Weekly Digest

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The More We Know… The Less We Know

At various stages in my career in the City I have felt that I had a pretty good grasp of exactly what was going on in markets. It might well have been that I was at my most confident very early on, when, in reality, I didn't really know very much. Thereafter there has been a fairly constant ebb and flow in my understanding of events, but a continual accrual of experience and knowledge. And yet, there has always been that nagging feeling that the more I know, the less I really know!

Now, I discover, there is name for this: the Dunning-Kruger Effect, which was proposed by a pair of social psychologists at the turn of the millennium. They outlined a curve that illustrates the gap between perceived knowledge and actual knowledge. The rookie doesn't know much at all, but thinks he knows everything, and is very confident in that belief. (I wonder how much that applies to the millions of people - I hesitate to call them all investors - who have been drawn into financial markets during the last year or so.) That blissful peak of perceived omniscience is followed by a trough of despair as the realisation of ignorance dawns, and it is only by acknowledging the gaps in one's knowledge that one can rebuild confidence.

Of course, this being about human nature, none of it is new. Mark Twain, an acute observer of mankind's foibles, is credited with the following words of wisdom: "It's not what you don't know that kills you, it's what you know for sure that ain't true".

I have commented on numerous occasions in the past that successful investing is about balancing the probabilities of a range of possible outcomes. Implicit within this statement is that nothing is 100% certain. Yes, death and taxes are inevitable, but we don't know when or at what rate. Some market developments in the last couple of weeks are testament to this opinion.

Two weeks ago, market participants were generally surprised by the reaction to the latest US Consumer Price Index release. Who would really have thought that the yield on the 10-year Treasury bond would end up

falling on the day in the face of rising annual inflation levels rarely witnessed in four decades? As I wrote about last week, the inflation outlook remains one of the most debated and contentious topics right now. One of the supposed harbingers of an incipient commodity super-cycle has been the sharp rise in the prices of a wide range of essential products. Lumber (that's wood to you and me) has been something of a poster child for this argument.

The price of lumber in the futures market in the US rose from a COVID-related 2020 trough of $260 per 110,000 board feet to a high of $1,686 at the beginning of May. It has since sunk by 47% to $897. One might infer from these movements that those who bought at the highs were either out of their minds or indulging in rampant speculation. But one can construct a perfectly justifiable case for paying top dollar. Imagine you are a homebuilder with capital and labour tied up in an existing project. Lumber is in short supply, and without it you can't build. The clock is ticking on labour and financing costs; permits might be expiring; penalties for late completion could be looming. In these instances it might well make sense to take the hit on lumber purchases to avoid an even worse financial (and possibly reputational) outcome. Such considerations will no doubt be motivating any number of decisions that, without the full facts, might appear to be irrational.

Last week's big "surprise" emerged from the Federal Reserve's latest meeting, which turned out to be more hawkish than expected. The "dot plot", which illustrates each member's expectation of future interest rate levels, showed that the median expectation is now for two quarter-point rises before the end of 2023, as opposed to none as recently as March. This constitutes a sharp compression of the horizon for policy tightening.

Perhaps the biggest shift was in terms of the Fed's attitude towards its tolerance for an average inflation rate of more than 2%. It has never been explicit about the period over which it was calculating the average, but the underlying message now is that it is increasingly uncomfortable with the current inflation spike, however transitory, and that it is also increasingly aware of the risk of more persistent inflation developing and of decades of inflation-fighting credibility being wasted. Of course, what we can also infer from this is that the members of the Fed are not omniscient and are as prone to changing their minds as any of us.

This news coincided with the release of Bank of America's latest client survey, which revealed that investors (or at least respondents to the survey, who are a pretty reliable proxy) are most overweight relative to history in Commodities, Materials, Banks and Industrials, while being most underweight in Bonds. In that case, perhaps, it was not entirely surprising that those cyclical sectors were subjected to a burst of profit-taking, and that bonds rallied.

