Weekly Digest

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Devil In The Deltas

While English football fans are experiencing the déjà vu of losing yet again after a penalty shoot-out, readers of this missive might well be having the same feeling in a few minutes (although hopefully less despondent!) because the main topics exercising the minds of investors remain very much the same as we covered last week, namely the gyrations of bond markets and the renewed pace of growth in the incidence of COVID infections.

No doubt everyone has had quite enough of COVID statistics by now, but it's impossible to ignore them, and the rapid spread of the Delta variant is forcing some recalibration of expectations for the pace of the economic recovery - although there is limited evidence of any shift lower in consensus forecasts yet. The big difference between now and the original outbreak, though, is that the impact of rising infection rates is being mitigated by vaccination. Data for the UK last week show that of the 3,460 people admitted to hospital with COVID, 65% were unvaccinated, 23% had only received 1 dose, while 10% were fully vaccinated – with the latter number a stark reminder that even double vaccination does not guarantee full protection.

Even so, as we have written about in recent weeks, the high infection rate of the Delta variant almost guarantees that, in terms of new reported cases, things are going to get a lot worse over the next few weeks, with mass participation events such as the Euro 2020 football championships and the Tour de France cited as particular risk factors in terms of spreading the virus faster and more widely. Investors (and indeed health officials and governments) will be faced with having to triangulate between infection rates, the percentage of populations vaccinated (and, possibly, which vaccine they have received) and the hospital occupancy rate. One cannot rule out a delay to the ending of certain restrictions, or of them being reimposed at some point. For the record, I will continue to wear a mask in indoor public spaces and attempt to do as much socialising as possible outdoors for the foreseeable future.

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There will be some distinct regional variations. On average, large (northern hemisphere) western developed countries are ahead of the game in terms of vaccinations, although there is an interesting wrinkle in the United States, where the vaccination rate tends to be lower in Republican-leaning states. Emerging Market economies are generally much further behind. That presents its own challenges for the developed world. In China, for example, local outbreaks and the ensuing lockdowns have shut ports which supply all sorts of goods to the rest of the world. Such supply chain bottlenecks have been a key contributor to short-term rises in inflation and might not ease as quickly as we would like them to. The latest data I have for China inform me that only 15.5% of the total population has been fully vaccinated, and, furthermore, the Chinese vaccines are deemed not to be as effective as those available in the West.

Even so, the generally held view, and one to which we subscribe, is that the full reopening of economies is delayed rather than cancelled. The greatest threat to such a view would be the emergence of yet another variant which can evade the defences provided by current vaccines. As for the corporate sector, perhaps the biggest risks are for those companies that continue to burn through cash resources while awaiting a return to normality. Should they look like running out, they will be forced to raise funds, the cost of which will dilute the benefits of the full recovery when it materialises.

The rising incidence of Delta variant cases (and the associated prospect of a delayed recovery) is one of the factors that has been weighing on bond yields, which have surprised the majority of market participants by heading lower in recent weeks. The key US ten-year Treasury bond yield, which effectively sets the discount rate by which much of the stock of the world’s financial assets is valued, maintained its falling trend last week, ending at 1.34%, which is down from a peak of 1.74% at the end of March. All sorts of other reasons are being put forward. These include: a recent lack of bond issuance by the US government while it has been running down its cash balances at the Federal Reserve; buying by pension funds taking advantage of stronger equities to switch into bonds to match their liabilities; risk parity funds leveraging up their portfolios in the light of reduced market volatility; momentum-driven funds, latterly, becoming buyers of bonds; and, the ultimate cop-out, positioning, meaning that the majority of investors were wrong-footed, having expected yields to rise (recent client surveys suggest that most fund managers expect the US ten-year yield to be much closer to 2% by the end of this year, and the majority of investment bank forecasts that I see are similarly inclined).

As ever, it’s probably an indefinable mix of all the above. But one thing I would emphasise is another type of delta, which is mathematical shorthand for the rate of change, also known as the second derivative of growth. This concept is always worth revisiting, because it plays an important role in financial markets. Investors tend to focus not on the absolute level of growth, but more on the pace of that growth relative to what is has been. This leads to behaviour that often appears counterintuitive. For example, equities can rally strongly even in the midst of recessions (as they did last year) once investors believe that the rate of deterioration is abating. Similarly, they can stop rising despite plenty of good news if that news is not accumulating any faster.

