Investec

OUT OF THE ORDINARY

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Market commentary

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Overview

Much as one might prefer to live in a world where markets rose steadily and long-term investing was about as exciting as watching paint dry, it still feels as though we are in an environment that resembles what one imagines a Jackson Pollock painting session might have been like. There are a lot of things going on, none of them linear, and it is a challenge to interpret what it all means.

What has driven strong equity markets?

The strong equity market performance, which has been replicated to a lesser degree in bond markets, has been driven by several factors. Two key ones involved potentially worse outcomes not being realised. The first was the abrupt policy shift by the Chinese Communist Party regarding its attempted suppression of Covid; the second, less in the hands of human actors, was the benign winter in Europe which reduced the risk of a more severe economic downturn developing because of soaring prices and possible shortages of energy.

In market-speak, we would call this “pricing out the left tail risk”. When investors are anticipating and positioned for bad things to happen, the mere whiff of them not occurring can elicit a rapid shift in sentiment and fund flows, often exacerbated by short positions being squeezed. However, it is one thing for the sky not to fall in, and quite something else for a more robust recovery to take hold, and, while we find attractive relative value in both European and Emerging equity markets, there are still plenty of obstacles to overcome.

What is the state of inflation?

Investors’ better mood has been bolstered further by a growing confidence that we have seen the peak in annual rates of inflation, even if prices continue to rise. Many commodity and goods prices are now well below their pandemic-induced highs, and the strong monetary medicine dispensed by central banks is beginning to take effect in areas such as the housing market.

Whereas 2022 was largely about the derating of risk assets in the face of higher interest rates, 2023 is expected to be more about slowing economic growth and its effects on corporate profits. We, like many, have been “waiting for the earnings shoe to drop” for several months, but it continues to dangle in mid-air. One theory is that company executives are so well prepared for the “most expected recession in history” that they have already taken evasive action. Much as it would be nice if that were the case, one recalls the words of Citigroup Chief Executive Chuck Prince in 2007, a year before the worst of the financial crisis hit: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We’re still dancing.” It is rare for managers to cede competitive advantage just in case business slows down. There is also the fact that one company’s cost-cutting tends to result in somebody else’s loss: either that of suppliers or of employees who are laid off. And while we note that cost-cutting announcements have generally been greeted with a rising share price, it’s hard to see more pervasive cost-cutting being good for growth overall.

What is happening in labour markets?

One sector where we have seen a high number of job reductions is the technology sector. Amongst the US giants, the Financial Times noted that more than 200,000 layoffs had been announced in recent weeks. Rather than revealing fear of imminent economic collapse, they seem to be more an admission, in many cases, of over hiring during the last three years as a result of over extrapolating the shift to online activity during the lockdowns. Total employee numbers remain well above what they were in 2020. And while 200,000 sounds like a substantial number, the US economy is still creating that many new jobs every month.

Of course, a knowledge worker in tech might have neither the skills nor the inclination to find a new job where it is on offer. And one feature of many employment markets, including that of the UK, is how tight they remain. The UK unemployment rate of 3.7% is barely off the multi-decade low of 3.5%. In the US, it’s still at the low point of this cycle at 3.5%. And the same goes for the eurozone, where the 6.6% rate is lower than anything experienced since the inception of the euro in 1999. This is as much as labour supply problem as one of demand, with many workers, especially older ones, having left the labour market, in addition to those suffering from pandemic-related long-term illnesses.

And it's this tightness in labour markets that is keeping central bankers awake at night. Their biggest fear, at least apart from things like geopolitical events over which they have no control, is that tight labour markets and sticky inflation lead to higher wage demands which, in turn, reinforce inflation. For now, at least, their worst fears are not being met. Annual wage growth of 4.6% in the US has fallen back from a peak of 5.6% and in Europe the figure is around 5%, although it's harder to be precise owing to the differences between countries. For example, a report in the Financial Times quoted a source saying that wage growth in Germany towards the end of 2022 was running at 7.1% year-on-year, whereas the figure in France was 4.7%. The biggest problem seems to be in the UK, where annual wage growth was running at a cycle-high of 6.4% in November, the last published month, and there is widespread strike action in pursuit of higher wage settlements.

