RATHBONES

AMERICAN STOCKS POP

REVIEW OF THE WEEK
12 FEBRUARY 2024

THE US S&P 500 STOCK MARKET INDEX BROKE THROUGH 5,000 FOR THE FIRST TIME, HITTING A RECORD HIGH LAST WEEK AS INVESTORS SHRUGGED OFF WORRIES THAT INTEREST RATES MAY NOT FALL AS FAST AS MANY HAD HOPED.

We have long preferred large US companies, as they tend to be the strongest businesses that can deliver solid growth year after year. However, valuations over there appear increasingly expensive. Not all companies and not all industries, but after some strong results and share price performance lots of investors assume very peachy US economic growth and continued company profit growth, especially from the big fish in the index. There seems to be a high and growing likelihood of disappointment at the index level, and we believe that active stock-picking focused on finding companies with a track record of protecting their profit margins and delivering consistent profitability will be more important in 2024.

Over the past few months, the probability of a US recession, which would likely spark a global downturn, has faded to roughly 50/50. Evidence that a manufacturing slowdown may be ending is particularly noteworthy. If the US does avoid recession, interest rates could fall by less than markets currently imply – and which seem baked into stock prices. However, if there *is* a recession, there's a very good chance that rates will fall by much more than forecast as central bankers try to support ailing economies. And while falling rates is a good thing for stock prices, the effect could be wiped out by the downdraught of recession. Where investors have invested a lot of hope, those stocks tend to fall sharpest.

We feel the mix of opportunity and valuation is improving on the Continent and is outright attractive in small and mid-cap American companies. Valuations of both are much cheaper, and our research suggests that, in Europe, small and mid-cap firms may be less vulnerable to sell-offs stemming from US interest rates staying higher for longer than expected (if that path is indeed how things play out).

Broadly, this is why we like government bonds too. If there's a recession, their prices should rise and help offset falls in our stocks. And, in the meantime, they offer a reasonable rate of return from their coupons. If the economy does better than expected, as long as inflation isn't resurgent, they may still post positive returns. Of course, the risk is that inflation flares up again – that could lead central bankers to keep rates high, which would hurt the value of bonds.

For inflation to return to levels that would concern the US Federal Reserve, we think US wage growth would need to accelerate, injecting more cash into the American economy and pushing up consumer prices. Wage growth seems to be easing, however. We're heartened by looking at how quickly laid off workers are rehired elsewhere. A measure of this that we look at leads wage growth by a year. Until recently, unemployed workers were snapped up very swiftly, yet over recent months that speed of rehiring has slowed right down to historically mediocre levels. We believe this shows the American labour market really is cooling after a red-hot couple of years. Currently 5%, wage growth has been deaccelerating sharply from its multi-decade record of 6.7% in July 2022. If the relationship between wage growth and a slow-down in re-hiring holds, that should mean wage pressures continuing to fall over the course of 2024.

A riddle wrapped in a mystery

On Thursday, the first estimate of UK Q4 GDP will be released. Most economists think the UK will post another 0.1% drop, which would mean the UK will have entered a technical recession (at least two consecutive quarters of a shrinking economy). Britain is in an odd place. Or at least, it's difficult to know exactly what place it's in. It's not great, that's for sure. But there are conflicting signs about just how bad it is.

The UK unemployment rate is expected to rise slightly to 4% when it's released on Tuesday. The jobs market has been largely robust of late. After a short spike to 4.3% in the summer, the jobless rate has steadily sunk back to 3.9%, which is near multi-decade lows. Meanwhile, average wage growth for the fourth quarter is forecast to slow from 6.5% to 5.7%. That's still a strong number! You would have to go back to 2007 to see salaries rising by anywhere near that magnitude.

Services – the driver of the UK economy – have been humming recently. The Services Purchasing Manager Index – which surveys businesses on everything from intentions to hire/fire, to change prices, and expectations for upcoming work – was revised up 0.9 to 54.3 in January. Services cover a huge range of commerce, from consulting and legal work to bars, theatres, restaurants and mechanics. That can make the data hard to unpick. Most of these businesses are optimistic about rate cuts from the Bank of England,

which would help reduce financial costs for both them and their customers. They also noticed an uptick in their customers' willingness to spend, despite continued cost-of-living pressures. That could be due to the wage growth that employers are still flagging as the largest cost pressure for their companies. Trying to find a restaurant in London that isn't booked out for weeks or months can be quite a task. Yet top accounting, consulting and law firms are suspending their intakes of youngsters and cutting jobs. These seem contradictory.

Meanwhile, despite mortgage rates many multiples higher than several years ago and poor headline economic growth, UK house prices are forging higher once more. In January, the average UK house price rose by 2.5% compared with a year earlier, hitting £291,029. That was the fourth consecutive monthly rise and leaves house prices within touching distance of their summer 2022 high. It's also a phenomenal 20% higher than at the beginning of 2020.

With rents rising between 6% and 9%, depending on which measure you use, perhaps people believe high mortgage costs are the lesser of two evils. At least a mortgage rate is locked in for years (and most people expect rates to fall over the coming years), while rents seem only to rise ever more rapidly. That buying pressure is arguably supporting property prices for now. It also highlights how short on decent housing the UK is.

These dynamics may be what's driving yet further consolidation among UK housebuilders, which have been struggling with lower sales in recent years. Last week Barratt Developments revealed an agreement to acquire rival Redrow in a £2.5 billion deal, which would create the UK's largest housebuilder. The Barratt acquisition follows US-owned Vistry buying Countryside Properties in 2022. The plan being, by bulking up and increasing scale, housebuilders can weather the current drop in volume and cash in on any concerted state-backed push to build more homes in coming decades. Barratt's share price responded by falling 5% on the day of the announcement, showing investors are wary of long-term bets on the UK. The deal needs approval from the Competition and Markets Authority, which is already conducting a year-long review of the industry because of concerns about the availability and cost of homes.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.

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