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OUT OF THE ORDINARY

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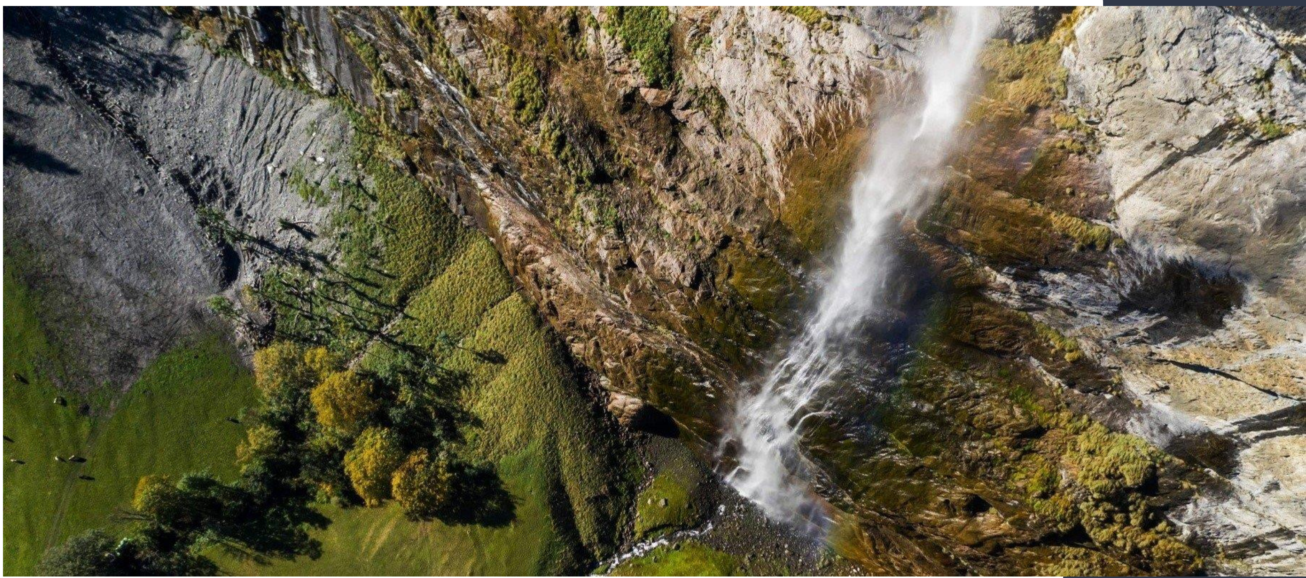
# Market commentary



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## Overview

In the pre-Covid world, these monthly commentaries were, in reality, quarterly, in that they were fully re-written at the end of every quarter and then just tweaked a bit in the intervening months to reflect new developments. This more than adequately reflected our long-term investment process. The advent of the pandemic turbo-charged not only market movements but also political, medical and social developments, necessitating monthly rewrites. As much as the author enjoys both researching and writing these reports, he looks forward to the day when he can adopt a less frenetic pace again. Unfortunately, that day does not appear to be getting any closer. Indeed, the first month of 2022 has encompassed enough action to have once filled an annual commentary.

## What is happening in the economy?

The context should be familiar to regular readers: inflationary pressures are building owing to a combination of generous fiscal and monetary policy combining with persistent supply chain disruption on account of the Covid virus.

The ensuing need to combat those inflationary pressures has finally been recognised by central banks, which are, to paraphrase former Federal Reserve chairman William McChesney Martin, preparing to "take away the punch bowl". The threat of more expensive money and higher discount rates is putting downward pressure on equity valuations, with unprofitable, formerly high-flying beneficiaries of the pandemic most affected. And that's before we sprinkle on a few grains of geopolitical risk.

## How is this affecting markets?

All of this uncertainty produced more volatility in both bond and equity markets in January, and it was the sort that we have feared for some time. We have commented in the past that the worst outcome for balanced portfolio investors (especially those with a traditional 60/40 percent split between equities and bonds) would be a positive correlation between those two asset classes in an environment of rising bond yields. To put it more bluntly, both bonds and equities lost money globally, with the odd exception, including the UK stock market.

And not only were equity indices under pressure, but within them there was a marked difference in performance between the winners and losers. Within the former group were companies favoured by more inflationary conditions. These included Energy stocks, a group until recently shunned by investors on account of their contribution to climate change. There was also a good bid for Banks, whose profitability will benefit from rising interest rates, at least until they rise so far as to create a new cycle of bad debts. Heading in the other direction were more growth-oriented companies, especially those of a speculative nature with promising but as yet unprofitable business models which were popular with retail investors during the pandemic. And latterly, with real interest rates rising off their lows, some of the mega-capitalisation technology leaders also came under pressure, even though their underlying businesses remain in fine fettle, as evidenced by the latest results from Apple, Google's parent company Alphabet and Microsoft. Meta – formerly Facebook – was the exception that proved the rule.

