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OUT OF THE ORDINARY

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(G)Rate Expectations

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At the beginning of last week, many were predicting that equity markets were heading into the abyss. As it turned out, the world's largest regional market in the US managed a small gain (as did other markets around the world), although not without experiencing some sharp intra-day turnarounds, with the largest being nearly 6%.

The market history team at Deutsche Bank made an interesting observation that despite all this intraday volatility, the NASDAQ Index (the one dominated by Technology) rose just 0.01% in aggregate over the five trading days, which constituted the fifth smallest weekly move in the history of the index (which was first calculated in 1971).

While I'm sure a few canny traders made a mint last week, there will also have been many, if not more, who were whipsawed by the gyrations. We do our best not to get caught up in such situations and to continue to focus on our investment process and on our long-term goals. There are often periods during which markets are driven by technical factors that tend to fade quite quickly – what is often described as "the tail wagging the dog". Such factors can include the trading patterns of momentum-driven funds, the forced selling of leveraged positions, or index rebalancing. The first two could be described as "pro-cyclical" and can exaggerate market movements, especially to the downside when market liquidity has a tendency to dry up. The latter can provide some relief when market moves have been extreme. For example, the fact that US equity markets have performed much worse than bond markets in January means that certain funds will have to sell bonds and buy equities at the end of the month to rebalance their portfolios in line with benchmarks.

However, fundamentals will always trump technical factors in the end, and that takes us back to what everyone is really worrying about, which is the inflation outlook and what central banks are going to do about it. And it's not so much now about whether interest rates are going up, it's more about by how much and how fast. As recently as last September the market (as reflected in the Fed Funds futures contract) was betting that we would be surprised to see even a single quarter-point rise in the Fed Funds rate in 2022. Now it thinks five! That's a big shift in expectations driven by persistently higher inflation and, perhaps more importantly, the fact that the Federal Reserve's members collectively realised that inflation is not as transitory as they had hoped and that they were in danger of losing control of prices (or at least of being seen to lose control).

You could say that we are also seeing inflation in interest rate forecasts, or at least a competitive escalation from sell-side economists. Bank of America raised the bar at the weekend by predicting that there will be no fewer than seven rate rises this year, which means one at every meeting, on average (they could do a 0.5% move to kick things off in March). Still, whatever the end result it is now taken as read that every Fed meeting this year is "live", and so the buildup to each meeting will be fraught with speculation and probably higher volatility. The better news is that it is possible that we have hit the peak of interest rate fear in the short term.

As I previewed last week, our Asset Allocation Committee (AAC) met on Thursday. First things first: we didn't change our marginally cautious approach to risk, although the vote was a very close 6-5 (with the five wanting to take our recommended equity weighting back up to neutral). The vote to reduce the risk recommendation last October was only carried by a margin of two, and so you can see that the balance remains very fine. There is nobody who believes that markets are about to crash. It's quite possible that bragging rights could switch from one group to the other from one day to the next (or even, if last week is anything to go by, from one hour to the next).

As we have written about on several previous occasions, the devil is in the detail of the market, notably in the style rotation that has taken place so far this year in favour of short-duration/value stocks over long-duration/growth stocks. At the global level, the MSCI World Value Index has delivered a total dollar return of -1.99% year-to-date, versus -11.84% for the MSCI World Growth Index. This has proved painful for investors with a growth bias or for those who favour longer duration equities. These are companies whose net present value is more largely attributable to profits that they will generate well into the future.

And the problem is not that future profit expectations have been downgraded; it is that rising interest rates have mathematically lowered the net present value. Arcane as this might sound, it is key to the relative performance of the two groups of stocks. And it can be frustrating, to say the least, to be holding a company whose prospects are as bright as they were a few months ago but have to watch its share price decline.

I don't mind admitting that we find ourselves in such a situation, and I think it is important that investors understand our thought process. To which end, I am going to include some excerpts from the AAC meeting minutes.

"As long-term investors, our in-house stock-selection process (CFROIC – see below for more) leads to a tendency to own longer-duration equities. These are often companies that operate with lower levels of invested capital and the nature of their business tends to lead to higher marginal profitability as well a more sustainable competitive position. The past persistent reduction in real interest rates has turbo-charged returns through a valuation rerating thanks to the discount rate effect on the net present value of future cashflow. It should be to the firm's credit that we stuck to owning this stuff when many were suggesting that price/earnings ratios were in "nose-bleed" territory... in the 20s! It would have been very easy to have instead got stuck in value traps several years ago.

