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Reflections and Insights

"She realizes she doesn't know as much as God but feels she knows as much as God knew when he was her age."

– DOROTHY PARKER

When you write reviews with a quarterly cadence, sometimes it's hard to think of new things to say. Things go up, things go down, things go sideways, or some variant thereof. Last time, the talk was about stronger for longer, which meant higher interest rates than expected, sticky inflation and strong corporate profits. Roll on three months and in the US the data shows a few signs of weakness, particularly in consumer spending. In Europe, the interest rate cycle seems to have peaked, with rate cuts having begun. This is, of course, a testament to the relative strength of the US, a feature we have all become used to in recent years.

These were predictable events. Monetary policy acts with long lags, but market participants are addicted to instant gratification. You think something might happen and if it doesn't happen straight away, you then assume it will never happen at all.

What this means is that the US is likely to slow down somewhat over the balance of the year. Interest rates there could begin to fall and corporate profit expectations could be shaded down. Companies, in particular, have relied on price increases to keep margins high, and evidence is growing that this is no longer a strategy that consumers will tolerate. Politics, too, will come into play, but how is anyone's guess? In Europe, things will muddle along, although politics there have turned rather ugly.

What is much harder to work out is how markets will respond to all this.

Hitherto, market participants have believed in the theory of bisociation, or to give it its vernacular name, magical thinking. This thesis suggests that investors can quite easily hold two contradictory concepts in their heads. The first is that interest rates will fall because inflation will fall, yet profits and valuation will rise. That is because there will be either no landing or a feather-bedded variant. In practice, if inflation falls, it is almost inevitable that nominal profits will also fall, especially in an environment where unit volumes are not rising rapidly. The point is

that these outcomes are strange bedfellows. One or the other (and probably both) is likely to be somewhat wrong.

This didn't matter when markets had not behaved as they just had. There was a safety net under prices. Investors weren't overly optimistic, valuations were high but not in the stratosphere, bond spreads were wide and the market was broadly based, that is, many stocks contributed to market returns (rather than a few (very large) stocks driving the majority of the index returns). The opposite is now true. All these indicators now bear the stamp of the true believer. We have commented before that valuations are not a reason on their own to be either negative or positive. There are too many variables in the calculation. Today, though, valuations are high, not just in comparison with history, but also against bonds.

In unusual territory

This is not a prediction that markets are set for a fall. Markets can remain irrational for very long periods. What it does say is that we are in unusual territory, a starting point where returns in the future struggle to match those we have experienced in the past couple of years.

Having said this, there is so much concentration in markets that values outside the stock market darlings offer much better prospects. To illustrate, the S&P 500 is up around 12% so far this year. This is unusual. In comparison, the equally weighted benchmark (which gives greater prominence to medium-sized and smaller companies) returned only 2%. This is unusual.

Why, you may ask. We have harped on about the Magnificent Seven, Five or Three, (number depending on when you look), but they do have spectacular earnings growth. On top of that, the fiscal stimulus in the US implied by the CHIPS Act and the spectacularly misnamed Inflation Reduction Act has gone disproportionately to large companies. The AI spending boom has also contributed, benefiting those who have gone that route. The big tech businesses have built walled gardens around themselves which protect margins, and they are powerful enough to drive every new technological development and either acquire or stamp out nascent competitors. At this

stage, it is hard to see how this might change, although history suggests that it will.

These factors help to explain why the market has gone up even when interest rates are not coming down.

Something to do with growth

Despite the earnings growth, the excellent market returns have largely come about because of P/E expansion. This is something to do with growth, but also with market composition. Over time, the largest companies in the world have become 'growthier' – they are no longer oil companies or banks, but tech companies, luxury goods businesses or pharmaceutical developers. Other things being equal, more growth, and particularly more consistent growth, demands higher valuations. This means that historical measures of appropriate valuation have to be adjusted to some extent. That has indeed happened, but the point here is that this process may nonetheless be extended.

If things are as extended as they appear, a legitimate question is whether we are in a bubble. Looking back to the 1920s, the economic sage JK Galbraith decided that the market crash was caused by speculation itself. There were horrible monetary mistakes which exacerbated the crisis, in particular allowing banks to go to the wall, but he felt there is little doubt that speculation was at the heart of the problem – "Speculation on a large scale requires a pervasive sense of confidence and optimism."

There are clearly areas of the market where this statement holds water, but arguably it does not apply to the market overall. More important, though, are the institutional circuit breakers which have been in place since the 2008 financial crisis. To summarise simplistically, there now exists the concept of 'too big to fail'. The idea that a Central Bank would allow a systemically important institution to fail, as happened in 1929 and 2008, is no longer realistic. This has given rise to the concept of the US 'Fed (Federal Reserve) put', which is there to protect investors from anything too dramatic unfolding in equity markets. This may be a comforting thought but has no precedent. The next crisis may indeed be defused by administrative fiat, but it may also come from a direction where nobody is looking

All this is to illustrate that market participants are generally relaxed, both about the economy and about the broader capital markets picture. This is not a speculative frenzy, but it is complacent.

What should we be fretting about?

They say that 'bull markets climb walls of worry.' The arguments here suggest that people aren't very worried about anything. What should they be fretting about? What follows is a non-exhaustive list:

1. Demographics – the one certainty in any forecast, and one where we can see that the rich world is only going to stay as rich by importing labour or by a jumping on a technological bandwagon which is not yet visible. This is both an opportunity – more healthcare, social care etc., and a threat, posed by the need to absorb greater immigration into ageing societies;
2. Protectionism – seemingly an inevitable trend, driven by a series of false premises about economic advantage. Protectionism benefits nobody, except the government introducing it, which collects tariffs on imported goods. Consumers get ripped off, inflation suffers, and companies grow uncompetitive;
3. Climate change – enough ink has been spilled about this, but it is likely to exacerbate the strains caused by demography and protectionism, quite apart from its direct effects;

4. Geopolitics – an exercise in forecasting the folly of mankind. The broad trend visible today is about the decline of the liberal world order (not in the American sense) and the rise in populism and nativism. Much of this is a reaction to the three factors already set out. We seem likely headed for a more transactional, inward-looking world at a time when we should be doing exactly the opposite;

5. Financial engineering – JP Morgan Chief Executive Officer, Jamie Dimon, recently warned about the opacity and scale of shadow banking, which takes up an increasing share of finance. This is an unregulated sector with no formal oversight, yet almost certainly has systemic influence.

Most of these longer-term issues will be absorbed into the market narrative, but they bear watching and will likely influence how, rather than whether, capital is deployed. In the meantime, the investment approach, as ever, is to remain as diversified as possible and to avoid the most overheated markets.

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