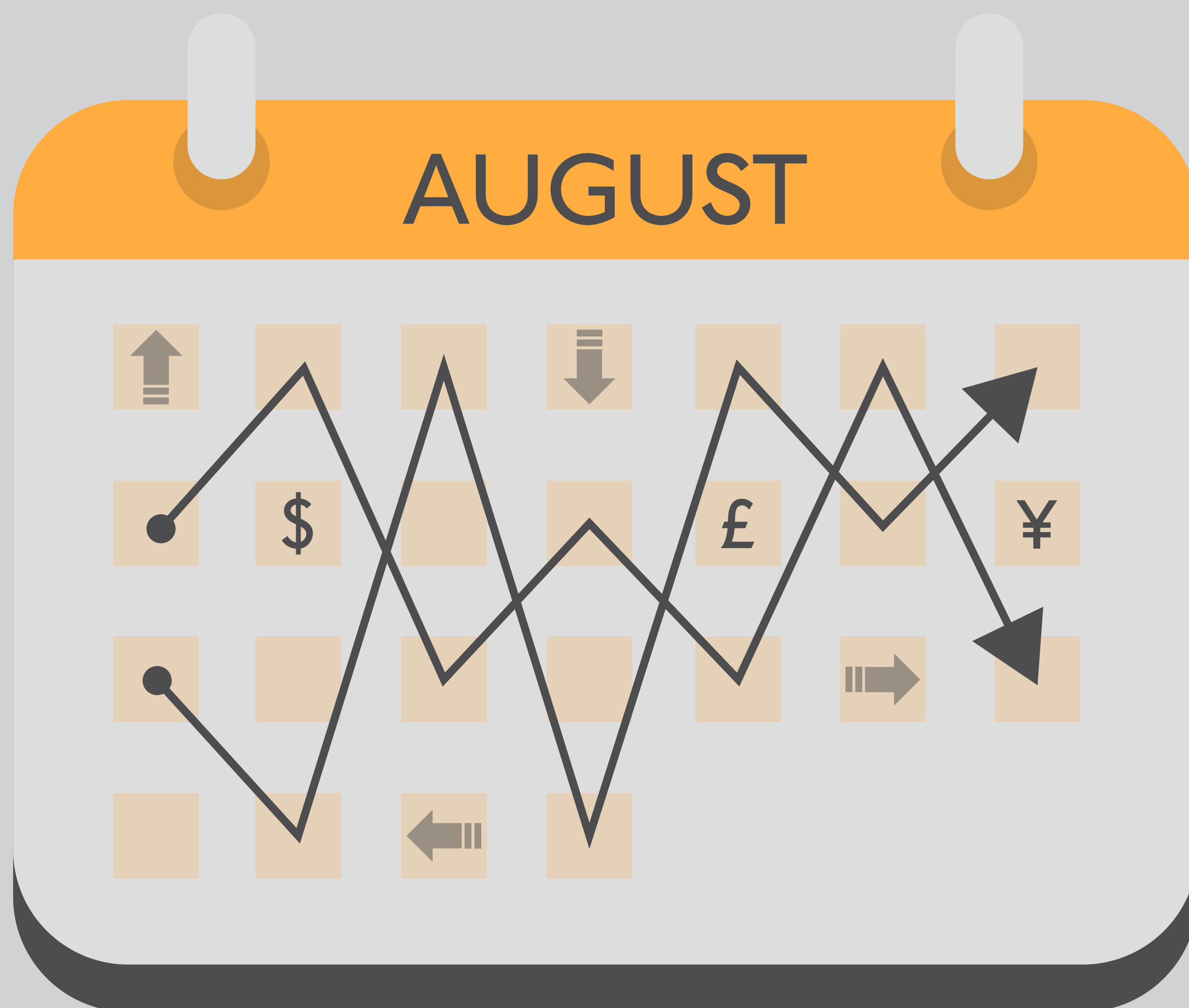
MARKET INSIGHT

Insight and analysis from Redmayne Bentley
straight to your inbox

Redmayne Bentley

ISSUE 35 - AUGUST 2024

Summertime Selloffs



IN THIS ISSUE

- Diageo
- Japanese Market Turmoil

SUMMERTIME SELLOFFS

ALASTAIR POWER | INVESTMENT RESEARCH MANAGER

IN THIS ISSUE

STOCK FOCUS
Diageo

READ THE ARTICLE

INSIGHT
Japanese Market Turmoil

READ THE ARTICLE

Summer months usually coincide with quieter periods for financial markets, however, that is not so this year with the return of short-term volatility in early August. Macroeconomic news was once again the culprit, as labour market data in the US stoked fears around a potential 'hard landing' as opposed to the 'soft landing' already priced in. The latter associated with slowing economic activity without leading to a recession, as opposed to the recession associated with the former. New job figures significantly lower than consensus forecast triggered concerns around cooling job demand and a potential weakening of economic activity. Having held interest rates steady in the 5.25% - 5.5% range at the July meeting, the US Federal Reserve teed up a September rate cut, but still managed to be criticised for being behind the curve. US and other major equity markets all moved lower given the concerns, while bonds rallied on hopes of further potential interest rate cuts.

While the US market headed lower, Japanese equities followed suit, falling 12.2% in local currency terms on August 5th. A surprise interest rate increase from the Bank of Japan contributed to the sell-off, with the associated Yen strengthening causing concern as markets repriced expectations for a number of interest rate cuts in the US. The Japanese market has been a strong performer this year in the run-up, reaching a peak 2024 return of 25% that is now a more moderated, but still a respectful, 10.4% as the market rallied sharply from the fall. Further detail can be found in the Insight article.

The UK's markets weren't immune to events, heading lower in early August on a broad sell-off for risk assets, before rallying. Elsewhere, the Bank of England's Monetary Policy Committee voted 5 to 4 in favour of reducing interest rates to 5%, with expectations of a falling rate of inflation feeding through to weaker pay and price setting dynamics. Following the meeting, July's inflation numbers showed a small increase in the rate of inflation to 2.2%, driven mostly by gas and electricity prices falling at a slower rate than last year. At a company level, positive reporting and trading statements have been coming through from the likes of Unilever and NatWest Group. Other household blue-chip names such as Diageo continue to struggle, however, which is the topic of discussion in our Stock Focus article.

