Drummond Capital Partners

Market Insights – March 2024

Market Update | Unfurling the Sails (a little)

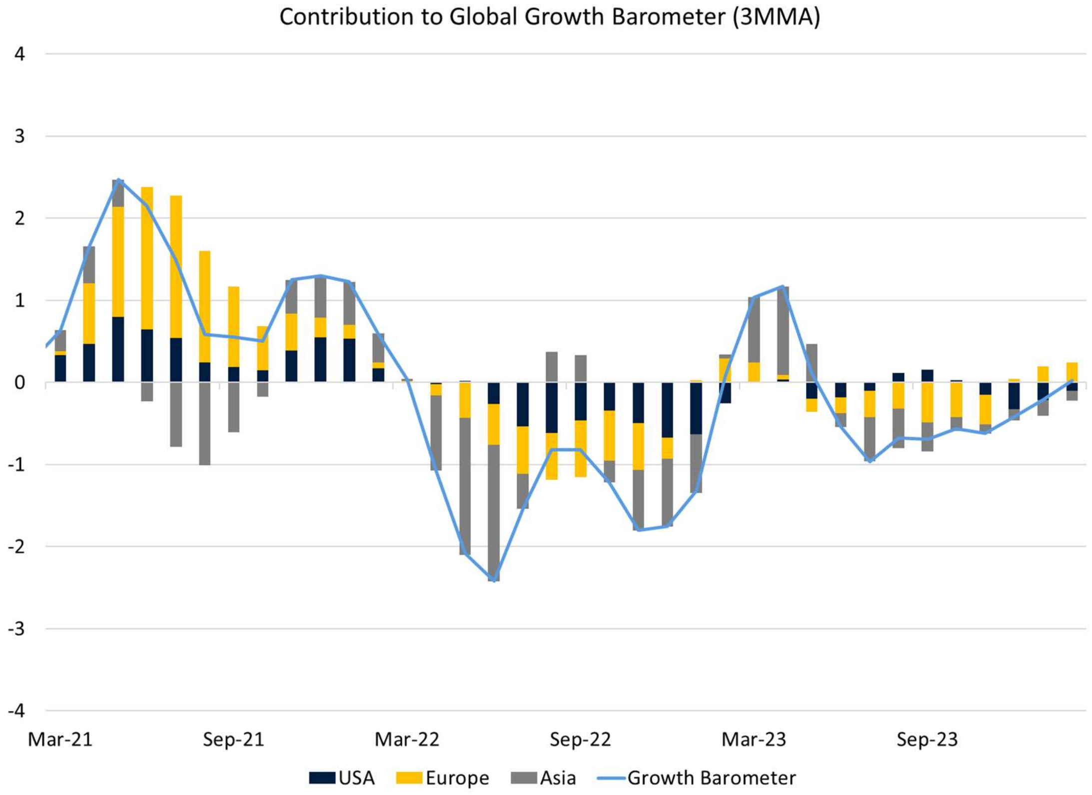
Key Points:

- *Global economic growth has improved a little and the US economy remains very resilient. However, progress towards lower inflation has slowed.*
- *Reasonable growth and lower interest rates have historically been a good combination for global markets. If a recession is avoided, and rates are cut this year, 2024 could be another good year for returns.*
- *Valuations for mega-cap technology stocks are pricing this rosy outcome, but other areas of the market are much cheaper and have room to grow should growth accelerate from here.*
- *The risk of a recession is still high, as is the risk inflation creeps higher, so we expect portfolio activity will be higher this year to navigate these risks.*

In this month's *Market Insight*, we provide an update on our outlook for the year ahead and some of the portfolio changes which have occurred recently. We have been writing about the implications of the global monetary policy tightening cycle since late 2021.

With interest rates being hiked meaningfully, a recession, which has been the most common consequence of hiking cycles historically, loomed large as a risk during this period. Since then, a number of major economies have suffered weak economic growth or even technical recessions. However, US economic growth has shown remarkable resilience and the US economy ranks first, second and third place in terms of importance for global markets.

