Weekly Digest

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Now Or Never Never

When Everton's footballers pitched up at Anfield, home of local rivals Liverpool, on Saturday, many observers and fans were of the opinion that this was a "now or never" moment for the Blues to notch up their first victory on enemy territory since before the dawn of the new millennium – September 27th 1999, to be precise *. Although one must never confuse correlation with causation, it was around then that stock markets around the world embarked upon the last, crazy leg of a Technology, Media and Telecoms boom that saw the NASDAQ 100 Index, which was highly representative of these sectors, double over the next six months, before handing back all of those gains by Christmas 2000.

If Everton's victory at the weekend were to be the harbinger of another such move, we would be in for a speculative melt-up and subsequent bust of epic proportions, especially given what we have already witnessed since the lows of last March. Certainly there are those who believe such a boom is possible, and the unrelenting flows into funds focused on innovation, disruptive technologies and carbon reduction, for example, are testament to that sentiment. However, it could be that the great works of Carlo Ancelotti, Everton's manager, signal something quite different this time – indeed the polar opposite of what happened almost twenty-two years ago in terms of investors' preferences.

For some time we have been concerned about how the current stock market cycle might evolve. For the majority of the period since the financial crisis, persistent low growth in the global economy combined with a lack of inflationary pressure has increasingly favoured what we have chosen to label "long duration" earnings, or what is often referred to as the "Growth" factor. This has, to a large degree, been at the expense of "short duration" earnings, more commonly labelled "Value" or "Cyclical". The outbreak of Covid-19 turbo-charged this effect, at least once investors had overcome the initial shock last March, aided and abetted by extreme monetary largesse from the world's central banks.

However, growth expectations are now very much on the up – this time aided and abetted by fiscal stimulus, notably in the United States, and the prospects for a vaccine-inspired consumption bonanza – and we have moved from fear of outright deflation to anxiety that inflation might become too high for comfort. Should this start to exert more upward pressure on bond yields initially, and interest rates subsequently, it would undermine the valuation case for longer duration earnings, the "never never" of the title, in favour of shorter duration – the "now". And that was certainly the prevailing theme in markets last week.

This month I have already received countless research notes from investment banks, as well as invitations to online presentations, examining the ramifications of the shifts in inflationary expectations and rise in bond yields. Yet more views are aired in public forums. It is the single most discussed topic on a strategic level by a long chalk. But as with any normal distribution, there are the outlying opinions. A few predict an "everything boom", in which increased growth and inflation, combined with interest rates pinned to the floor and central bank control of bond yields, create the recipe for both long and short duration earnings to continue to rerate higher. Then there are those at the other extreme who envisage a return to the 1970s era of rampant inflation and plummeting equity valuations. As ever, the majority of opinions are centred around a more stable consensus at the overall market level, although there remains scope for substantial rotation within markets.

The danger, perhaps, is that there is too much reliance on historical correlation models. One feature of markets today is that historical market data can be mined with relative ease, and correlation models built to "predict" what will happen in similar circumstances today. One primary example illustrates the relationship between bond yields (and notably the yield curve) and the performance of banks. Historically the Banks sector has done well as the yield curve has steepened, which it is doing now. But what if central banks intervene and suppress yields and interest rates even as inflation rises further – so-called "financial repression"? And there is also the fact that the financial sector is vulnerable to technology-led disruption which can gnaw away at big banks' margins.

Then there is Energy. On numerous occasions in the past inflation has been stoked by higher oil prices. Therefore oil is often claimed to be good hedge against rising inflation. Certainly there remains a strong short-term relationship between market-derived inflation expectations and the cost of a barrel of oil, even if it's not entirely clear that the longer-term impact is as lasting. After all, the price of oil would have to continue to rise year after year to have a sustained effect on inflation rates. Currently the debate is also clouded by the impact of environmental concerns, with the Energy sector having been subject to big outflows from investors looking to burnish their environmental credentials. Having said that, what people do away from public scrutiny might be rather different. The latest Deutsche Bank client survey asked this question: "How likely are you to personally invest in something that scored badly on an ESG basis if you thought there was a strong likelihood of making a higher return from it?" The majority of respondents in all geographical and age categories answered either "very likely" or "slightly likely"!