What happens in the remainder of 2024 is open for debate. Geopolitical tensions and a US election will be focal points, along with key macroeconomic data point releases. A subsect of highly rated technology companies have captured attention in recent times, and if recent events tell us anything, it's that the market remains on edge, with potentially further short term periods of volatility to come.

OPENING HOURS
Monday–Friday, 08:00–17:00

GIVE FEEDBACK
publications@redmayne.co.uk

HEAD OFFICE
0113 243 6941

FOR MORE DETAILS
redmayne.co.uk

FOLLOW US

RISK WARNING
Please note that this communication is for information only and does not constitute a recommendation to buy or sell the investments mentioned. Investments and income arising from them can fall as well as rise in value. The information and views were correct at time of publication but may have changed at point of reading.

STOCK FOCUS

DIAGEO

RUTH HARRIS | INVESTMENT RESEARCH ANALYST

Britain has long since been known for its drinking culture: alcohol has been a way to celebrate, socialise, and unwind for centuries. For many of us, a rare sunny day is synonymous with a crisp pint, a glass of wine, or a cocktail shared with friends. However, there are early signs that this culture may be shifting, especially among young people. More and more Britons are cutting back on their alcohol consumption, and low and no alcohol alternatives are increasing in popularity. The trend is even more pronounced among Gen Z, with analysts finding about a third of people aged 18-24 choose to drink no alcohol at all. Market research company Mintel believes the trend away from drinking alcohol among young people will only grow in the future.

This demographic trend raises some questions for the alcohol industry, which globally is worth an estimated market value of US$2.3tn. Diageo, the world's largest spirits producer, has been facing both short-term and long-term challenges, struggling with difficult market conditions and weakening investor sentiment. The FTSE 100 company owns a portfolio of over 200 brands, including iconic names such as Guinness, Smirnoff, Captain Morgan, Baileys, and Tanqueray. Diageo has a broad global reach, with sales in nearly 180 countries.

Diageo has recently fallen out of favour with investors, with the share price hitting a seven-year low following the release of its annual results. Earnings were surprisingly weak, with overall organic net sales falling by 0.6%. While pricing was strong, increasing by 2.9%, this was more than offset by a 3.5% decline in the volume of sales.

