Investec

OUT OF THE ORDINARY

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Alternate Realities

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Most weeks there is an overarching theme for the Weekly Digest, but this week's edition feels more varied. There are a lot of things going on, and yet none of them appear to be capable (yet) of knocking financial markets out of their current stride. Indeed, to read/listen to the daily headlines one might believe that markets were all over the place, but in fact the headline indices are relatively stable. Every Monday when I host our internal Morning Meeting I recap some of the moves from the previous week and recently they have rarely amounted to much.

Of course, there will always be an exception to prove any rule. Natural gas prices have been particularly volatile of late, and then there was the bond market reaction to the Bank of England's decision not to raise the base rate the week before last. Last week it was the move in US inflation expectations following the release of the latest consumer price indices (CPI). The most timely indicator is the inflation breakeven rate, which is calculated from the difference between the yields on conventional and inflation-protected Treasury bonds.

The two-year breakeven rate shot up over the week from 3.05% to 3.37% which is uncomfortably higher than the Federal Reserve's target rate of 2% (although, as we have discussed before, under its average inflation target proposal, it is happy to let inflation "run hot" for an undefined period to make up for past shortfalls). The better news is that the longer end of the curve did not react as violently, with, for example, the ten-year breakeven rate rising "only" 0.17% to 2.72%. And we can tell what the market thinks about inflation prospects for just the second half of the decade ahead from the five-year/five-year rate (which tells us what the market thinks inflation will be on average for the five years that begin in five years' time). That was even lower at 2.31% (+0.1%).

The key message here is that inflation expectations have not become unanchored, which is central banks' and investors' greatest fear. Yes, inflation will remain elevated for a while, possibly well into 2022, but it will then subside, although to higher levels than generally prevailed pre-COVID. The same is true in pretty much all the major regions we follow, although we note that markets expect inflation to be higher in the UK and lower in Europe.

The next CPI release in the UK is due out on Wednesday, and it will look relatively benign compared to the US figure of 6.2%, with the headline number forecast to rise from 3.1% to 3.9%. Don't be fooled. We are still several months away from the predicted peak in annual inflation readings. We have an almost guaranteed sequence of dreadful inflation headlines in front of us, potentially stretching as far as April's data which will reflect the next raising of the retail energy price cap, and that will only serve to inflame the negative sentiment about prices and living standards.

This is beginning to be noticed. I bumped into a neighbour at the weekend who was on his way home from Iceland (the supermarket!). He is a pensioner living in council accommodation. He commented that if prices keep rising at this pace he will have to rob a bank to buy his groceries. The best advice I could offer was not to get caught. Of course, it is hardly scientific to use anecdotal evidence as a key economic indicator, but it does look as though this particular demographic is experiencing a nasty squeeze. I sense a "winter of discontent" ahead for the government.

A final point worth making here is that even if you think you know what inflation is going to be, making the correct investment call is not necessarily as straightforward as one might think. If a year ago anyone had predicted current inflation rates, I'm pretty sure they would not have expected to see global equities at all-time highs and bond yields and interest rates still extremely low by historical standards.

Speaking of discontent, the reaction to the outcome of the COP26 climate summit has been that it failed to make much progress in the campaign against rising temperatures. Bloomberg noted this morning that we are still on track for warming of 2.4 degrees, although the International Energy Agency proposed a rather more optimistic 1.8 degrees based on the pledges that were made. Anyway, it's still not enough to get us to the bare minimum (or should that be maximum?) 1.5 degrees that is required to stabilise the situation.

More positively, there was progress on emissions from coal use and on methane, but even on these issues there were compromises and a general watering down of targets. At least the event raised the profile of climate change risks to a new height, but I still fear that it will take some kind of apocalyptic event to force the hands of the unwilling. That may or may not happen before COP27, which is scheduled to take place in the Eqyptian Red Sea resort of Sharm El-Sheikh next November. Shorts and T-shirts rather than raincoats and thermal undies. Once we have had a chance to evaluate the whole conference I will return with more detailed comments on the subject.

If you don't like what's going on the real world, though, there is the prospect of heading into an alternate reality (although I suspect that my elderly neighbour will not be on this journey). In past presentations I have posed a trick question to the audience; what is the world's most highly populated country? And the answer is, of course... Facebook! It most recently reported having 2.91 billion active users, which is about a third of the world's population. Facebook recently caused a bit of a stir by changing its corporate name to "Meta", which represents its ambition to be a leading player in the rapidly evolving "metaverse".

According to Investopedia (because you would not want to rely on me to define this concept), the metaverse is a "digital reality that combines aspects of social media, online gaming, augmented reality, virtual reality and cryptocurrencies to allow users to interact virtually". Wow! I doubt I shall be an early adopter, but that doesn't mean that there will not be investment opportunities. There are already exchange-traded funds available that are populated with many of the usual suspects, from enabling computer chip manufacturers and cloud hosting companies to those that will provide "content", but this new opportunity will not necessarily represent the main profit-generator for them, at least initially.

As my colleague and Technology sector analyst Simon Lapthorne puts it: "A key point to bear in mind if looking for pure-play companies is that we don't yet know how the metaverse will evolve. From an investment point of view one of the critical factors here is whether the relevant segments will become 'winner take all' markets, in which case investments can take on some alarming binary characteristics; that is much less of an issue for companies for whom exposure to the metaverse is a small part of their offering."

Strange as it may seem to some, you can now buy branded fashion items to "wear" in the metaverse. Virtual pop concerts are taking place within games, opening performers up to audiences in the millions, with revenue to match. More prosaically, we can look forward attending work gatherings as avatars. But we would mock such developments at our peril. The cat is out of the bag and there is going to be a cross-fertilisation of several industries and technologies that will provide both risks and opportunities. Again, this is a subject that will no doubt bear more coverage in future.

Economic Commentary

FTSE 100 weekly winners

ITV PLC	11.7%
Polymetal International Plc	9.3%
Antofagasta plc	8.8%
Fresnillo PLC	7.8%
Pearson PLC	7.0%
Associated British Foods plc	6.5%
Anglo American plc	6.0%

FTSE 100 weekly losers

Johnson Matthey Plc	-16.4%
International Consolidated Airlines Group SA	-8.8%
Whitbread PLC	-6.6%
InterContinental Hotels Group PLC	-5.7%
AstraZeneca PLC	-5.5%
AVEVA Group plc	-5.1%
B&M European Value Retail SA	-4.0%

FTSE 100 index, past 12 months

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