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'Will October's Pivot Shape 2024? '

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2023 was a different year than most investors expected. A year ago, financial markets were priced for a recession, which didn't arrive, at least not in the US. Meanwhile, China's widely expected post-COVID recovery stalled out. Investors began 2023 fearing inflation and the consequences of higher for longer interest rates. While the demise of SVB and the life support given to other regional banks seemed to justify their fears, the vital signs of US economic health persisted, and policy rates continued to rise until August.

But a few weeks later, following some Federal Reserve smoke signals, investors began believing rates had peaked. Bond yields tumbled, risk assets rose as short positions were closed, and the bond rush subsided. Financial conditions and liquidity eased, the dollar weakened, and investors rolled out the red carpet to greet the improbable soft landing. The "immaculate disinflation" is now investors' base case scenario. But as we enter 2024 and financial markets are priced for multiple rate cuts, critical investor questions remain unanswered: has the recession already happened or just been delayed? And can we return to economic growth without reigniting inflation?

In the coming year, 40% of the world's population will vote in national elections, including both its wealthiest and most populous nations (the US and India). The results are already as good as known for some, such as Russia's presidential election in March. Others are likely to be more geopolitically consequential, for example, Taiwan this month and Korea in April. However, it is unlikely that many will match Argentina's recent poll for outright radical uncertainty, as few countries can match its structural economic problems.

By contrast, the UK's election, likely in May or October, will be of little consequence for global investors, most of whom wrote off the UK as a home for proactive investment long ago. Having won last year's Most Improved Player Award for Political Stability, this year, a smooth UK political transition could be all that is required for both direct and portfolio investors to tie a bow on the UK as a place to increase their position sizes.

However, in stock market terms last year, the UK remained a laggard by global standards. The S&P 500 was pipped by Tokyo's Nikkei 225 (+28% to +25%) in the major country indices stakes. But, the real story of the year was the continued power of US Big Tech, with the NASDAQ 100 up over 50%. Within it, the newly crowned Magnificent Seven AI wonder stocks (the FAANGS minus Netflix, plus Nvidia, Microsoft and Tesla) were ahead by more than 100%, ending the year, accounting for nearly 30% of the market cap of the S&P 500 and 19% of the 12,500 stocks from 23 countries comprising the MSCI Developed World All Share Index. As a result, just seven stocks now account for almost $12tn of market value (more than six times the size of the FTSE100), a degree of market concentration greater than the Dotcom Boom of 25 years ago and the Nifty Fifty of 50 years ago. When these previous periods of excessive market concentration unwound, the result was the multiyear outperformance of smaller companies and the value style. The early signs suggest that 2024 might follow such a pattern.

While the big equity story of 2023 was the Magnificent Seven, equity market performance in Q4 was altogether different. As sentiment changed towards the future path of interest rates, liquidity-starved smaller companies reawakened. The NASDAQ 100 gained an impressive 14% in the final quarter, but the Russell 2000 rose by 22% from its early October low. Is the long-awaited divergence of return starting to take shape?

The UK's AIM 100 index ended the year down a disappointing 8% but also rallied from its post-COVID low in October by 8%. The more value-laden FTSE Smaller Companies Index, broadly unchanged over 2023, rose by 13% from its October low point. These moves have yet to constitute a new trend. But they offer signs of hope that normalised rates will establish a divergence of equity returns that reward active stock picking over trend following and indexation. A trend, if established, that could significantly re-rate the UK mid-market.

As we enter a year of elections, the issue of fiscal dominance and bond yields remain essential drivers of financial market performance. 2023 ended with US and UK 10-year yields broadly unchanged. However, this masked a roller coaster ride. Capital poured into sovereign debt during the year, offering the prospect of a real return for the first time in many years and crowding out investment for other assets. US 10-year Treasury yields hit 5% in October, while the CPI for November was just 3.1%. (The respective figures for 2022 were a 3% Treasury yield and 9% inflation). The lesson from 2023 is that bond markets influence equity valuations, but quality equities can adapt and survive.

Although Argentina's recurring default cycle reminds us that governments can fail, developed world sovereigns extend borrowing beyond normally permissible levels by imposing financial repression, creating inflation, or both. With inflation falling in most Western countries, the risk of repressive measures on capital increases, assuming projections for sovereign debt and growth remain unchanged. Unsurprisingly, since the financial pivot in October 2023, alternative stores of value, outside money or assets that are not someone else's liability, have rallied. Gold is up 14%, and Bitcoin is up 50% from mid-October as investors discount the prospect of more repressive fiscal regimes.

Argentina's newly elected President Javier Milei faces a more extreme version of fiscal overreach than most nations and has set about adopting radical measures to restore monetary discipline. To a lesser degree, this year's newly elected governments all face similar policy choices. While quality equities can sustain any bond market environment, liquidity constraints and crowding-out effects remain valuation risks. Despite this, the core narrative for 2024 is of normalised interest rates and more widely dispersed returns favouring smaller companies and the value style.

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JACKSON'S CHART - AIM ALL SHARE - (MONTHLY)

An analysis by Jackson Wray

Source: TradingView.com

EXPLANATION

The UK AIM market was notable among equity indices in 2023 by revisiting its post-COVID low. It has also proven to be a fertile hunting ground during the year for PE and trade acquirers when global M&A activity is at a relative low. Below, Jackson revisits the AIM All Share chart from a technical perspective.

In issue 8 of the Curious Investor, we highlighted the importance of the 660-675 region, having held as support on six occasions since it flipped from resistance in 2009. In the following weeks, the index continued lowering and tapped the 675 again, at which point a bullish reversal was evident. Price moved up strongly towards the next area of interest, to which price is now experiencing a slowdown in momentum. The grey trend-line, first formed in 2012, must be broken before any material continuation can be expected. From the highs, the downward trend remains intact, with the 870 level being the crucial "higher low" level to focus on. If momentum can be sustained through the current resistance, the AXX can form a new upward trend (if 870 is broken) and confirm the current double-bottom formation, which is now pending. For now, the 675 level has once again reconfirmed its importance.

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FURTHER READING & LISTENING

- January 2024 Newsletter: Fiscal and Monetary Divergence
- Expect Lower Oil Prices in The New Era Of Abundant Supply
- Why Deutsche Bank reckons the UK economy will avoid a recession in 2024
- A Goldilocks recovery does not mean a return to economic vibrancy
- Central banks rethink forecasting after failures on inflation
- A Christmas Bonus for the UK's Struggling Retailers
- The optimistic case for the British economy
- An 'Outrageous' Prediction That American Capitalism Is Ending

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