Weekly Digest

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One step back

I've never subscribed to the "what goes up must come down" school of thought as it pertains to long-term equity investment. One only has to dig out a few charts to observe that equity markets tend to follow a path that leads from the bottom left hand corner to the top right. Admittedly most of these charts are in nominal values, and so do not account for the effects of inflation, but even in real terms equities do well. After all, the revenues, profits and dividends that drive them are derived from the real world and therefore generally keep up with inflation across the cycle. So why are so many people worrying about a resurgence of inflation now?

The problem lies in getting through the cycle. Those with longer memories will recall the 1970s and 1980s, when much higher levels of inflation prevailed. Two factors in particular weighed upon equity markets during those periods. First, profits were put under pressure by high interest rates. Not only did these raise the interest bills for companies, thus reducing net profitability, but revenue also suffered owing to reduced demand as consumers had to divert more of their income towards servicing their debts. The combination of these factors also propelled unemployment higher, greatly exacerbating the effect.

Second, higher interest rates and bond yields raised the discount rate used to value longer duration assets such as equities. This sent equity valuations plummeting. Indeed, at its lows in 1974, the UK market was trading on a price/earnings ratio of about 4. That compares to a current 12-month forward PE of around 15.

Now, we are not suggesting for one moment that we are going to revisit those valuation lows. But it's useful to remind ourselves what an important role the discount rate plays in the valuation process.

Where are inflation expectations currently? Well, they are far from extreme, according to the breakeven rates derived from the bond market, but they are definitely edging higher. In the UK, the 10-year breakeven rate (the expected average rate of inflation over the next decade) is 3.2%. This is based on the somewhat discredited RPI (Retail Price Index) measure, which tends to be around 1% higher than the more widely used CPI (Consumer Price Index). So 2.2% is closer to the mark. That is reassuringly close to the Bank of England's preferred 2% target.

The same measure in the US reads 1.9%. Again this is very close to that 2% target, but markets are getting a little antsy because the measure has risen from as low as 0.55% last March and is now higher than it was immediately pre-pandemic. In the Eurozone the readings are generally lower. In Germany, for example, the figure is 0.92%, and the other major countries are grouped reasonably closely either side of that. That is a long way below the European Central Bank's 2% target. Japan's bond market has pretty much given up hoping that the Bank of Japan will ever reach its aspiration of 2% inflation. The 10-year breakeven rate there is just 0.008%.

But, as we often observe in financial markets, it's not always the current absolute level of any indicator that matters, so much as what direction in which it is travelling.

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Therefore, even if current inflation expectations are not too worrisome, the fact that they are rising might be. Just to confuse matters further, when inflation expectations are rising from very low levels, that is seen as good news because threats of deflation – potentially an even more pernicious beast – are being alleviated. Somewhere, though, there is a tipping point at which rising inflation expectations become decidedly bad news. Our observations suggest that somewhere closer to 3% is where the trouble starts. Indeed, inflation in the 1-3% range historically has been something of a sweet spot for equity valuations – the fabled "goldilocks" range: not too hot, and not too cold.

It will be very interesting to see how things develop over the next few months. Year-on-year inflation levels could be quite perky by the middle of 2021, owing to the very low base effects of 2020. The price of oil, in particular, will be a major factor. Brent crude bottomed below $20 in April and is now close to $50. Of course, these extremes are not reflected in retail prices because of tax and duty effects and the fact that there are other costs that have to be covered, but the pressure will still be up. If the population decides to go on a massive binge once the vaccines do their work, there is the possibility of supply shortages in certain industries, which could lead to higher prices too. And this resurgent demand will be underwritten by loose fiscal policy.

The message from this is that the ongoing recovery in equity markets will not necessarily be straightforward, although we do believe that it will continue. There is much to suggest that we are at the beginning of a new economic cycle, and that neither governments nor central banks are intent on cutting it off prematurely – quite the opposite. But markets will jump at the shadows of the threat of higher inflation. The economic recovery itself will be bumpy. We are already seeing that, following a resurgent third quarter, many major economies will have shrunk again in the fourth quarter thanks to the imposition of more stringent social restrictions. That might well be a recurring theme throughout the winter.

