Weekly Digest

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New Year – Similar Outlook

Three weeks ago I rounded off the year with my holiday reading list, and I'm happy to say that, with the exception of the last fifty pages of the final John Le Carré novel (which will be completed tonight), I have met my objectives. The arrival of Barack Obama's latest tome in my Christmas stocking, though, does present a new challenge, weighty in terms of both poundage and content.

In the (overoptimistic?) expectation that there will be quieter weeks ahead, I hope to share more observations about both Factfulness and The Future Is Faster Than You Think with respect to investing, but I thought I would start with just one pair of dots that I joined between the two books. These concern humankind's general inability to make ample provision for the future – whether it be saving for retirement, adopting healthy practices today, heading off climate change or, indeed, planning for a pandemic.

Behavioural science has become a greater factor in investing, as we seek to overcome natural biases that tend to lead to suboptimal outcomes. In his chapter in Factfulness on The Urgency Instinct, Hans Rosling highlights how our primal need to do (and to be seen to be doing) something in the face of an immediate threat can amplify many of our other less helpful instincts, which, in turn, "blocks us from thinking analytically, tempts us to make our minds up too fast, and encourages us to take drastic actions that we haven't thought through". Something to consider in times of Covid and political uncertainty when we are constantly assailed with doom-laden prognostications from the media. He continues: "We do not seem to have a similar instinct to act with risks that are far off in the future. In fact, in the face of future risks, we can be pretty slothful". Peter Diamandis and Steven Kotler in The Future Is Faster Than You Think make a very similar observation, but backed with more scientific evidence. "Studies done with fMRI show that when we project ourselves into the future […] the medial prefrontal cortex shuts down. This is a part of the brain that activates when we think about ourselves. When we think about other people […] it deactivates. And when we think about absolute strangers, it deactivates even more. […] The brain treats the person we're going to become as a stranger. And the farther you project into the future, the more of a stranger you become. […] The brain believes that the person who would benefit from making those difficult choices isn't the same one making those choices".

Obviously we wouldn't want to base our whole investment proposition around these observations, but, at the margin, they can improve our approach. When everything looks rosy, we need to be mindful of having some "insurance" in portfolios. Equally, when current circumstances are terrible we must look ahead to the cycle of recovery. It is also why ESG (Environmental, Social and Governance)

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factors are playing an ever greater part in investment decisions and corporate management behaviour and incentives.

The authors of The Future… have a more optimistic angle, pointing to the unprecedented convergence of technologies that will create growth opportunities far beyond what most of us can imagine. No doubt we have already witnessed some of that in the performance of Technology stocks. Of course, the skill that is then required is to evaluate the opportunity relative to the current valuation and to attempt to differentiate between a sustainable trend and outright speculation. I can't guarantee that we will spot all the winners or avoid all the duffers, but our analytical approach is set up to recognise long-term growth opportunities and not to be scared off by seemingly high short-term valuations. As for some of the opportunities that are currently garnering headlines with extraordinary daily moves, I would emphasise that we are investors not speculators, and that the movements of any individual security should be viewed within the context of a balanced and diversified portfolio. Good luck to those who sold their houses and "invested" the proceeds in cryptocurrencies a few years ago!

As for the investment landscape today, it looks very similar to the one of a few weeks ago but for the removal of one particularly nasty blot, namely the threat of a "No Deal" Brexit. As I commented in December, all of the well-connected commentators that I had listened to were leaning towards a deal built on pragmatism, with perhaps the most compelling evidence being that had either side not wanted a deal they would not still be talking. The relative calm in currency markets reflected a similar belief from investors, and thus when a deal was struck there was minimal reaction. But the elimination of tail risk is a positive factor, and has fuelled some hope that both corporate buyers and global investors will be tempted back into the UK given the lifting of uncertainty, even if our overall trading relationship with the EU is less attractive than before, and there remains considerable doubt as to the nature of new trade deals with other partners.

Covid, of course, dominates the headlines, and it is fair to say that things have taken a turn for the worse since I last wrote, thanks to the emergence of the variant strain which appears to spread much more readily than the original one. However, investment markets (in aggregate) continue to shrug off the record case and hospitalisation numbers, although the existential threat for businesses at the sharp end of restrictions remains very real, leading to very high levels of idiosyncratic risk at the individual stock level. Investors' more relaxed attitude is still predicated on two key factors: the approval and distribution of vaccines and the continuing support of both fiscal and monetary policy.