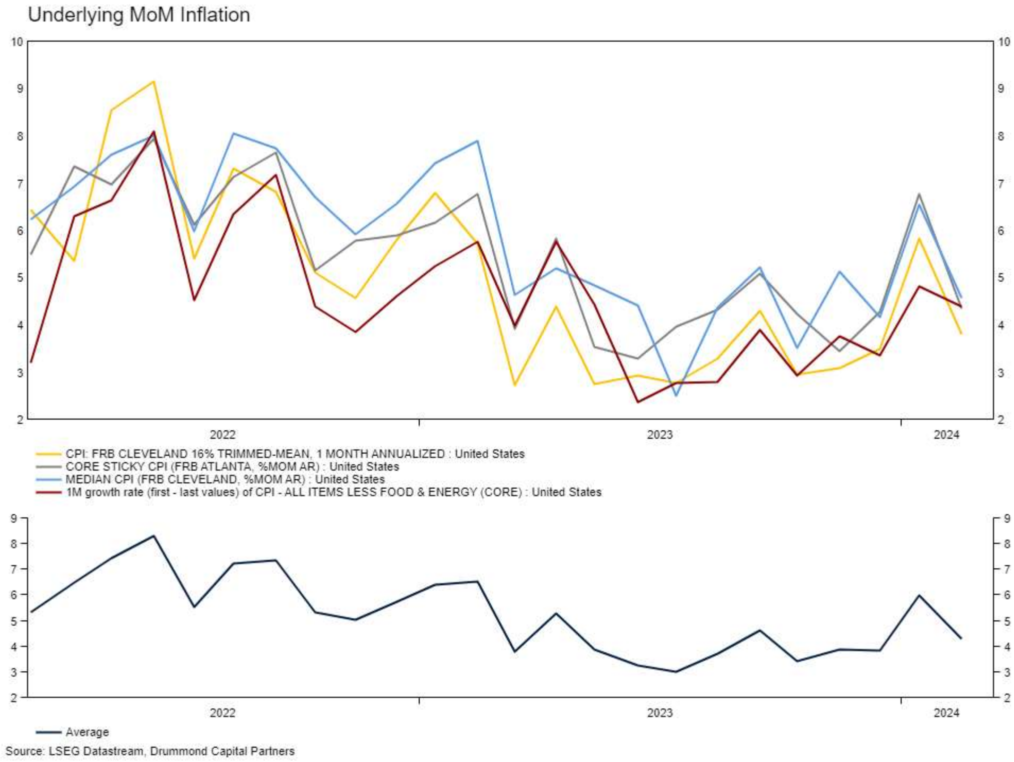
Based on higher frequency data and some leading indicators, there doesn't seem to be an imminent risk of a recession in the US in the near term. Indeed, global economic growth actually began to improve late last year.



Counterbalancing this positivity has been slowing progress on lower global inflation. Inflation in the US has accelerated a little in the past few months and remains somewhat sticky in a number of other countries.

This trend will make it more difficult for the Federal Reserve and other central banks to deliver their projected rate cuts this year.

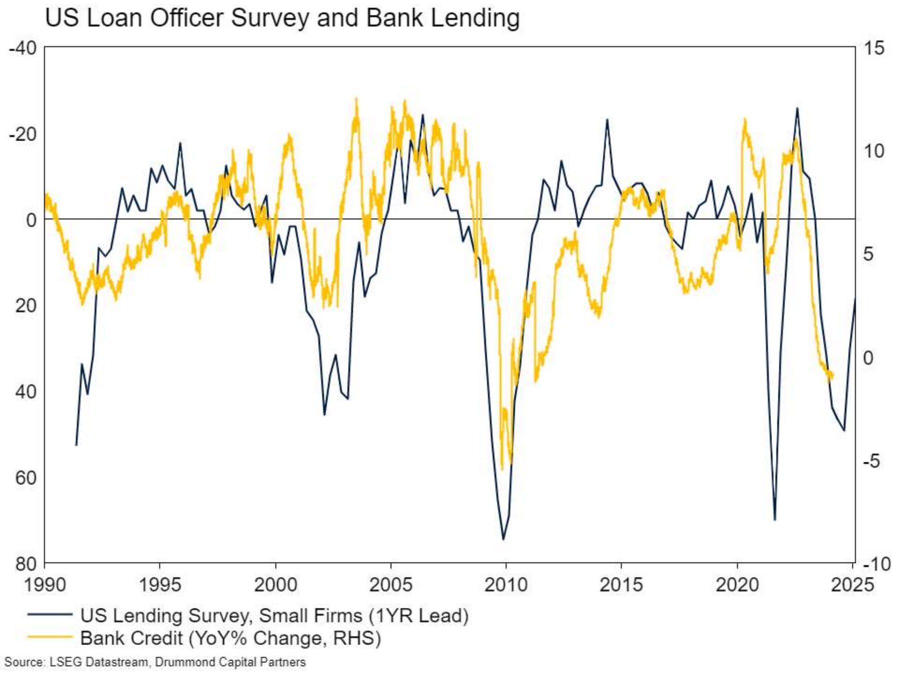
Source: LSEG DataStream, Drummond Capital Partners



There are some positive signs on this front. The US labour market has rebalanced considerably while (so far) avoiding a material increase in the unemployment rate. This has seen wages growth slow to a more sustainable level. Rent price growth is also slowing and should continue to do so as more apartment supply comes online.

