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OUT OF THE ORDINARY

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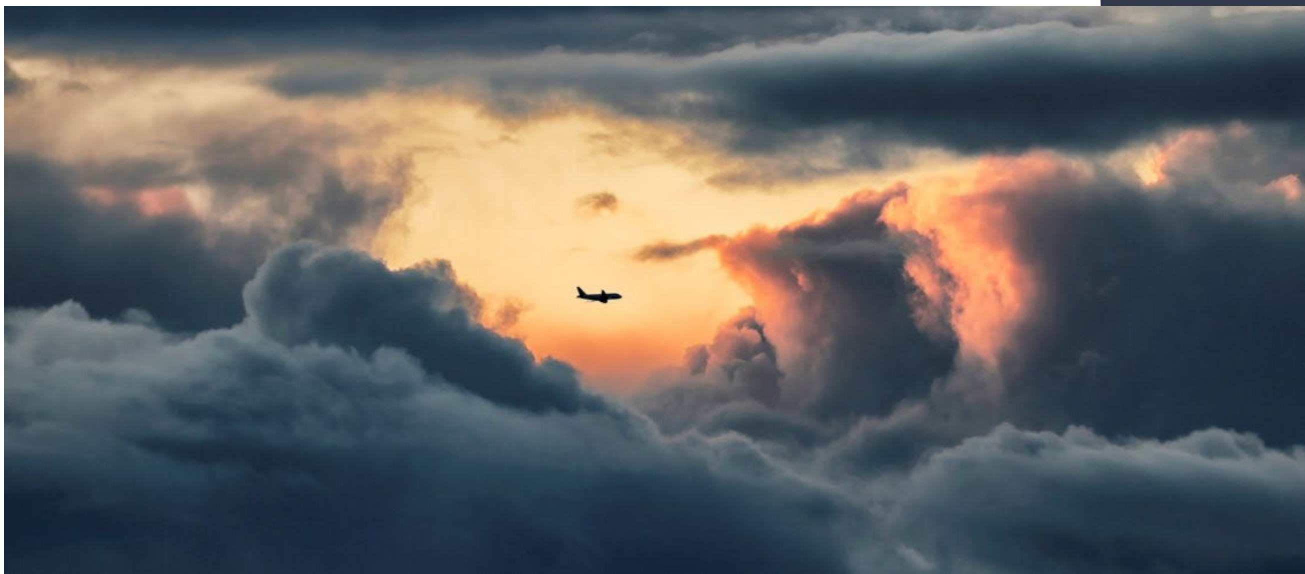
Eye Of The Storm?



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Head of investment strategy

Our Asset Allocation Committee met last week. Having turned markedly more cautious in March, we have been looking for opportunities to become more constructive on risk. We did recommend nibbling at investment grade corporate bonds in May but have not yet taken the leap back into riskier High Yield credit or equities. On a one-month view that looks like a mistake, but the current judgement is that there are too many uncertainties to be adding risk. In this week's commentary, I will share with you some of the discussion from the meeting so that you can see how we reached our current conclusion.

The background to the meeting was a lot more constructive. The major debates in the market continue to revolve around the path of inflation, what that means for interest rates, and whether major economies will enter a recession. The snapshot view on meeting day (as inferred from markets) was that inflation is at or close to peak levels, central banks will be able to reverse rate rises by the first half of next year, and that a recession is more probable in Europe and the UK than in the US. Basically, the "soft landing" is on.

What is causing inflation?

Activity and data continue to be influenced by the effects of the pandemic, but economists are far from in agreement about the causes of the current bout of inflation. The trouble with not knowing the exact cause of the illness is that one might be administering the wrong medicine. Tighter monetary policy to temper demand will not improve supply chains; heavier investment in supply could exacerbate overall excess demand in the economy.

The other great imponderable is how far rates might need to rise to bring demand down to levels that will alleviate inflationary pressures. The US Federal Reserve currently believes that the neutral rate (R* – at which demand and supply are in balance) is around 2.5%, which is exactly where the Fed Funds rate has been raised to, but there are many who believe this to be too low an estimate. In any case, the Fed maintains that it intends to take Fed Funds above R* to slow the economy to below-trend growth, and that is discounted in futures markets, which suggest a peak rate of around 3.3% early in 2023. But with estimates of inflation stuck in mid-single digits at the end of this year, that will still constitute a very negative real interest rate and past cycles have not peaked with real rates still negative.

What impact will employment rates have?

Another layer of uncertainty lies in labour markets, with millions of workers having exited during the pandemic. How many of them will return? Many will, either by choice or through necessity, but many will not (retired baby boomers, those who have made permanent lifestyle changes, and, sadly, those lost to or affected by Covid). If the availability of employees remains constrained, upward pressure on wages will remain high and central banks will be forced to keep policy tighter for longer.

Have we seen the lows for this market cycle?

While the committee believes that it can be reasonably confident owning equities on a longer-term view, the majority believes that there remains "unfinished business" as far as this part of the cycle is concerned. Sharp and swift rallies are a feature of bear markets when news turns out better than worst expectations and investor positioning is set up for a squeeze. The current rally fits that description perfectly.

