INTUITION

9 FEBRUARY 2024

An ongoing tug of war

We have made the comment before that Americans believe themselves to be at the centre of the universe. Unfortunately, when it comes to global finance, they are right. US markets set the tone for the day-to-day movement of most other global markets – equities, bonds and currencies. Events there are important. At present, markets are caught in a giant tug-of-war. Good news is bad news and vice versa. On the one hand, data is pointing to a strong economy and labour market – the good news. But that implies less need for interest rate cuts – the bad news. On top of that, US companies are reporting results, which is only adding to the daily volatility.

Michael Porter

Given the importance of the US to the global economy, we keep a close eye on what is happening on the other side of the Atlantic. After the most aggressive period of monetary tightening in living memory, we, like many others, expected the US economy to start slowing. So far, that has not been the case. In fact, growth over the past two quarters has been some of the strongest in years – 4.9% for Q3 and 3.3% for Q4 - if we ignore the noise around the Covid Pandemic. That is rather impressive.

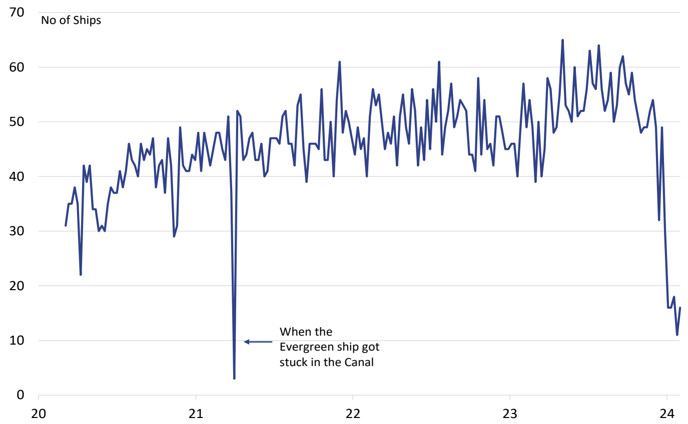
It is therefore hardly surprising that the labour market remains strong. In January, the US economy added 353,000 new jobs, almost double the number forecast, and the highest number of jobs in a single month since January 2023 – hardly a sign of the US economy slipping into recession. Other data released pointed to a rise in the average hourly wage – not good news for inflation – but an equally sharp drop in the numbers of hours worked. The blame for these unusual movements has been laid squarely at the feet of bad weather – which forced workers to stay home and therefore work fewer hours. Yet they received the same salary. The result is that net income across the economy didn't change much.

The other key variable is inflation, which continues to trend lower, albeit at a slower pace. Headline inflation has been below 4% for eight months in a row, suggesting that the fight against inflation is definitely being won. However, core and services inflation remain stubbornly high at 3.9% and 5.3% respectively. These are far higher than the 2% level targeted by the Federal Reserve. To complicate things, one of the reasons for lower headline inflation has been a decline in manufactured goods, now that all the disruptions from the Pandemic are well and truly behind us. But no sooner has the Pandemic faded than a new threat has reared its head. Attacks on western shipping in the Red Sea by Houthi rebels are pushing freight rates higher again. The cost of shipping a container from China to the Netherlands through the Suez Canal has risen from $1,500 per container to almost $6,000. Furthermore, the number of ships actually willing to take that risk is plummeting. Normally between 50 and 60 container ships pass through the Suez Canal each week. Last week just 16 did. Ships are now coming around Africa, which is longer and therefore costing more. This was before the ramp up in hostilities from the US against Iran and Syrian targets, so we can expect the number to drop further. Taken together, it means we should temper our expectations on inflation in the near term.

SPEED READ

- **The US economy is performing well. Growth is strong, and consequently, so is the labour market. The unemployment rate continues to hover near all-time lows.**
- **A stronger economy implies less need for interest rate cuts, especially if inflation is persistent.**
- **The outlook for inflation has been clouded by issues in the Red Sea.**
- **Expectations around interest rates are changing almost daily. That has implications for all markets, not least the Rand.**
- **And all the while, US markets push higher, and higher….**

CONTAINER VESSELS THROUGH SUEZ CANAL



Attacks on western shipping in the Red Sea are forcing shipping companies to divert ships around Africa. This is once again causing disruptions to global supply chains.

By implication, that means we should be tempering our expectations around interest rates as well. In November and December, blood was pumping through the veins of markets. Some of it clearly went to investors' heads. Markets were expecting the first US rate cut to be in March, with a steady decline every month thereafter. That timing has now been pushed out to May, and we think that it might even be as late as June or July.

Why is this important? For two reasons. Firstly, the first place where expectations around interest rates manifest themselves is in the US Dollar. Having weakened towards the end of last year, the Dollar has staged a comeback. Since the end of December, the Dollar has strengthened by 4% against other major currencies. That is a sizeable move in just 6 weeks. The flipside is that both emerging market currencies and commodities tend to come under pressure when the Dollar is strong. So naturally, the Rand has weakened, which will keep our inflation rate and interest rates higher for longer.

> "There is a lot of hype in markets at present – whether it be around AI, computer chips, or weight-loss drugs... we would also urge caution about getting too carried away. "

Secondly, interest rates are a key variable in equity markets. The rally over November and December last year was fueled by the expectation of falling interest rates. That looks to be delayed. Yet the rally has continued. Markets have conveniently switched their focus to stronger growth. According to data compiled by Bloomberg, 46% of companies in the S&P 500 Index have reported results so far, and of those, 78% have beaten earnings expectations. That doesn't sound too bad! Yet that masks the uncomfortable fact that the only reason why expectations have been beaten is because they have been consistently revised lower and lower. Consequently, the PE ratio for the S&P 500 Index continues to climb higher – the ratio is now close to 24x, the highest it's been since 2002 if we ignore the distortions caused by the GFC and Pandemic.

S&P 500 PE RATIO

Valuations on US stocks have risen to their highest in decades, driven by the surging tech sector.

In conclusion, there is a lot of hype in markets at present – whether it be around AI, computer chips, or weight-loss drugs. Whilst we would agree that these are secular trends that will unfold over years, we would also urge caution about getting too carried away. The risks of a US recession are still present, especially as more debt converts to floating rates, yet valuations are stretched! Furthermore, there is risk that interest rates take longer to fall than what the market is expecting. Together, there is plenty of room for volatility in markets. We have been surprised at the extent of the rally in markets over the past three months. On balance, we believe that a cautious approach to investing cash is prudent. The market will give us better opportunities if we are patient.

Our next Insight seminar will be held in March, and will focus on why our investment philosophy places so much importance on income.

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Topic:	Why the Obsession with Income
Natal Midlands	
Date:	14 March 2024
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	12 March 2024
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	N/a
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za