Weekly Digest

| 16 November 2020 |

John Wyn-Evans
Head of Investment Strategy

Gridilocks

STOP PRESS For the second consecutive week, my musings have been rudely interrupted by vaccine news. This time we have heard from Moderna, another developer using mRNA technology. There is much to applaud relative to Pfizer's version– not least the higher efficacy rate of 94.5%, and apparently less challenging logistical hurdles (temperature requirements and shelf-life). There also seem to be good results on preventing the development of severe symptoms, as well as encouraging data on the over-65s. The market's reaction is pretty subdued compared to last week, but directionally similar, which is about what I might have expected. Nothing that follows has needed to be changed as a result. Can't wait to see what is announced next Monday!

After all the excitement of last Monday and Pfizer's enthusiastically received news about its vaccine, the rest of the week had an anticlimactic feel to it. Indeed, on reflection, even Monday was not as memorable as it might have been owing to the fact that I experienced it alone in my office at home. At least it was good news. Thinking back over the years, some of the memories that are most deeply etched in my mind, and which I experienced in the company of colleagues, are fairly traumatic. These include 1987's stock market crash, the UK's ignominious exit from the European Exchange Rate Mechanism on "Black Wednesday in 1992, the destruction of the Twin Towers in 2001 and the bankruptcy of my then-employer, Lehman Brothers, in 2008.

There is something special about the buzz that goes round a trading floor as events unfold, markets respond and everyone tries to interpret the news. On another occasion in 1990, the day on which the UK announced its entry into the Exchange Rate Mechanism, the two economists in my firm at that time had opposing views. One wandered up the banks of desks extolling the virtues of the decision, while the other proclaimed it to be an absolute disaster that would only end in tears… as it did! And of course, these events were often punctuated at the end of the day by a trip to a local hostelry to consolidate the memories. Fat chance of that happening at the moment.

And so back to the present. We are still in thrall to the "BVB" trade narrative – Biden, Vaccine, Brexit. So far none of them is fully resolved, although we would be extremely surprised if Inauguration Day on 20th January 2021 does not bump the number of US presidents up to 46. The main outstanding unknown is the composition of the Senate, which will be resolved by the two Georgia run-offs on January 5th. Two wins for the Democrats would take the tally to 50-50, with Vice President Kamala Harris having the casting vote. Anything less would leave control in the hands of the Republicans,

Investec

thus ensuring at least another two years of congressional stalemate.

The latter outcome is not necessarily a bad thing (for investors). Although it might lower the size of future fiscal stimulus packages, it also reduces the potential for higher taxes and tighter regulation of many industries, with Technology and Banking to the fore. With a nod to the recent benign "goldilocks" era, which featured economic growth and inflation that were neither too hot nor too cold, but just right, some have dubbed the next era as "gridilocks".

As for the vaccine, there is precious little more to add just now. Certainly there has been an attempt to diffuse extreme optimism by focusing on the incomplete data as well as the logistical challenges involved in inoculating sufficient numbers quickly, but we remain of the opinion that a meaningful scientific breakthrough has been made, and that the return to more normal levels of activity is a case of "when" rather than "if". Markets, in their usual way, have already begun to discount this shift in the narrative, but, despite the initial moves that we have seen, not yet with total conviction.

As for Brexit, the news feels like it remains on an endless loop, with the "level playing field" of state support, fisheries and aspects of governance still the sticking points. We keep on saying that time is running out, and yet on go the negotiations. Next Monday (the 23rd November) is now being touted as the ultimate deadline, and the latest games of musical chairs inside Number 10 are being interpreted by some (wishful thinkers?) as a prelude to an agreement being reached. To recap our views, any sort of "deal" would be positive for the pound and more domestically-focused companies' shares (largely mid- and small caps at the expense of large caps), with the opposite being the case in the event of "no deal". Thus one might not see a big move in headline indices such as the FTSE 100, but there could be an awful lot activity under the surface.

Indeed, this might well be the narrative for global markets over the next few months if all the elements of the "BVB" trade are resolved in investors' favour. And this, in turn, leads to some other problems. We have discussed on several occasions in the past the potential for rotation out of, for want of a better description, "Growth" into "Value". I prefer to label these factors as "long duration" and "short duration", which better captures the nature of the perceived future earnings visibility of the respective businesses. With little visibility on the earnings of a vast swathe of the economy under Covid, people have flocked towards certainty, especially where that has been enhanced by the current situation. The boom in "long duration" stocks has also been turbo-charged by another factor, momentum, in which investors (often, it must be said, of the electronic variety) buy more of the stocks that have performed the best.

