



VIEW FROM THE SQUARE

June 2024

Interest rates may Trump politics

There is no doubt we are going through a major period of political turmoil. We are now embroiled in the run up to the UK General Election with political noise at elevated levels, the potential huge swing from Conservative to Labour is extraordinary. The situation is just as noisy in the US with an ex-president now a convicted felon; and the incumbent President driving national debt to unheard of levels. In India Narendra Modi now looks less than all powerful, and the same is true of the African National Party. Israel also looks less stable with Benjamin Netanyahu walking a tightrope of political pressures.

And yet. The European Central Bank has just pre-empted the Bank of England as the second global player to cut interest rates on 6th June (Canada being the first the day before). The International Monetary Fund meanwhile believes the UK has the potential to cut interest rates five times before December 2025. The US would like to be involved in this as well but is constrained by Joe Biden's push for revitalising US infrastructure, taking US national debt to the dangerous level of 140% of Gross National Product. The global drive to increase short term interest rates has chilled economic growth in an effort to dampen inflationary pressures. This now leads to policy makers shifting their stance as high levels of national debt are incurring huge interest demands.

We are therefore at an interesting stage where the nightly news programmes focus on unsettling issues, all at a time when economic relief might be at hand. The UK equity market has suffered at a time when the lure of fast-growing US technology companies has triggered huge outflows from the London Stock Exchange. Many sectors have been affected, but the reduction in stock ratings has been most pronounced in the small company sector. While all portfolios need balance there is a widening gap between what the retail market will pay for shares in this sector and the value corporate investors perceive. For example, we have seen a number of takeover bids in the specialist and sometimes volatile AIM market. The bellwether event, however, has been the bid for Anglo American by BHP, a mega project suggesting exceptional value, for such a major company to break cover with such a bold move. Unsuccessful as it was, it highlights how low valuations offer opportunity and simplicity over starting from scratch.

So, what does that mean for portfolio positioning? History suggests that early interest rate cuts stimulate stock markets, and we are keen that our clients benefit from this trend. However national debt levels and the spending of nearly all Covid savings suggest that one eye must be kept on a revival in inflation. Passive investments are susceptible to large price swings when uncertainty grows, particularly in the US where the concentration of indices is historically high due to the recent growth of the “magnificent 7” stocks. With the market cap of these seven stocks now greater than the market cap of the Japanese, Canadian and UK indices combined, the concentration of the MSCI World index is more noticeable than ever.

These stocks have premium valuations that leave little margin for error on future earnings. While there is a good chance they can continue to perform well, the differential between the other US stocks in the S&P as well as global stocks is large. The latter are more cheaply valued and have a good opportunity to outperform. It is a testament to the funds that have delivered similar returns while not owning any of these seven stocks and it is why we believe that this is clearly a time for active management, not just to invest in an equal weighted Exchange Traded Fund.

A balance between portfolio growth and preservation is key for our clients and we will do our best to help you benefit from any declines in interest rates while keeping a close eye on inflation.

William Forsyth
Executive Chairman & CIO
11 June 2024

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