Weekly Digest

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Passing The Baton

Normally at this time I am getting very excited about the prospects of viewing the Olympic Games, but there's an odd feeling about this year's delayed instalment, which will unfold (if at all…) in front of largely empty stadia starting on Friday. It's all a far cry from 2012, when, thanks to an aggressive strategy in the ticket ballot, my wife and I were able to attend events in several different sports and locations – even synchronised swimming, which was surprisingly gripping!

I have always enjoyed watching the sprint relay races in athletics. There is an extra frisson of excitement about the passing of the baton, especially in the 4 x 100 metres. And I also love the 4 x 400m because, once the stagger unwinds after the first lap, it's the only time you see top-class sprinters racing shoulder-to-shoulder. And woe betide the runner who gives too much down the back straight only to appear to be going backwards when overtaken in the home straight (while still travelling faster than most mere mortals could manage). As is often the case in financial markets, relative performance trumps absolute performance.

Financial markets also feel as though they are in the process of negotiating a baton-pass at the moment, and it is proving to be a tricky manoeuvre. In fact, as in an actual relay race, there are several batons being passed simultaneously, and, while none of them have been dropped yet, there is a bit of juggling going on. We have the shift from a world of tight COVID-related restrictions to one that is more normal, with today's "Freedom Day" in the England being a prime example. Then there is the potential for policy shifts by central banks, with the more extreme forms of monetary largesse being withdrawn. These, in turn, could lead to a different phase for equity markets, as we have discussed in past Weekly Digests.

I'm not going to dwell on the COVID situation this week. We have maintained our view that the virus will ultimately be largely contained by vaccines, but that the path will continue to be very bumpy, with restrictions being lifted and reimposed (at least to some degree) as conditions demand. Of course, this is not exactly helpful either to the public or to the companies providing services to them, as evidenced in

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the latest decree from our government concerning self-isolation for travellers returning from France. And the “pingdemic” situation with our track-and-trace system is a further source of disruption that was not well anticipated. This is leading to some volatile performances of the shares of companies deemed to be at the forefront of the reopening trade, especially in the Travel & Leisure sector.

Central bank policy remains firmly in the spotlight. Of the main developed world central banks, only those of Australia, New Zealand and Canada have formally started to pull on the reins, and then only in the reduction of asset purchases rather than shrinking balance sheets or raising interest rates. The US Federal Reserve is widely expected to announce a similar move at the end of the summer, with the news possibly being trailed at the Jackson Hole central bankers’ symposium in late August. But memories of 2013’s “taper tantrum”, which sent bond yields and equity markets lower, mean that any tightening of policy is being approached extremely tentatively.

And despite all the worries about a tantrum, it does appear that markets are acting in a quite different way this time. The fact that bond yields have fallen in response to the risk of tighter policy suggests that investors are more attuned to the positive implication that inflationary expectations are not going to become unanchored, as was the growing fear just a few months ago. That is consistent with the US breakeven inflation curve, which infers future levels of inflation from the prices of conventional and inflation-protected bonds. It suggests that inflation will average 2.78% on a two-year view, 2.55% on a five-year view, and 2.33% on a ten-year basis. It will then remain pretty flat at 2.23% if one is prepared to look thirty years ahead. Naturally, these inferred expectations come with plenty of caveats. Bond investors were perennially behind the curve during the disinflationary period that prevailed from the early 1980s to the present day, failing to recognise the paradigm shift and, for a long time, anchoring to the painful experiences of the 1970s. While we remain in the camp that believes that the current inflation spike is, indeed, transitory, we are highly aware of the factors that might make it more persistent and therefore balancing the risks accordingly.

As for interest rates, although there is a lot of chat about when they will start to rise, the futures markets still don’t expect any action until December 2022 in the case of both the Federal Reserve and the Bank of England. The European Central Bank is expected to sit on its hands until July 2023 (a view confirmed by its recently announced policy shift to be willing to accommodate higher inflation than in the past), with the Bank of Japan limping home last in September 2027. Furthermore, the levels to which interest rates are then expected to rise remains very low compared with history, as debt-service requirements will quickly constrain activity as rates rise.

