Weekly Digest
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Investec
Wealth & Investment

The weekly insight into world stock markets

Happy Birthday, Mr Powell

Guess what? Another week goes by, and still no Brexit progress. Each side is blaming the other for its intransigence; there are daily rumours of Machiavellian plots in the darker corridors of Westminster; and all camps are trying to interpret any piece of economic data as supporting their own cause. The net effect has been to see various political analysts edge up their probabilities of a "No Deal" Brexit as we move inexorably towards March 29th. The fact that I shall be in Italy on that day, potentially (hopefully?) returning on the 31st, adds a certain unplanned frisson of excitement to the trip. The net effect in financial markets has been that the pound has drifted marginally off its recent highs and the FTSE 100 has clawed back some of its underperformance against the FTSE 250 Index so far this year, much as one might expect.

In the wider world, investors continue to focus on two main topics: US monetary policy, and the progress of trade talks between the US and China. Today I will focus on the former. In my first Weekly Digest this year I discussed the concept of the "Powell Put", the idea that the current chairman of the Federal Reserve would continue the policy choices of his three immediate predecessors by reacting to financial market stress with some loosening of policy. Although he and other board members had already given heavy hints to that effect, the shift was confirmed at last week's official monthly meeting. On the face of it, nothing much changed. The Fed Funds rate remains within a range of 2.25-2.5%, and the balance sheet will continue to be run down at a rate of $50bn per month. But there were notable changes to the wording and tone of the accompanying statement.

The Fed's new buzzword is "patient", adopted in the text and used several times in the press conference. The Fed is now clearly in "wait and see" mode, having been spooked by the reaction of markets to a steady drip of disappointing economic data (not just in the US) and various geopolitical threats. The reference to "further gradual increases in the target rate for the federal funds rate" was dropped completely, additionally justified by the lack of inflationary pressure. Expected US inflation, as priced by the bond market (the difference between index-linked and conventional yields) stayed in a range of 2.1-2.25% from most of 2018 before plummeting to 1.8% at the start of this year. It has since bounced to just over 2%, as it tends to correlate strongly with movements in the oil price, which has also recovered. That's bang in the line with where the Fed would like it to be.

Perhaps more significantly, the Fed also ruminated on the possibility of curtailing the reduction of the size of its balance sheet. This ballooned from around $900 billion before the financial crisis to a peak of $4.5 trillion as an assortment of bonds was purchased under the Quantitative Easing programme, and the general expectation has been that it would be reduced to a similar size relative to the economy – suggesting somewhere around $1.5 trillion (the US economy has grown about 40% in nominal dollars over the last decade). Combined with increased bond issuance by the government to fund its burgeoning fiscal deficit (courtesy of Mr Trump's generosity), that represented a considerable headwind for bond markets. However, in the post-meeting press conference, Mr Powell didn't disagree with the idea that the balance sheet could end up around $3.5 trillion. Its current size is $4.1 trillion. At a current reduction run-rate of $50 billion per month, they could be done and dusted within a year.

The fact that there is an inconclusive debate within the economics community as to whether it is the stock or the flow of QE that makes the difference to financial markets means that there has been a somewhat mixed reaction to the news in the ivory towers, but markets generally are reading this as a significant policy shift by the Fed, even to the point of being a complete U-turn relative to its position just six weeks ago.

Of course, there's always a "but". In my comments earlier this year I noted concerns about the risk of inflating speculative asset bubbles by persisting with exceptionally loose monetary policy. That risk remains real, increasing the potential for a bust at some point in the future. There is also the risk that the Fed falls "behind the curve", meaning, in this case, that inflation starts rising too quickly with the result that interest rates have to be raised further and faster in future. As we have seen in recent market episodes (notably the 2013 "taper tantrum" and the early-2018 wage inflation scare), investors do not take kindly to abrupt shifts in the perception of the direction of monetary policy towards greater tightening. All of this suggests that we will have to pay even closer attention to economic data releases, especially those relevant to inflation.

For now though, markets appear to be off one of the hooks that was restraining them, although we continue to await developments on the trade front. Specifically, a softer tone from the Fed should remove some support for the dollar (although it hardly looks as if anyone else is in a position to tighten policy aggressively for now), and this is traditionally good news for Emerging Markets. Investors could do worse than send birthday greetings to Mr Powell. He can't escape the inflation of candles on his cake, though, of which there will be sixty-six today. Clickety click! ("Stairway to Heaven" next year).

John Wyn-Evans
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FTSE 100 Weekly Winners

British American Tobacco	13.3%
Rio Tinto	9.1%
Evraz	7.2%
BHP Group	6.9%
Diageo	6.8%
Antofagasta	6.8%
Melrose Industries	6.7%

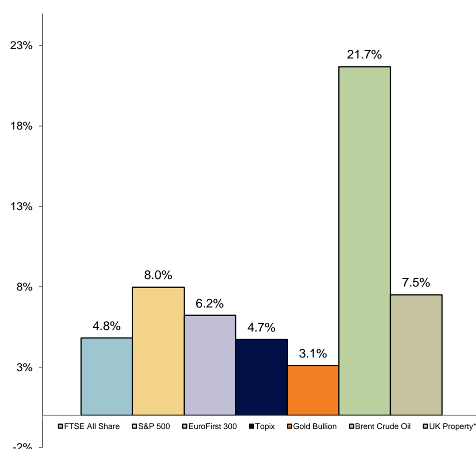
Source: FactSet

FTSE 100 Weekly Losers

Royal Mail	-9.0%
Hargreaves Lansdown	-8.1%
TUI	-4.3%
Barclays	-3.3%
NMC Health	-3.2%
BT Group	-2.7%
Standard Life Aberdeen	-2.2%

Source: FactSet

Year to Date Market Performance



Source: FactSet

*IPD Total Return to December 2018

FTSE 100 Index, Past 12 Months

Source: FactSet

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