These factors should support ongoing normalisation in inflation as long as there isn't a substantial re-acceleration in growth. Weak economies should deliver softer inflation in other countries, including Australia.

The Pre-emptive Pivot



If the Federal Reserve and other central banks begin to cut interest rates from around the middle of this year, this will mark a key difference from previous monetary tightening cycles.

Normally, central banks hike rates too far, drive the economy into a recession and then ease policy too late.

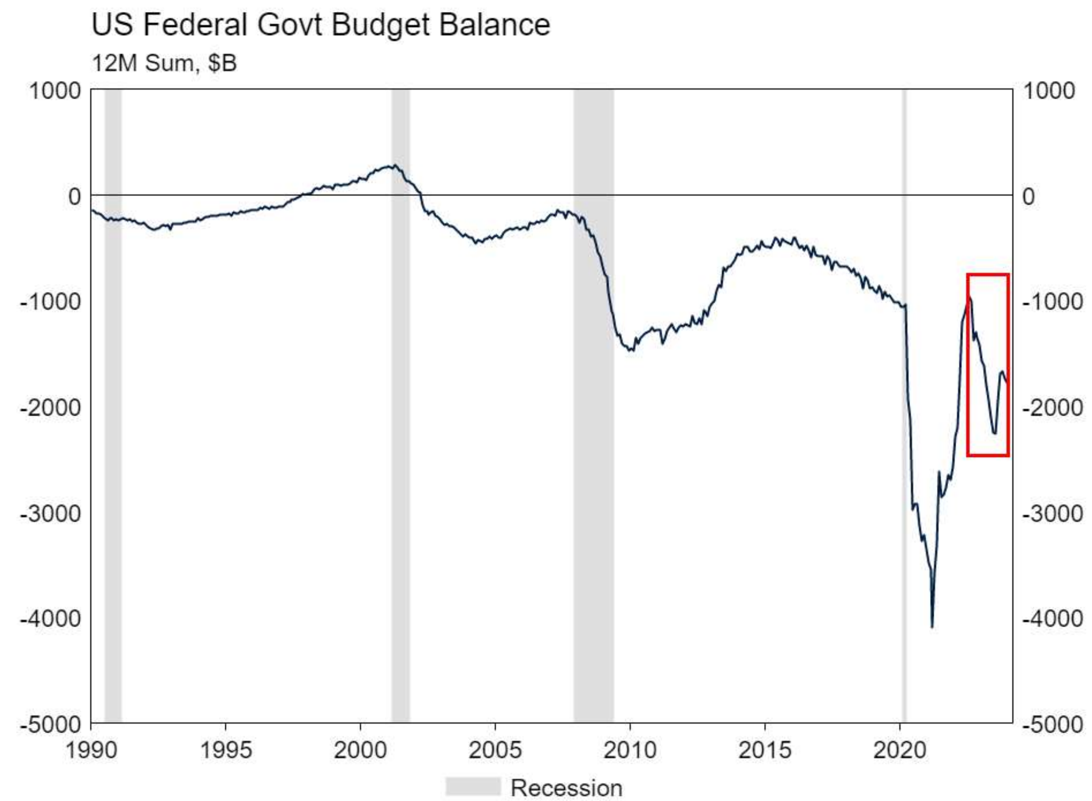
Interest rate cuts this year mechanically lower the risk of a recession because it gives central banks a jump start on supporting growth.

The pivot away from tightening has also led to easier financial conditions as long term interest rates have priced in rate cuts and equity markets have rallied.

Likely in response, some of the leading indicators which had been pointing to a recession in the US have begun to improve. Importantly, bank lending standards are on track towards easing again, which should support credit growth in the economy, particularly in an environment of lower interest rates.

Fiscal Dominance

Another major factor specific to the US is the impact of fiscal policy. This, alongside a very high proportion of long term mortgages that were fixed at very low rates, goes a long way to explain the divergence in economic growth between the US and the rest of the developed world in the last couple of years. The US federal budget deficit has widened significantly since mid-2022, by around 3% of GDP. Normally in an environment of strong economic growth, it would be narrowing, dragging on growth. The deteriorating fiscal position reflects a combination of lower tax receipts and increased spending, but the net effect has been substantial support to the US economy, likely doing a lot of work to offset the impact of higher interest rates.

