Investec
Wealth & Investment

How Low Can You Go?

This week sees me writing the Weekly Digest – not for the first time – in Italy, a trip that has taken in a World War II cemetery not far south of Bologna. The purpose was to visit the grave of my wife's great uncle, who died seventy-five years ago tomorrow. The sight of around two thousand headstones is extremely moving, especially when one considers why their lives were given. The thought of a man in his twenties dying nearly five thousand miles away from his home in a tiny village in Saskatchewan gives pause for thought when we live in a world of increasingly polarised ideologies.

However far apart Growth and Value investors might be in their beliefs, at least they haven't started fighting yet! Even so, Value investors, as we have observed before, have been having a tough time of it this year (and indeed for much of the period since the financial crisis), but there has been a remarkable swing in their favour. In just five trading sessions to the end of last week, the MSCI USA Enhanced Value Index outperformed the US Growth index by 6%, which, according to the number-crunchers at Bank of America Merrill Lynch, is the second largest such shift in so short a time period since the collapse of the Tech boom in 2000. Only the implementation of the first round of Quantitative Easing (QE) by the US Federal Reserve (Fed) has been a stronger catalyst. If one looks at all the investment factors involved, Quality Momentum, Low Volatility and Low Beta have all come under pressure. Similar moves have been witnessed in most markets around the world, raising the question: "Is this the start of a more permanent rotation into Value?"

Unsurprisingly, several Value managers have been getting in touch with our Collectives team to answer in the affirmative, but we have been here many times before. Using Cyclicals versus Defensives as a proxy, Goldman Sachs points out that there have been no fewer than thirteen similar rotations in the European equity market since the trough of the financial crisis, and on only one of those occasions did the overall market fail to rise. However, the average swing from Growth to Value has been just 4%. Where there is a much clearer swing is in the relative performance of Financials versus Staples, which averages 16% in favour of Financials. What Mr Market is telling us is that he believes that the recession (and even stagnation) fears that have been built into relative valuations are exaggerated, and this has also been reflected in the sharp upwards move in bond yields over the last couple of weeks. Since the end of August the total amount of negative-yielding debt has fallen from over \$17tn to less than \$15tn. Given our core preference for the types of companies that tend to fall into the Growth basket - high cash flow returns on capital with good opportunities to reinvest in their businesses - we have not yet been tempted to follow this rotation, although openly acknowledge that it will cost us some relative performance in the short term. That has certainly been the right decision for the long term the last thirteen times.

There seem to be two main reasons for increased belief in improving economic growth. The first is monetary policy. Whatever intention the world's central banks might have had until quite recently to "normalise" policy (and that's in inverted commas because there is absolutely no consensus as to what constitutes normal any more), they have now gone all in on loosening again. There have been forty interest rate cuts around the world so far in 2019. This week we will almost certainly see another one from the Fed. Ten days ago the People's Bank of China cuts its Reserve Requirement Ratio for banks, effectively freeing up more funds for lending. These are among the reasons that we have been willing to remain fully invested despite the persistent downgrading of growth forecasts (at both the country and company level). It's a very different monetary backdrop to the one that prevailed in the second half of 2018.

The main event last week was the latest meeting of the European Central Bank, which was also ECB President Draghi's swansong before handing over to Christine Lagarde. It's fair to say that the market's initial reaction was pretty confused, possibly slightly miffed by a deposit rate cut of just 0.1%, even if that was to a new all-time low of minus 0.5%. But in the end investors warmed to "forward guidance" about interest rate levels and the longevity of the ECB's new Asset Purchase Programme (QE). It was also encouraged by a few tweaks that should help the profitability of the banking sector, while also encouraging lending.

The statement was not unalloyed good news, as it contained downgrades to growth and inflation forecasts (and that was assuming no Hard Brexit, and did not account for any escalation in the US/China trade war). But those downgrades suggest that interest rates are not going up on the Continent until at least 2022, because the ECB will need to see inflation heading towards 2% again (new forecast 1.5% by the end of 2021, which is not high enough to trigger tightening).

The other main element of Draghi's farewell was to encourage European governments to take advantage of his largesse by borrowing more money and initiating fiscal stimulus. Slightly worryingly, perhaps, there is a tacit acknowledgement here that monetary stimulus alone is insufficient to kick off another growth cycle (which the evidence of the last ten years might support). The better news, though, is that "the system" is not yet out of ammunition. Of course, any de facto monetisation of government debt raises its own questions about the value of money and the risks of too much inflation, but the desire to rekindle growth would seem to suggest that policymakers will be willing (forced?) to take the plunge.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Barclays	11.8%
Centrica	11.8%
easyJet	11.5%
Schroders	11.4%
Wm Morrison Supermarket	11.3%
Royal Bank of Scotland	11.0%
Legal & General Group	10.2%

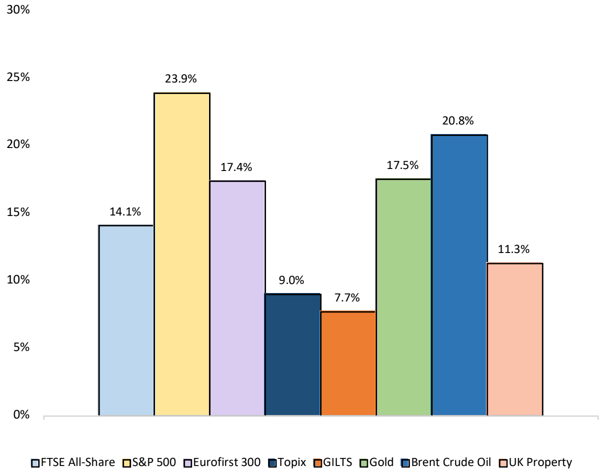
Source:FactSet

FTSE 100 Weekly Losers

JUST EAT	-11.6%
Coca-Cola	-7.6%
Rentokil Initial	-6.3%
Experian	-6.2%
Sage Group	-6.1%
Compass Group	-6.1%
RELX	-5.8%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months