Weekly Digest

| 07 June 2021 |

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All At C

As I was writing the latest Monthly Commentary last week, I noticed that a lot of the things I was writing about began with the letter “C”. In fact, once I had noticed that, almost everything seemed to start with a “C”. And so this week’s missive is dedicated to the third letter of the alphabet. When Samuel Morse developed his eponymous code, he wanted the more frequently used letters to have the simplest cyphers. C (- · - ·) was in the middle of the pack. A more recent study using the contents of the Concise Oxford Dictionary has “C” as the tenth most frequently used letter. According to one internet-based source, “C” is the third most common letter to find at the start of a word (after “S” and “P”).

COVID: I should probably start with this all-consuming topic (if only to get it out of the way). Despite news of new variants and the disruption they continue to cause in terms of the planned relaxation of social restrictions, our central investment case is based upon our opinion (backed up by analysis of the science) that we are on a reasonably steady path towards a return to pre-COVID levels of economic activity, even if the components of activity might be somewhat different in their relative contributions – think of the accelerated development of the online economy, for example. It is clear that not all global regions will normalise at the same pace, with vaccine availability a key factor, and this unsynchronised element of the recovery will present its own challenges as well as opportunities.

Consumer Price Index (CPI) and Central Banks: This heading has several subheadings which also begin with a “C”. Inflation (have I cheated here? That’s an “I”!) is probably the subject that most exercises investors at the moment. How it progresses will be key to central bank policy decisions in the months and years ahead. Although the central banks of Canada and New Zealand were first out of the traps with explicit statements about reining in monetary largesse, it will be decisions made by the US Federal Reserve (Fed) that most impact financial markets. The Fed is testing the water by allowing its members to start talking about the fact that tighter policy is at least a possibility within, say, the next twelve months. This would start with a tapering of asset purchases, with interest rate rises and then balance sheet reduction further out.

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The reaction so far has been relatively relaxed, but much will depend on how "transitory" the current spike in the CPI turns out to be, and we won't really know that for a few months yet. More immediately, this week's CPI release on Thursday, followed by Friday's University of Michigan consumer sentiment survey (more precisely the inflation expectations component) will be examined very closely for further clues.

Containers, Chips and Cardboard: These are all things that are in short supply, with prices being bid up in response. I wrote at some length about supply chain issues two weeks ago, and so will not repeat that. Suffice to say that companies affected largely have two options: to pass the higher costs on to customers or to take the hit in their own profit margins. The first option would feed through into higher CPI.

Corporation Tax: Here is something else that promises to be something of headwind for companies' profit margins. At the weekend, G7 finance ministers agreed the principal of a minimum 15% global corporation tax rate. This is mainly aimed at the top 100 largest and most profitable companies, who have been able to arbitrage the global tax system by being domiciled in a country with a low tax rate. They claim that their "value added" comes from their intellectual property (IP). The cost of that IP is then charged to subsidiaries in countries with higher tax rates, where they subsequently generate less reported profit. It's a clever ruse, and by no means illegal. Indeed, such practices have been encouraged by countries such as Ireland, which has turned itself into something of a tech hub thanks to its low (10%) corporation tax rate. And it's been a double winner for them. Not only does the tax revenue come in handy, but the lure of the low tax rate creates a positive network effect as more companies arrive.

In the US specifically, President Biden wants to reverse the Trump-era cuts to company taxes, although he already appears to be softening his demands for a rise to 28%. Meanwhile in the UK, the Chancellor's last budget outlined a plan to raise UK corporation taxes too. However, I continue to believe that the prospect of a general election will deter him from carrying out the plan - or at least delaying it until afterwards.

Carbon: There have been two very interesting developments recently that tell us which way the wind is blowing in terms of the pressure building up on companies that emit or enable the emission of carbon. First, a district court in The Hague ruled that Shell, the oil major, must reduce its carbon emissions by 45% from 2019 levels by 2030 - much more than Shell's own target of 20%. Second, a small activist hedge fund with a green agenda owning just a 0.02% equity stake in Exxon, the US-listed oil giant, managed to secure three seats on the board, with a little help from a few much bigger holders, admittedly. I expect more of this sort of thing to happen, with banks who provide capital to large carbon emitters possibly being the next target.

One effect is that this type of activism will potentially make carbon assets more scarce and consequently more expensive, although if it accelerates innovation and efficiency in less carbon-intensive technologies, so much the better. However, there is also the risk that it ends up concentrating far greater power over the residual production resources in the hands of national oil companies who are less beholden to the will of investors.