But if you live by the sword, you must expect to die by it too, and one cannot argue against the fact that rising real rates will (all other things being equal) put downward pressure on current valuations. Cognisant of this, the AAC previously recommended mitigating the risk of rising real rates by rotating into some shorter-duration assets. While this advice was taken, it was, in retrospect, not aggressive enough, at least in the context of what has happened in markets since.

It is clear that some Investment Managers were uncomfortable with the idea that a shift towards shorter-duration (possibly lower "quality") companies could be seen to represent a shift away from the principles upon which we have sold our investment management capabilities to clients, especially if it was only a tactical move.

The key thing is that everyone understands why: 1) overall portfolios have fallen in value from recent peaks; and 2) the stuff that we tend to prefer for the long-term has fallen faster than the overall equity market, at least for now. On the first point we have been very clear for the past few years that the single largest risk to portfolio construction and future returns would be a shift towards a positive correlation between bonds and equities in a rising yield environment (in normal language, bond and equity prices go down at the same time). That's where we are today. For how long, nobody can be sure, but it is more likely to persist if current inflation and

expectations of future inflation continue to rise, or at least remain elevated. The main exception to that will be if central banks follow a path of overt financial repression (keeping interest rates low relative to inflation), and even then, it's not entirely clear what will happen. The Tactical Asset Allocation process has done its best to mitigate the risks by recommending an allocation away from conventional sovereign bonds (in favour of index-linked bonds and credit), a reduction of some equity (and duration) risk and an increase in Alternatives weightings. But, within the confines of our Strategic Asset Allocation benchmarks and available liquid strategies, we can only mitigate drawdown risk, not eliminate it.

On the second point, I hope I have made it clear over several years of written communications that our "style bias" (for want of a better label) will not work in all seasons. I have observed in a few meetings with external managers that "we are all Terry Smith now", and there is no doubt that the acceptance and embracing of CFROIC-style (Cash-Flow Return On Invested Capital) investment principles has become more widespread – because it works. The world has moved on from the days when indices were dominated by capital-intensive industries and is not going back. But even Terry is underperforming currently (cue wailing and gnashing of teeth in the financial press), although he sounds unperturbed (as indeed he should).

In retrospect (and isn't the Hindsight Portfolio always the top performer?!), the departure of fund manager Alastair Mundy from the value-oriented Temple Bar Investment Trust just before the first Covid vaccines were announced was a brilliant contrarian signal. The trust's shares have almost doubled. But does that mean that Value as a style is back for good? Terry Smith famously asserts that his investment philosophy is to: 1) Buy good companies; 2) Don't overpay; 3) Do nothing. That just lets the power of compounding the excess returns over the cost of capital (preferably on a growing asset base) do the heavy lifting. Value strategies are by their nature mean-reverting: find something that is trading below some objective measure of "intrinsic" value and wait for it to revalue. And then you have to find the next cab off the rank. Is that a true compounding strategy? And it is also fraught with the difficulty of timing when the market will recognise the value, assuming it is not a value trap. Meanwhile the compounding growth investor cruises by in a limo."

I accept that these are dangerous words to write when every value manager on earth is calling the turn in their favour. And we also accept that value strategies have been outperforming recently. The limo driver might have to stop for a while to change a flat tyre. But a wholesale shift into the sorts of companies that we have not felt compelled to own for several years is not on our agenda. We know this could be uncomfortable for a while, but we also know that we retain holdings in robust companies with strong credentials for long-term value creation and share-price appreciation.

Economic Commentary

FTSE 100 weekly winners

Company	Change
Vodafone Group Plc	8.6%
J Sainsbury plc	5.4%
Tesco PLC	5.1%
Shell PLC Class B	4.8%
HSBC Holdings Plc	4.5%
Standard Chartered PLC	4.5%
BT Group plc	4.4%

FTSE 100 weekly losers

Company	Change
Fresnillo PLC	-23.9%
Polymetal International Plc	-14.1%
Just Eat Takeaway.com N.V.	-12.6%
Barratt Developments PLC	-10.2%
Sage Group plc	-9.8%
Pearson PLC	-8.0%
Antofagasta plc	-7.8%

FTSE 100 index, past 12 months

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