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OUT OF THE ORDINARY

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A stitch in time...

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An old proverb (which, I have to say, I don't hear as much these days as I used to) declares that "a stitch in time saves nine", meaning that taking some early action to fix an emergent problem can save having to do a lot more later. This thought process can be applied to the two major themes that will dominate the news this week: climate change and monetary policy.

Climate change

The first is the existential threat, and with COP26 taking place in Glasgow we can expect to hear a lot about the subject, ranging from optimistic opinions about mitigation, stabilisation and even the reversal of carbon emissions and global warming to the outright apocalyptic. The G20 leaders' summit in Rome over the weekend did not suggest that we should be eagerly anticipating any great breakthroughs at COP26, unfortunately. We will continue to wait for the event to unfold properly and deliver a post-mortem in the next couple of weeks.

However, I will observe that COVID has made it pretty clear to me that relying on autonomous changes in individuals' behaviour is not going to be sufficient to shift the course of climate change. Either there will have to be a major climate-related catastrophe (probably on this side of the world) that gives everyone a massive wake-up call, or governments will have to take initially unpopular decisions. Those decisions could involve a mix of carrot and stick, including incentives – financial or otherwise - for "better" behaviour and punishments for "worse". They could include restrictions on activities that we have historically treated as a right. Given the nature of electoral cycles and the power of the swing voter, I wonder who might have the guts to try it.

Monetary policy

After all that, seeing through the "Jedi mind games" of central bankers suddenly seems quite easy! The reason that people refer to the statements of central bankers as such is that the intention of the central banks often appears to be to create the impact of changing policy without ever actually doing it. The threat is more than sufficient to do the job. Or perhaps they believe that if they tell us something is true enough times we will actually come to believe it (interestingly Eric Schmidt, former CEO of Google, makes exactly the same assertion when it comes to "fake news" and it how it is disseminated over social media).

When Mario Draghi, was President of the European Central Bank, he famously declared that the ECB would do "whatever it takes" to save the euro in 2012. Job done. It was only a lot later, and in response to different threats, that the ECB pulled out all the monetary stops. "Forward guidance" is another form of the same approach to policy. Tell investors and consumers that rates are going to be at a certain level well into the future, and they change their behaviour accordingly, more certain in their knowledge of the future and of their financial liabilities. The Federal Reserve's average inflation targeting policy (FAIT) is another example as it cleverly never defined the averaging period. It led people to believe that rates would remain subdued even if inflation rose above target for a longer period of time.

Most recently, there is the whole business of "transitory" inflation. The Fed coined the term (increasingly to its regret, one feels) to assure both investors and consumers that the burst of inflation that we all knew was coming as we emerged from the COVID-related downturn was not going to last for long. I would have to admit that we, too, had a similar belief. It was clear that base effects for consumer price indices meant that there was going to be a big spike up in May

of this year, but that was expected to be the worst of it. However, supply chain disruption in the face of strong demand and a squeeze in labour markets (for all sorts of reasons) has led to a more enduring period of elevated inflation.

The worry for central banks is that this prolonged period of price gains will start to elevate everyone's expectations for future levels of inflation, leading to demands for higher wages which in turn lead to higher prices, and so on – the classic wage/price spiral. So far, we have seen a rise in inflation expectations, both as measured by consumer surveys and as implied by the difference between the yields of conventional and index-linked government bonds – the breakeven rate. But they have not become what economists describe as "unanchored"... yet.

The current task of central bankers is to make sure they don't, and to this end they have been gently encouraging expectations for future monetary policy to tighten. The Reserve Bank of Australia stopped intervening to hold down the country's three-year bond yield last week, which saw yields shoot up. It holds a policy meeting tomorrow, which should be interesting. The Bank of Canada abruptly ended its asset purchase programme when the expectation was for a gradual taper. It also hinted at interest rates rising sooner rather than later as it brought forward its expectations for inflation reaching its 2% target.

