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OUT OF THE ORDINARY

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The Less You Know...

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In the eight-and-a-half years that I have been in my role at Investec, there has always been something for the market to worry about over and above any run-of-the-mill economic cycle. It all started with the Scottish Independence Referendum. That was superseded by Brexit and swiftly followed by the election of Donald Trump. He was finally squeezed out of the headlines by Covid, and that left me wondering what it would be that allowed us to move on from the pandemic.

I must admit that the impending outbreak of World War Three was not high on my list of threats, but to read the news and to listen to statements from political leaders one might think that this is the situation. And yet, markets remain relatively relaxed. Yes, we have seen a sell-off in risk assets this year, but, as I wrote last week, that has mainly been attributed to the threat of an acceleration of monetary tightening, itself driven by inflation that keeps surprising to the upside.

The historian Professor Niall Ferguson delivered a thoughtful Bloomberg opinion piece at the weekend, in which he noted that there have been many wars that nearly happened but didn't. The uncertainty is very unsettling for investors, although catnip to short-term traders. We are definitely in the former category. It's almost impossible to calculate the probability of war, but the emerging markets team at Goldman Sachs have had a go, basing their opinion on the current level of the Russian ruble relative to their estimate of its fair value. Their conclusion? A 65% probability of de-escalation; 20% of the current stand-off being maintained for the foreseeable future; and 15% of military escalation. Is that consoling or not? In reality it's a binary outcome.

Professor Ferguson is something of an expert on the history of money, too, and joins the dots between finance, government and conflict better than most. He relates how in the 18th and 19th centuries, the go-to trades amid the threat of war were to buy gold and to sell the bonds of the combatant countries. The former trade is alive and well, as we saw last week when the price of bullion rose to its highest in a year. (Interestingly, at its previous peak last May it was being bought much more as an inflation hedge).

The latter trade looks different today, though. Sovereign bond prices are more likely to rise than fall as investors seek safe havens. I can see the reason why they would have fallen in the past. Waging war is expensive and would also have been a lot more costly relative to the size of economy and the tax base. And Quantitative Easing had not been invented, either. Of course, demand would be directed to safer, core bond markets, especially that of the United States. Russia is likely to be on the end of punitive, economically damaging sanctions if it does attack, and the yield on its 10-year bond has risen to more than 10%.

We have also seen some rise in the spread of 'peripheral' European countries' debt yields versus the core, as investors fear economic dislocation from a disruption to energy supplies. A reduction in gas supplies, for example, could knock several percent off Italy's industrial production if gas and electricity have to be rationed.

Another point that Professor Ferguson makes is that after long periods of relative peace (as between 1815 and 1914 in Europe) nobody can remember what a proper war is like. He cites the complete lack of preparation in financial circles for the outbreak of World War One, which led to what he describes as the biggest financial crisis in history, which unfolded even before the first shots were fired in anger. I must admit that I was not aware that the New York Stock Exchange was closed between 31 July and 12 December 1914, and that the Dow Jones Industrial Average plunged by a quarter on reopening.

Where does he think we are now? Worryingly, he believes the mindset is more akin to 1914, although I would counter that both governments and central banks are much more attuned to the risks of financial dislocation now, as was proven by the eventual response to Covid. Even so, that does not preclude some sort of short-lived liquidity shock, although these are notoriously difficult to trade.

Another piece of work circulating at the moment looks back at market outcomes following twelve geopolitical crises from the attack on Pearl Harbor to the Iraq War. On average, the S&P 500 Index was up 8.6% a year later, which sounds comforting, and higher on nine of those occasions. But the danger with positive averages is that they hide the effects of the big negative moves, and there were some really nasty ones, with the worst being after the Arab oil embargo in 1973 (-36.2%).

They key thing about all of the negative experiences in this work is that they were accompanied by a recession. The other two followed the Suez Crisis (1956) and 9/11. Maybe the question we really need to ask now is whether a recession is coming, because that would exacerbate any fallout from events in Ukraine. The probabilities of recession are low, but not negligible. The main fear is that central banks will have to lean more heavily on inflation and therefore induce a recession “on purpose”. Again, there is plenty of current comment saying that the only way to beat inflation is to create a recession, because demand needs to be brought back in line with supply. Even then, though, there are still huge uncertainties about the extent to which supply will normalise following the disruptions to logistics chains and labour markets that we have experienced. Taking a large directional “bet” still feels too aggressive, but portfolio hedges are sensible.

Rounding out Professor Ferguson’s views, he worries about the inflationary impact of Russia cutting off commodity supplies to Europe (although a pragmatist would say Putin needs the currency), and he also wonders, as others have done, whether an unopposed incursion into Ukraine might encourage China’s ambition to bring Taiwan back into the fold. No shortage of next things to worry about, then.

Channel 4 aired a specially commissioned documentary about Vladimir Putin in April 2020, which I recorded. It’s called “Putin: A Russian Spy Story”. One contributor comments that “The less you know, the better you sleep”, which refers to the threat one’s life is under if one knows the inner workings of the Russian government and security forces and is considered a traitor. The same could be said of investors. There’s so much (scary) news available today that we can’t help being exposed to it and worrying what effect it might have on portfolios. Long-term returns data suggest that panicking out is rarely the correct course of action.

Economic Commentary

FTSE 100 weekly winners

Fresnillo PLC	10.2%
Reckitt Benckiser Group plc	6.4%
Polymetal International Plc	5.4%
SSE plc	4.2%
Standard Chartered PLC	3.8%
AstraZeneca PLC	3.4%
Burberry Group plc	2.9%

FTSE 100 weekly losers

AVEVA Group plc	-10.0%
International Consolidated Airlines Group SA	-7.5%
NatWest Group Plc	-7.3%
Flutter Entertainment Plc	-7.3%
Barclays PLC	-7.2%
Just Eat Takeaway.com N.V.	-6.5%
Scottish Mortgage Investment Trust Plc	-6.2%

FTSE 100 index, past 12 months

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