RAYMOND JAMES

Flying High

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"Oh, I have slipped the surly bonds of earth, and danced the skies on laughter-silvered wings" – William Shakespeare

Is this the best start to any year for stock markets around the world? It certainly feels like it. Equity benchmarks from Australia, Japan, India, Europe to the United States have exploded to new all-time high levels over February. The UK stock market hasn't quite followed suit, but helped by some good results over the corporate reporting season it too has come within striking distance of highs achieved in February last year. Investor sentiment is buoyant even as the sovereign bond markets across developed economies have continued to "give back" some of the rally witnessed into the end of 2023 as markets have caught heed of central bankers' insistence that the battle against inflation has yet to be won decisively enough to start cutting interest rates. The fact that stock markets have performed so strongly, even as two G-10 economies, the UK and Japan, have slipped into mild contraction while the European economy is moribund, has prompted observers to wonder whether we might be witnessing the inflation of another bubble similar to the "dot. com" experience at the turn of the century.

There are similarities with the internet frenzy of 1999 / 2000, most obviously ongoing investor enthusiasm for anything related to the roll-out of artificial intelligence. This has resulted in a pronounced lack of breadth with the technology sector, particularly in the United States and Europe very much in the vanguard. But there are differences too. Back then stock market valuations were sky high, in large part the consequence of a mania for anything associated with the internet irrespective of the fact that many businesses were both unprofitable and haemorrhaging cash. In contrast, valuation measures, although elevated, are not so stretched now as the companies in question are not just well established but highly profitable too. For those wondering how long prevailing conditions can last it should be remembered that valuation, whilst a good measure of potential future returns, has a very poor record of market timing.

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Whilst the soaraway performance of the US stock market has captured most of the headlines, arguably the most eye-catching development over February has been the strength in the Japanese stock market. In particular, that country's index benchmark has recaptured and exceeded levels last seen back in December 1989. In part this has to do with a generally positive corporate reporting season, aided in no small measure by a weakening currency. In consequence, revenues and profits earned overseas benefit when being translated back into yen. But that is not all. Japanese stocks have built on their best annual performance, over 2023, for more than a decade thanks to measures announced by the Tokyo Stock Exchange aimed at overhauling and reforming corporate profitability. Readers with long memories might recall a similar initiative, popularly described as "Abenomics" after the previous Prime Minister's attempt to breathe new life into stocks. Where today's initiative differs lies in the threat of index delisting for company's failing to comply. For a country as conservative and reactionary as Japan, the proposals are nothing short of revolutionary. Little wonder, now, that legendary investor Mr Warren Buffet's Berkshire Hathaway increased its stake in Japanese trading houses back in May last year.

There is, of course, an exception to every rule and in marked contrast to buoyancy elsewhere, the Chinese stock market has struggled, falling to levels last seen during the global financial crisis of 2008/09 the result of investor concerns regarding the health of the country's giant property sector and that of the world's second largest economy more generally. More pressingly, uncertainty has coalesced around Beijing's apparent insouciance. The country's central bank has cut its five-year interest rate and by a little more than expected, but has left shorter-dated rates, more important for both households and businesses, unchanged. Beyond that, regulations aimed at curbing speculation have been introduced and efforts have been made to goad sceptical investors back. While these adjustments have helped a bit, we have been here before and to no lasting effect. Barring a root and branch overhaul of the Chinese economy, thought highly unlikely, markets want a more full-blooded stimulus than that which has been forthcoming so far. Beyond the very short-term, confirmation that former US President, Mr Donald Trump remains the overwhelming favourite to secure the Republican Party's nomination ahead of November's presidential election raises the spectre of a return of the economy-negative trade wars that marked his first term of office were he to be re-elected. In consequence of all the above, investors have continued to avoid China, broadly diversified portfolios preferring to add to exposure both to the neighbouring markets of India, South Korea and Taiwan as well as perceived China proxies such as Japan and even Europe.

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That European stock markets might be viewed as an alternative destination for investment in China might, at first glance, strike readers as odd, particularly so given its lack of geographical proximity. Not lost on those asset allocators responsible for oversight of broadly diversified investment portfolios is the fact that Europe's aggregate stock market indices derive only around 33% of revenues from the continent, but 22% from North America and 25% from Asia, including China (the remainder relating to other emerging markets elsewhere). Thus, whilst the Euro Area economy continues to stagnate, its stock markets have benefited, in part, from a desire to maintain some exposure to China without having to dip a toe directly into its markets.

The big question now is, can this stock market strength last? Eventually something may happen to alter investor sentiment negatively. What that might be can only be known in hindsight, but more encouragingly, inflation is thought likely to fall further, although the path will probably not be smooth, allowing central banks scope to cut interest rates and in so doing allow households and businesses to plan for a more prosperous future. An economic revival should allow stock market leadership to broaden, prompting echoes not of the frenzied "dot.com" era but of the more sober buoyancy of the mid-1990s.

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