OUT OF THE ORDINARY

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Just The Time Of Year

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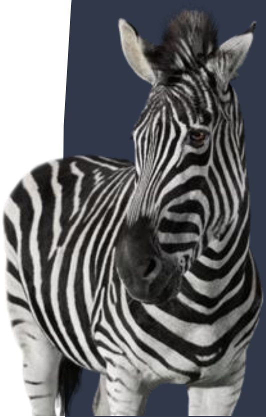
One of my all-time favourite rock albums is Peter Frampton's "Frampton Comes Alive", which I must have played hundreds of times, firstly in the original vinyl format and then on cassette when I got a car. CD followed next. But it was only with the evolution of Spotify that I discovered the acoustic gem of a track called "Just The Time Of Year". It's clear from the lyrics that Frampton was not writing about financial markets(!), but the title seems timely as



concerns continue to mount about a possible correction for equity markets. Upward progress has stalled, and the opening movements this week saw indices heading sharply lower.

I must admit that I am not convinced that autumn is necessarily a bad time to be an investor. Still, I can't deny the fact that three of history's major market declines have occurred during October. These will certainly play a part in skewing the average monthly returns lower, if not the median. The years in question are 1929 (The Wall Street Crash), 1987 (Black Monday) and 2008 (Lehman Brothers' bankruptcy). The hedge fund Long-Term Capital Management blew up in September 1998. There is also the fact that every four years there is a US presidential election in November (with mid-terms in the off years too), and markets tend to become more volatile ahead of that event if the outcome is uncertain. Some have ascribed market moodiness to psychological factors, including the depression of returning to work after summer holidays and the shorter, colder days (in the Northern Hemisphere, at least). Add all these factors up, and there is ample reason for some concern, which can lead to an element of the self-fulfilling prophecy.

It's fair to say that there is no end of things to worry investors at the moment, and we, along with many other market participants, are well aware of them. Indeed, 58% of respondents to Deutsche Bank's latest client survey expect a 5-10% equity market correction before the end of the year (31% are less concerned, but 11% are fearful of something worse). Put options are trading more expensively than call options, suggesting that investors are taking out a bit more insurance against a setback than they normally might.

That being said, although the average risk score of the participants in our Global Investment Strategy Group meeting last week ticked down from marginally "risk-on" to marginally "risk-off", the move was insufficient to recommend an actual reduction of equity allocations in client portfolios. So we remain neutral relative to strategic asset allocation benchmarks over our 18-month investment horizon, even if a bit more cautious in the shorter term. The reasons are well-rehearsed. We believe that financial conditions will remain accommodative (if a little less so), that growth will remain in a firm uptrend (although slower than during the initial V-shaped recovery), and that lower-risk assets such as government and investment-grade bonds and cash offer little by way of potential long-term return. We have been expecting a shallower return profile for risk assets for some time now. It was unreasonable to expect returns to continue accumulating at the pace we have enjoyed since April 2020.

What are the main concerns, and are we underestimating them? Front and centre is the imminent withdrawal of monetary stimulus by central banks. We would continue to characterise this as taking their foot off the accelerator rather than slamming on the brakes. But, as we have discussed before, markets focus on the rate of change (in this case, mainly of asset purchases). Central banks are buying fewer bonds than they were, even if they are still, in aggregate, expanding their balance sheets. The real trouble will come when and if they ever start to shrink them. The lessons of previous attempts in 2013, 2015 and 2018 are cautionary. We don't think that such shrinkage will be contemplated until there is a near cast-iron guarantee that it will be possible without disruption. Let's see what clues we get from the Federal Reserve, the Bank of England and the Bank of Japan at their respective meetings later this week.

On the growth front, it is undeniable that the pace of economic expansion is declining. This is partly down to the fact that the recovery from the initial disruption from Covid-19 could not have continued at the same rate as we returned closer to pre-pandemic levels of activity. However, more recently, the Delta variant has also been a factor, disrupting both demand and supply. The good news is that the latest data suggest that the worst of the latest wave is behind us in many western countries. However, low vaccination rates and lower levels of herd immunity will continue to hamper activity in many other regions. What we have to fear most now is a new variant, especially one that is more resistant to existing vaccines.

The growth deceleration is also being witnessed in company earnings estimates, with revisions slowing following an extraordinarily positive second-quarter earnings season. This is a function of lower demand in some sectors, such as those where increased demand during the worst of the pandemic is now returning to normal. But the slack is not necessarily being taken up by the "reopening sectors", where demand is patchy and labour supply is constrained. And then there are some sectors such as automotive manufacturing and construction where various components (semiconductor chips) and materials (timber, cement) are in short supply too.

While we continue to believe that much of this disruption will turn out to be temporary, we have to admit that it's likely to persist for longer than originally expected. And new problems are emerging. The latest one is the spiralling price of natural gas, with unexpected domino effects being revealed. Gas prices have been soaring owing to a combination of factors that are being described as one-off. These include weather disruption in America; excess demand for gas in Europe owing to a lack of wind to power turbines and not enough sun for full-capacity solar energy production; shortages of supply from Russia; a fire in the electricity interconnector between the UK and France (whose generation is largely from nuclear plants); and booming reopening demand in Asia. That has been reflected in wholesale gas prices going vertical, undermining the finances of gas supply companies, with several smaller ones on the brink of going bust (indeed, some have already collapsed). The government (aka the taxpayer) is being encouraged to step in with rescue packages.

