OUT OF THE ORDINARY

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Hi Ho Silver Lining

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Last week I attended my first live music event since the advent of Covid, going to see the guitarist Jeff Beck at the Royal Albert Hall. When rock stars in their seventies have gigs postponed because of a global pandemic it's a possibility that the chance to see them might have passed by for good, but he was in fine form. Beck's highest charting single, released in 1967 (a good two years before I bought my first single) was called Hi Ho Silver Lining, although it's not a work of which he is particularly proud as it highlights his ropey vocal capabilities rather than his extraordinary guitar-playing skills.

The reason I bring this up is that during May's Asset Allocation Committee meeting (which I referred to last week), and at which we maintained our cautious stance, we did ask the question "What could go right?" Put another way: are there any silver linings? Certainly, the news remains focused on gloomier issues, although the Jubilee celebrations provided a pleasant diversion.

Market concerns continue to be centred around inflation, central banks' reaction to inflation and the threat that monetary policy tightening holds for economic activity (as well as for the valuation of financial assets). There are also residual problems with global supply chains, lately exacerbated by China's stringent zero-Covid strategy. What, if anything, could allay those concerns?

Let's start with inflation. Price indices are still making new highs in Europe and the UK and are marginally off the top in the US, but still elevated (the forecast for this Friday's Consumer Price Index print is 8.3%). In a recent Pew Research survey in the US, inflation ranked as the number one concern of households. In a sign of the times, of the 12 problems offered to respondents, Covid ranked twelfth. Can inflation come down fast enough to satisfy central banks that inflation is under control and, almost as importantly, that inflation expectations remain anchored at acceptably low levels?

Will inflation subside?

The good news is that base levels for inflation are now pretty high. For example, the price of a barrel of oil is up 68% from where it was a year ago, trading today at $120. To maintain the same inflation impact in a year's time it would have to breach a hitherto unseen $200 per barrel, a level that would massively impact demand and, in all probability, send the global economy into a severe recession. And, as they say in the commodity industries, the best cure for high prices is high prices, because they attract new supply as well as suppressing demand.

That sounds encouraging, but life is rarely so simple. There are plenty of other things to take into account, such as refining capacity or the grades of crude available (some being better suited to certain products, such as diesel or jet fuel). This can put further upward pressure on pump prices. One must also consider the response of governments, many of which have either announced cuts to fuel duties or provided extra income to households to shield them from rising prices. Not only does this support demand but it also increases fiscal burdens, a factor which might well have its own negative repercussions down the line.

Neither is inflation a simple story of supply and demand imbalances. The supply side of the equation is made more complex by the ongoing effects of Covid (not least in China) as well as the disruption caused by Russia's invasion of Ukraine. And the effects are still working their way through the system. For example, the UK's domestic production of various salad ingredients including cucumbers and peppers is set to be slashed because growers can't make a profit given current fertiliser and greenhouse heating costs. No doubt we can survive without them, but the story is symptomatic of the unexpected consequences of disruptive events.

Wages are another component of inflation, and I note a story today that three-quarters of a million professional cleaners in Germany have been awarded a double-digit pay rise. Either the owners of the premises being cleaned will have to take that hit to their margins or someone further down the line is going to be charged more.

Then there is the composition of inflation, split between goods and services. Goods inflation surged during Covid as a huge leap in demand met supply bottlenecks. At the same time services inflation was almost non-existent because many service industries shut down. Now the boot is on the other foot. While there are some signs that goods demand is flattening off, services demand is recovering rapidly as economies continue to reopen and as families make up for lost holidays and utilise some of the excess savings that were built up during the pandemic (calculated to be around £160bn in the UK and $2 trillion in the US).

While we believe that inflation indices will decline towards the end of the year and into 2023, we can have little confidence in how much, and central banks' favoured 2% target looks like a stretch. We note that last week former Fed Chair and current US Secretary of the Treasury Janet Yellen admitted that she had been wrong about the inflation risks.

Will the Ukraine crisis be resolved?

What else could go right? Top of the wish list, for reasons that surpass mere financial market interest, would be a rapid de-escalation of the war in Ukraine. I have read nothing recently to suggest this is in the offing, but we could be surprised. The consensus view on such matters tends to reflect the status quo. After all, before Russia invaded, the majority opinion was that it would not dare to and that a diplomatic solution would be found. Even so, it is questionable how fast sanctions would be lifted or how quickly normal levels of supply of key commodities could be resumed. This does not fell like a bet to make at the moment.

Will the Chinese economy recover?

Another source of possible good news is widely deemed to be a reacceleration of China's economy, which is currently mired in the aftermath of restrictive monetary policy, a real estate slump and harsh government interference in several growth sectors as well as having to deal with the Omicron variant. For now, the consensus view is that President Xi will hold the line on his zero-Covid policy until he is safely installed for a third term in the autumn, but that could change if a domestically produced mRNA vaccine became available sooner. There is also the possibility of more stimulus, either fiscal or monetary, and there have been baby steps in that direction already. This would support demand in China, but would it be that good for the rest of the world if renewed demand for goods and commodities put further upward pressure on prices?

Will the Federal Reserve lessen its stance?

Another thing on investors' wish list is for the US Federal Reserve to "pivot" again, to back off from its current monetary policy tightening plan. In an article in the Financial Times, Ruchir Sharma (once a strategist at Morgan Stanley Investment Management, now Chair of Rockefeller International) observes that the majority of S&P 500 bear markets going back to 1926 have seen selling pause in the -15 to -20% range for a median period of four months before resuming.

In the five cases when the market held the -20% line and failed to enter a bear market it was on account of the Fed intervening to loosen monetary policy, with the most recent examples coming in 1990, 1998, 2011 and 2018. The S&P 500 is currently down around 15% from its peak and flirted with a close more than 20% below just a few weeks ago before pulling back in the nick of time. But the Fed was not dealing with 8% plus inflation on any of those past occasions, and neither had it effectively said (as it has done this time) that reducing financial wealth is one of the aims of its policy to tighten financial conditions. If it does conduct a policy U-turn, it is probably going to be with equities down rather more than 20%.

Is there a reason for optimism?

Certainly, then, the short-term view from our perspective still looks cloudy, although we do not discount the possibility of markets squeezing higher in the absence of concrete bad news. It is difficult to break the "buy-the-dip" mentality that has served investors so well during a 40-year period when we never had to worry much about inflation and when interest rates and bond yields remained on a falling trend.

Looking further out, though, we remain optimistic that good companies will be able to continue to take advantage of new technologies and the need for investment in productivity which will enable them to generate strong returns. We also know that nothing spurs innovation quite like the search for cheaper substitutes for commodities or products that become too expensive for comfort.

Returning to Jeff Beck... if one listens carefully the lyrics to Hi Ho Silver Lining it is clear that the singer is berating the object of the song for being too optimistic in the face of an unappealing reality. Maybe that's an even more pertinent message for the current times.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	18.1%
Scottish Mortgage Investment Trust Plc	12.5%
Melrose Industries PLC	11.2%
JD Sports Fashion Plc	9.0%
Burberry Group plc	8.4%
Just Eat Takeaway.com N.V.	7.7%
Rolls-Royce Holdings plc	6.2%

FTSE 100 weekly losers

Johnson Matthey Plc	-10.7%
B&M European Value Retail SA	-9.8%
National Grid plc	-8.6%
Severn Trent Plc	-7.7%
United Utilities Group PLC	-6.5%
SSE plc	-5.7%
Fresnillo PLC	-4.3%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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