So where does that leave central banks, who, we continue to believe, hold much of investors' fate in their hands? There were policy meetings at the Federal Reserve (Fed), the Bank of England (BoE) and European Central Bank (ECB) in the first two days of February, and they delivered rate increases of 0.25%, 0.5% and 0.5% respectively, exactly as expected. Traders took heart from relatively benign comments from Fed chairman Powell in the post-meeting press conference, with confidence building that the end of the tightening cycle is imminent. Even so, there is still a big gap between market expectations of rates being cut rapidly later this year and the Fed's current declared intention to keep them unchanged at whatever peak is reached until 2024. There was a similarly positive reaction to comments from BoE Governor Bailey and ECB President Lagarde, although enthusiasm in the former case was tempered by a still pessimistic outlook for the economy.

Markets – US

Not for the first time, we note that performance so far this year has been a case of "the last shall be first and the first shall be last". The worst three performing sectors of 2022 were Communications, Consumer Discretionary and Information Technology, and they are the top three so far in 2023. Meanwhile, the best performers of last year (leaving aside Energy, which was a bit of special situation) were Utilities, Consumer Staples and Healthcare. They now occupy the bottom places. This speaks to a rapid repositioning in light of the shift to a less pessimistic outlook for the world, with lower bond yields providing an additional tailwind to longer duration stocks. Some of the biggest winners have been non-profitable companies, the type of company whose shares suffered worst last year. It is not unusual to find share prices that have doubled and more since November. Even so, we would be cautious about expecting them to regain their past heights in the short term, if ever, and regard this as a highly speculative area. As we go to press, we have just seen results from some the biggest beasts in the arena, with Apple, Amazon and Alphabet all admitting to a slower growth environment, although far from catastrophic. Meanwhile, Meta (parent of Facebook) positively surprised the market by reducing its capital expenditure budget. We believe that all these companies have a decent runway of growth ahead, although the trajectory will almost inevitably be shallower than in the past. Investors are still struggling to calibrate their expectations accordingly.

UK

The FTSE 100 Index came within 17 points of closing at a new all-time high in January, although any celebrations would have been muted, one feels. (A new peak was finally reached on 3 February) The index does not reflect the fortunes of the UK economy, with three-quarters of constituents' revenue generated overseas. The peak itself was made in May 2018. Since then, on a total return basis (including reinvested dividends) in sterling, the S&P 500 index has increased by 77% vs 17% for the FTSE 100. The EuroSTOXX 600 Index managed +32%. At least the UK's higher dividend income has kept its nose in front of Japan (+13%) and Emerging Markets (+12%) over that period. We have seen several asset managers publish their long-term capital market assumptions recently. The UK (along with Emerging Markets) tends to come out of them quite well in terms of potential prospective returns, but the higher starting yield inflated by nominal growth in the economy has often made it look attractive in the past to no avail. As we discovered last year, good years these days tend to be driven by strong cyclical performances in the

Energy and Mining sectors. The prior peak for the FTSE was 18 years earlier, on the eve of the new millennium. If we go back that far, the FTSE100 has only gained 12% in terms of index points but generated a total return of 143%. That's less than 4% on an annualised basis. The S&P 500, despite starting from its highest ever valuation at the same time (following which it lost half its value in two years) is +464%, with Europe +268%. Emerging Markets have delivered 410%. Japan is the laggard, with a return of just 78%, although, amazingly, that still constitutes a positive real local return (after taking inflation into account). Maybe if, as some suggest, a commodity boom lies ahead, the UK indices' relative fortunes will improve. However, to wish for that might be to wish ill on most of the rest of one's portfolio.