This market tension is unlikely to be resolved quickly. There is no clear evidence that inflationary pressures have peaked, and there is no sound floor for equities based on either valuation or the level at which central banks will worry that financial conditions have deteriorated to such an extent that the broader economy is under threat, and thus suspend or reverse their policy tightening. The Bloomberg journalist Lisa Abramowicz eloquently asks this question of the Fed: "How do you tell consumers we've got your back without causing a market disruption that has pernicious ramifications?"

Referring back to the exact words of Mr McChesney Martin, it is worth looking at the whole quote: the Fed "is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up". The problem is that the party is in full swing already, with governments and consumers spending like drunken sailors on shore leave. Will the Fed (and other central banks) end up having to tighten the screws a lot more than if they had taken pre-emptive action? This is an important question. Right now, we are experiencing a "rates shock", as the market grapples with fast-rising expectations of future interest rates. In the US, the futures markets have gone from signalling at most a quarter-point increase in the Federal Funds (base) rate by the end of this year, to five, with more to come in 2023 and 2024. The expectation for the UK base rate is for it to rise to 1.2% by December 2022 (from 0.5% following the meeting of 3 February). Even the European Central Bank, bastion of negative deposit rates, is now expected to get in on the act.

Markets should be able to withstand a rates shock as long as earnings and dividends are growing steadily, even if the leadership might change. The danger which lies ahead is that the need for more aggressive monetary policy tightening to head off sticky inflation leads to a "growth shock". I want to emphasise that this is not our central view, nor the market's, but it is a tail risk that is being partially priced in. Should such a shock occur, it would almost certainly lead to another "pivot" in favour of looser policy and we might well find ourselves replaying 2019, a year of strong gains for risk assets. But it would start from a lower base than the current one.
Our preference for investing in companies with strong business models and balance sheets suggests that the risk of permanent loss of capital is limited and, given the fact that this is a tail risk than a central view, we are in no hurry to raise substantial cash balances. There are enough studies available that warn of the dangers of market timing strategies to make us wary of not being "in the market" for an extended period.

### What other events are we monitoring?

It is remarkable, perhaps, that the word "Omicron" has not yet appeared in this commentary. Indeed, we have noticed in several recent meetings with various counterparties that whole hours have elapsed with no reference to Covid whatsoever. This is encouraging and supports our long-held opinion that the world is on a path back to normalisation, although there will be speedbumps to negotiate. Thus, when Omicron hit, we were not inclined to take defensive action. Even so, we note consistent references to supply chain disruption and also note that the economic data releases for December and January are being affected by Omicron. However, the market is already looking past this data. We remain alert to the possibility of a much more dangerous variant emerging but think that "learning to live with it" is the best investment approach to Covid now.

Even though "partygate" constitutes an existential threat to the continued leadership of Prime Minister Boris Johnson, investors are much more concerned with geopolitical activities further east, on the border between Russia and Ukraine. We cannot claim to have specialised knowledge of the situation and are thus dependent upon external opinion. Those we have heard from so far are less pessimistic about the prospects for large-scale conflict, but, more concerningly, do expect the post-1990 "peace dividend" to be reduced substantially. A potentially prolonged period of "stable insecurity" lies ahead of us, which will no doubt be punctuated by moments of alarm. Does that sound familiar? Like Covid, it might be something else that we must learn to live with.

## Markets

### US
The consensus opinion around the market is that if equity valuations are going to remain under pressure from rising interest rates, then it is US equities that have the most to lose. The US has been the main beneficiary of falling rates, after all, thanks to its greater exposure to high-growth companies generating strong cashflow seemingly in perpetuity. The US market was also helped along by Uncle Sam's cheque book, with households receiving generous handouts during the pandemic. Much of the proceeds found its way into the more speculative areas of the market, and it is these areas that have endured the greatest pain. Around 40% of the three thousand plus constituents of the technology-driven NASDAQ Index have seen their market capitalisation fall by a half or more from recent peaks. The fact that so much froth has been blown off the top of the market without inducing more panic is relatively encouraging and speaks to the resilience of the larger leaders. And buried in the rubble will be a handful of tomorrow's winners. We continue to believe that the market is underpinned by more sustainable profits than it was in 2000, although the transition to a world of higher interest rates will continue to be choppy.

### UK
The UK market distinguished itself in January by being one of the very few (alongside Hong Kong) to post a positive return. We have long bemoaned the Jurassic Park-like composition of the FTSE 100 Index, but the dinosaurs reasserted themselves with a vengeance. The leading shares in January, all with gains of 15% or more, were Standard Chartered Bank, HSBC, Shell, BP, Vodafone, BAT, and BT (and we note that the latter company embodied the spirit of the new inflationary age by increasing broadband prices by 9%). The fact that the index's gains were limited to just 1% is testament to the fact that many more share prices were heading in the opposite direction. The largest negative points contributions came from longer duration growth companies such as Diageo, Experian, Scottish Mortgage Investment Trust, Croda and Halma. Their underlying businesses remain in good health, but, as with the technology companies in the US, valuations came under pressure from rising rates and some repositioning of portfolios.

