Weekly Digest

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FAQs

I have recently hosted a couple of webinars for clients and Advisers, and during the course of them received a lot of questions – far more than could be answered in the allotted time. Therefore I decided it might be a good idea to bundle up the most frequently recurring themes into this week's commentary. As questions were solicited in advance, as well as on the day, I'm glad to say that I was able to anticipate some of the main concerns, notably inflation and bubble fears, although I will reiterate the views on both of those subjects. Plenty to get your teeth into here with the most Frequently Asked Questions. Apologies if yours was missed. I will endeavour to take others into account in future commentaries.

Inflation: This was by far the number one topic, unsurprisingly perhaps, as the financial press is all over it too. Not only does it potentially have a meaningful impact on our daily lives, but it also has major implications for investments and portfolio construction. We have just lived through four decades during which inflation has trended lower, delivering excellent returns for balanced portfolio investors. Might that be about to change?

Central banks have been trying to create more inflation since the financial crisis (or earlier in the case of Japan) with little success. In an increasingly leveraged world, deflation can be seen as a much greater threat, leaving countries and companies trapped under their debts. Will they succeed this time? Perhaps what is different is that fiscal stimulus has also been recruited, reversing the austerity trends of the past decade.

Much of the fiscal stimulus so far has been used to replace investment and consumption lost to Covid. What if it continues as underlying demand recovers? Will that create excess demand relative to tight supplies, finally boosting prices? And how persistent will it be?

As we have observed in the past, there is absolutely no consensus on this, with the majority of inflationists and deflationists sticking to their guns. But if one were to take a signal from markets, it is clear that the threat of deflation that was evident last March has now been erased, and that the risk of higher inflation is recognised. The key indicator is the US Breakeven rate, which infers future inflation expectations from the difference in yields on inflation-protected and conventional Treasury bonds. Last March it was 0.5% (expected average for the next ten years), and now it is 2.21%, matching peaks last seen in 2018, when, of course, the Federal Reserve embarked on policy tightening that helped to contribute to the sharp sell-off for equities in the final quarter. But this time they are set to let inflation "run hot" for a period.

One thing we do believe, though, is that inflation indices are set to spike higher in the spring, as the deflationary effects of Covid last year set a very low comparative base for this year. Remember that oil briefly traded with a negative price (in futures markets at least), for example, and many countries

reduced certain taxes on a temporary basis. These base effects will be exacerbated by short-term supply issues with, for example, shipping containers (too many empty ones on the wrong side of the world), semiconductors (several auto manufacturers have had to reduce production of their computers-on-wheels) and even cardboard boxes (thanks to online shopping). But all of these should be no more than passing problems. There will also be some highly volatile pricing for things like air fares and hotels. It is not impossible that markets extrapolate these short-term trends, leading to a sell-off in bond markets and the consequences of that (see below).

Further out, though, we continue to see inflation remaining relatively subdued owing to overhanging debts, ageing populations (who save more) and the advance of technology. The "sweet spot" for equity investors has historically been in the 1-3% range. Obviously we will be watching like hawks for a break out of that range, but for now the policy is to seek out viable inflation insurance assets (index-linked bonds, real assets, for example) rather than to bet the farm on it taking off.

Market Bubbles: There is little doubt that there are pockets of speculation and euphoria evident in financial markets. Much of this is down to the abundance of cheap liquidity enhanced by increasingly frictionless access to financial markets. The "buy the dips" mentality in which central bank support is seen as underwriting losses is pervasive. Media reporting of what, in overall market terms, are relatively trivial episodes (such as the recent GameStop saga), help to inflame sentiment. Neither does it help that any number of high-profile investors and market commentators would love to gild their reputations by "calling the top". However, we struggle to see a pervasive market bubble.

To be fair, much of our opinion is dependent upon the prevailing level of interest rates and bond yields, and so is deeply entwined with the inflation debate. Current low rates greatly enhance the net present value of future cash flows and dividends – that's just how the maths works. Furthermore, especially if one observes the upper echelons of the US stock market (which is the target of most people's bubble charges), the leading companies are exceptionally profitable and still have attractive growth profiles. These characteristics make them extremely valuable using dividend discount or discounted cash flow models. Short-term price/earnings multiples fail to capture the opportunity. Meanwhile, a lot of apparently "cheap" companies are valued as such for a reason. Their future growth and return outlook is limited and they will struggle to compound the returns within their businesses – although none of this precludes a short-term rally if the current economic cycle turns in their favour.

"Bubble" suggests irrational behavior, and we find markets, by and large, to be quite rational at the moment. The biggest risks to the current trends are two-fold. First, if interest rates/discount rates rise rapidly and meaningfully, the high-fliers will almost definitely de-rate.

Unless central banks execute a massive U-turn, this appears improbable, although we cannot discount a short-term scare if/when inflation indices spike in the spring (see above). Second, there is risk to profitability in the form of, say, tighter regulation or higher taxes, as well as the more prosaic business risk from competition or the advent of new, better technologies. These are things that we monitor as part of our regular analytical process. Much, perhaps, will depend on the attitude of the Biden administration, but bear in mind that Big Tech tends to be Democratic in its politics. How aggressively will it want to bite the hand that feeds?

