Weekly Digest

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John Wyn-Evans
Head of Investment Strategy

Bubbling Up

A physicist once described a bubble as something with "infinite capacity, but limited structural integrity". Which is a clever way of saying that something will continue to expand until it pops. And, of course, there is no way of knowing when that moment will arrive. Much airtime was given last week to veteran investor Jeremy Grantham's view that we are witnessing one of the "great bubbles of financial history", the sort of assertion that is hardly designed to calm one's nerves. I will discuss some of the pros and cons of his arguments later in this piece. But first…

Old stock market lore has it that the first month of the year sets the tone for the rest of it. I know we have only had a week so far, but if the next fifty-one continue in the same fashion we're in for an exhausting rollercoaster ride. Global equities had a weak start followed by a strong rally despite the scenes at the US Capitol. The Democrats pulled off a double victory in the Senate run-off races in Georgia. Inflation expectations and bond yields rose sharply. Covid cases continued to accelerate with new versions of lockdown being widely imposed. Bitcoin, the cryptocurrency that seems to be loved and mistrusted in equal measure, traded above $40,000 having been below $20,000 when most of us logged off for Christmas. That's an awful lot of conflicting factors to get one's head around. Let's unpack all of those developments and see if we can shine some light into the murky corners.

I'm going to kick off with the US political situation, which, in all probability, is the one that can be resolved soonest. After all, we should be less than two weeks away from the inauguration of a new President.

For all the headlines generated by a man wearing animal skins and horns, the most enduring influence, and the one that financial markets chose to focus on, was the fact that the Democrats won both Senate seats in the Georgia run-offs, thus taking control of the Upper House of Congress. Although the majority is the slimmest possible, it does open up the prospect of more fiscal stimulus, not just in immediate response to the pandemic, but also structurally in terms of infrastructure and the environment, with numbers in the trillions of dollars being bandied around.

The effect on certain market sectors was immediate and dramatic. For example, a US-listed Exchange Traded Fund (ETF) that tracks the solar energy industry rose 15%. Another prime beneficiary was Banks, encouraged by stronger growth potential and a steepening yield curve. The global Banks index rose 6.5%. And yet one could also look upon these moves with some suspicion. There is plenty of evidence to suggest that by far the lion's share of current stock market trading is undertaken not by humans balancing facts and opinions, but by computers reacting to new information based upon

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historical correlations. And a substantial amount of the human trading that is done is based upon "buying the narrative", rather than any reference to valuation. I'm going to come back to this when I discuss Jeremy Grantham's views.

The other notable thing about the response to the Democrats' Senate gains was that markets interpreted the news positively. Think back to the immediate response to November's election result. The "Blue Wave" was avoided, and investors celebrated the prospect of at least two more years of Congressional deadlock with a diminished threat of big tax rises and regulation. And yet here we are with Democrat control and that was also celebrated. Admittedly there was a revival of the rotation in favour of shorter duration earnings over longer duration (value over growth, if you prefer), but the overall market rose too.

This looks like "cakeism" of the first order. It does suggest that there is more to the relentless rise of risk assets than political clarity. There is still a large amount of liquidity being created, and that continues to find its way into financial assets. Indeed, liquidity is consistently cited as the key support for markets - which is why we will continue to return to the threat of it being withdrawn. Right now the year-on-year increase in global central bank asset purchases is running at around $5 trillion, more than twice as high as it had been at any time since the financial crisis. Although a reasonable chunk of this is balancing new government debt issuance, there remains a surplus finding its way into financial markets.

What everyone fears is that this liquidity tap will be turned off. The big fall in risk assets in the fourth quarter of 2018 was at least partially a result of Federal Reserve balance sheet shrinkage, and the "taper tantrum" of 2013 was similar. So what might cause central banks to take their foot off the accelerator, or, worse, apply the brakes? In a word - inflation. I will focus on US inflation, given that the Federal Reserve is pre-eminent amongst central banks and that US bond yields are the primary driver of the global discount rate. Expectations have picked up markedly. The 10-year breakeven rate (the market-implied average inflation rate over the next decade) bottomed at 0.55% last March when the world was peering into a deflationary abyss. Investors are in many ways even more fearful of persistent deflation than inflation, and so the rise in that measure to a current 2.04% (the highest level since the fourth quarter of 2018) signals that that threat has passed.

That leaves us, for now, in "Goldilocks" territory (not too hot, not too cold), which financial markets love. But the trend is up, which is of concern. Some commodity prices are rampant, in response to cyclical recovery demand, but also the promise of secular demand increases. Copper, for example, a key element in the rush to electrify many modes of transport, is trading at levels not seen since 2013, and up 70% from last year's low. Mind you, it's not always easy to differentiate the chicken from the egg – there is also an element of people buying commodities (often through trackers) as a hedge against possible inflation. The current consensus forecast for headline inflation in the US sees a print of around 2.5% in the second quarter. That's quite a lot higher than the Fed's preferred 2% target, and I think it is almost inevitable that markets will have a case of the collywobbles when it is printed.

But so much will then depend on the Fed's reaction. First of all, it does look as though this will represent a short-term inflation peak, because the rise will be measured off 2020's trough. Second, the Fed has said that it will allow inflation to "run hot" (for an unspecified period) to make up for past shortfalls. And so it's not clear that policy will tighten. Much will also depend on the path of Covid. If vaccine deployment has been as successful as one might hope, then economic activity could be recovering quickly. And there are all those pent-up savings to spend (for those who have been able to accrue them). In that case, any tightening of policy could be viewed as a "high class problem", thanks to a normalisation of activity and stronger growth. The market effects would be seen much more in the rotation between "back to normal" and "stay at home" sectors.