Right now, we are in the latter camp as far as economic momentum and corporate earnings growth are concerned, meaning that the upward trajectory of equity markets has decelerated, and that sectors more exposed to the reopening trade have come well off their peaks. It shouldn’t really come as a big surprise. If economic growth and company earnings were rebounding from COVID-related lows, it was always going to be impossible for the rate of recovery to persist. More encouragingly, the same principle applies to consumer price inflation. Another one of the reasons why bonds rallied when headline US annual inflation hit 5% in May was that the market decided that the monthly rate of change had peaked.

The falling bond yield has been especially positive again for the valuations of long duration growth stocks, leading to a much better performance for the five big companies that make up around a quarter of the S&P 500 Index. These are currently Apple, Microsoft, Amazon, Alphabet and Facebook, with Microsoft having recently joined Apple in the exclusive $2 trillion dollar market capitalisation club. But if investors continue to apply the logic expressed above, it is quite possible that bond yields will start rising again and that more cyclical stocks will start to outperform just when we are witnessing substantially higher absolute numbers of COVID infections and consequently rising hopitalisation rates later in the summer – at least as long as the rate of increase in those numbers is declining.

This is the sort of stuff that leaves you needing to wrap your head in cold towels, especially if you try to keep up with every single twist and turn in the data. It also means that you can easily get whipsawed if you try to trade them all too. And so, even though I often write about factors that are driving markets on a short-term basis, we very rarely attempt to trade them, preferring, instead, to stick to longer term investments and themes, driven by our analytical process.

Last week's Economic Highlights

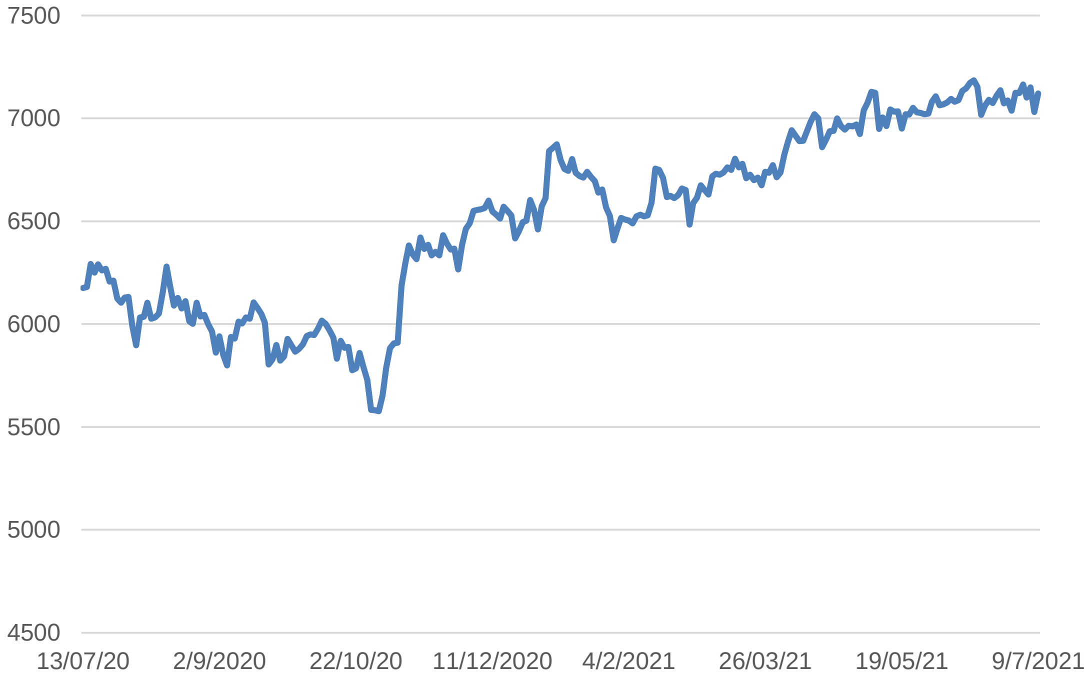
FTSE 100 Weekly Winners

Tesco PLC	5.8%
Bunzl plc	5.2%
BHP Group Plc	5.1%
SEGRO plc	5.0%
J Sainsbury plc	4.5%
Entain PLC	4.0%
United Utilities Group PLC	3.9%

FTSE 100 Weekly Losers

Associated British Foods plc	-6.1%
B&M European Value Retail SA	-4.6%
Compass Group PLC	-4.1%
Just Eat Takeaway.com N.V.	-4.1%
Flutter Entertainment Plc	-4.1%
Informa Plc	-4.0%
BT Group plc	-3.8%

FTSE 100 Index, Past 12 months



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