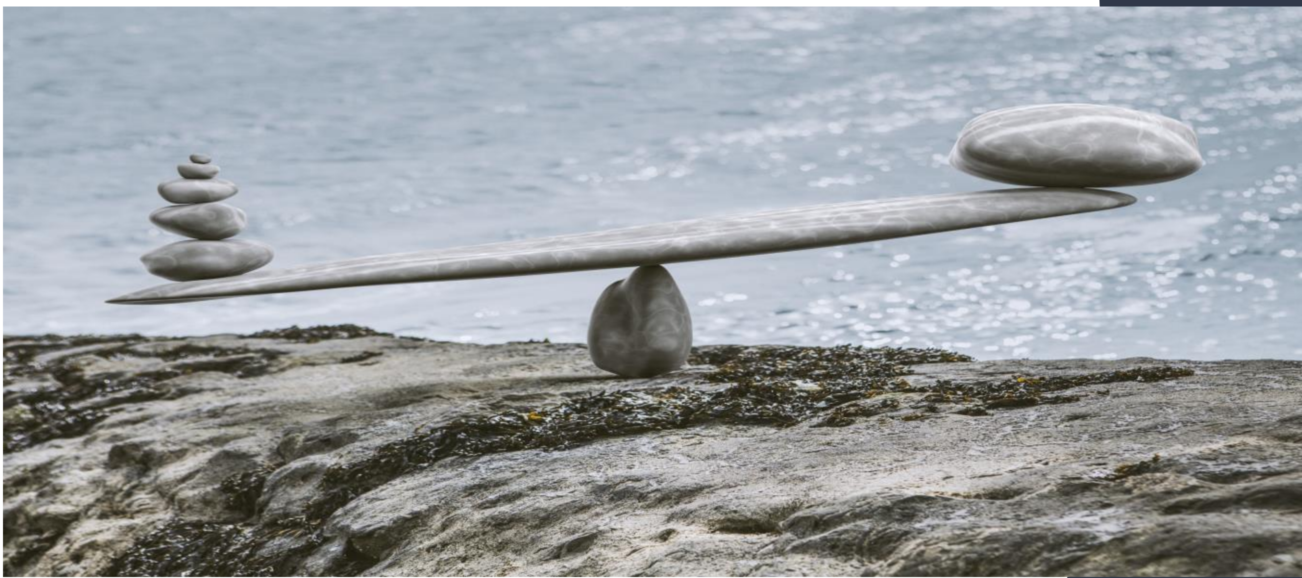
Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 08 November 2021

Happy Vacciversary!



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Head of investment strategy

Still no coffee for me, then! The Bank of England dropped a bombshell on markets last week by not raising the bank rate despite multiple warnings to the effect that it was going to. Cue much consternation and complaint. Governor Andrew Bailey was demoted to the status of "unreliable boyfriend" by financial market commentators, the label originally applied to previous incumbent Mark Carney when he changed the Bank's policy tack unexpectedly.

This whole concept of central bank guidance is fascinating, and I alluded to it last week when discussing the Jedi mind games played be central bankers. It was not always this way. Central banks used to retain an element of surprise in delivering policy changes, which at least introduced some jeopardy into the investment process. In the UK, before the Bank of England was granted independence in 1997, the base rate was in the control of the Chancellor of the Exchequer, which allowed for some theatrical cuts to accompany budget statements and, unsurprisingly, an element of manipulation to fit in with the electoral cycle if possible. To that extent, at least, it is healthy to have interest rates under the control of technocrats rather than politicians.

One of the undoubted aims of forward guidance is to create financial stability, and I don't necessarily refer to that just in the context of the economy, but as much in the context of financial markets. This has increasingly become the case as financial markets have become more complex and interdependent, and also more leveraged. Reports are circulating about some high-profile hedge funds suffering large trading losses in their government bond positions last week as a result of having been positioned for a tightening of policy. The fear is that if the losses become too big it forces the unwinding of other positions which then further increases volatility which, in turn, forces more deleveraging owing to the application of the concept of "value at risk" (VaR), by which gross trading positions are controlled by the level of volatility.

This might all sound very arcane and technical, but we have seen before what can happen when an aggressive forced VaR reduction leads to liquidity disappearing from markets very quickly. It created turmoil in equities during the "Volmageddon" episode of February 2018, and in the bond market during the early stages of the COVID panic in March 2020. One solution might be to reduce the amount of leverage in the financial system, but that seems an unlikely outcome, in which case central banks will continue to stand by with a liquidity firehose at the ready. And they will have to continue to choose their words extremely carefully.

If one were to give Mr Bailey - and, to be fair, the other members of the Monetary Policy Committee (MPC), who voted 7-2 in favour of no change - any benefit of the doubt, it would be that he was taking into account the element of uncertainty in the UK labour market. The government's furlough scheme has only just ended, and it is far from clear what the effects are, especially when you try to factor in continuing COVID and Brexit-related disruption. There are two employment reports scheduled before the next MPC meeting (16th December), and so one would expect a more decisive outcome next time.

But one thing seems to be clear, and that is that central banks are far more concerned about economies tipping back into recession/deflation than they are about higher inflation in the short-to-medium term. This point was made most aggressively by Christine Lagarde, President of the European Central Bank, last week, when she pushed back strongly against the market's view of rising interest rate expectations.

