OUT OF THE ORDINARY

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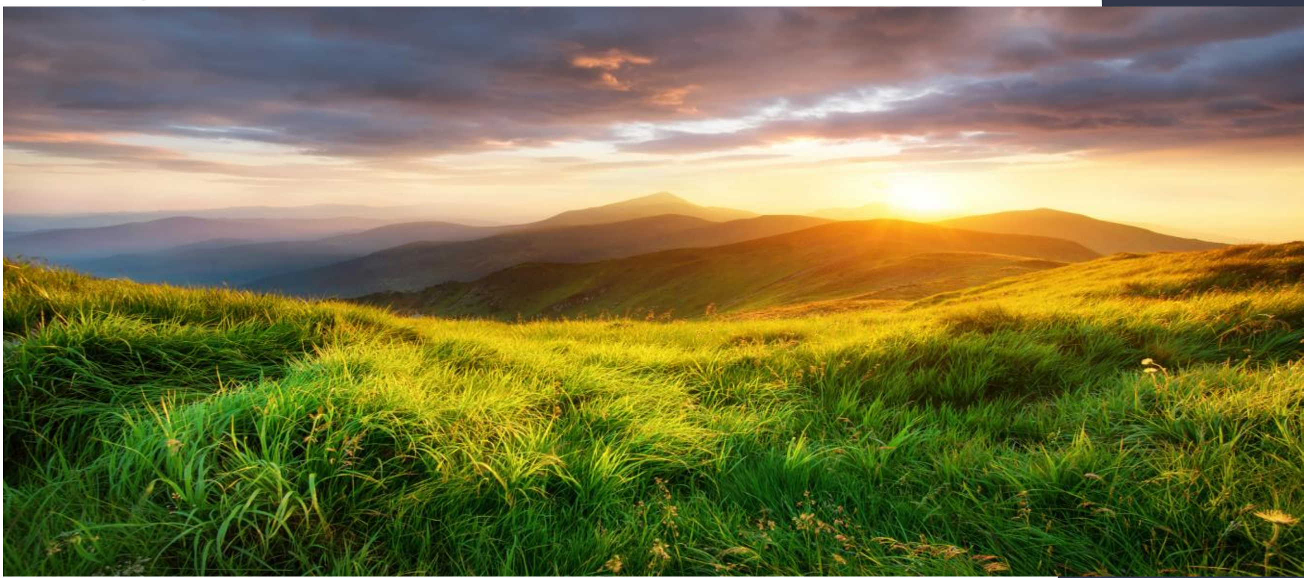
The charge of the light brigade



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When my dad (born in 1905) was at school, he was made to learn poems by heart. He must have had quite a facility for it, because more than three quarters of a century later he regularly used to launch into renditions of his favourites, one of which was Tennyson's Charge of the Light Brigade, which narrates the doomed assault by the British cavalry during the Battle of Balaclava in the Crimean War. And that happened on 25 October 1854.

When I saw that, my mind stretched to thinking that investors might be facing their own charge into a battlefield with "cannon to right of them, cannon to left of them, cannon in front of them" in the weeks ahead. Indeed, for the past few months we have been threatened by a number of negative and potentially negative developments. In In Just The Time Of Year, I wrote about the seasonal fears that haunt investors during the autumn, and while we acknowledged the risk of a bumpier road ahead, we did not advocate taking an outright cautious stance. A month or so later, we have definitely experienced a few bumps, but equity markets have, in aggregate, made further progress.

However, at our latest Asset Allocation Committee meeting last week, it was decided that the time had finally come to don a little more protective gear. This is by no means a prediction of impending doom, more a realistic reassessment of the balance between the upside potential and downside risks of equities in particular. Neither does it mean a wholesale selling of equities. First, we would recommend rebalancing equity positions back towards strategic asset allocation benchmarks because the recent strong performance of equities versus bonds will have led to some drift away. Then we would consider taking a little more out of Growth/long-duration holdings, because we believe that if there is one overriding current risk it is that inflation expectations continue to rise for a while and that this will encourage central banks to implement countermeasures in the form of higher interest rates. We would expect that (and the expectation) to lead to higher bond yields, and the rising discount rate would weigh on equity valuations, notably of Growth companies with their longer duration earnings stream.

As simple as that thesis (hopefully) sounds, real life will no doubt be a lot more complicated. We are currently in the throes of the third quarter corporate reporting season, and it has been pretty good so far. Using data for the S&P 500 in the US (although other regions have had some strong reports too), of the 117 companies to report to date, 85% have beaten earnings estimates and 74% have beaten sales estimates. The average eps beat is 13.05%, and the average revenue beat 2.06%. These are both above recent averages, although perhaps the earnings beat is more in line with the average if one controls for the continuing large loan loss provision releases from the big banks. But still impressive, nonetheless.