The price of carbon, at least as measured through carbon credits granted by governments, is in its own bull market right now. It's easier for certain carbon emitters (such as, for example, airlines) to buy a credit to offset emissions than it is to reduce them. EU-issued carbon allowances have seen their price rise from below €30 to more than €51 per tonne already this year. Some of that is the result of investment demand, where carbon is deemed to be a potentially attractive asset in its own right, uncorrelated to risk assets such as equities. Whatever the reason behind its rise, it's yet another source of inflationary pressure.

Commodities: Yet another inflationary influence. The Bloomberg Commodities Index (based on futures prices)

continues to creep higher, and now stands at its high for the current cycle. As with carbon credits, there is some element of the tail wagging the dog here, as investors have been buying commodity futures and funds as an explicit hedge against the tail-risk of higher inflation. Could this turn out to be a self-fulfilling circle? Again, having written about commodities at greater length earlier this year, I am not going to undertake another deep dive today. There remains no consensus about the potential strength and depth of the current cycle, and I receive as many opinions supporting the "supercycle" theory as I do those calling an imminent peak. As long as equities (and other risk assets) continue to rise alongside commodities (that is, that they remain "positively correlated", in the jargon), there is less to worry about. But if they part company, with equities selling off, then commodities will become even more desirable as a diversifying asset. For now, we prefer to gain exposure through the shares of mining companies instead, and these will continue to throw off huge amounts of cash even if the underlying commodity prices stall.

Correlations: As hinted at in the last section, correlations between asset classes are a key driver of optimal portfolio construction, and the advent of "big data" and unconstrained computing power has spawned a whole industry built upon forecasting the future based on historical precedent. We have written regularly in the past about the benefits of bonds and equities being uncorrelated for the past two decades, which has reduced overall volatility in balanced portfolios, handing investors excellent risk-adjusted returns (with the understanding that risk is defined as volatility). Seeking out the right type of uncorrelated assets with which to populate a balanced portfolio in different investment regimes has therefore become something of a "holy grail" mission for asset allocators. And like that mythical religious relic, it will probably be equally unattainable. Why? Because correlations have a nasty habit of changing. After all, bonds and equities were positively correlated from the 1970s until the turn of the millennium.

Much attention (see above) is now being paid to inflation. The last time we had really nasty global inflation was in the 1970s, and so analysts and strategists are looking back at what worked best then, with Energy and Gold consistently coming out on top. But how much of that energy performance was down to, first, the machinations of OPEC's embargo and, second, the revolution in Iran? How much of Gold's performance was a direct result of President Nixon's breaking of the Bretton Woods monetary system in 1971? And while it's possible to see echoes of those factors today, it still feels like soft ground on which to be building the foundations of a whole portfolio. Remember, also, that instruments such as index-linked bonds didn't exist in the 1970s, with UK I-L Gilts being the first of their kind in 1981 – just in time for the peak of that inflation cycle!

Cryptocurrencies: Finally, and if only to head off further enquiries for now, we continue to exclude cryptocurrencies from our list of assets deemed appropriate for the portfolios which we manage. Even were we able to establish a robust valuation model (which we are not), there are further complications around the custody of crypto assets and the high costs of the investment vehicles that do exist. The recent volatility in the price of, for example, Bitcoin, provides a stark reminder of the risks involved, especially for those with leveraged positions. We continue to be mindful of the potential for crypto tokens, the underlying blockchain technology, non-fungible tokens and decentralised finance, but with no intention to commit client funds at this time.

I know I have promised to write more on this subject, but the further I go down the rabbit hole, the darker it gets. Not only that, this being a nascent industry, it is expanding faster than the universe at the dawn of time, with central banks now also getting in on the act with the development of their own digital currencies. I have no doubt that this train has left the station, but it could be heading to one of many potential destinations. Any assertion of certainty in this regard remains in the realms of speculation, in our opinion.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Scottish Mortgage Investment Trust Plc	5.1%
Johnson Matthey Plc	5.0%
Admiral Group plc	4.8%
BP p.l.c.	4.2%
Intermediate Capital Group plc	4.2%
Entain PLC	4.1%
Burberry Group plc	3.8%

FTSE 100 Weekly Losers

B&M European Value Retail SA	-7.2%
Fresnillo PLC	-4.1%
Kingfisher Plc	-4.1%
National Grid plc	-3.1%
Intertek Group plc	-3.0%
International Consolidated Airlines Group SA	-2.4%
Ocado Group PLC	-2.2%

FTSE 100 Index, Past 12 months

Source: Factset

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