While we are pretty optimistic about vaccines, with more trial data soon to be announced, it would also be naïve to believe that there will not be any glitches in the distribution, which will no doubt be reported in apocalyptic tones. Perhaps the biggest risk is that one person in a million will develop an adverse reaction to a vaccine. It would probably be a miracle if nobody did at all. But, again, just imagine how this will be reported and then amplified through social media. However, as long as we see that the underlying trends of vaccination, normalisation of activity and economic recovery remain in place, we can stick to our guns.

Finally, I can't not mention something else that has very much been a process of steps forward and then back, and that is Brexit. Indeed, we are now a lot further from agreement than we appeared to be twelve months ago. With both sides accusing the other of various acts of perfidy, there is certainly no guarantee of a deal, despite the fact that it remains our opinion that "no deal" would be damaging to all.

The irony is that although this is supposed to be about a trade deal, the main sticking points regarding aspects of governance and the level playing field of regulation are more about sovereignty. Accommodating ideologies is much more difficult than thrashing out terms of trade. Somehow, the major actors on both sides have to come out of this looking like they have won. I honestly don't know what happens next. The pragmatic view has been that a deal would be the most sensible outcome, but who can be sure? Maybe it is only the Irish border situation that can keep talks on the rails.

Such uncertainty has been reflected in the pound's weakness today, and sterling has been a consistently efficient barometer of the current state of play. It is not beyond the bounds of possibility that one side storms out of talks within the next day or so, but even then that does not guarantee the end of them. Sometimes it takes such a shock to concentrate minds again. Given that the last European Union Council meeting of the year begins on Thursday, though, it looks like everything might come to a head in the next couple of days. Greater volatility is about the only thing I am prepared to predict with any confidence.

Last week's Economic Highlights

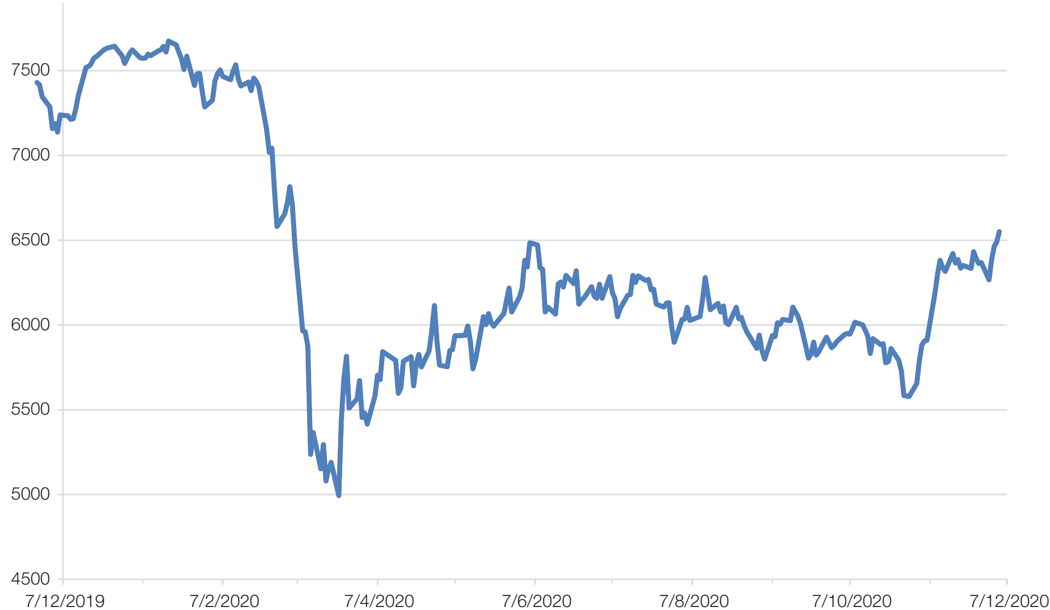
FTSE 100 Weekly Winners

Company	Change
Rolls-Royce Holdings plc	21.0%
Antofagasta plc	14.1%
Anglo American plc	11.9%
JD Sports Fashion Plc	11.4%
Glencore plc	11.3%
BT Group plc	11.2%
BHP Group Plc	11.1%

FTSE 100 Weekly Losers

Company	Change
Phoenix Group Holdings plc	-8.2%
Sage Group plc	-5.9%
Unilever PLC	-5.7%
Wm Morrison Supermarkets plc	-4.8%
AVEVA Group plc	-4.7%
Severn Trent Plc	-4.0%
Hikma Pharmaceuticals Plc	-3.2%

FTSE 100 Index, Past 12 Months



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