But these were just the hors d'oeuvres ahead of this week's main course, when we have meetings of both the Federal Reserve (Wednesday) and the Bank of England's Monetary Policy Committee (Thursday). The good news is that a lot is already discounted. The market fully expects the Fed to announce the reduction of asset purchases. This is the taper that was once expected by many to cause a "tantrum", as in 2013, but has been exceptionally well telegraphed. I know that there is a saying in some parts of the market that nothing is properly discounted until it is announced, but it really would be surprising if there was a severe negative reaction to this.

Maybe there is scope for greater volatility if there is a shock on rates guidance, but here, too, the market has already done a lot of the heavy lifting, as has the Fed's "dot plot", which illustrates the rate expectations of all its members. It's only a few months ago that markets expected no rate rise until well into 2023. Now it thinks we will have three in 2022, another two in 2023... and then nothing in 2024. The Fed's pre-emptive moves will have tamed inflation without the need for more stringent measures. I might add that there is also a feeling that the levels of debt in the economy mean that interest rates can only rise so far before they cause a sharp reduction in activity.

UK policy changes

The story is similar in the UK, but here the order of policy changes is different, with the MPC now widely expected to raise the base rate by 0.15% to 0.25% on Thursday (and if not this month, then definitely in December). It still has firepower of around £20bn in its asset purchase programme, but this might well be stopped at the same time. The market is also expecting as many as four more rate increases of 0.25% by the end of 2022, taking the base rate to 1.25%. Much as that might sound like a very low figure to those with longer

memories, it can also be construed as a twelve-fold increase from the current level. We have already seen fixed-rate mortgage rates rising as bond yields have risen in anticipation. And as much as a higher deposit rate might be welcome (if passed on), it will still be a lot lower than inflation.

This exit from emergency policy settings is one of the reasons why we became a bit more cautious recently. I note that the last two proper tightening cycles in the UK both petered out after a rise of 1.25%. The first was in 2003-4, when rates went from 3.5% to 4.75%, and it caused a sharp slowdown in the housing market, such that the MPC cut rates again in 2005. The 2006-7 cycle saw rates rise from 4.5% to 5.75%, culminating in (although not entirely responsible for) the financial crisis. Two later 0.25% tweaks in 2017-18 can also be seen to be associated with a domestic slowdown, although one also has to take into account Brexit and the ripple effects of Donald Trump's trade wars, as well as what turned out to be over-aggressive policy tightening by the Fed.

While we are not expecting a major setback by any means and have been especially encouraged by the levels of profits reported by companies in the current reporting season, we do have to acknowledge that former monetary tailwinds are now blowing a lot more softly and could turn into headwinds. Choppier waters are ahead, but our investment vessels are deemed to be capable of weathering potential squalls without shipping water.

On a lighter note, I stopped drinking anything caffeinated about a decade ago, but promised to allow myself a proper cup of coffee every time UK interest rates were raised. That makes two cups in ten years – actually three, but the third was a waiter error in a café – and I only realised about an hour later when I was still speaking the same sentence that I'd started thirty minutes earlier. How might I harness all that stimulated energy if rates go up on Thursday? Probably best not to call me.

Economic Commentary

FTSE 100 weekly winners

Compass Group PLC	7.5%
Reckitt Benckiser Group plc	7.4%
GlaxoSmithKline plc	6.2%
InterContinental Hotels Group PLC	5.5%
International Consolidated Airlines Group SA	5.0%
Whitbread PLC	4.8%
Bunzl plc	4.5%

FTSE 100 weekly losers

Just Eat Takeaway.com N.V.	-8.7%
London Stock Exchange Group plc	-6.6%
BAE Systems plc	-6.4%
Fresnillo PLC	-5.8%
Admiral Group plc	-5.4%
Smiths Group Plc	-4.7%
Royal Dutch Shell Plc Class B	-4.7%

FTSE 100 index, past 12 months

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