What about equities? The baton was passed from long-duration to short-duration stocks last November once news of successful vaccine trials was released. The confirmation of Joe Biden’s victory in the US presidential race, followed by the Georgia Senate run-off victories (as well as the Brexit deal, more locally), encouraged stocks expected to benefit from the reopening of economies and increased fiscal expenditure to accelerate aggressively down the back straight. However, they started to run out of puff once the threat of variants was established and as bond yields hit their peak. Longer-duration stocks, notably Technology giants, have come to the fore again. This leadership is set to ebb and flow for a while as the news on COVID develops.

Earlier this year I cited research from Goldman Sachs in which they outlined the various phases that equity markets pass through across the cycle. These phases are Despair, Hope, Growth and Optimism. It was Goldman’s opinion that we were transitioning from Hope to Growth. Hope is characterized by rising valuations as investors begin to discount the recovery that is not yet evident in reported profits. Growth is driven by those profits coming through, but at the expense of lower valuations. This tends to be the longest phase in the cycle, but a lot shallower in its return profile.

Bearing in mind all the caveats about the unprecedented nature of the last year or so, this still seems largely to be how things are playing out, with equity markets failing to keep up with reported earnings growth this year, but still providing positive returns. Investors should be prepared for this pattern to persist for a while yet and will have to be a bit more patient about the pace of overall market appreciation, while also expecting to endure the odd setback, as we are currently experiencing.

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Last week's Economic Highlights

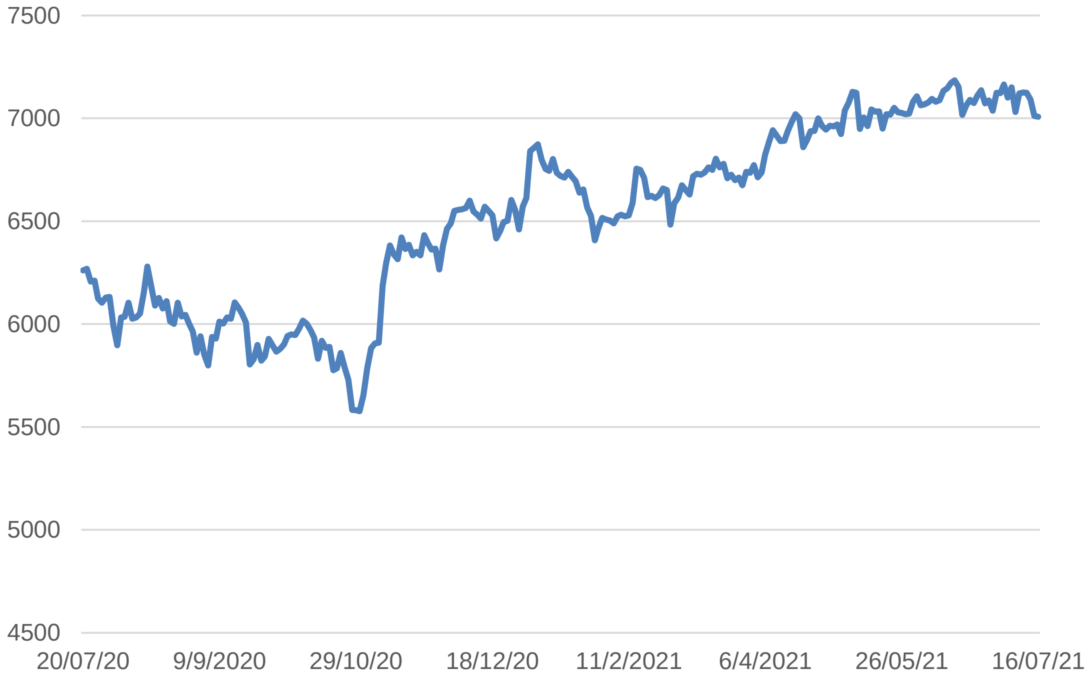
FTSE 100 Weekly Winners

Avast Plc	23.0%
Admiral Group plc	5.3%
Experian PLC	5.0%
Rightmove plc	3.2%
Auto Trader Group PLC	3.2%
British American Tobacco p.l.c.	2.7%
Croda International Plc	2.5%

FTSE 100 Weekly Losers

International Consolidated Airlines Group SA	-9.2%
Just Eat Takeaway.com N.V.	-9.1%
Rolls-Royce Holdings plc	-7.9%
JD Sports Fashion Plc	-7.4%
Whitbread PLC	-6.8%
Melrose Industries PLC	-6.6%
Associated British Foods plc	-6.2%

FTSE 100 Index, Past 12 months



Source: Factset

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