Weekly Digest

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Springing Forward

The approaching end of the first quarter and the welcome prospect of a four-day long weekend prompt some reflection on what has been an action-packed year so far. The mercury is over twenty degrees in London today. From my window I can see magnolias, forsythia and cherry trees in full blossom, and my wisteria is ready to explode. Hopefully all harbingers of sunnier times ahead in all respects.

So far in 2021, we have been tested by some large gyrations in both equity and bond markets; the SARS CoV-2 virus has continued to provide more negative surprises, mainly owing to new variants; scaremongering about bubbles in various financial assets has been a constant distraction; and there have been a number of individual events that might have had the capacity to undermine confidence. And yet, barring a last-day catastrophe, balanced portfolio investors should be able to look back on a period of modest, but respectable, progress.

For this we must continue to thank a combination of central bankers, finance ministers and vaccine developers. The latter group provides greater confidence in the eventual return to economic normality (even if certain aspects of our lives, including working arrangements and shopping habits, might have changed permanently); the former pair, whether in cahoots or not, continue to provide a financial bridge across the Covid crisis, with funding costs remaining remarkably low by any historic standards. It is worth reiterating the point that the contrast with the post-great financial crisis (GFC) approach to government finances is extreme. Following the GFC, austerity was the name of the game, with governments everywhere scrambling to cut their deficits, fearful of being punished by bond investors. Now, with both current and accumulated deficits in the majority of cases higher than post-GFC, the emphasis is on not hindering the recovery.

Furthermore, with the Democratic Party and the US Federal Reserve (Fed) leading the charge, there is an increasingly apparent desire to reverse the societal inequalities that have compounded in past decades. For example, the Fed is committed to not raising interest rates until it has returned the economy to full

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employment, even if this requires allowing inflation to run well above its 2% target for a period of time. This is a radical change from the pre-emptive approach to monetary policy that has characterised the last few decades. In the UK too, "levelling up" is very much on the government's agenda, with more funds earmarked for development outside London and the South East.

At the headline asset class level, the fallout from this shifting approach to policy has primarily been felt in bond markets, thanks to the increasing anxiety about future levels of inflation. No longer are bonds pricing in the risk of a permanent deflationary threat. And while they are not discounting a return to nineteen-seventies-style price spirals either, an upward trend in inflationary expectations and bond yields has been evident. Indeed, Bank of America's March Fund Manager Survey had "Higher than expected inflation" replacing "Covid-19 vaccine rollout" as the respondents' number one tail risk.

All of these factors have come together to ensure the continuation of a substantial rotation within equity markets, a development that is not evident in headline indices, nor much reported outside the more specialist financial press and broadcasters. In previous commentaries I have referred to the market's shift in preference from "long duration" sectors and stocks to "short duration". This was already evident towards the end of 2020 following the successful vaccine trial announcements, but was more a case of the laggards catching up with the leaders. Indeed, the speculative frenzy supporting (mainly) innovative and disruptive technology companies (and I use the term "technology" in a very broad sense to include pretty much anything that conducts its business online) did not peak until mid-February, when the acceleration of the rise in bond yields started to put real downward pressure on long duration equity valuations.

Although I remain loath to use the "Growth" and "Value" factors to describe the rotation between long and short duration stocks, they are still the most readily available and easy to use, and give a reasonable idea of the relative movements. Year-to-date, then, the S&P 500 Growth Index (again, the simplest proxy) has produced a total return of 1.45%, whereas the Value Index is +11.36% (to C.O.B. 29/3/21). The divergence in performance clearly begins on 18th February, although I cannot identify a specific trigger. It seems just to be the result of an accumulation of stronger-than-expected US economic data and the relentless increase in the 10-year Treasury yield. It's also possible that the latest round of stimulus-cheque-related retail speculation dried up around this time.

At the extremes we can also see investors taking their profits in "stay-at-home" companies, while moving into "re-opening" stocks. For example, Zoom and Peloton, a couple of lockdown's poster children, are down 46% and 37% from their Covid-inspired peaks (although still substantially higher than pre-Covid). Despite the fact that neither cruises nor cinemas are exactly routine activities just yet, Carnival is +161% from its crisis trough (+15% YTD), while Cineworld is +369% from its lows (+56% YTD). Perhaps more remarkably, shares of Live Nation, the company that owns Ticketmaster, hit a new all-time high on the 1st March.

We believe that the market's general tone in the second quarter will continue to be much as it was in the first. Investors will continue to look forward to the re-opening of economies, although the path will be bumpy. The main obstacles are likely to be sporadic flare-ups in case numbers and problems with vaccine distribution. A variant that was completely vaccine-resistant would be a game-changer, but that is not viewed as a probable development. My own concern (for both professional and personal reasons) is that international travel will remain severely curtailed as long as countries fear the import of a new variant. This fear is currently seen in the Day 2 test for returning travellers. The cost (around £200 per person) for an average family would be prohibitive if the scheme continues – and, somewhat against the grain of other "levelling up" policies, leave overseas travel options firmly in the hands of the "haves". We shall just have to see how that goes.

We also know that inflation indices will pick up sharply during the second quarter, and these will have the capacity to put further upward pressure on bond yields. What we still cannot be sure of is what happens later in the year, and I can show you forecasts that range from a return to the pre-Covid status quo of low growth and inflation to ones that predict much higher levels. The uncertainty suggests the potential for volatility around the publication of any associated economic or survey data.

