Investment Views

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Gains & Losses in the Labour Market

Shifts in the US labour market continue to be a key theme of interest. The notable divergence between company layoffs and actual economic data suggests an impressive rate of job growth and not an economy heading for recession.

Headlines have been dominated by news of job cuts in large Technology and Communication Services companies, which are sizeable constituents in the S&P 500 index. A common thread running through these companies is that they were beneficiaries of the pandemic and increased headcount over the past three years.

Shopify, an e-commerce platform, provided one of the most candid explanations for redundancies. In a memo to staff last summer, the CEO explained: “when the Covid pandemic set in… demand… skyrocketed. To help merchants, we threw away our roadmaps and shipped everything that could possibly be helpful. We bet that… the share of dollars that travel through ecommerce… would permanently leap ahead by 5 or even 10 years. It’s now clear that bet didn’t pay off… (and)… now, we have to adjust.”

In a similar vein, last year Uber’s CEO told staff: “after earnings, I spent several days meeting investors… it’s clear that the market is experiencing a seismic shift and we need to react accordingly.”

So far, the story is fairly uncontroversial. Some sectors experienced a pickup in demand, then extrapolated trends too far and when demand fell and the cost of capital rose, companies reduced spending and headcount. The natural rise and fall of a typical business cycle. But we are in anything but a typical business cycle now and this is where it gets interesting.

The Information (Technology) sector accounts for around 2% of total employment in the US while the Information Processing Equipment and Software sectors account for around 18% of investment and 6% of the total economy. The composition of the S&P 500, however, is very different.

The January employment report in the US showed payrolls grew significantly by 517,000. Gains were broad based across manufacturing, retail and professional & business services. Leisure and hospitality, which was badly hit by the pandemic, made a comeback and accounted for 25% of the additions. So, although job cuts were being made in the Technology sector, much larger parts of the economy were hiring.

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With 11 million job openings still advertised in the US, the moving parts of the labour market are proving to be a challenge for economic forecasters and for the Federal Reserve. Previous Treasury Secretary Larry Summer recently said that “it’s as difficult an economy to read as I can remember”. Weakness in the Technology sector allows other industries to hire talented employees to help drive efficiencies, and in the long run this reallocation of resources is a positive.

The strength of recent data suggests that the US is further from recession than many believed coming into the year. The US economy has weathered the inflation and interest rate shocks of 2022 incredibly well and this has supported the strong start to the year for financial markets. However, this does not provide an all clear for risk assets as it increases the probability of more interest rate hikes to fight inflation.

Liquidity Floods the Market

2023 started strongly and risk is firmly 'on' across all asset classes. This broad rally across credit and rates markets since the end of October 2022 has been dramatic. Double digit, positive returns in emerging market debt and long dated corporate bonds have recovered approximately half of the losses experienced last year.

The key driver is rapidly falling inflation together with China re-opening, expanding central bank liquidity and much improved European energy and growth dynamics. In addition, the messaging from Jerome Powell has been dovish. Monetary policy operates with lags and time is needed in order to judge whether the increases made throughout 2022 are achieving the intended outcome before raising rates further. This fuelled risk assets to rally and without any major pushback from central bankers so far, the market isn't hesitating to add risk for fear of missing out.

Total returns from fixed income in January were a combination of tighter credit spreads (average high yield spreads have narrowed by 50bps) and global government bond yields falling (prices rose). The US Treasury 10-year yield fell from 3.88% to 3.51%, with the two-year falling from 4.42% to 4.21%. Germany's 10-year yield declined from 2.57% to 2.29% and the UK 10-year yield fell from 3.67% to 3.34% with larger yield declines in Australian and Italian bond markets.

January was a quiet month for central bank decisions, but the tone was set by the Bank of Canada. They hiked rates by 25bps to 4.5%, but signalled a pause in tightening, while the Bank of Japan made no further adjustments to its yield curve control policy, despite a sharp rise in core inflation. The US Federal Reserve increased its base rate by 25bps in February with more aggressive moves by the Bank of England and European Central Bank (ECB) fully priced into short term Fixed Income markets.

In the US and the Eurozone, headline inflation rates continued to ease, driven by retreating energy prices and base effects. While there was a modest uptick in month-on-month US core inflation, the general disinflationary trend is clear for now. In contrast, core inflation in the Eurozone has remained stickier and is likely to prompt a further hawkish response from the ECB relative to their US counterparts.

Looking to our leading indicators, we are seeing some signs that inflation pressures could re-accelerate in the US. Used car prices resumed their rise and the housing market showed signs of life, boosted by the 100bps decline in mortgage rates since October. The price of Spot Lumber (a key material in homes) has risen by 40% during January alone. With US financial conditions having eased substantially, there is a growing risk that central bankers may have declared victory too early. Within our US Dollar bond funds, we are continuing to build positions in inflation protection as a hedge.

3.51%

The figure that the US Treasury 10-year yield fell to from 3.88%.

4.5%

The figure that the Bank of Canada hiked rates by 25bps.