Europe

The first few weeks of 2023 have seen economists reducing the probability of the European economy falling into a deep recession and possibly avoiding one completely. The main reason for this is captured in the dramatic fall in wholesale natural gas prices. A mild winter means that the risk of shortages is greatly reduced and that the rebuilding of inventories for next winter should prove to be less onerous than once feared. We note, too, that industrial users of energy have found ways to reduce consumption without a commensurate drop in production. That could be a silver lining in the quest for greater energy efficiency. Another tailwind for Europe has been the planned re-opening of China's economy, with industrial and consumer goods companies (notably luxury goods) being beneficiaries of increased demand. If there is a caveat, it is that pre-Covid natural gas prices tended to trade in a range between €10 and €25 per MWh. Even though they have fallen a long way from their peak, they are still above €50. The current price in the US of $2.5 per million BTU is towards the lower end of its pre-Covid range of $2 to $4 (equivalent to €6.8 to €13.5 per MWh) thanks to the boom in supply from shale deposits. This hands the US a competitive advantage. The US government has also been more generous in its funding of clean energy alternatives. The EU is acutely aware of this and there have been ambitious statements about the need to catch up before innovative businesses are lured across the Atlantic.

Emerging Markets

In the Emerging Market section, we usually focus on equities. This month we take a diversion into Fixed Income. EM central banks were early players in the current rising interest rate cycle, in contrast to past cycles where they had been laggards, often forced into action by the competition of higher US interest rates and the squeeze imposed by a stronger dollar. Having taken their medicine early, they are now in a position to loosen policy sooner. The reduced probability of a global recession is another positive factor when we assess default risk, and there is an obvious potential benefit from China's re-opening. The prospect of a weaker dollar as the US reaches the end of its monetary tightening cycle ices the cake. Income is a key attraction of EM debt, given that it rewards investors with a premium yield for the risk taken. And the fact that so many EM countries have cleaned up their act following the existential shocks of the late 1990s means that the market's perception of their risk probably outweighs the reality. Our preferred fund has a current yield of 8.1%.

Fixed Income

While not quite in the same league as equities, global bonds have also had an excellent start to the year, with the Bloomberg Global Aggregate Index climbing 3.5% in January and receiving a further boost after the central bank meetings. That's a long way from making up for last year's 16% loss, but there is a general acknowledgment that government bonds now have a much-improved claim for their place in a balanced portfolio. They no longer offer just "crash protection", but also a modicum of income. The US 10-year Treasury Bond has just posted two consecutive years of negative returns, which is a rare event and has not been followed by a third loss in the last century. The odds appear to favour a better performance this year. The last two occasions of consecutive losses were in 1955-6 and 1958-9. Interestingly, this was when the US was exiting a period of financial repression, when interest rates and bond yields had been kept artificially low to help the government inflate away its debt burden accumulated during the Second World War. The end of Quantitative Easing offers a parallel. But back in the

‘50s, the cumulative loss to bondholders over the years 1955-1959 was a mere 2%. Last year’s losses were the worst since the eighteenth century!

UK Gilts have delivered a total return of +1.14% over the last three months and -1.76% over the last year. Index-Linked Gilts returned +1.12% and -30.03% over the same respective periods. Emerging Market sovereign bonds produced a total return of +4.53% in sterling over the three months to end December (-3.97% over 12m). Global High Yield bonds delivered +2.98% (+1.69% over 12m) in sterling.

Conclusion and Outlook

We cannot deny that the strength in financial markets so far this year has taken us somewhat by surprise, and we are far from being alone in that. Even so, our ongoing “cautious, not fearful” approach means that we have participated in the rally. Some of our longer duration holdings have benefited from lower bond yields, and companies exposed to China have enjoyed a strong re-opening tailwind. And yet short-term doubts linger. The majority of market participants today have not experienced an economic slowdown born out of a fight against inflation. The last two big drops in risk assets were a result of deflationary shocks, namely the financial crisis and the Covid pandemic. They were very different in terms of their catalysts but both addressable through the opening of liquidity taps and (in the latter case) fiscal taps. That is not an option this time, in our opinion. And so, while we now have greater confidence that the worst of the storm is behind us, there remains the possibility of a more drawn-out slowdown to provide a few nasty surprises. That is by no means an exhortation to become extremely defensive; more counsel to remain patient in increasing risk in portfolios.

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