Much of the work on inflation cycles suggest that the trouble really only begins when core inflation starts heading above 3%. There are plenty of people who will argue that this won't happen in a world of technological innovation and disruption, as well as with ageing populations. Peak equity valuations in history lie in the 1-3% inflation band. Bond and

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equity correlation tends to start turning positive as inflation rises above 3%, thus making life very difficult for balanced portfolio investors primarily exposed to those two asset classes. We remain highly vigilant to this risk.

And so to Jeremy Grantham. His latest Viewpoint examines the "Hazards of investing in a Late-stage Major Bubble". Much as I have admired Mr Grantham's writing over the years, I find two major problems to address. First, is this a bubble?; second, if it is, how does one time one's exit? Bubbles really only tend to reveal themselves in hindsight. There are plenty of people who have been calling the current bull market a bubble for several years, but it's hard to argue with the growth (and extraordinary profitability) that has been generated by many (not all) of the market leaders. Furthermore, it's certainly not clear that this is a bubble in everything – just ask investors in Banks and Energy stocks, for example.

Still, I do have some sympathy with him. There are some investments that have assumed cult-like status. Any attempt to talk supporters out of their views is met by a behavioural trait known as the "Backfire Effect", in which they become even more entrenched in their opinions. (Is it possible that Mr Grantham, a renowned value investor, is a victim too?). A quick glance into the comments section of, for example, any Financial Times article on Donald Trump, Brexit or Bitcoin, shows exactly the same phenomenon at work. I am also concerned that there is a lot of price-insensitive buying. The afore-mentioned US Solar ETF is one example amongst a host of ETFs with similar price momentum. Then there are the passive flows into indexed funds, which, by their nature, steer more and more money into the winners.

Trying to compare the current situation to the South Sea Bubble is, perhaps, a bit rich. First of all the South Sea Company (SSC) involved fraud on a grand scale, and it is not clear that this is the case currently (even taking into account Wirecard, Patisserie Valerie, etc). Second, much of the ensuing bust was the result of bad loans that individuals had secured against their supposedly valuable holdings in the SSC. While we can't rule out that some people now have loans secured against portfolios that crumble, the systemic threat to the banking system does not look as great. But, yes, there will be casualties.

What about 1929? Again, the levels of disinformation and margin trading were off the charts compared to today. Furthermore, it is difficult to see the financial system being allowed to collapse as it did then (and indeed as it did in 2008). Central banks just won't let it happen. Maybe this does create a degree of moral hazard, in which everyone believes in the "Fed put", but that doesn't necessarily make it a bubble.

I lived and worked through 2000, and so at least I experienced that boom and bust first hand. There was definitely a large element of "forced' buying (index-hugging funds) as well as rampant speculation, and, as it turned out, quite a decent level of fraud (Enron, Worldcom). Perhaps the biggest difference between now and then, though, is interest rates. The last leg of the boom came in the face of the US 10-year bond yield rising from 4.2% in mid-1998 to 6.8% in January 2000. The Fed's last rate hike of the cycle didn't arrive until May 2000 (+0.5% to 6.5%). With the current Fed Funds rate at effectively zero (and expected to remain there until 2024), and a bond yield of 1.13% (with the Fed expected to cap it between 1.25% and 1.5%), we are in a completely different environment. Going back to my earlier observation, that's why the market's view of inflation and central banks' reaction is going to be key.

I am aware that I am only at the entrance to what could be a very long and deep rabbit hole here, and I am also aware that I can only begin to scratch the surface of this subject today. But the key message is that we do not view the current market as being in a bubble, although we do acknowledge that there are significant pockets of speculation. Our forward-looking returns work also suggests that there will be better returns available outside the US stock market (in aggregate) over the next few years as economic activity and bonds yields normalise to some degree. But other models that rely on dividend growth expectations and the present value of future dividends fail to signal bubble territory. As always, a balanced and diversified portfolio is the best insurance against the risks identified by Mr Grantham, while at the same time offering exposure to further gains.

Last week's Economic Highlights

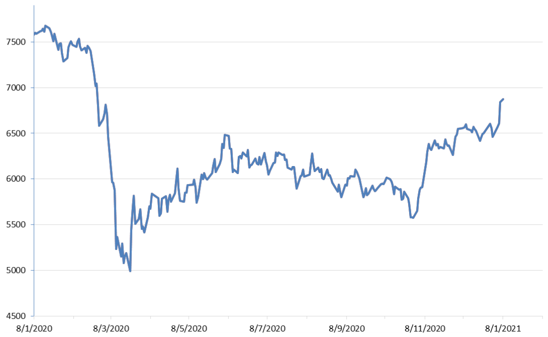
FTSE 100 Weekly Winners

Entain PLC	30.1%
Glencore PLC	16.6%
BP PLC	17.2%
Anglo American PLC	16.4%
BHP Group PLC	15.4%
Rio Tinto PLC	15.4%
Royal Dutch Shell PLC Class A	13.1%

FTSE 100 Weekly Losers

British Land Company PLC	-4.9%
Rolls-Royce Holdings PLC	-3.6%
Rightmove PLC	-2.5%
Associated British Foods PLC	-2.0%
International Consolidated Airlines	-1.9%
NatWest Group PLC	-1.5%
JD Sports Fashion PLC	-1.1%

FTSE 100 Index, Past 12 Months



Source:FactSet

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