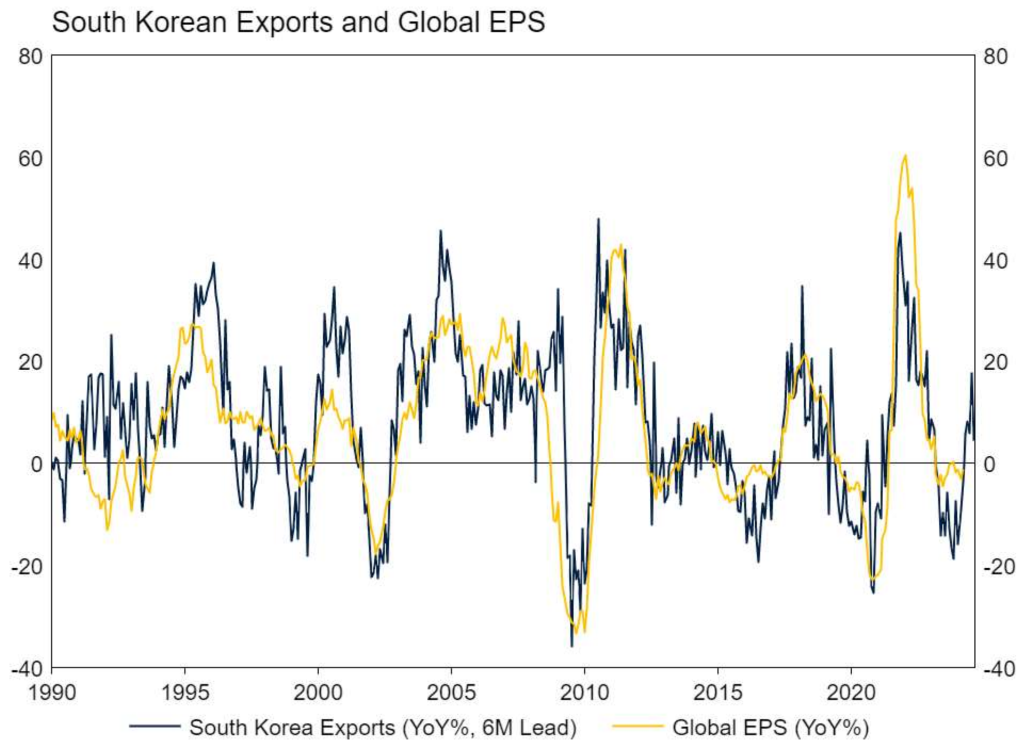


Source: LSEG Datastream, Drummond Capital Partners

With an election this year, both major political parties in the US are unlikely to take any steps to rectify this problem. If Trump is elected, more corporate tax cuts are probably coming. If Biden is re-elected, we can expect more social and climate transition related spending.

