Investec

OUT OF THE ORDINARY

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FOBIA

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Only an investor with their head stuck, ostrich-like, in the sand would have been able to ignore the shift in market sentiment that has become more apparent over the last week or so. Whereas not so long ago there was a "buy the dip" mentality accompanied by the four letters FOMO (Fear of Missing Out), now the mood has swung towards "sell the rally", and the four letters might become FOBI (Fear of Being In).

This is not my first attempt to coin an acronym. I once hoped that “FANGST” (an existential fear of losing money by holding onto the FANG stocks – Facebook, Apple, Netflix, Google) might be destined for wider adoption, but a Google search still reveals a Norwegian fish wholesaler to be the top result.

As we have discussed at some length in previous missives, the proximate cause of this behavioural change is concern about rising inflation and central banks’ response to it. In the early summer of 2021, one of the members of our Asset Allocation Committee came up with the concept of “the inflation flinch”, defined as the moment when consumers, central banks and investors would suddenly recoil from the threat of what seemed to be higher inflation that was not going to be anything like as transitory as hoped for. Crucially, we also thought that this might well happen just as the year-on-year inflation readings were close to their peak. The flinch could be upon us, finally. And, if the theory is correct, it might also present us with some opportunities. The committee reconvenes later this week, and I’m sure it will be a leading topic of debate.

Further up the asset allocation chain of command, our Global Investment Strategy Group (GISG) met last week. This body decides how much risk our portfolios should be taking relative to their strategic asset allocation benchmarks. In October 2021, we recommended dialling down the risk budget to below benchmark levels for precisely the reasons that are now becoming more widely cited, with the focus on central bank policy tightening. It is notable that expectations for tightening have increased since then, especially as far as the US Federal Reserve (Fed) is concerned. For example, futures markets were then discounting a rise in the Fed Funds rate to 0.5% by the end of 2022. Now they are saying 1%. And the Fed has also revealed a preference for an accelerated end to its asset purchase programme as well as hinting at earlier balance sheet reduction.

GISG decided to maintain its position last week, and not without a detailed debate. But, as in the wider investment and economics community, it was evident that there was a gamut of opinions about the persistence of the current inflation situation. These ranged from the more inflationist view driven by an adherence to the belief that bulging monetary aggregates (money supply) will drive demand and prices higher, to the more deflationist view that huge levels of accumulated debt are increasingly unproductive and that they will quickly cap the level to which interest rates can rise before choking off demand.

I heard someone talking about the idea of “destination investing” recently. This is when an investor has a particularly strong belief in a certain outcome and tailors their portfolio to that outcome. Thus, for example, a rampant inflationist would now be loading up on commodities and commodity shares while dumping bonds. There would also be a strong preference for Value stocks over Growth, or, as we might prefer to say, for “short duration” over “long duration” assets. By the same token, a deflationist would be much more enamoured of longer duration assets, with an eye on thirty-year maturity US Treasuries, fifty-year UK Gilts or even, at the extreme, Austria’s sovereign bond that matures in 2120.

I'm sure that you can see the pitfalls of such strategies: they will probably either be very right or very wrong, exposing clients to extreme volatility and potential extensive loss of capital. Of course, the financial press loves this sort of thing, and there are endless column inches expended on the year's biggest winners and losers. The funny thing is that they often swap places from one year to the next as their particular ideology matches the current market environment or not. There is nothing wrong with having a bit of appropriately-sized exposure to these more aggressive strategies as part of the risk-management within a balanced portfolio, but we are not likely to "bet the farm" on such conditional directionality.

Not long after I finished writing last week's Digest, Deutsche Bank and Bank of America released the results of their latest client surveys, and it is always of interest to see what our peers (in aggregate) are thinking. This can give us an idea about what sort of news has the potential to upset (or delight) the market. Across the two surveys, a few themes were strongly echoed. Investors are most focused on (and fearful of) inflation and the central banks. No surprise there. Bond yields are generally expected to go higher, but the majority is still expecting equity market returns to be positive in 2022, with more cyclical sectors leading the way. That may have something to do with the fact that Covid-19 is seen as a receding threat, with Omicron accelerating the shift from pandemic to endemic status. Yes, the "re-opening" trade is back on the agenda. Inflation expectations are creeping higher but remain consistent with the peak coming in the first half of this year before readings settle back to levels somewhat higher than the pre-Covid average.

Although we agree on positive equity returns, it's possible that the view might have to be challenged a bit more before the current market malaise subsides. So far this year, flows into equity funds have matched those during the same period of early 2021, even if they are decelerating. They were running at just above $50bn over the course of the first 13 trading days for which data is available. Both government bonds and credit have experienced outflows, and we should always be a little bit wary when money is flowing out of credit.

The tension between the desire to head for the hills and to ride out the storm is evident in the latest musings of two doyens of investing, Jeremy Grantham (of GMO) and Howard Marks (of Oaktree). Mr Grantham, in his latest Viewpoint, is pressing his view that we are witnessing the bursting of a "superbubble", prophesying a near-halving of the S&P 500 Index. We have discussed his opinions before, and we don't agree. But I guess one of us will be left with egg on our face. Unsurprisingly, given the propensity of the media to give airtime to such apocalyptic views, we received a number of incoming calls on the subject at the end of last week.