Still, markets seem generally to be sticking to the script for now. Last week saw a notable rise in sovereign bond yields. The US 10-year Treasury yield rose from 1.21% to 1.34%. 10-year Gilts saw a similar move from 0.52% to 0.7%. For equities, that meant that while the S&P 500 Index was down just 0.7%, there was quite a big divergence between the winning and losing sectors. Energy (+4.5%), Financials (+3.8%) and Materials (+1.9%) led the way, with Utilities (-2.8%), Healthcare (-1.7%) and IT (-1.4%) bringing up the rear. There was a very similar shape to markets the world over. This could well be how equity markets continue to evolve this year, with headline indices not entirely reflecting greater movement under the surface – what I have previously referred to as a "swan-like" market.

Quite where the inflation rate and bond yields start to undermine the whole edifice, with bonds and equities of all stripes falling in value, remains up for debate. For now the majority of opinion is looking at the range of 1.5% to 2% for the US 10-year yield as the equilibrium range at which equity markets don't lose too much altitude although the rotational effect will become increasingly evident. If we head over 2%, then the outlook is expected to become much more challenging. Remember that base effects for inflation rates almost guarantee some pretty high year-on-year Consumer Price Index prints during the second quarter of this year. Investors' (and possibly central banks') desire to "look through" this spike is going to be tested. We certainly expect a period of increased volatility in the coming months.

*Full disclosure – I am an Everton supporter!

Last week's Economic Highlights

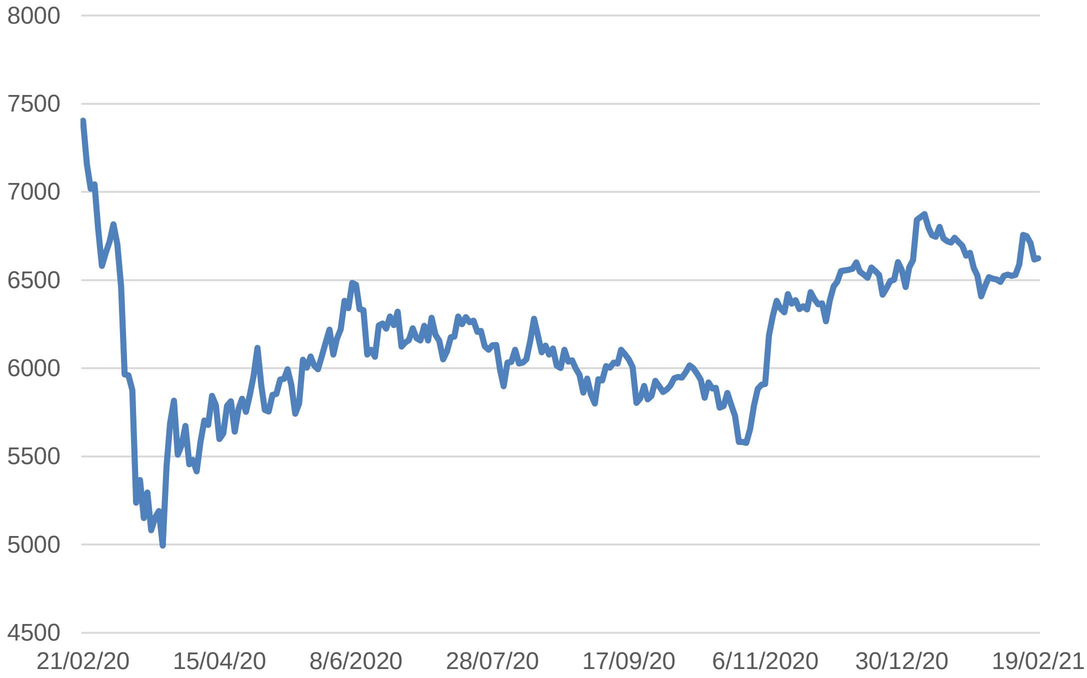
FTSE 100 Weekly Winners

Antofagasta plc	19.9%
Glencore plc	11.7%
Intl Consolidated Airlines Group SA	10.9%
Evraz PLC	8.5%
Anglo American plc	7.8%
BHP Group Plc	7.6%
Rio Tinto plc	7.0%

FTSE 100 Weekly Losers

Hargreaves Lansdown plc	-7.9%
Imperial Brands PLC	-6.7%
Smith & Nephew PLC	-6.3%
RELX PLC	-5.7%
Experian PLC	-5.6%
British American Tobacco p.l.c.	-5.6%
Just Eat Takeaway.com N.V.	-5.3%

FTSE 100 Index, Past 12 months



Source: Factset

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