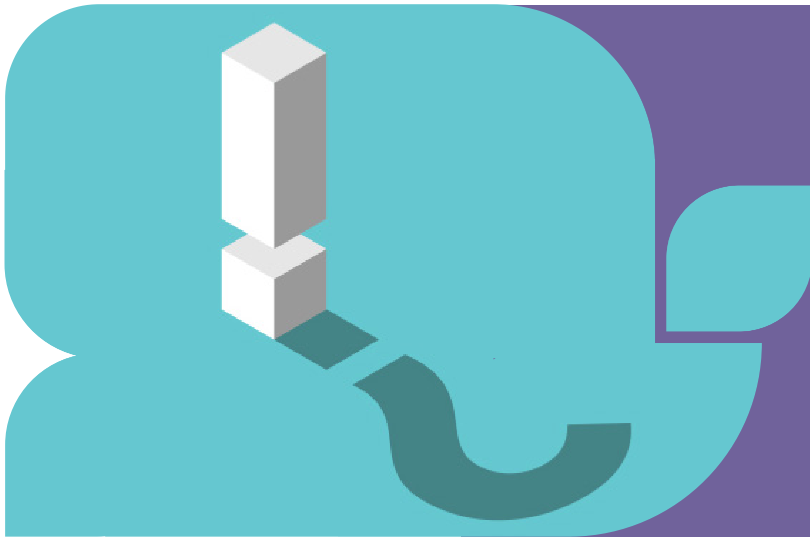

Rathbones
Look forward

Review of the week

15 May 2023

Expectations vs reality

There's a disconnect between how everyone feels and how stock markets are moving. Meanwhile, the US debt ceiling looms ever larger.

Virtually everyone you talk to is bearish: the future is uncertain; inflation isn't falling as fast as everyone would like; costs from labour to debt interest payments are rising; central bankers are like a riddle of sphinxes. And yet stock markets keep creeping higher in 2023.

Markets don't rise by themselves. They rise because investors bid them higher. They rise because - after all the caveats, consternation and short-term doubts - more people think stocks offer good value. It's the old principle of revealed preferences: the best way to judge what people really think is to see what they buy, not listen to what they say.

It helped that the latest US quarterly earnings results were better than expected. The average earnings of S&P 500 companies fell 2.5% in Q1, for the second quarter in a row. However, as we note from time to time, it's not the change that's the most important number in markets - instead it's the change relative to what everyone was expecting. At the outset of the reporting period, analysts had expected earnings to fall by 6.7%.

Managing expectations is crucial. Often this becomes a bit of chicanery from company managers, guiding analysts toward targets they believe they can comfortably hit, tempering expectations ahead of time, that sort of thing. This way, when results arrive they are more likely to be well received. Still, trying to smooth out volatility and keeping markets relatively calm isn't necessarily a bad thing for all involved.

Arguably, it's worse when businesses overpromise and then get creative with accounting to hit the numbers. Maybe they report sales early, before they've done the job (or before the work has even been agreed), perhaps some expenses can be magically transformed into 'investments', boosting their bottom line, or maybe their accounting department comes up with a new, more flattering, adjusted profit figure that dispenses with the costs that are ruining performance. These accounting sleights of hand can quickly compound from small tweaks here and there to large holes that can only be covered by fraud or large write-downs. One of the tell-tale signs of this sort of manipulation is a growing divergence between the cash that a company receives after costs and the profit it reports. This is why we tend to keep an eye on these measures of profit quality for our investments.

Looking ahead, despite many people forecasting a recession in America before the year's end (ourselves included), most analysts believe US company profits will be growing again by the second half of 2023. After a forecast 6% drop in Q2 profits, average earnings growth is expected to be roughly flat in Q3 and then 8% higher in the final quarter. With so much up in the air, and recession on the cards, we think this is a bit overoptimistic.