Rather less airtime was given to Mr Marks's counsel to hang on in there. His letter, entitled "Selling Out", focuses more on the secular nature of positive returns from risk assets and suggests that timing a short-term tactical exit from long-term investments is fraught with danger on (at least) two fronts: will your decision to sell be correct? And if it is, will you actually have the nous/strength of mind to get back in again in a timely manner? No doubt such tactical decisions might vary between investors with different investment time horizons. It's important to match the duration of your assets with those of your liabilities. But, for the longer-term investor, there is enough evidence to suggest that staying the course tends to pay off.

There is plenty of potential fun and games ahead this week. Following disappointing news (and very poor share price performances) from Netflix and Peloton last week, this week we will see around a third of the S&P 500 by market capitalisation reporting results (mainly for calendar 2021), of which over half will be accounted for by the Technology sector. I fear that any company that disappoints will find its share price duly bludgeoned.

And on Wednesday we will have the first meeting this year of the Fed's policy-setting Open Market Committee. It will be fascinating to see its latest views on inflation, any update on its intended policy response, and, perhaps most importantly, whether or not it is paying heed to the market's attack of the collywobbles. One massive question right now is: what is the level of R* (R-star), or the equilibrium real interest rate – the level at which growth is perfectly balanced, with the economy at full strength and inflation stable? The last estimate by the Federal Reserve Bank of New York was around 0.4%, but they suspended calculations owing to the economic volatility triggered by Covid. A broad market consensus seems to coalesce around zero. The measure of current real interest rates that I look at (the Federal Reserve US Treasury H15 Constant Maturing 10-Year Real Yield – because I know it's consistent and that the Fed looks at it too) is at -0.59%, having risen from below -1% at the start of the year (hence the pressure on long-duration assets). If it does get to zero, that suggests more pain to come. But the truth is that this is a bit like a physics experiment to test the tensile strength of a piece of metal: you just keep on stretching it until it breaks. A period of uncertainty awaits.

One of the key factors that the Fed will have its eye on is wage inflation and the threat of the dreaded "wage/price spiral". There is already some evidence that the Phillips Curve (which plots the relationship between unemployment rates and wage inflation) is beginning to reassert itself as inflation sticks at higher levels. Stories of labour shortages abound on both sides of the Atlantic, but here's a crumb of comfort. The labour market participation rate in South Korea has risen from 62.5% to 63.4% over the last six months. Why is that germane? Because South Korea was a hotbed of retail investor frenzy in equity markets... and the market is down 16% over that period. (Hat-tip to Christopher Wood of Jefferies for pointing this out). Is it too much to infer that some US retail investors, once high on the hog of speculative gains and government stimulus cheques, might suddenly find themselves compelled to work for a living instead? We will see.

And talking of retail speculation, there is much schadenfreude being expressed at the sharp price fall of Cathie Wood's Ark Innovation Fund, the Exchange Traded Fund that was the poster child for investing in disruptive technology stocks, many of which generated little in the way of current profits. It is down more than 50% from its peak. The ultimate embodiment of the concept of long-duration equity is stocks where a very high proportion of current value is attributed to profits expected to be generated far into the future – a point made by fund manager Terry Smith in his latest annual letter. Suffice to say that this type of share is the biggest loser from today's sentiment shift. It is quite feasible that we will look back in a decade and see that this was an amazing buying opportunity, but today no prisoners are being taken.

The key observation, though, is that the average investor in this fund is now losing money, and that was never the promise that was held out to the new cohort of retail investors. Some of them will have bought on margin and will be forced to exit their positions. The same is true for investors across a broad range of "retail favourites" according to data compiled by Citigroup, and we are witnessing a similar clear out in cryptocurrencies too. History suggests that those who don't crystallise their losses immediately will tend to sell as soon as they are back close to breakeven, which will cap rallies.

In closing, at last, I should emphasise one thing. The vast majority of our clients' portfolios are balanced, and so have investments across a range of assets, some of which are chosen specifically to move in a different direction to others. Therefore, most portfolios will tend not to display either outsized gains or ruinous losses. Furthermore, our preference within equities is for companies that have strong finances and an ability to generate returns above their cost of capital. They will still be here tomorrow. Those who report on financial markets thrive on boom and bust, big numbers and the stirring of emotions. There is a reason that the BBC News still refers to the Dow Jones Industrial Average in its bulletins: it's because it has a huge denominator. With the index sitting around 34,000, even a small percentage move adds up to a lot of points! How dull to report that a standard private client medium-risk balanced portfolio was up/down 0.1% today.

Economic Commentary

FTSE 100 weekly winners

Pearson PLC	9.0%
Antofagasta plc	5.1%
BT Group plc	5.1%
Polymetal International Plc	5.0%
Reckitt Benckiser Group plc	4.0%
Anglo American plc	3.7%
British American Tobacco p.l.c.	3.5%

FTSE 100 weekly losers

Ashtead Group plc	-9.9%
Barclays PLC	-7.5%
Melrose Industries PLC	-7.0%
Royal Mail plc	-7.0%
Evraz PLC	-6.8%
Unilever PLC	-6.6%
Lloyds Banking Group plc	-5.9%

FTSE 100 index, past 12 months

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