Perhaps the most surprising effect, especially in a world with too much carbon dioxide, is a shortage of... carbon dioxide. CO_2 is a by-product of fertiliser manufacturing, and fertiliser manufacturers are shutting down production owing to punitive natural gas costs – natural gas being a key input. CO_2 is used to kill poultry humanely and is also important in the packaging, storage and transport of frozen food. Thus, under pressure from a lack of HGV drivers and Brexit red tape, food supplies are being placed under even more pressure. This will further increase inflationary pressures and, without wanting to sound alarmist, raises the threat of the sort of panic buying of non-perishable goods that will only give more fuel to those forecasting a return to 1970s economic conditions. Not to mention no turkey at Christmas!

Something else that will garner more (negative) headlines in the coming weeks is the US Federal Debt Ceiling. Although raising the limit for the amount of debt that the government is allowed to assume should be (and has in the past mostly been) a formality, the polarisation between the Republican and Democratic Parties increases the risk of no agreement being reached. The money is expected to run out sometime between mid-October and early November, depending on spending and tax revenues. But there is almost definitely going to be a lot of shenanigans in Congress first. There is some form on this matter. In 2011, the ratings agency Standard & Poor's (now known as S&P Global Ratings) downgraded the investment rating of US Federal debt just before a new ceiling was agreed. It was worried about the size of the deficit. In 2013 the government had to shut down many departments and certain benefits were not paid before the ceiling was raised. For now, markets expect a pragmatic deal to be reached, but there are no guarantees. I might well return to this subject in more depth if it looks as though it is becoming more serious – possibly with a Lionel Richie-inspired title, even if nobody is likely to be dancing.

Another dampener of sentiment is a seemingly imminent major default at Chinese property giant Evergrande, as well as increasing worries that China will impose some sort of restrictions on Hong Kong's developers (much as it has intervened in other sectors already). As for Evergrande itself, more notes and bonds are due for repayment this week, and funds are unlikely to be forthcoming, which could finally trigger default, bankruptcy and some sort of restructuring. This is seen primarily as a domestic event for China, with minimal exposure for global investors, and it's not as if the locals haven't had a long time to prepare for the event. The company's bonds are trading at 30 cents on the dollar. But there remains much uncertainty over how the authorities will deal with this. The general expectation is that the state will backstop the worst effects and that it won't trigger a systemic crisis. That is reflected in very steady investment-grade corporate bond spreads in the country, many of which are issued by banks. But we can't be certain.

If you want to become more apocalyptic, look no further than North Korea's latest round of missile testing. I have always wondered how the country paid for its nuclear weapons programme, and I discovered that it's funded by Bitcoin (according to the United Nations). It seems that they have obtained much of their stash by hacking into crypto accounts and wallets. The cryptocurrency sell-off earlier this year put a damper on their activities, but the subsequent recovery has improved their finances. You couldn't make this stuff up!

The fact that I have listed all of these negative factors suggests that they fall into the category of "known unknowns", which provides some comfort. It's usually the "unknown unknowns" that trip us up. And looking back at past recessions (which are the usual cause of equity bear markets), the majority are caused (possibly quite deliberately) by restrictive monetary policy and financial conditions, which, as mentioned earlier, we do not envisage imminently. But that does not preclude a bumpier period ahead as we work through all of the concerns.

Economic Commentary

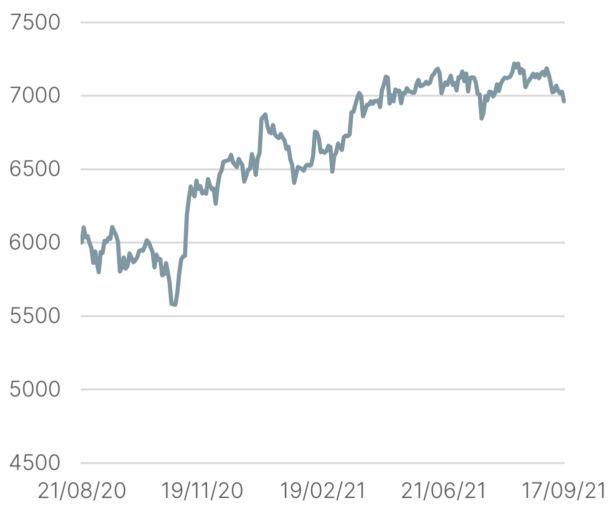
FTSE 100 weekly winners

Lloyds Banking Group plc	5.8%
Flutter Entertainment Plc	5.5%
Kingfisher Plc	4.6%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	4.4%
Reckitt Benckiser Group plc	3.1%
National Grid plc	3.1%
Phoenix Group Holdings plc	3.1%

FTSE 100 weekly losers

Anglo American plc	-15.6%
Ocado Group PLC	-10.5%
BHP Group Plc	-9.5%
Just Eat Takeaway.com N.V.	-9.1%
Rio Tinto plc	-8.3%
Burberry Group plc	-6.6%
Auto Trader Group PLC	-5.7%

FTSE 100 index, past 12 months



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