Weekly Digest

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Smoke & Mirrors

I've alluded in the past to scratched records and the film Groundhog Day when describing the repetitive nature of financial markets' areas of focus. I suppose I can at least be grateful that both Brexit and the daily pronouncements of Donald Trump have now faded into the background, but the foreground is still filled with an endless stream of commentary on Covid, and the outlook for inflation and what this will mean for monetary policy and consequently the performance of and within equity markets. There are times when it feels as though one is in a Hall of Mirrors, with reflections stretching ad infinitum in all directions.

I'm not going to reiterate the whole playbook again today, but the key points remain as follows. Despite the fact that last week witnessed the highest number of new infections recorded globally since the start of the pandemic, investors continue to "look through" current difficulties towards a world of more normal activity. This will be a function of achieving some kind of herd immunity through a combination of vaccination and immunity acquired through infection. The main obstacles to smooth progress are variants, especially those that might be more resistant to vaccines, and vaccine side-effects (although none of those related to blood clotting do we deem sufficiently worrisome to throw the recovery off course).

On the inflation front, the latest data has been relatively benign, which has helped to put a bid back under government bonds. The expectation remains for a more pronounced spike up in annual indices over the next couple of months, but it's the persistence of inflation thereafter that will remain the key to investment strategy. The biggest shift in this cycle is that central banks are actively seeking higher inflation, and want to see evidence of a sustainable recovery in the rear-view mirror before tightening policy.

A recent speech (March 23rd) by US Federal Reserve Governor Lael Brainard clearly set out the context of the Fed's mission: "By taking a patient approach based on outcomes rather than a preemptive approach based on the outlook, policy will be more effective in achieving broad-based and inclusive maximum employment and inflation that averages two percent over time." You will note the reference to "broad-based and inclusive

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employment", which illustrates a more political sub-agenda. Remember that the new Democrat Treasury Secretary is Janet Yellen, a former chair of the Fed. It was reported that Ms Brainard herself was also under consideration for the post, and she is widely tipped to replace current chair Jerome Powell should he (be asked to) step down at the end of his current term next year. Add this policy shift to a greater tolerance for large government budget deficits, and the potential for higher inflation is there for all to see.

In the UK, specifically, we also have to take into account the recovery of the pound (helpful) and the effects of Brexit (unhelpful). Domestic inflation in certain goods and services will also be affected by overseas travel policies. Again, the consensus expectation is for the Consumer Price Index to rise above the Bank of England's 2% target shortly, although there is much less consensus on what happens after that.

In the absence of certainty about reported data, markets will turn to inflation expectations, either those embedded in the prices of index-linked government bonds, or those reported in surveys of the public. In this regard, the key US 10-year breakeven rate (the market-derived expectation of average inflation over the next decade) has recently stalled around the 2.35% level, having been as low as 0.55% last year. Interestingly, the 5-year breakeven is higher at 2.6%, suggesting that the market sees higher inflation in the shorter term, but lower later. Whether this is because it believes that the Fed will rein in inflationary excess or because trend growth and inflation will revert to a lower level is not made explicit, but clues are available in interest rate futures, where investors continue to price in a tightening of policy well ahead of the Fed's latest "dot plot" of expected interest rate levels.

In terms of survey expectations, economists at Jefferies have observed that the Inflation Expectations component of the University of Michigan Consumer Survey has a strong correlation with inflation outcomes. The latest reading, last Friday, popped up to 3.7% on a twelve-month view from 3.1% previously, although it should be noted that this series never dropped below 2% even during the trough of the pandemic-related recession. The 5-10 year view is a more benign 2.7%.

The fact that inflation expectations have recently flattened while bond yields have drifted lower has meant that real yields have also fallen back. The reading for real 10-year rates that I follow, which is published by the Fed, has fallen back from a recent high of -0.56% (still ridiculously low from any historical perspective) to a current -0.77%. As recently as 10th February, the reading was -1.06%. This means that the headlong rotation into value/cyclical/short duration equities at the expense of growth/defensive/long duration has also stalled.

