"There are signs of improvement"

Subdued manufacturing activity has been a feature across the world. We've spoken with industrial and construction component supply company Fastenal about the challenges of the US market, while a few Japanese companies, such as robot and computer numerically controlled machine tool company Fanuc, have been through the cyclical ringer. There are signs of improvement emerging in both, but the key point is that having weathered tough conditions, they remain well-placed to benefit from long-term growth trends as leaders in their respective industries.

For many leading businesses, earnings delivery is seldom linear. There will be periods where cyclical ebbs and flows will impact a company's results and share price. Walter Scott is a long-term investor with holding periods that can span many years and cycles. We have never engaged in the dark art of market timing, i.e. attempting to trade positions by predicting the rhythm of cycles and markets. Irrespective of market phases, we've always believed that investing in great companies with excellent growth runways, paying the appropriate price for them, and with time and patience allowing compounding to work, is an excellent way to achieve good returns.

CURRENCY CAPERS

We have also never based our investment approach on the siren call of a seemingly attractive macro story. In that regard, the economic narrative in Japan has become slightly blurred. The Bank of Japan (BoJ) announced a further, tentative step towards monetary normalisation, raising its benchmark interest rate to 0.25% at the end of July. A small move, but it was sufficient to propel the yen upwards, prompting concerns about the impact of a stronger currency on corporate export earnings.

This sent the equity market into a short-term tailspin before it staged a partial rebound as more sanguine views on the future path of monetary tightening gained traction. The September BoJ meeting saw no change in interest rates, hinting at policymaker acknowledgment that it will have to tread carefully, given the impact on asset markets and the nascent state of Japan's emergence from deflation. From our perspective, the appeal of Japan rests on its leading companies in fields such as technology, healthcare and factory automation, rather than hopes of economic resurgence.

"Investors are perhaps taking a more measured view"

Events in Japan also had repercussions for global markets as the perceived end of the carry trade generated short-lived volatility. A longstanding macro trading wheeze has been to borrow 'cheap' yen, given Japan's low interest rate environment, and invest in higher-yielding asset classes or in in- vogue equities elsewhere. The unwinding of this trade was evident in the duller performance of certain members of the Magnificent Seven in the third quarter, including those at the forefront of the market's focus on AI-related themes. This is partly reflective of previous strong share price performance, but investors are perhaps taking a more measured view, awaiting further tangible evidence as to how the AI theme will be monetised in the long run.

BEIJING BAZOOKA?

With the politically-challenging possibility of the economy not achieving the government's 5% GDP target for this year, China announced a monetary, and yet-to-be fully disclosed fiscal stimulus programme aimed at underpinning growth and alleviating some of the pressures in the property market. Putting the brakes on the decline of the latter would go a long way towards the reinvigoration of consumer confidence and spending. Our recent article about China discusses some of our on-the-ground findings by members of the Research team after an intensive two-week trip to Mainland cities and Hong Kong. In meetings with various companies, management attributed the tepid environment to excess consumer savings rather than falling incomes, so it is a question of how to rekindle the animal spirits of the Chinese consumer.

"Investors are awaiting further clarity"

The main measures, so far, include interest rate cuts, lowering banks' reserve requirements (i.e. encouraging more liquidity in the system), and support for the equity market. Are we at a Draghi 'whatever it takes' moment in China? After initial euphoria, investors are now awaiting further clarity regarding the fiscal element of the stimulus. However, despite due wariness about the merit of 'supporting markets', and concerns about it all being akin to a fiscal and monetary Band-Aid, a potential clearance of property market blockages would be positive for the economy and the cautious Chinese consumer. The exit from a property-driven growth model has indeed proved a painful process.

A core criticism of President Xi's administration has been that it has favoured state-owned enterprises to satisfy the government's 'control' agenda, while bludgeoning the private sector. However, there has been a focus on thrusting the industrial sector up the value-added ladder. This has helped foster the development of globally competitive industries in fields such as electric vehicles and solar energy. It has nonetheless occurred at a time of strained Sino-Western political tensions, with China's trading partners increasingly sensitised to the perceived dumping of Chinese exports. As our trip showed, amidst the macro smog, there's innovation and enterprise aplenty in China. The country is still a linchpin in many global supply chains, despite the steady march of the 'China+1' trend. The next car on your driveway might just be a BYD...tariffs permitting!

POLITICAL RIPPLES

This brings us, of course, to the subject of global politics which have been mostly ignored by markets. The forthcoming election in the US raises the prospect of fiscal giveaways, tariffs, and a reset in the economic relations between the US and its trading partners. Strife in the Middle East and the Ukraine has not featured in the market's thinking, largely because the oil market has been stable. North Korea is going through a period of heightened sabre-rattling against its southern (and increasingly distant) cousin. As they are known risks, they shouldn't be considered as nesting grounds for Black Swan events, but they remain a source of volatility. Against the backdrop of a patchy outlook for global growth, equity market progress may not be plain sailing.

"There are many opportunities for the patient investor"

However, we are resolutely optimistic in the long term. Over time, economies develop and grow, and enterprise and innovation rarely cease. We believe there are many opportunities for the patient investor. There remain long-term growth trends that transcend economic or political cycles. So, we will stick to our approach as we have done through a multitude of cycles. Our strategy will be focused on investing in leading, financially strong companies that are often veterans of navigating economic or political ebbs and flows, while remaining well-placed to deliver good returns to investors over time.

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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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