We continue to believe that the latter will not be withdrawn prematurely, and so the greater volatility is more likely to be around the speed and effectiveness of vaccination programmes. With only around 1% of the UK's population vaccinated, we still have a very long way to go to achieve herd immunity. Maybe Israel, which has quickly reached 10%, will give us some early clues as to how fast economies can open up, at least domestically.

Just to illustrate how much focus is on this area, Deutsche Bank's final client survey of 2020 asked what the biggest risks to financial markets were in 2021. The top three responses were: virus mutates and dodges vaccines; serious vaccine side effects start to emerge; and enough people refuse to take vaccine thus hampering back-to-normal drives. At least there is no sign yet that the more infectious variant is deadlier or resistant to current vaccines. So far there are limited signs of side effects, although it is almost inevitable that some recipients will suffer an adverse health event within a short time of being injected. Michael Osterholme points out that from a population of ten million 55-64 year-olds in the US, statistically one would expect 1,705 to die within the next 7-day period. Someone, somewhere, is going to blame a vaccine.

The last hangover from 2020 is the US political situation. At least a new stimulus package was agreed over the holidays, but the potential for a much larger one continues to hang on the results of tomorrow's Senate run-offs in Georgia. As a reminder, the Democrats need to win both to achieve parity in the number of seats, with Vice-President-elect Kamala Harris then having

the casting vote. A win for the either Republican candidate promises at least two more years of stalemate in Congress. In the event of the Democrats pulling off a double victory - and they are marginally ahead in the latest polls – there would be upside to US growth estimates, but also to inflation expectations, which markets might find slightly unnerving, despite the fact that the general belief is that the Federal Reserve will allow the economy to "run hot" for a period before tightening policy. Such a result would also be expected to weaken the dollar, thus putting further upward pressure on commodity prices and also benefitting the recovery trade in non-US markets, notably those in the emerging world. Another reminder – there is going to be a lot of chat about inflation this year, and it is going to very difficult to disaggregate Covid effects from more durable underlying trends. Prepare for volatility on this front.

Despite the fact that he continues to challenge the result of the US election, Donald Trump should finally exit the White House on 20th January, ushering in a regime that is expected to be much less turbulent, even if not one that will immediately unwind all of Mr Trump's policies. It's nice to have a fixed date in the calendar for the inauguration. Even so, I caught a reminder over the holidays that becoming fixated on certain dates to provide a resolution to one's problems or current predicament can be fraught with danger (and this is equally applicable to Covid, especially when it comes to the promises of policymakers).

This is encapsulated in the Stockdale Paradox. Colonel James Stockdale was a prisoner of war in Vietnam for seven-and-a-half years. He survived (mentally) by being able to hold two apparently contradictory thoughts in his head: belief in the fact that he would be released in the end, and the grim reality of his current situation. His mechanism was that he lived from day to day. Those who pinned their hopes on being "home by Christmas", then "home by Easter", often died as much of a broken heart as from their deprived conditions.

In investing, then, we place a lot of emphasis on creating what we believe to be the most appropriate portfolios for the longer term. We chip away at achieving those returns incrementally. It's also why you'll never see me give you a forecast for the level of the FTSE 100 at the end of the year. I'd hate to disappoint you!

Last week's Economic Highlights

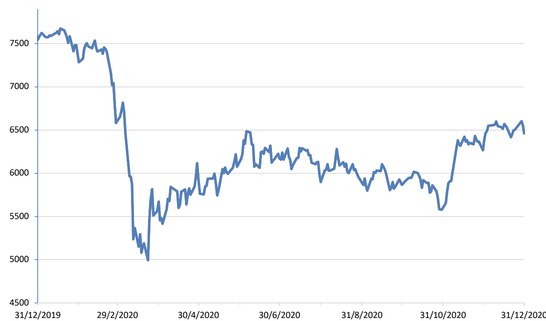
FTSE 100 Weekly Winners

Berkeley Group Holdings PLC	7.0%
Legal & General Group PLC	6.7%
Next PLC	6.1%
JD Sports Fashion PLC	5.7%
Melrose Industries PLC	5.7%
NatWest Group PLC	5.5%
Tesco PLC	5.0%

FTSE 100 Weekly Losers

HomeServe PLC	-4.0%
Johnson Matthey PLC	-3.5%
CRH PLC	-3.1%
Intertek Group PLC	-3.1%
Diageo PLC	-3.0%
Smith & Nephew PLC	-3.0%
DCC PLC	-2.6%

FTSE 100 Index, Past 12 Months



Source:FactSet

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