A major beneficiary of the re-opening/reflationary trade has been the Travel & Leisure sector, and there is a lot of chat about holidays at the moment, and whether or not we will able to travel overseas again – at least without huge amounts of hassle and prohibitive cost. Bearing that in mind, I came across an interesting piece of research from Bernstein last week, which looked at the history of paid holidays (or "annual leave" as it seems to be called these days, although I always considered that to be a military term). If there was ever an industry that responded to potential demand, it was Travel & Leisure. (The next bit will also explain why photos and film footage from much before the 1970s generally tend to show only relatively rich people wafting around the Continent, as opposed to the knotted handkerchief-on-the-head and rolled-up-shirt-sleeves brigades populating Britain's beaches. I have family photos of various forebears displaying the contemporary fashions, as well as of yours truly - aged four - in an inconceivably high-waisted pair of swimming trunks wearing a captain's hat!).

At the turn of the last century, there was no such thing as a statutory paid holiday in the UK, only eight Bank Holidays. That did not change until the Holidays with Pay Act of 1938, which awarded a week's paid

leave to employees. By the 1970s, this had expanded to fifteen days. Only in 1998 (and I had forgotten this) was the statutory minimum raised to twenty days, where it remains. Perhaps unsurprisingly, then, overseas package holidays only really took off in the 1970s, and low-cost airlines at the turn of the millennium. Have holiday, will travel! By the way, should you be on the fence at the next general election, all three Labour Prime Ministers who won general elections in the twentieth century increased the statutory holiday entitlement!

If we look at (paid and national) annual holiday entitlement around the world, Peru tops the list with 45 days, while Taiwan comes in at the bottom with a mere 17. The UK's 28 is in the bottom quartile, as is the US at 24. In the US, if you exclude public holidays, and look at the 14 days of paid holiday available, on average only 10 are taken, while in Japan, of the 20 days available, only 10 are taken. In the UK we tend to leave just one day of holiday on the table. The French leave none.

There is clearly a huge amount of pent-up demand for holidays now. Not only to return to "normal", but perhaps to make up for lost time. A lot of holiday entitlement has been carried forward from 2020. A survey in the United States revealed an intention by workers to take more days off than usual this year. (The US actually still has no statutory minimum for days off.) Then there is the potential for flexible working arrangements, with the possibility of "WFH" evolving from "Work from Home" to "Work from Hotel". The campaign for a four-day working week is gathering momentum. It is clear that there remain plenty of interesting possibilities ahead in the Travel & Leisure sector.

Finally, a note on the passing, last week, of Bernie Madoff, perhaps the biggest financial crook in history. His story is one which serves to remind us that if the investment returns delivered appear to be too good to be true, they probably are! The fact that he reported annual gains of around 8% over many years with no real setbacks, thus achieving fabulous risk-adjusted returns, should have alerted both investors and regulators to the scam, but his "front" (including incredibly detailed portfolio reports) was immaculate, and, of course, there is no easy cure for the susceptibility to deception of those seeking such returns without doing the leg work. Rather than accruing returns within the fund (which reached a notional value of $65bn) he spent much of the cash on his own lavish lifestyle, as well as making charitable donations which buffed the sheen of his respectability. But he also kept a substantial sum on deposit to meet potential redemptions, thus maintaining the illusion of underlying profitability and liquidity. Eventually, faced with mounting redemptions during the financial crisis in 2008, he ran out of cash and the game was up. It's an amazing story of deception, and rereading the details never fails to create a frisson of excitement mixed with fear.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Just Eat Takeaway.com N.V.	9.1%
Antofagasta plc	8.2%
Rio Tinto plc	6.9%
Polymetal International Plc	6.8%
Evraz PLC	6.2%
Entain PLC	5.2%
Standard Life Aberdeen	4.9%

FTSE 100 Weekly Losers

Rolls-Royce Holdings plc	-6.5%
Legal & General Group Plc	-5.9%
Standard Life Aberdeen PLC	-3.9%
SSE plc	-3.3%
Hikma Pharmaceuticals Plc	-2.7%
HSBC Holdings Plc	-2.3%
Associated British Foods plc	-2.3%

FTSE 100 Index, Past 12 months

Source: Factset

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