"The challenges facing Diageo are undeniable, the real question is of valuation, and whether the reaction from investors has been excessively negative."

Poor sales in the Latin America and Caribbean (LAC) region were a major detractor, with revenues falling 21.1% compared to the previous year as wholesalers worked through elevated levels of inventory. Of perhaps greater concern was North America, which constitutes 39% of Diageo's sales, where revenues fell 2.5% and management is warning of a cautious consumer environment. During the pandemic, many consumers stocked up on spirits for home consumption, and then in the immediate aftermath there was a surge in alcohol purchases as people returned to social drinking. This appears to be normalising now, and people working through stocked-up bottles of spirits from the pandemic is an obstacle to new sales. In addition, Diageo is increasingly focussed on more premium brands, which are significantly more profitable to sell. However, with some anxiety about the US economic outlook and high inventory levels, consumers may find themselves more reluctant to splash out on a US$60 bottle of premium spirit.

Diageo is not alone in its struggle with current demand levels. Pernod Ricard, which owns brands such as Absolut, Malibu, and Jameson, recently reported a sales decline of 7%, and luxury sector giant LVMH saw organic sales in its Wine & Spirits division fall by 9%. However, these results have not come at a good time for Diageo's management, as investor trust was already wavering. Last November the company released a surprise profit warning, causing a 11% fall in share price. It had continued to push stock into Latin America despite poor sales, raising questions about the quality of management. It has been a difficult tenure for Debra Crew, who was appointed CEO just over a year ago. During that time, both investor confidence and the share price have plummeted.

The challenges facing Diageo are undeniable, the real question is of valuation, and whether the reaction from investors has been excessively negative. After all, the company boasts a strong broad-based portfolio of brands and worldwide exposure. There are bright spots in the results, with Guinness seeing double-digit organic sales growth supported by strong demand for the alcohol-free Guinness 0.0. At the time of writing, the price-to-earnings ratio of 18.9 seems attractive, far below the 5-year median of 24.6. The share price is down over 13% so far this year and declined almost 26% over the past 12 months. Analysts at RBC Capital have recently upgraded their view to 'neutral' from 'sell', and it's possible that there is a degree of upside from the current price. Management is 'confident that when the consumer environment improves, the actions we are taking will return us to growth', but the timing of such a recovery is anyone's guess. ■

Please note that this communication is for information only and does not constitute a recommendation to buy or sell the investments mentioned. Investments and income arising from them can fall as well as rise in value. The information and views were correct at time of publication but may have changed at point of reading.

INSIGHT

JAPANESE MARKET TURMOIL

GREG LODGE | PERFORMANCE & RISK ANALYST

The start of August saw a turbulent time for Japanese equities. On Monday 5 August 2024, investors saw the benchmark index Nikkei 225 fall by a record 12.4% from close on the previous Friday, an even steeper drop than the one seen on Black Monday in 1987. Trading on the Osaka Stock Exchange was temporarily halted in a bid to restore calm after a flurry of sell orders were placed. However, the following day the market had regained over 10%. Japan was not alone in this sudden volatility; the selloff was global and partly prompted by weaker than expected US employment data, but the Japanese market suffered a larger drop than many others. This raises the question of why the labour market in Ohio or Texas should have such a large impact on a stock market across the Pacific? Let's examine the background of this unique market and the factors involved in its plunge and subsequent recovery.

To understand where we are now, we have to look back over 30 years to the end of the 1980s. The stock market had seen huge growth over the decade, with Japanese equities representing an incredible 45% of the global stock market. The boom extended

to real estate, with Tokyo's fashionable Ginza district valued at US$230,000 per square metre. On 29 December 1989, the Nikkei hit an all-time high. The nation had never felt so confident and prosperous, but the economic boom was about to come to an abrupt end. Within the space of a year, the stock market lost more than US$2tn in value. Real estate and the Japanese Yen followed. A lost decade ensued and the economy never quite found its footing. The Japanese economy has had to contend with persistent low growth and a weak currency ever since.

