Weekly Digest

| 17 May 2021 |

John Wyn-Evans
Head of Investment Strategy

Welcome To VUCA

On Saturday my wife and I had lunch at a restaurant for the first time in fifteen months. Even though we were outside, an intricate network of tarpaulins afforded decent shelter from the odd torrential downpour, although extra thermal layers were still very much in evidence. The scene was testament to both the ingenuity of restaurateurs and the resilience of customers.

One slide that I regularly use in my presentations illustrates how global activity has become less affected by lockdowns as we become more used to their impact. Not only have we evolved our ways of living and working, but the “shock factor” is also diminishing. Research in the field of behavioural psychology has shown this to be a reliable human trait. We don’t like our routines to be broken, nor our preconceived ideas of normality to be upended. But we can really only be properly surprised once. In the past I have commented on investors’ response to, for example, terrorist attacks, which has become increasingly less pronounced since the events of 9/11. The stuff we really don’t like is what Nassim Taleb might describe as a “black swan”, or Donald Rumsfeld as an “unknown unknown”.

Thus markets have been able to weather any number of potentially shocking events recently because, one could say, “we’ve seen this all before”. Admittedly, the extraordinary short squeeze in GameStop’s shares in January was a novelty, in that it was orchestrated through the medium of retail social media forums, but the concept was not new; Archegos will be consigned to the annals of hedge fund misadventure; a ship blocking the Suez Canal was really just a new take on an old theme of supply chain disruption.

If we look back at the last few events that have really properly jolted markets, they have pretty much come out of the blue. COVID, obviously; the late 2018 sell-off was, perhaps, more telegraphed, but it was the unexpected escalation of tariff wars by President Trump that proved to be the spark (with Federal Reserve policy tightening acting as the dry tinder); the early 2018 hiccup was caused by what turned out to be rogue economic data suggesting a sharp uptick in inflation and the need for more aggressive monetary

Investec

tightening – this episode was exacerbated by what was dubbed "Volmageddon", as volatility bets and hedges were unwound; 2015's downturn was catalysed by a totally unexpected (and extremely badly handled) currency "devaluation" by China, followed by the outbreak of a price war in the oil industry when OPEC and Russia tried to be put the US shale sector out of business; the "taper tantrum" of 2013 was unleashed when the Fed unexpectedly suggested that it was going to start scaling back its asset purchases. I could go on, but I'm sure you get the drift. Markets don't like surprises.

Was last week's much-higher-than-expected US inflation print a surprise, then? On the evidence of the reaction, not really. There was a sell-off for equity markets on the day, but a subsequent recovery, and bond yields were hardly changed. There was not a lot to choose between Value and Growth indices by the end of the week, when one might have expected Value to have done a lot better.

Are investors becoming inured to the inflation threat? Probably not. We certainly continue to take it very seriously. But there is a big difference between making higher inflation one's core investment outlook and looking to hedge against it as a meaningful tail risk. I continue to be bombarded with research notes exhorting more exposure to "real assets", which can encompass asset classes such as commodities, real estate and even "collectibles", but much of the evidence for these recommendations is founded on historical correlations, with the experience of the 1970s carrying a very heavy weight. Thus Oil and Gold are perennial favourites, possibly not taking into account where we are in the Energy cycle (or the ESG considerations – that is factors relating to the Environmental, Societal and Governance aspects of a business, with the first of these being especially relevant in this case), nor the potential for new digital assets to usurp Gold's historic and long-proven preeminence as an inflation hedge. We are not calling these arguments either way at the moment, but reaching a conclusion has to be made more scientific than just relying on past data.

Even so, last week reminded us that higher and rising inflation remains the scenario that least suits balanced portfolio investors who retain most of their assets in equities and government bonds. Both asset classes were down.

There are probably other influences at work too. Today is the day that US citizens have to pay their taxes, and it's quite possible that cash has been raised from current investments to pay capital gains taxes, which will have been substantial for many. It is also clear that the headlong retail investor surge into shares and funds exposed to technology, disruption, innovation and carbon reduction is reversing. While not commenting on the underlying investment cases, I would point out that the flagship Innovation Fund run by ARK in the US is down by exactly a third from its peak in February. And even though the fund is up 200% from its trough in March 2020, we calculate that the "average" investor now in the fund is losing money relative to their original investment. The UK's standard bearer in this area is the Scottish Mortgage Investment Trust. It is down a rather less gut-wrenching 20% (but still around double the level at which it traded at the beginning of 2020). It's not hard to find shares related to the nascent boom in the hydrogen industry that have lost half of their value.

One other thing that has broken down recently, which is muddying the waters further, is the relationship between Technology shares and the real bond yield. As real yields fell last year, Technology shares boomed thanks to the effects of the falling real discount rate. When real yields popped higher in February, Tech pulled back sharply. But as real yields have drifted lower again through April and early May, Tech has failed to rally as it might have done before, and this despite a great earnings season for the industry. That suggests continuing repositioning by fund managers into more cyclical sectors.

What time I had to spend in my car at the weekend was spent listening to podcasts, as usual, and during one I was introduced to the concept of VUCA, which was brought to the world of military education by the US Army War College in the 1980s. The letters stand for Volatility, Uncertainty, Complexity and Ambiguity, and were meant to convey the global geopolitical situation at the end of the Cold War. For me, these four words perfectly describe the world of investing currently, with the emphasis being that people offering simple solutions might not fully comprehend the complexity of our world today. We continue to search for the best mix of assets to take into account all the risks while still being able to provide a decent return, but cognisant of the fact (or at least our opinion) that overall portfolio returns are likely to flatten out.

Last week's Economic Highlights

FTSE 100 Weekly Winners

M&G Plc	8.6%
Ashtead Group plc	3.7%
Lloyds Banking Group plc	3.6%
BAE Systems plc	3.4%
SSE plc	3.2%
J Sainsbury plc	3.1%
Wm Morrison Supermarkets plc	2.5%

FTSE 100 Weekly Losers

Flutter Entertainment Plc	-13.2%
Just Eat Takeaway.com N.V.	-12.4%
International Consolidated Airlines Group SA	-7.6%
Scottish Mortgage Investment Trust Plc	-7.0%
Entain PLC	-6.1%
Rio Tinto plc	-6.1%
Experian PLC	-5.3%

FTSE 100 Index, Past 12 months

Source: Factset

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London EC2V 7QN.

Investec