All of which has been manna from heaven for equity investors, as markets tracked higher yet again, with more new all-time highs for a number of indices around the world (although still not the UK). Talk is rife of a potential "melt-up" in equity markets, which is a little disconcerting when our asset allocation committee has just taken a marginally more cautious stance. But the latest highs are being driven primarily by liquidity, and we continue to wonder for how long that is going to be as abundant. The two more fundamental drivers of equities are earnings and the discount rate. Despite a strong quarterly earnings season there is limited evidence of any great increase in expectations of future earnings. And real bond yields are back down to their cycle low (-1.09%, for example, in the United States, using the Federal Reserve's official measure).

Can they realistically go much lower? Possibly, but then we would be getting deeper into the realm of outright Financial Repression. And for all we have talked about it as a potentially expedient way to escape current debt burdens, it's not clear that this is actually policy... yet. This leaves investors in a bind. Because if growth and inflation are going to be allowed to rip without a rise in interest/discount rates, it will result in a huge difference in how the relative trade between growth/value, defensive/cyclical, long/short duration plays out. A balanced portfolio realistically needs one foot in each camp until matters become clearer.

It's now pretty much a year to the day since Pfizer announced the trial data for its COVID vaccine. Indeed, Monday 9th November 2020 has gone down in financial market history as "Vaccine Monday". And there were similar announcements from Moderna and AstraZeneca on the two following Mondays. It was quite a month, in which everyone began to reassess the prospects for life in the post-COVID world.

Equity markets have enjoyed a good run since then. The MSCI All-Countries World Index is +27.7%. The UK's FTSE 100 is +23.5%, with the more economically sensitive FTSE 250 +31.4% and Small Caps +42%. The EuroStoxx is +31.9%. In the US, the S&P 500 is +33.8%, while the more tech-orientated NASDAQ Composite is +34.2%. Japan's TOPIX has lagged, rising 22.7%, but that's nothing compared with Hong Kong (-3.7%) and China (CSI 300 -0.8%). The latter have been dealing with their own specific issues of tighter regulation, more restrictive monetary and fiscal policy and stress in the real estate market.

But, as ever, headline indices fail to capture the whole story. The leading UK sector, by a mile, is Industrial Transportation, with a gain of 121%. That is followed by Oil & Gas (+69%), Metals & Mining (+56%) and Aerospace (+53%) - all sectors that are deemed sensitive to the "re-opening trade". Next in line is Banks, which is not so much about re-opening as less concern about bad debts and the potential for rising interest rates to boost profitability. The picture in the US is similar, with Energy (+98%) and Financials (+59%) leading the way, and Consumer Staples (+14%) and Utilities (+5%) lagging.

But if we look at the relative performance of Growth and Value styles at the global level, it is somewhat surprising to find that the performance difference is not as great as one might have expected. MSCI World Growth is +29.5%, while MSCI World Value is +32.5%, with a slightly bigger gap on a total return basis owing to the higher dividend yield offered by Value.

Unfortunately, MSCI does not produce what we might call a “meh” index, which would cover all those stocks that offer neither compelling value nor growth (“meh” is defined as “uninspiring” or “unexceptional”). My suspicion is that it would be a distinct laggard, but no doubt its day will came again at some point when markets are faced with a more toxic combination of rising discount rates and slowing growth. For now, though, investors – particularly those managing to benchmarks as opposed to absolute return – appear more inclined to continue with the barbell approach.

Economic Commentary

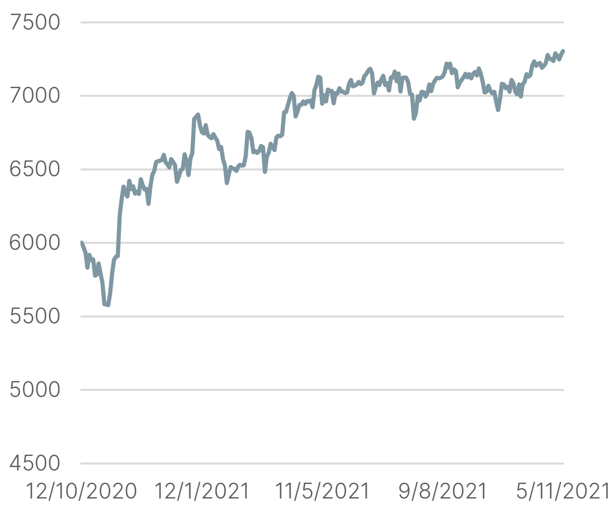
FTSE 100 weekly winners

International Consolidated Airlines Group SA	10.0%
Smith & Nephew PLC	9.1%
Rolls-Royce Holdings plc	8.4%
Melrose Industries PLC	6.2%
Smiths Group Plc	5.9%
Informa Plc	5.6%
Associated British Foods plc	5.5%

FTSE 100 weekly losers

Flutter Entertainment Plc	-8.2%
Standard Chartered PLC	-7.4%
J Sainsbury plc	-5.0%
Barclays PLC	-4.9%
Ocado Group PLC	-4.3%
Antofagasta plc	-4.1%
Evraz PLC	-3.3%

FTSE 100 index, past 12 months



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