Equity Insight

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# Monthly Equity Market Topics

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## In brief

- Will the UK budget unlock the equity market?
- Consumers are keeping both hands on the wheel of the economy.
- From the cheap seats, what's up with gold?

## What does the UK budget mean for investors?

From my desk in London, it would be negligent to overlook the United Kingdom's first Labour budget in nearly a decade and a half. This budget signals a discernible relaxation of fiscal constraints despite a rise in taxation — predominantly due to enhanced employer contributions to National Insurance aimed at underpinning the elevated expenditures. In the short term, this spending may well stimulate growth, albeit with the risk of exerting upward pressure on both inflation and gilt yields.

The initial response from the markets was one of restraint, indicative of the Chancellor of the Exchequer's pre-budget news flow. But the gilt markets adopted a more adverse stance upon the release of a report by the Office for Budget Responsibility the subsequent day, which detailed the magnitude of prospective borrowing. The price action does not rival the Liz Truss episode two years ago, when gilt years skyrocketed; however, rising borrowing costs and a weaker pound have left investors grappling with the prospect of a structurally elevated interest rate environment.

Regarding equities, we believe the consensus suggests resilience in the face of increased taxation and interest rates. Nevertheless, the long-term prognosis for growth hinges on whether the additional capital expenditure can surmount sizable challenges such as flagging productivity, deficient transport infrastructure as well as the challenges posed by climate change, defense and technological advancement. While the uptick in investment marks progress, it doesn't meet the mantra of Chancellor Rachel Reeves' call to "invest, invest, invest." The strategy bears a closer resemblance to a conventional tax-and-spend approach as the bulk of new borrowing is allocated to current spending.

For the government to gain the fiscal latitude necessary to drive heightened investment, we feel it must cultivate an environment that will foster private sector investment. Such an approach is integral to breaking free of the low-growth trajectory so as to drive UK equity markets.

## It's about the consumer

A benign macro picture remains supportive of risk assets. Inflation continues to moderate, and while it may not get to the desired 2% soon it's close enough for companies to deal with. Cash rates are falling as central banks look to move their policy rates closer to what they consider neutral from their current restrictive settings. GDP numbers remain strong, with France and Germany both surprising to the upside, but we remain cautious on those two economies. China is also facing headwinds, with a lot riding on the muted fiscal package it is set to release. Employment and wages remain robust, though the volatility in US nonfarm payroll due to revisions, strikes and hurricanes makes it difficult to get a clear picture. Judging by tight credit spreads, some fixed income investors don't appear to have many concerns over corporate cash flows or profitability.

This brings us to the consumer, who is keeping this train on the track. When looking at PMIs, manufacturing and construction are struggling, and while the goods economy is sluggish, it's the robust service economy that continues to drive growth. This was again highlighted in the recent US GDP numbers, which were driven by services and government. Real wages and low unemployment levels continue to support consumption. Middle- and high-income cohorts, which are the major drivers of consumption, remain strong. However, there are signs that lower-income and younger consumers are stressed. Even so, they should be among the biggest beneficiary of falling interest rates.

Continued growth may trigger a new bout of inflationary pressure. Mitigating this risk is continued subdued demand for oil, though the risk of Middle Eastern supply disruptions can't be ruled out. The United States produces more energy than it needs, and OPEC is extending production cuts to keep prices elevated. On the unemployment front, falling job openings are causing the unemployment rate to tick up more than major layoffs. But falling job openings do not rhyme with inflationary pressure.

All this paints a favorable picture for risk assets such as equities. Further supporting the health of the equity market are the continuing signs of breadth in earnings returning to the market as reporting season unfolds. That's not to say we're in an early-cycle risk-on world. Since QE, zero rates and COVID, we've been stuck in this peak-to-late cycle market dynamic that lacks the creative destruction of a typical business cycle. While increased breadth offers more opportunity for investors beyond AI and the Magnificent Seven to outperform, it's still about identifying good businesses with structural tailwinds. Given the elevated levels of the S&P 500 PE multiple, it's our belief that investors should be focused on earnings rather than multiples to drive share prices.

## All that glitters

Gold has been making headlines after a 33% runup year to date. Traditionally it's seen as a hedge against inflation, currency devaluation and a falling USD or as a safe haven in uncertain times. It's perhaps the ultimate hedge. So why is it rallying and what to do now?

There may be several reasons behind gold's recent strong performance. After many years of not doing much — and frankly not working as a hedge — gold has been underowned by institutional investors, though that seems to be changing, partly due to momentum but also for other reasons, such as those outlined below.

- Central banks have been buying gold to diversify their assets away from the USD, particularly BRICS central banks, which are actively looking to break the dollar's hegemony and feel vulnerable holding greenbacks after Russia's dollar reserves were seized following the invasion of Ukraine.
- There's been a debasement of fiat currencies, and government fiscal policies are profligate.
- There exist geopolitical concerns ranging from trade tensions to hot wars.
- China's property crisis and economic slowdown, as well as a clampdown on cross- border flows, has seen demand from the Asia region rise steadily.
- India has traditionally been a buyer of gold because of its cultural significance. As the Indian economy has flourished in recent years, the demand for the precious metal has risen.
- Gold has momentum as the price continues to rise, drawing in more investors.

However, according to the World Gold Council (WGC), central banks have slowed their purchases by some 49%, the lowest level in two years. The rising price has also slowed demand for jewelry, which the WGC says accounts for 40% of global demand. Jewelry demand fell 7% in the third quarter.

There are three key variables that need to be understood in valuing any investment: cash flow, growth and risk. Gold is particularly difficult to value as it doesn't have a cash flow, so investors need to focus on growth in demand to push the price up and factor in the risks to that growth. Models have been built to try to price gold. These are often linked to macro variables like real yields (with which gold has traditionally been highly correlated), but in recent years few of these have been helpful.

Retreating central banks and slowing jewelry demand may hinder momentum, and we could see a near-term air pocket. That said, the momentum is still with gold, and this augurs steady demand for the metal as a hedge in portfolios.

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