Last week's episode in the Suez Canal added a little fuel to the supply constraint story which has so far mainly featured semiconductors, shipping containers and cardboard boxes, as well as timber for construction in North America, and anything that resembles garden/patio furniture. Around a tenth of the world's traded goods and crude oil pass through the canal, and while they could be rerouted via the Cape of Good Hope , that would be more costly (while also reducing overall shipping capacity by requiring more time at sea). Thankfully, the situation was resolved smartly, but it provided another illustration of the fragility of supply chains, and might well prompt more investment in capacity that is closer to end markets.

I should also mention another situation that had the potential to cause an upset. That was the forced liquidation of assets "owned" (via derivative contracts) by a low-profile family office in the US called Archegos Capital. "Family Office" sounds like a nice conservative operation, but is a catch-all for any sort of investment vehicle that is not open to the wider investment community and invests on behalf of one or a small number of individuals or families. For some, the benefit of running a family office structure is the lower regulatory and disclosure hurdles that have to be overcome. I am certainly not implying that Archegos breached any rules. However, it would appear from reports in the press that its gross assets were multiples of its underlying capital of around $10 billion (the Financial Times has quoted figures ranging from three times to twenty times so far), constituting a highly leveraged and potentially unstable edifice.

The first trickle of the landslide started with an issue of shares and convertible stock by ViacomCBS, the multimedia broadcaster, last Wednesday. This triggered a combination of profit-taking after a seriously strong rally and, in all probability, the selling of shares by convertible arbitrage funds. These funds will hold the convertible and sell short the equity, leaving themselves with a bond-like asset that has the potential to provide an equity-like upside kicker. The selling snowballed, and Viacom's shares fell 23% on the day. We still await confirmation of Archegos's exact exposure, but it is reported that it was a substantial investor in the shares, with its exposure funded by borrowed money. Once the value of its shares started to fall below the value of its loans, margin calls were triggered, and these were fulfilled by selling the underlying shares and also other holdings within the fund. After a 5% fall on Thursday, more selling was forced on Friday, with several banks now involved. Friday's fall was another 27%, and as of Monday's close Viacom's shares had more than halved. It is hard not to believe that other opportunists will have taken advantage of the situation to profit from the forced selling. Cumulative multi-billion dollar losses have been reported by a number of banks.

What are we to take from this? First, the good news. Despite the losses, there has been no sign of systemic risk within the financial system. This speaks to the strong underlying liquidity conditions, and also to the fact that banks must now hold much more safe capital than they did prior to the GFC. Even so, we must not be complacent. This episode also highlights the risks of highly leveraged and concentrated investment structures, and how if one leg fails, a nasty domino effect can ensue.

Much has been written about financial sector leverage, and it is clear how it can amplify both positive and negative returns. As long as the underlying securities involved are not impaired (ie there was no threat to the solvency of Viacom or other companies swept up in the selling), unleveraged investors, while having to bear a short-term mark-to-market loss, should not be greatly affected. But one can only assume that this incident will throw a sharper focus onto leveraged investment strategies and how they are funded. While that

might make the world a safer place in which to invest, it will also curtail the profitability (notwithstanding the losses experienced in this case) of the participants in such trading.

The last thing I need to do is to rebut some of the calls suggesting that this is the harbinger of another GFC, in that it echoes the need to bail out two hedge funds in the summer of 2007. Those hedge funds, run by Bear Stearns (which itself needed bailing out the following year), were invested entirely in mortgage-backed securities, the instruments that eventually triggered the demise of Lehman Brothers and the bail-outs of AIG and Merrill Lynch, to name but three high-profile casualties. But this was a whole asset class based on unsustainable collateral valuations (US residential property) and mortgages that had been mis-sold on an epic scale. Oh yes, and some of the investment vehicles had multiple layers of leverage. While we acknowledge pockets of speculative froth in certain areas of markets today, this does not appear to be a similar canary in the coalmine. No doubt this is yet another entry into my long list of potential “famous last words” written in these missives over the last few years, but ones that I am again not uncomfortable in writing. Yes, high leverage might well compound some future downturn, but it won’t be the catalyst per se.

Other than that, have a Happy Easter. And may it be filled with as much social activity as the rules currently allow and as many Easter eggs as your most expandable set of clothes can bear! The Weekly Digest will return on Monday 12th April – the next planned milestone re-opening day in the UK. Maybe you’ll all be out shopping and getting haircuts, or in the gym…

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Last week's Economic Highlights

FTSE 100 Weekly Winners

Company	Change
Halma plc	6.3%
Smiths Group Plc	5.2%
Rightmove plc	4.8%
Ocado Group PLC	4.1%
DCC Plc	4.1%
Whitbread PLC	4.0%
Kingfisher Plc	3.9%

FTSE 100 Weekly Losers

Company	Change
Rolls-Royce Holdings plc	-9.2%
Burberry Group plc	-6.7%
Polymetal International Plc	-6.5%
International Consolidated Airlines Group SA	-5.0%
Fresnillo PLC	-5.0%
Melrose Industries PLC	-4.5%
Informa Plc	-4.0%

FTSE 100 Index, Past 12 months

Source: Factset

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