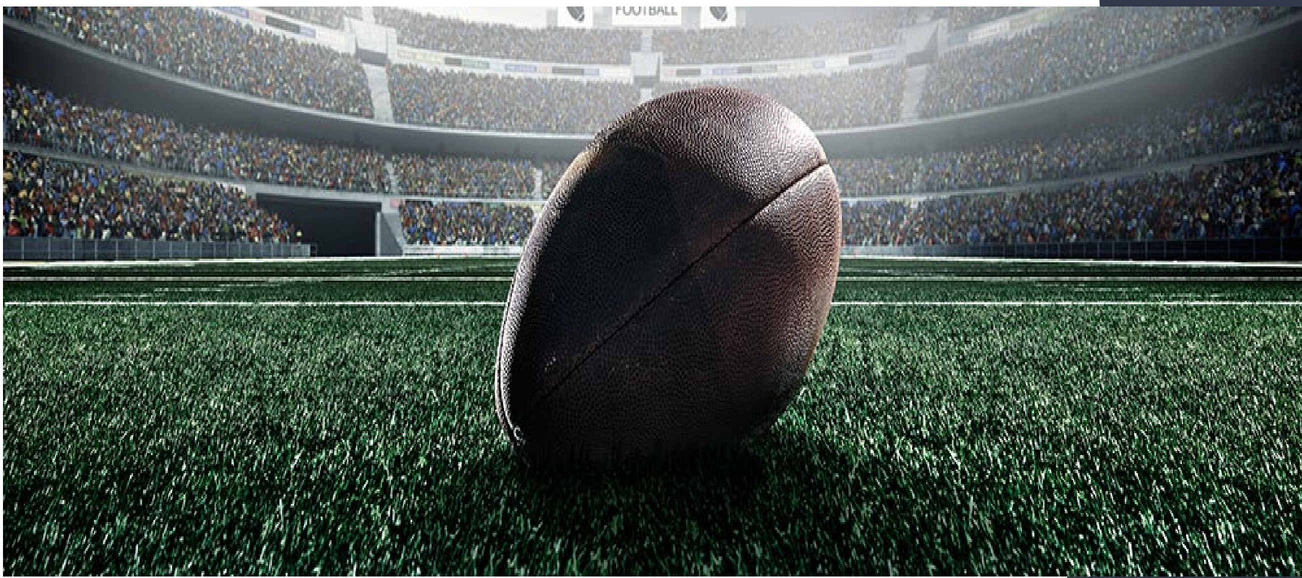
Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 22 March 2022

Tom Brady's Ball



John Wyn-Evans

Head of investment strategy

On Saturday 12 March, a bidder paid $518,000 for an American football. That might sound like a lot of money for a lump of leather, but it seemed justified as the ball in question was a unique collector's item – the ball thrown by legendary quarter-back Tom Brady to complete the final touchdown pass of his career before he announced his retirement. Unfortunately, the bidder had less than 24 hours to wallow in his achievement before Brady reversed his decision, stating his intention to return to action for at least one more season.

At this stage, nobody knows what said ball is now worth, especially as valuing such an item is more art than science and subject to the whims of individual taste. The concept of 'social capital' is fascinating. While it is more traditionally ascribed to the benefits of living in a smoothly-functioning, inclusive society, it can also be used to describe what individuals can personally gain from their participation in certain activities. For some, investing in 'meme' stocks was more about the thrill of being involved in a movement that purported to stick it to hedge funds than it was about making money. In a similar vein, many supporters of cryptocurrencies are as much interested in displaying their anti-establishment credentials as they are in diversifying their investment portfolios. And if you think you are immune to such forces, then remind yourself of the last time you entered, for example, the office Grand National sweepstake. It's as much about the participation and the possible bragging rights (derived from pure chance) as the possibility of winning a few quid.

On a much bigger scale, I was reading an article at the weekend about the high-end property market in New York. Some people have made life-changing sums of money by owning cryptocurrencies, and now some of them are keen to utilise this windfall to buy the grandest properties, as much to show off their financial status as to inhabit, it seems.

The influence of outside forces

I thought I would relate these tales to remind us that no matter how much fundamental analysis one might undertake on financial assets, there will always be other, much less tangible factors influencing outcomes, at least in the short term. We never forget the words of Benjamin Graham, often described as the father of modern investing, that "in the short run the market is a voting machine, but in the long run it is a weighing machine".

I have written in recent weeks that we have been trimming the sails of portfolios rather than completely changing the rigging. Although global equity indices remain down for the year-to-date, they have been lower, and it would have been very easy to submit to the temptation to bail out altogether when Russia's invasion of Ukraine began. As with Mr Brady's about turn, the news can change very quickly, and that can cause extremely sharp moves in prices. Even the highly regarded Lex column writers of the Financial Times found out last week that making bold statements can catch you out.