A Manufacturing Renaissance

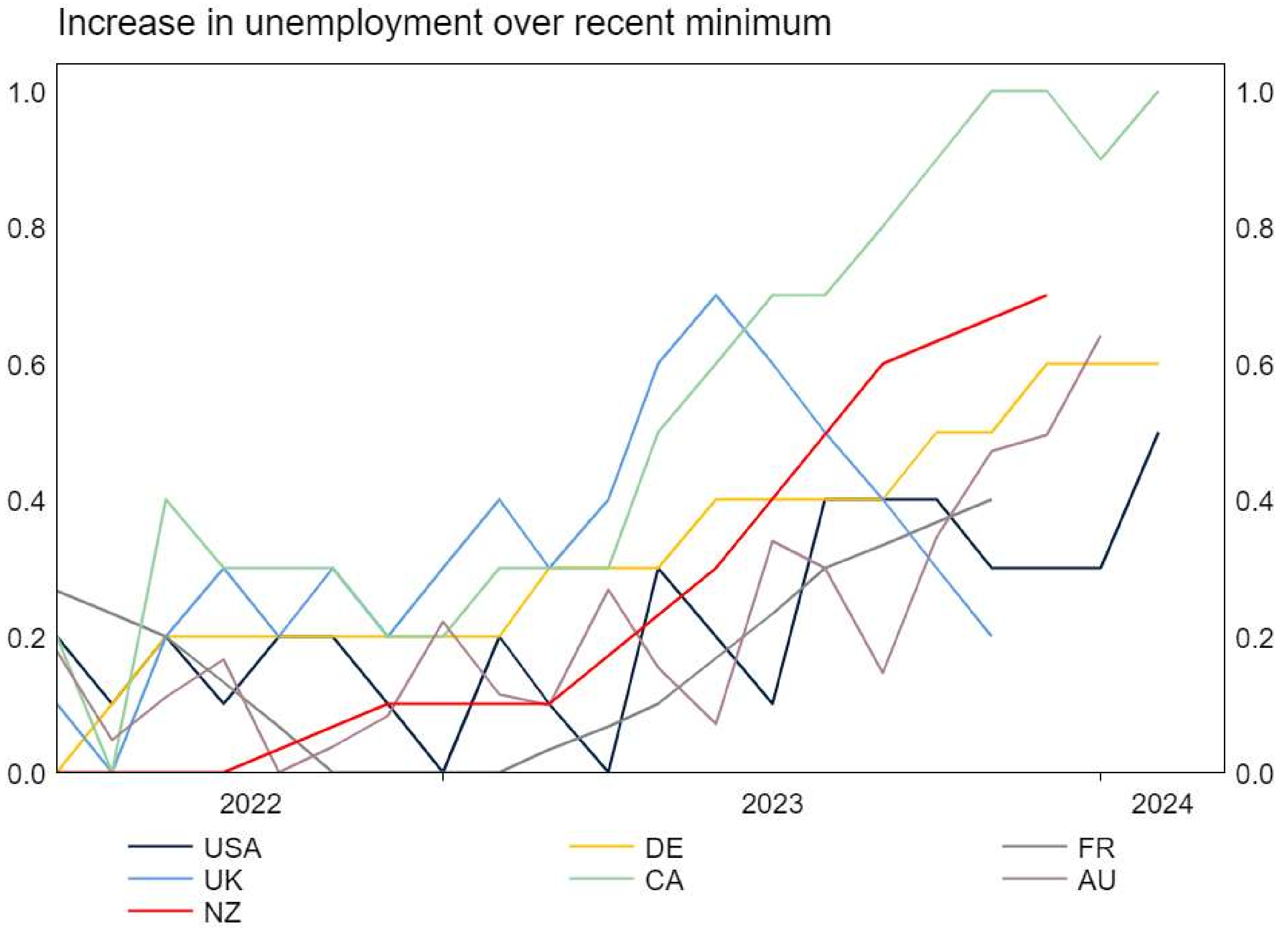
There also seems to have been a turnaround in the global manufacturing cycle, including in the US. Historically, this has coincided with stronger economic growth overall and an improvement in corporate earnings growth. Even if this is driven by the global inventory cycle, it will support overall growth. The JP Morgan Global PMI is back above 50 (which signifies expansion) for the first time since mid-2022.



Source: LSEG Datastream, Drummond Capital Partners

Buckle Up

While most of the above sounds positive, there are a number of obvious key risks to the outlook. There is still a reasonable risk of a recession. The lags between the monetary cycle and economic activity are long. Just because there hasn't been an obvious macro impact from higher interest rates in the US yet doesn't mean there won't be one eventually. Households globally have also drawn down pandemic stimulus savings, which could see retail spending soften from here. Potential weakness in labour markets is key to monitor here. Unemployment rates globally have been creeping up and the risk is that this accelerates.



Source: LSEG Datastream, Drummond Capital Partners

Otherwise, if a recession is avoided, we think interest rate cuts this year and continued high (or higher) US Government spending are a recipe for renewed inflation pressure in late 2024, or early 2025. This would see rate cuts priced out and rate hikes potentially re-entering the equation. In our view, this would see long term interest rates begin to rise again, likely triggering valuation concerns around expensive technology companies.

Ultimately, managing the portfolios in the year ahead will be about weighing these risks and adding or decreasing equity, credit and bond exposure as they rise and fall. As such, after a year of rather few changes in the portfolio, we think this year could feature a good deal more activity.

Portfolio Positioning

We recently reduced infrastructure exposure in favour of global small cap equities and Australian equities. We were overweight infrastructure in large part because of the heightened risk of a recession induced equity market correction – infrastructure is more defensive than the broader equity universe. However, we think it is also more interest rate sensitive and less likely to outperform in a positive economic environment than small caps and Australian equities. Small caps tend to perform well when economic growth is strong. They are also much cheaper than the S&P500 or Nasdaq indices.

Source: LSEG Datastream, Drummond Capital Partners

While valuations mean little from a tactical perspective, global equity returns have been extremely concentrated in a small number of expensive technology companies. While these companies are expensive for a good reason – tailwinds from AI and a very solid track record of delivering superior earnings growth – we are conscious that having too much portfolio exposure in mega cap technology companies is a risk should these companies not meet lofty market expectations. From our perspective, the change helps bring more balance to portfolio exposure. Tech could continue to dominate equity markets, in which case the portfolio will do well because we still have substantial exposure. Alternatively, the small caps can outperform if markets price a positive economic growth cycle driven by rate cuts.