I do like using this type of client survey to help assess current sentiment. The surveys are not necessarily any good at forecasting a turning point, but they are helpful in providing some guidance about what the extent of the reaction might be if there is a shift in the fundamentals – such as in the case of the Fed's mood change last week. Deutsche Bank's monthly client survey (to which we contribute) was released this morning. It reveals that investors are currently most concerned by the threat of higher-than-expected inflation and bond yields. But it's the "higher-than-expected" that needs to be taken into account, because 82% believe that inflation will be higher in the post-COVID world than it was before the pandemic, and 61% see US inflation settling in a 2-3% range.

And if you are wondering what the view is of how life will look like by the end of this year, 97% see it being either “completely back to normal” (7%), “very close to normality” (48%), or “approaching normality but with some daily life/economic restrictions still in place” (42%). So no nasty surprises on the virus front, please.

Related to that, I read a very interesting piece last week from the Economic and Policy Research team at JP Morgan, which looked at how herd immunity and non-pharmaceutical interventions (NPIs - such as masks, good hygiene habits and social restrictions) are influenced by the reproductive rate (R0 – or R nought) of the virus. This note was written in light of the Delta (India) variant, which now accounts for almost all of the positive cases that are being sequenced in the UK (the UK is the world leader in sequencing percentages, and so we probably have a clearer picture than most). The R0 of the original “Wuhan” strain was 3, meaning that a single infected person in a population with no immunity and no NPIs would pass the virus on to three more people. The compounding effect of growth means that such a virus can be transmitted through a population very quickly, thus the need for mitigating actions, or NPIs, to get the R0 below 1 to contain the spread. The R0 of the Alpha (Kent) variant was a higher 3.9, and the R0 of the Delta variant is a worryingly high 5.2.

These differences might not sound great, but it’s that compounding effect that causes the surge. Here’s the maths. If you start at 1 person and multiply by three ten times you get to 59,049. Multiply by 3.9 and you get to 814,041. Multiply by 5.2 and the resulting number is a mind-boggling 14,455,511. Hence the need for restrictive measures. But the good news is that immunity reduces the R0, and this can be acquired either through being infected by the virus (not recommended and of potentially limited duration) or by being vaccinated. JPM calculates that the level of vaccination of the population required to achieve herd immunity (that is to get the effective reproduction to below 1 and to start reducing the number of cases) with no NPIs is 75% for the Wuhan strain, 83% for the Alpha variant and no less than 90% for the Delta variant. As of the weekend, only Malta has fully vaccinated more than 60% of its population, with the UK on 46.5%, and the US on 45.05%. Favourite holiday destination countries are far behind. For example Spain (29.8%), Portugal (25.6%) and France (25.2%).

But the incidence of the Delta variant remains low in most of those countries, with the risk that they have yet to catch up with the UK’s latest wave. A Financial Times article today lays out by country the percent of cases that are the Delta variant and the percentage of cases that are sequenced: UK 98/30; Portugal 96/5; US 31/5; Italy 26/2; Germany 15/8; France 6.9/1. (Sorry, Spain is not listed)

The conclusion reached by the JPM team, and it will be unpopular with many, is that until the 90% vaccination threshold is reached, any country in which the Delta variant is prevalent will have no option other than to maintain at least some form of travel and social restrictions. I’m not going to enter into a debate about policy and civil liberties here, but this conclusion is based upon the reactions that we have generally seen so far, and also assumes that future decisions are made on a reasonably consistent basis. None of this negates the re-opening trade or the eventual return to more normal conditions, but it reminds us of the uncertainties created by this virus, and the fact that the road to recovery will remain bumpy with inevitable setbacks.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Admiral Group plc	4.6%
BT Group plc	4.2%
London Stock Exchange Group plc	3.1%
J Sainsbury plc	3.1%
Sage Group plc	2.8%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	2.4%
Intertek Group plc	2.2%

FTSE 100 Weekly Losers

Anglo American plc	-13.6%
Glencore plc	-9.6%
Antofagasta plc	-8.8%
Intermediate Capital Group plc	-7.6%
Melrose Industries PLC	-7.4%
BHP Group Plc	-6.9%
Land Securities Group PLC	-5.9%

FTSE 100 Index, Past 12 months

Source: Factset

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