Indeed, it is quite welcome after a recent fall in aggregate earnings revisions. However, they remain in positive upgrade territory for now. A recent note from strategists at JP Morgan pointed out that we are currently in a regime of "EPS Upgrades + Falling Earnings Revisions". In their data set that runs from January 1995 to June 2014 (I'm not sure why it ends there), that regime delivers average monthly global equity returns of 0.71%, which, as it delivers compound annualised returns of almost 9%, we would be more than happy with. The best regime for returns is, perhaps unsurprisingly, one of "EPS Upgrades + Rising EPS Revisions", which in the past has delivered 2.29% per month.

What one might not expect is that the second best (of four) is the period of "EPS Downgrades + Rising EPS Revisions" (+1.85% pcm). Here, even though earnings are still falling, the pace of cuts is slowing and investors are already looking to the other side of the valley, as it were. This is very much what happened as we went through the COVID trough, when markets rallied strongly, ostensibly in the face of dreadful news. The time to be definitively out of the market is the period of "EPS Downgrades + Falling EPS Revisions" (-0.61% pcm). Of course, these are all averages, and so there will be up and down months in all the regimes.

But you can see that, using average historical data, there is quite a high bar to surmount if one is going to get very defensive. And remember that this data set includes both the Tech Bust and the financial crisis. Are we being too cautious? Liquidity in financial markets is another key factor, and there is little doubt that central banks, notably those of the US and UK as far as we are concerned, have cranked up the hawkish rhetoric in recent weeks. This comes as inflation indices persist at higher levels and supply chain disruptions continue to be a factor. Then there's the energy price squeeze. And the outcomes that all of these create appear to be increasingly non-linear; they are prone to create extreme volatility in economic performance and asset prices.

You would hardly suspect that from looking at volatility indices such as the VIX index right now, but we note that in the past some of the market's sharpest reversals have come from situations very similar to the current one, with many potential negative catalysts visible but few investors willing to jump ship until the torpedoes actually hit. And then it is often too late. Alongside inflation risks and monetary policy tightening we also listed: tight labour markets; a reduction in fiscal support; a slowdown in China and the associated situation at property company Evergrande; the potential for more bad news on the COVID front; and take your pick from several geopolitical threats. And we also note that retail investor participation and leverage, both of which are fickle beasts, are at historically high levels.

On the other side of the coin, we believe that our favoured Absolute Return funds are well positioned to be able to provide some positive returns in a more volatile market. And if we have a bit more cash, then that gives us firepower to react should a correction materialise. After all, we are not expecting the apocalypse, but trying to find the right balance between risk and reward in what we believe is a potentially trickier market environment.

And I write all of this with no reference yet to the overarching crisis of the era, which is climate change. I must admit to being a bit worried that the COP-26 conference, which starts at the end of the week, will not provide the answers that many are hoping for. A statement from India caught my eye over the weekend and it hints at the possibility that emerging from the summit with a united front might be something of a stretch. A top civil servant said that India will be demanding compensation from developed countries for losses caused by climate-related disasters. And he won't be alone in making the case for emerging market countries to be treated differently from developed markets, owing to the fact that they did not produce most of the carbon (even if they do produce a lot now) and that they want their chance to be able to develop further.

The Prime Minister of Bangladesh, a country massively prone to climate-related crises, similarly made a plea for funds and more joined up policies in an opinion article for the Financial Times last week. I'll be as happy as anyone if some firm conclusions are reached in Glasgow and positive action taken. And when we see what does happen, it will provide a useful moment to update you on our current thoughts about climate change and how it affects our investments.

Economic Commentary

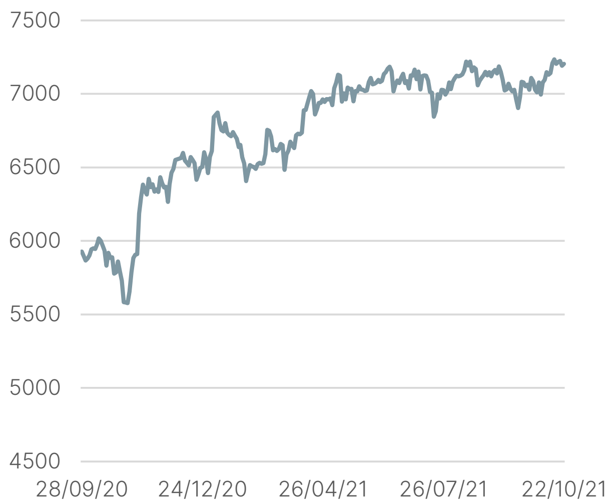
FTSE 100 weekly winners

Polymetal International Plc	6.6%
Hargreaves Lansdown plc	5.3%
Croda International Plc	5.1%
Hikma Pharmaceuticals Plc	4.4%
Spirax-Sarco Engineering PLC	3.6%
SSE plc	3.5%
DCC Plc	3.1%

FTSE 100 weekly losers

International Consolidated Airlines Group SA	-14.7%
Whitbread PLC	-7.4%
Rio Tinto plc	-7.3%
Barratt Developments PLC	-6.8%
Rolls-Royce Holdings plc	-6.5%
Glencore plc	-6.0%
Informa Plc	-5.6%

FTSE 100 index, past 12 months



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