### Europe
As we pointed out last month, European equity indices have an attractive balance of sectors and may offer the best of both worlds for those investors less willing to take a big bet on the direction of interest rates and the rotation between Growth and Value factors. As such, Europe's performance in January sat squarely between the US and UK. But something noteworthy occurred on the very last day of the month: Germany's ten-year government bond (the Bund) had a positive yield for the first time since May 2019. We are only talking mere basis points, and, given that the country's inflation rate is close to 5%, the real return on offer remains very negative. But this change of sign from minus to plus is symbolic of the fact that the deflationary fears that haunted markets are now well behind us. The first political obstacle of the year, the election of a new Italian President, has been negotiated safely, and the front runners in April's French Presidential election are the incumbent Emmanuel Macron and Republican Party challenger Valérie Pécresse, with little expectation of an upset in favour of the more disruptive candidates such as Marine Le Pen or Eric Zemmour. The main challenge to both political and economic stability in Europe is the threat of an invasion of Eastern Ukraine by Russia which could lead to severe disruption in the energy market.

## Emerging Markets

Following a period of underperformance relative to global indices there is an enormous temptation for contrarians to start buying Emerging Markets (EM) again. One key determinant of EM performance is the direction of the dollar. A strong dollar is unhelpful because it tightens financial conditions and diverts away investment flows. The dollar continues to flirt with its highs for this cycle, bolstered by tough talk from the Fed and rising interest rate differentials. A topping out of US rate expectations would provide a firmer footing for EM, and that will need tangible progress on the inflation-fighting front. It is notable that the “ex-China” version of EM has been out of synch with China in the last couple of years, with China’s own technology sector boom and bust being the main factor. With China’s government determined to stamp out speculative excess and to rein back the influence of certain high-profile individuals, the performance gap in favour of China has closed again. China is also out of sync with most of the rest of the world in that it has neither a burgeoning inflation problem nor excess domestic demand, allowing it to start loosening monetary policy rather than tightening. There are precious few signs of investors responding to this lure yet.

## Fixed Income

Bond yields continued to rise in January, leading to a further 2% negative total return for the Barclays Global Aggregate Bond Index. Bond investors face numerous threats: persistently elevated inflation; rising interest rates; and the ending or potential reversal of central bank bond-buying programmes. The fact that the Fed continues to buy bonds now despite some members already floating the idea of selling them in the future is testament to how cautiously the Fed is approaching this element of policy tightening, this is no “taper tantrum” repeat of 2013.

However, as one commentator pointed out, it’s a bit like a man digging a hole with no greater purpose than to be filling it in again soon. There is enthusiastic debate about just how much higher interest rates and yields can go. They both remain in negative real territory (that is much lower than inflation), which, historically, has not been sustainable. But there is a strong body of support for the notion that record levels of debt impose a ceiling on rates, above which the cost of interest would become unbearable. The total value of negative-yielding global government and corporate debt has fallen from $18.4 trillion in December 2020 to $7.8 trillion, which almost takes us back to the level that prevailed in late 2018, just before the Fed pivoted to looser policy again in the face of collapsing equity and credit markets. But we won’t be able to begin to declare this extraordinary era of monetary policy over until everything has a positive nominal yield again, a situation that was last experienced before the euro zone crisis of 2012.

UK Gilts have delivered a total return of -3.59% over the last three months and -7.23% over the last year. Index-Linked Gilts returned -2.53% and 4.12% over the same respective periods. Emerging Market sovereign bonds produced a total return of -1.07% in sterling over the three months to end January (-1.78% over 12m). Global High Yield bonds delivered -0.47% (1.35% over 12m).

## Conclusion and Outlook

We stated in the last commentary that “we are slightly more cautious heading into the New Year as we anticipate running into the headwinds of tighter monetary policy”, and we stand by that opinion. But so long as growth remains steady, we do not fear a major loss of capital. Balanced portfolios should remain resilient, although there could be large differences between the performance of individual components as the market continues to grapple with the change in the monetary regime. Indeed, “resilience” is increasingly the buzzword in corporate circles too, replacing “efficiency” as the primary operating target. This should be helpful to investors in the longer term but will incur some upfront costs. The opening days of 2022 have set the tone for more volatile conditions, which, again, is not unexpected. We have already seen huge intraday movements in individual stocks and indices. It will be important not to be influenced by such swings which bring the risk of being “whipsawed”, especially if trading liquidity is reduced, of which there has been some evidence.

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