In the years that have followed, attempts have been made to boost Japan's lacklustre economy. Shinzo Abe, the Japanese Prime Minister between 2006-2007 and 2012-2020, introduced a raft of monetary and fiscal reforms during his tenure. Taking the form of "three arrows", these consisted of a substantial stimulus package, quantitative easing and structural reforms aimed at businesses and the labour market. This approach came to be known as 'Abenomics' and has been upheld by his successor Fumio Kishida. However, growth, inflation and interest rates have all been slow to recover since the 1989 asset bubble collapse.

"If there is a lesson to be learned from this, perhaps it is a reminder that short-term movements, however dramatic, shouldn't dictate an investment strategy."

The Japanese Yen has had a particularly turbulent period in recent years. As part of Abe's reforms, the Bank of Japan kept interest rates very low in a bid to increase inflation, bank lending and overall demand. As other central banks worldwide have raised interest rates to combat the sharp rise in inflation which began in 2021, the Bank of Japan bucked this trend and maintained interest rates under zero until March of this year. This has seen a substantially weaker Yen, losing more than a third of its value since the beginning of 2021 until the interest rate increase. In April this year, the Yen reached a low that has not been seen since 1990. The impact of a weaker currency within Japan has been mixed. Increased import costs on energy and food in particular have squeezed household budgets, while Japanese exports have benefitted. The weak Yen has also fuelled a tourism boom, as visitors discover the very favourable exchange rate. A record 17.8m foreign tourists arrived in the first six months of this year.

Conversely, as the Yen has struggled, the Nikkei 225 climbed to a new all-time high earlier this year, reaching a level not seen since the boom years of the 1980s. There are several headwinds behind this recent resurgence in the Japanese market. Partly this has been caused by the weakening of the Yen whereby Japanese equities appear cheap to overseas investors. Overseas buyers have also found the market an attractive alternative to China when looking for Asia Pacific exposure, investing US$24bn into the equity market in 2023. Corporate reforms have also played their part in reigniting interest in this long-neglected market. The Tokyo Stock Exchange has been pushing companies with underperforming shares to make better use of their capital and improve fundamentals to make them more appealing to investors. This has led to record buybacks and the unwinding of unproductive cross-shareholdings. The exchange has also called on companies to disclose their plans for improving capital efficiency, and has published a list of those who have complied with this request. Japanese companies and households alike have substantial cash savings, in the quadrillions of Yen, which if invested would see substantial market growth.

2024 has found a Japanese economy somewhat at odds with itself: struggling currency and a resurgent stock market. In early August, the Bank of Japan raised interest rates for a second time in 2024 and the market has speculated that further raises may be on the horizon. Japan's bid to increase inflation has worked, but perhaps too well. The core measure stands at 2.6%, which in isolation is not cause for alarm, however, this has consistently outpaced earnings and the bank is concerned about this impact on consumers. At the same time, in the US, the Federal Reserve has indicated that a rate cut may be imminent, alongside lower than expected employment figures, the lower employment numbers would suggest a rate cut is more likely. This narrowing interest rate gap has seen the Yen strengthen recently, at one point reaching a seven-month high. This divergence is significant and goes some way to explain why the subsequent market fall was so steep. A 'carry trade' is where investors borrow from a market with low interest rates (such as Japan) and invest it in a currency with a higher interest rate, capturing the difference between the rates. In this case, a stronger Yen means the loan will be harder to pay back, potentially wiping out any gains. As the Yen rapidly rose, traders were compelled to exit their positions. Negative sentiment spread, and markets bore the brunt. The panic was short-lived however, stocks swiftly recovered and stability was resumed.

If there is a lesson to be learned from this, perhaps it is a reminder that short-term movements, however dramatic, shouldn't dictate an investment strategy. Investing is a long game, and for Japanese equities it has been a very long game. The Bank of Japan will have to balance the need for growth, while keeping inflation at a tolerable level and boosting the strength of the Yen. The challenge is complex and many-faceted, but with the equity market seeing a recovery, there may be cause for optimism. ■

Please note that this communication is for information only and does not constitute a recommendation to buy or sell the investments mentioned. Investments and income arising from them can fall as well as rise in value. The information and views were correct at time of publication but may have changed at point of reading.

Redmayne
Bentley

redmayne.co.uk