It was also noted that this is a very different bear market to the ones that most investors will have experienced, driven, as it is, by central banks' desire to reduce inflation and to rein in future inflation expectations. In that respect it bears no resemblance to the Covid crisis (exogenous shock), the Financial Crisis (structural,

systemic shock) or the TMT bust (capex and value implosion), all of which were ultimately reversed by generous central bank policy in a deflationary environment. The Fed is insistent that it will not wave its magic wand soon and maintains that it wants to see more stress in the economy, as well as real progress in reducing inflation, before contemplating a reversal of policy. Meanwhile the effects of earlier interest rate rises are only beginning to become evident in, for example, housing markets.

Another, almost forgotten, aspect of monetary policy is the reduction in size of central bank balance sheets. We have observed that in the post-financial crisis world, risk assets tend to struggle in the absence of such liquidity support and especially when it is being reduced. The Fed's plan is to ramp up monthly balance sheet reduction to $95bn in September. A year previously they were growing the balance sheet at $120bn per month. That constitutes a negative "QE impulse" of $215bn, or more than $2.5 trillion on an annualised basis. Meanwhile, monetary aggregates are decelerating rapidly.

Another odd aspect of this bear market is an apparent lack of capitulation on behalf of the average investor. Yes, there has been substantial de-leveraging and de-risking by hedge funds as well as a sizeable reduction in retail margin debt, but there has been next to no reversal of equity fund flows. One theory (put forward by Michael Hartnett, chief strategist at Bank of America) is that many investors panicked out of the market during the Covid crash and failed to re-enter in a timely manner. They do not intend to make the same mistake again. But this time they are not going to be bailed out by fiscal and monetary largesse. The Fed did not blink when the S&P 500 was down 25%, nor when High Yield credit spreads hit 600bps. And while governments have developed a taste for fiscal generosity, central banks are more likely to lean against that this time around if it perpetuates inflationary pressures – take note, Liz Truss and Rishi Sunak.

Will we experience a recession?

There is plenty of debate about possible recessions. Indeed, the US reported a second successive quarter of negative GDP just after the meeting, and so entered a "technical" recession. However, the National Bureau of Economic Research is unlikely to declare this an "official" recession because underlying demand remained positive; it was inventories that were largely to blame. The good news is that it is largely expected that any recession will be relatively shallow. The imbalances in the private sector are not as great as in the past; the immediate transmission of monetary policy will be dampened by a greater prevalence of fixed rate mortgages (and very little of the adjustable-rate product that catalysed the rout in the mid-00s); the banking sector is extremely well capitalised. But we are coming out of an era of peak margins at a time when input costs are increasing, workers have greater bargaining power over wages in a tight labour market and there will be limits as to how much of an increase in prices consumers can tolerate.

What impact will energy markets have?

Alongside monetary tightening, the greatest threat was viewed as being a further shock in energy markets. Russia's decisions over oil and gas supply to Europe will be a key factor, and any loss of output in Europe will ripple out globally through trade channels. The view was also expressed that Saudi oil supplies might not be as robust as some would hope and that the world remains vulnerable to further supply shocks. JP Morgan has suggested an oil price as high as $380 per barrel in its worst-case scenario.

How are companies faring?

While the second quarter reporting season has turned out to be relatively benign, it has delivered a number of individual casualties. Earnings surprises have been positive in the US (but no more so than might be expected in "normal" circumstances) and more negative in Europe. Guidance has been mixed, but some pressure on margins is evident. The biggest losers have come primarily from two groups of companies: those that have struggled to pass higher input costs through to customers; and those that have seen demand for their products shift to different categories, revealing bloated inventories that have had to be cleared (often as a result of an increased demand for services relative to goods). Some of the key winners have been big brand consumer goods companies which have been able to push through and maintain large price increases. This certainly echoes patterns we have witnessed in past downcycles, where larger, more profitable companies with deep pockets were more able to defend their market positions.

Even so, it was noted that much of the stress to earnings was only beginning to become evident towards the very end of the quarter and that there might be a much fuller reckoning to come. The "back to school" season in September represents a real threat as the northern hemisphere, having been fully let off the leash for the first time since the pandemic began, returns from summer holidays booked months ago to face the full force of the cost-of-living crisis.

Market volumes have already thinned out considerably and we know that we could yet find ourselves on the wrong side of a further squeeze. That will feel uncomfortable, but we believe that reality will bite again as we approach the next reporting season. Markets tend not to bottom out well before the trough in economic activity and earnings expectations has been reached and we don't think that the lows are in yet, in either case.

Economic Commentary

FTSE 100 weekly winners

Weir Group PLC	11.6%
Anglo American plc	10.7%
Admiral Group plc	10.5%
NatWest Group Plc	10.4%
Fresnillo PLC	10.1%
Ashtead Group plc	9.6%
Glencore plc	9.4%

FTSE 100 weekly losers

Smith & Nephew PLC	-12.0%
JD Sports Fashion Plc	-8.7%
BT Group plc	-8.7%
Avast Plc	-7.6%
Vodafone Group Plc	-6.4%
British American Tobacco p.l.c.	-5.8%
Just Eat Takeaway.com N.V.	-5.0%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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