On Tuesday they wrote a piece about the Chinese equity market. It will probably not have escaped your attention that China's main indices have been in effective freefall for about a year now. The peak was driven by a rush of speculative activity, similar to that seen in certain areas of the technology sectors in the US and UK. The decline started with tighter regulation of some of the big technology leaders, which was repeated in other sectors, including private tutoring and, most recently, home delivery of meals. We have also witnessed the fall from grace of China's real estate industry, which, not unlike the bankruptcy described by a character in an Ernest Hemingway novel, happened "gradually, then suddenly". The arrival of Omicron in China then set off another round of social restrictions and economic disruption. The final straw was the situation in Ukraine. Not only was China unwilling to condemn

Russia's invasion, but the market's focus shifted to the next possible conflict, a Chinese invasion of Taiwan. The idea of China being 'uninvestable' was widely heard. As of last Tuesday's close, the MSCI China Index was down 54% from its high in February 2021. The NASDAQ China Golden Dragon Index, which is chock full of the stocks that have been most negatively affected, was down 75%!

The final paragraph of Lex's comment was a single sentence: "The worst is far from over for local stocks". Cue a speech from China's Vice Premier, Liu He, in which he said that the government would implement measures to "boost the economy in the first quarter" and introduce "policies that are favourable to the market". The markets started to rally even before the ink was dry on the FT's print run. The MSCI China Index rose 14.5% on the day, while the Golden Dragon Index was up an extraordinary 33%.

This tale serves to highlight that we are in the sort of markets where conditions can change very quickly and where prices are potentially subject to very sharp movements. I don't doubt that at some point we will make a more aggressive tactical asset allocation decision and be made to look foolish almost immediately. But the fear of the possibility should never stop one from making what one believes to be the right decision at the time.

What causes volatility?

I will round off by talking about some of things that go towards creating this volatility. Inevitably there is the flow of news itself, especially when we are dealing with unfamiliar matters that present an existential threat, such as a pandemic or the possibility of nuclear war. But, as we have noted in the past, the initial shock is always the worst and humans are very quick to get their bearings and to adapt.

From a market perspective, much of the volatility stems from technical factors. One key driver of falling equity indices (and, to some degree, the recent outperformance of Value versus Growth stocks) has been the phenomenon of "de-grossing". As market volatility rises, then so does the "Value at Risk" of leveraged investment vehicles such as hedge funds and risk parity funds. They effectively become forced sellers of assets in aggregate, which creates a pro-cyclical spiral of lower prices and more selling. Recently the falls were exacerbated by the fact that a lot of investors had taken out put options to protect themselves. That might sound like a good thing, but it meant that the people who held the other side of the trade had to continue to hedge their positions into the falls, putting more downward pressure on prices. Add in margin calls and momentum selling, and we were close to an 'offer only' market at times.

But there is only so far things can go without incremental negative news (or positive news if we look at extreme market peaks), and the stage was in fact set for a rally, which is what happened last week. Whether it persists will be more dependent upon factors such as company earnings and monetary policy, which we believe will remain the key determinants of returns.

First quarter earnings calls

The first quarter earnings season is not far away now. Although the commentary on input costs, margins and the fallout from loss of business in Russia has become progressively more downbeat, there is little evidence yet to be seen in earnings forecasts. Citigroup's Global Earnings Revisions Index, which is a diffusion index of the number of upgrades versus the number of downgrades, has dipped marginally into negative territory, but overall earnings expectations are steady. There is more nuance at the sector and regional level, with increases in Energy outweighing declines elsewhere. Perhaps analysts find it easier to put through upgrades than downgrades. Resource-rich Australia is currently the best market for upgrades, with Europe ex-UK the worst for downgrades.

Central bank action

As for central banks, the fact that the markets brushed off interest rate rises last week from both the US Federal Reserve and the Bank of England is encouraging. A lot of rate rises are already factored into expectations. But the Fed in particular, seems to be planning to raise rates more than the market expects. Put another way, the market thinks that the Fed will have to back off before it gets to where it thinks the neutral interest rate lies (about 2.4%) because the economy will not be able to bear the pain. It might well be that the Fed is 'talking tough' to keep a lid on inflation expectations, which it has having a modicum of success in achieving, but there is always the risk that it keeps pushing until something breaks. It's not as if the members of the Fed are in broad agreement, either. Although the median expectation for rates at the end of this year is 2.125%, the range goes from a low of 1.375% to a high of 3.125%. That's one of the widest gaps ever seen.

When the people who populate one of the most important committees in the world financial markets cannot come close to a consensus about policy, it still doesn't feel like a time to be making bold moves within our asset allocation.

Economic Commentary

FTSE 100 weekly winners

Intermediate Capital Group plc	13.4%
Entain PLC	12.7%
Ashtead Group plc	12.3%
Scottish Mortgage Investment Trust Plc	12.1%
St. James's Place Plc	11.8%
Croda International Plc	11.0%
Diageo plc	10.9%

FTSE 100 weekly losers

Polymetal International Plc	-28.6%
Avast Plc	-11.5%
Glencore plc	-6.3%
Anglo American plc	-5.5%
M&G Plc	-3.5%
BAE Systems plc	-1.4%
Shell PLC	-1.1%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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