Government Debt/Taxes: While governments across much of the world are being given a free pass to open the fiscal taps in response to Covid, it is not unreasonable to ask when and how the debts get paid off. Under normal circumstances, countries with debt/GDP ratios over 100% would be given a wide berth. Now it is par for the course amongst most developed countries. Implicit within this is safety in numbers. If you sell one country's debt or currency, where do you invest instead? Even so, such high debt levels are shown in the past to have curtailed future growth, and there will come a point at which investors will begin to want to see concrete plans for debt reduction. We envisage three potential paths.

The first would be a return to austerity, but we do not believe that this is a politically palatable option, especially as many public services are on their knees already. The exit route we would all love to

see would be a return to strong, productive growth in which the numerator (debt) would shrink relative to the denominator (GDP). Not impossible, but it does require judicious investment decisions and persistent technology tailwinds. The most probable outcome in the opinion of many – and one that I tend to share – is some form of financial repression combined with higher taxes aimed at top earners and those whose assets have benefitted from the tailwinds of loose monetary policy. Financial Repression involves suppressing the returns available on safer cash deposits and bonds while allowing higher (but not ridiculously high) inflation rates to lower the debt burden in real terms. This strategy was carried out with some success by the United States after World War II, but with overall demand boosted by more borrowing from the private sector (households and companies) which was starting out from a very low debt position.

No easy options, really. As long as interest rates remain as low as to make the servicing of public debt easily affordable, then investors appear willing to wait and see on this front, and so it appears that no public debt crisis is imminent. Burgeoning savings also help to create demand for new debt. But we are aware that this situation cannot persist indefinitely – and so is the market. Thus the demand for alternative assets such as Gold, other precious metals and Bitcoin, assets deemed (rightly or not) to be better stores of value if faith in fiat currencies is undermined.

Return Targets: I often make the point that we don't offer year-end targets for indices such as the FTSE 100. Why leave oneself hostage to fortune to a prediction that could be affected by any number of short-term random factors? However, we do have an internal process that attempts to project seven-year forward returns across a range of asset classes, and therefore what the outcome should be for balanced portfolios across the range of risk appetites. We are currently undertaking this year's "Blackbook" meetings to reach our updated conclusions, and I will share some of them when they are available. Without giving too much away in advance, though, it's clear that current bond yields will curtail overall returns in balanced portfolios. Not only do they offer little in the way of income, but neither will they deliver much in the way of rerating potential for equities.

Crypto: This is another subject I am planning to write about in more detail in the weeks ahead. You might have noted that the UK's Financial Conduct Authority has recently done its best to dissuade private investors from getting involved in, for example, Bitcoin, by telling them that they should be prepared to lose their whole investment. But Bitcoin, in particular, has also recently received the endorsement of several high-profile professional investors. There's an awful lot that needs to be unpacked here, which is why it deserves its own piece. Some key things to consider include the difference between cryptocurrencies and the blockchain ledgers that underlie them; also the difference between cryptocurrencies and government-sponsored electronic currencies; and, should one conclude that some form of cryptocurrency is a viable portfolio constituent, then how should one size a position? I could be spending a few weeks down a deep rabbit hole!

Negative Interest Rates: This has been a concern for a while. It's one thing for deposits in the bank to be earning nothing, but can one stomach the prospect of having to pay for the privilege of having cash on deposit? In reality, in those regions which do have negative interest rates (e.g. the euro zone and Switzerland), negative rates have not filtered down to the average consumer account. The banks are taking the margin hit on the chin, one factor that has contributed to poor performance for the sector.

I believe that in Switzerland the negative deposit rate (-0.75%) kicks in over CHF 2 million. Large corporations (and aggregated cash balances in wealth managers' accounts) are losers too, forcing cash deposits into other, potentially more risky, assets. The Bank of England's policy on negative rates remains a work in progress. Most recently it has asked banks to consider how they might apply a negative rate, but not within the next six months. Meanwhile building societies complain that their systems would not know how to deduct interest. The Bank appears to want to keep all its options open without actually reaching a conclusion. Part of me thinks that it is desperately hoping that the economy recovers sufficiently quickly to render the whole discussion unnecessary. We find little evidence to support the case for negative rates, and note that Sweden abandoned them as being unhelpful, and possibly even making matters worse.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Company	Change
Whitbread PLC	17.7%
Natwest Group PLC	15.4%
JD Sports Fashion PLC	14.2%
InterContinental Hotels Group PLC	12.3%
Lloyds Banking Group PLC	12.1%
Barratt Developments PLC	11.1%
Taylor Wimpey PLC	10.3%

FTSE 100 Weekly Losers

Company	Change
Pearson PLC	-11.0%
BP PLC	-7.2%
GlaxoSmithKline PLC	-6.7%
Unilever PLC	-6.1%
Just Eat Takeaway	-5.0%
Hargreaves Lansdown PLC	-4.7%
J Sainsbury PLC	-3.5%

FTSE 100 Index, Past 12 Months

Source:FactSet

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