In currency markets, the US dollar was weaker against most other developed market currencies

In currency markets, the US dollar was weaker against most other developed market currencies. The Australian dollar was the top performer among G10 currencies, following much stronger inflation data and further support emanating from optimism around China's re-opening. There was also broad-based strength across emerging market currencies, given optimism that US interest rates would soon peak. Global credit markets outperformed government bonds across both high yield and investment grade markets as investors dialled back some of their worst recessionary fears and investors locked into the best yields in over a decade, especially in Europe.

With global economic growth stabilising and inflation rapidly slowing in the US, a goldilocks scenario is currently playing out as central banks have the potential to pause and reflect. However, we remain cautious and defensive. Aside from the risks that the situation in Ukraine deteriorates and US inflation stabilises uncomfortably above the Federal Reserve's 2% target, there is a potential liquidity risk.

Recent risk sentiment has been boosted by over US$1trn in temporary central bank balance sheet expansion (quantitative easing) since October last year, with the Bank of Japan and the Peoples Bank of China offsetting the tightening from the ECB and the Federal Reserve. In addition, the debt ceiling in the US has prompted the US Treasury to drain funds from their general account - effectively adding additional US dollar liquidity to markets. Combined, these increases in liquidity have been significant and have likely helped fuel risk appetite over the past few months. The bad news is that once a new debt ceiling is (hopefully) agreed, liquidity will be drained rapidly out of the system, which could be a headwind for risk assets in the months ahead.

Equities power ahead

The market recovery continued in January with the MSCI World returning 7.1% in US dollar terms. This follows a rebound in the fourth quarter, with equity markets up 18% since last year's October lows. More speculative areas of the market, which suffered heavy losses last year, outperformed. The substantial recent gains in areas of the market that were particularly impacted in 2022 illustrate this point. In January alone, the ARK Innovation ETF returned 28%, Bitcoin was up 39%, AMC Entertainment 32%, and the De-SPAC Index 20%. Investors appear to be shrugging off the rapid rise in interest rates and are anticipating rate cuts, which are priced in to take place during the second half of 2023.

Cyclicals outperformed defensives in January, with Consumer Discretionary and Communication Services returning 14.6% and

7.1%

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11.8% respectively. Healthcare and Utilities lagged, returning -0.6% and 0.3% respectively. Growth outperformed Value, with the MSCI World Growth index delivering a 9.7% gain vs 4.7% for the Value index. This reverses the trend seen last year where Value outperformed Growth by 23.2%, but continues the long-term trend over the past decade of Growth outperforming Value. On a regional basis, Europe outperformed the US by 2.8%, supported by lower valuations and strength from the luxury goods sector as China reopens. Emerging markets also performed strongly, returning 7.9% in January.

The fourth quarter earnings season is now well underway and so far, results have been mixed with aggregated estimates being downgraded. Despite this, stocks have had positive reactions to revenue and earnings misses. The average share price movement on a top and bottom-line miss in January was 1.7% versus a five-year historical average of -1.5%. A possible explanation to this atypical share price movement is that market estimates and sentiment had already moderated relative to sell side numbers. A good example is UPS which missed on revenue with a slight beat on earnings and guided investors to a volatile, backend loaded 2023. However, the stock price closed up 4.7% on the day results were announced.

In terms of stocks, Technology bell weather, Microsoft, announced a slowdown in its Cloud business, Azure, with guidance weaker than consensus expectations. The real battle however is in Artificial Intelligence (AI), with Microsoft benefitting from first mover advantage over Google.

AMD guided down its datacentres business by double digits quarter-over-quarter and flagged a weaker PC market. However, it was more resilient relative to Intel, resulting in the stock rallying 12.6% on the day. Procter & Gamble, the first global consumer staples company to report earnings, announced weaker than expected volumes with the roll-over in commodity prices taking longer to materialise in their cost base.

On the positive side, Mondelez exceeded estimates with strong organic growth, which was 4.4% above consensus expectations. Although positive, this was mostly driven by increases in prices rather than volume/mix. Mastercard reported resilient consumer spending with 2023 guidance modestly ahead of consensus. Cross-border transactions were strong with travel up 59% versus a year ago and at 126% of 2019 levels. Chevron authorised a new $75bn share repurchase program reflecting a strong year and the company's commitment to return cash to shareholders.

Overall, we are positioned slightly underweight to neutral in equities, and within our equity allocation we are positioned defensively, being overweight Healthcare and Consumer Staples and underweight Consumer Discretionary. With US equity valuations having again nudged back above the long-run average of 18.8x, our conservative stance feels appropriate given that the market is priced for a favourable mix of resilient growth and falling inflation, which is far from assured.

4.4%

The amount Mondelez exceeded estimates above expectations.

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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	CASH (MODEST UNDERWEIGHT) EQUITIES (MODEST UNDERWEIGHT)	FIXED INCOME (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT HIGH YIELD DEBT
Equities Regional		EMERGING MARKETS
Equities Sector	CONSUMER DISCRETIONARY + UTILITIES	CONSUMER STAPLES HEALTHCARE

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