Meanwhile, earnings expectations for the UK are overly depressed, all things considered. British stocks are often lambasted, but they are much cheaper than their American peers, even after accounting for the differences in sectors. What we mean here is that the US stock index is dominated by digital technology companies and other industries that tend to make more money per dollar invested (and therefore command higher values, or price-earnings multiples). The UK has fewer technology companies, and sports 'capital-heavy' businesses like consumer brands, oil and gas businesses and miners. These sorts of companies have lots of factories, mines and buildings that need to be bought and maintained, as well as legions of staff that need to be paid. Therefore, these businesses tend to have lower values relative to their profits.

Despite this, a particularly high proportion of UK stocks are in 'defensive' sectors that should weather recession better than most. These include utilities, telcos, healthcare businesses and sellers of consumer staples. Diversification is important for portfolios; we think UK shouldn't be ignored. Added to UK stocks' cheap values and surfeit of defensive options, the UK economy has been perennially underestimated. While it has lagged its advanced peers, it hasn't done as poorly as was widely expected, which has helped support share prices.

Once again, this difference between expectations and reality has driven stock markets. British stocks starkly outperformed most other nations' bourses over the past year.

Raising the ceiling

US inflation dipped slightly to 4.9% in April, despite continued strength in employment and wage growth. Falling inflation is encouraging for investors because it means the US Federal Reserve (Fed) shouldn't need to keep hiking interest rates. Lower interest rates increase the value of stocks, bonds and property, all else staying equal. Of course, higher interest rates are good for those people and businesses that have more savings than debt. After more than a decade of derisory returns on cash, many older people will be cheered by the return of monthly interest payments on deposits (and quite a few younger people won't understand why a bank is paying *them*).

American interest rates are widely expected to stay at 5.25% or below for the foreseeable. According to futures markets (where you can agree interest rates in advance), there's a 50/50 chance of a cut in rates over the summer, but we think that's unlikely. For the Fed to loosen its monetary policy with inflation still above its 2% target there would have to be an economic calamity (not a mild recession).

In the UK, the Bank of England (BoE) last week hiked interest rates by 25 basis points to 4.5% as expected. This is believed to be the last for a while; however, we're less certain about this than the situation in America. We think UK inflation is about to drop considerably from March's 10.1% rate and should continue to decline over the rest of the year. If so, the central bank will be able to sit on its hands. But, to state the obvious, British inflation is bananas, so if it refuses to fall (and it has a long way to fall), the BoE may feel it is forced to hike again.

Moving back across the pond, concerns about the US debt ceiling are ratchetting up. A few weeks back, Treasury Secretary Janet Yellen warned that the US will run out of money and default on its debts by 1 June if Congress doesn't agree to pass legislation to allow the government to issue more debt. Yellen's warning has been reinforced by reports that the federal government received about 25% less in tax receipts in the tax year to April than the previous year. This is believed to be because of lower capital gains (markets were down over the period), and higher costs eating away at the taxable income of households and businesses.

The debt ceiling is currently set at $31.4 trillion, which is about 135% of US GDP, and the US has already used all of it. For the last few months it has used workarounds to keep the government funded, but the ability to do this is quickly evaporating. Republicans in Congress proposed raising the ceiling by just $1.5trn in return for very large cuts to welfare and government budgets, which Democrats are strongly against.

Crunch time is rapidly approaching and Congress appears yet to really take the risk seriously. The Democrats and Republicans, at least in public, appear further apart from each other than the deadline is from today.

It's important to remember that increasing the ceiling doesn't approve extra spending – the spending has already been approved by Congress. Instead, this ceiling just approves the issuance of debt required to fulfil those promises, which include government budgets, interest on outstanding debts, social security and other programmes. If the US doesn't raise the debt ceiling, it won't be able to pay its bills and will default, which would be cataclysmic for the economy.

In the past, this game of chicken tends to go right to the last minute before a compromise. This has happened so often in the past that there's a risk that politicians get complacent and allow the imbroglio to proceed. That would mean many government departments and services shuttered until an agreement is reached and no interest payments for holders of US Treasuries. It would cause pandemonium in markets.

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

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