This all went into reverse last Monday, with the momentum factor suffering its biggest negative move in history. Even so, the rotation is barely visible on long-term charts given how large the prior performance divergence had been. As (should I say "if", so as not to tempt fate?) confidence continues to build, this trade probably has further to go. However, our own investment style is tilted towards a preference for those longer duration earnings and companies with strong balance sheets and hefty free cashflow margins. This has stood us in good stead during the Covid crisis, but will turn into something of a headwind during a recovery phase. The potential price to pay for this is a period of underperformance relative to various benchmarks and certain peers, but that should not deflect us from longer-term strategic investment objectives.

Of course, that doesn't completely preclude investment in "BVB" beneficiaries, and there are plenty of good quality companies that have found themselves on the wrong side of the virus, as well as there being skilled managers of external funds that we use whose style has not been in vogue. We can certainly dip into this particular pool of opportunity, but don't expect it to represent the bulk of portfolios.

And it's with an eye to the longer term that I should mention something else which I felt went largely unnoticed in all the US election ballyhoo. That was the suspiciously coordinated policy

announcements that were made on Thursday 5th November. That was the day on which the Bank of England (BoE) announced a £150 billion extension to its asset purchase programme (Quantitative Easing), taking it to £895bn. This was swiftly followed by the Chancellor's extension of the furlough scheme accompanied by various other economic support measures, totalling expenditure of several billion pounds per month.

BoE Governor Andrew Bailey and Rishi Sunak both said that the moves were "coordinated", according to the Financial Times, but then appeared to go to some lengths to dilute that. Mr Bailey said that the Chancellor had not ordered the central bank to announce further bond purchases, nor had it set the new levels of purchases with any reference to the latest round of fiscal expenditure. But neither could Mr Bailey explain why the Monetary Policy Committee had settled on £150bn.

Am I reading too much into this? Well this looks like monetisation of government debt in everything but name, as is the case with Federal Reserve in the US, and the European Central Bank (ECB). And the leaders of all three central banks have said that they will remain flexible in their policies as required. Here's a great piece of central bank-speak from the ECB: we will "recalibrate [our] instruments, as appropriate, to respond to the unfolding situation". That's basically an exhortation to governments to open the fiscal taps in the knowledge that the ECB will hoover up the bonds that need to be issued to pay for the spending.

Once we get beyond Covid, attention will turn more fully to this accumulated debt pile and how it might ever be reduced. As we have discussed before, the prospects of growing out of it are slim, leaving some kind of default as the probable outcome. But defaults can be explicit or implicit. An explicit default is to refuse either to pay the interest or to repay the capital, leading to some sort of restructuring in which the debt holders lose out. A more subtle, implicit default, is to term the debt so far out into the future that nobody alive today will be around to demand repayment.
The more probable form of implicit default is through "financial repression", which is effected by repressing the return on savings products (particularly government bonds in this case) to well below the levels of growth and inflation. It's been done before, quite successfully, in the United States after the Second World War. Crucially, it involves some form of state intervention, either through central bank asset purchases or regulator-enforced institutional purchases (for example to fulfil capital requirements or to match liabilities) – all of which are currently being used in various countries.
All of this has major implications for portfolio construction in the years ahead, especially when it comes to protecting clients' wealth from inflation when cash and investment grade bonds virtually guarantee losses in real terms. Thus we continue to advocate some exposure to index-linked securities and/or gold. I am often asked how one can value gold, and I admit that it is more art than science, although there are models linking past price levels to current values for the dollar, inflation and real bond yields that are pretty good at determining the current price.

In the end, though, there is an element of subjectivity to the price of gold, and this brings to mind John Maynard Keynes's concept of the beauty contest as a reference for investing. When betting on the outcome of a beauty contest, he counsels not to bet on the contestant that you think is the most attractive, but the one that you think the majority of judges will find the most attractive. Failing that, I heard this from renowned economist/strategist David Rosenberg recently: the value of gold can be defined as 1/T (that is one divided by T), where T=Trust. When trust, whether that be in governments, central banks, markets or financial institutions falls, the value of gold rises exponentially.

Last week's Economic Highlights

FTSE 100 Weekly Winners

International Consolidated Airlines	39.6%
Rolls-Royce Holdings PLC	34.7%
British Land Company PLC	27.4%
Lloyds Banking Group PLC	26.9%
Land Securities Group PLC	26.8%
Legal & General Group PLC	23.9%
Informa PLC	22.9%

FTSE 100 Weekly Losers

Fresnillo PLC	-14.2%
Ocado Group PLC	-11.5%
Polymetal International PLC	-9.8%
Just Eat Takeaway	-8.7%
Avast PLC	-8.6%
London Stock Exchange Group PLC	-5.1%
Ferguson PLC	-4.9%

FTSE 100 Index, Past 12 Months

Source:FactSet

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange. Authorised and regulated by the Financial Conduct Authority. Investec Wealth & Investment Limited is registered in England. Registered No. 2122340. Registered Office: 30 Gresham Street, London EC2V 7QN.

Investec