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OUT OF THE ORDINARY

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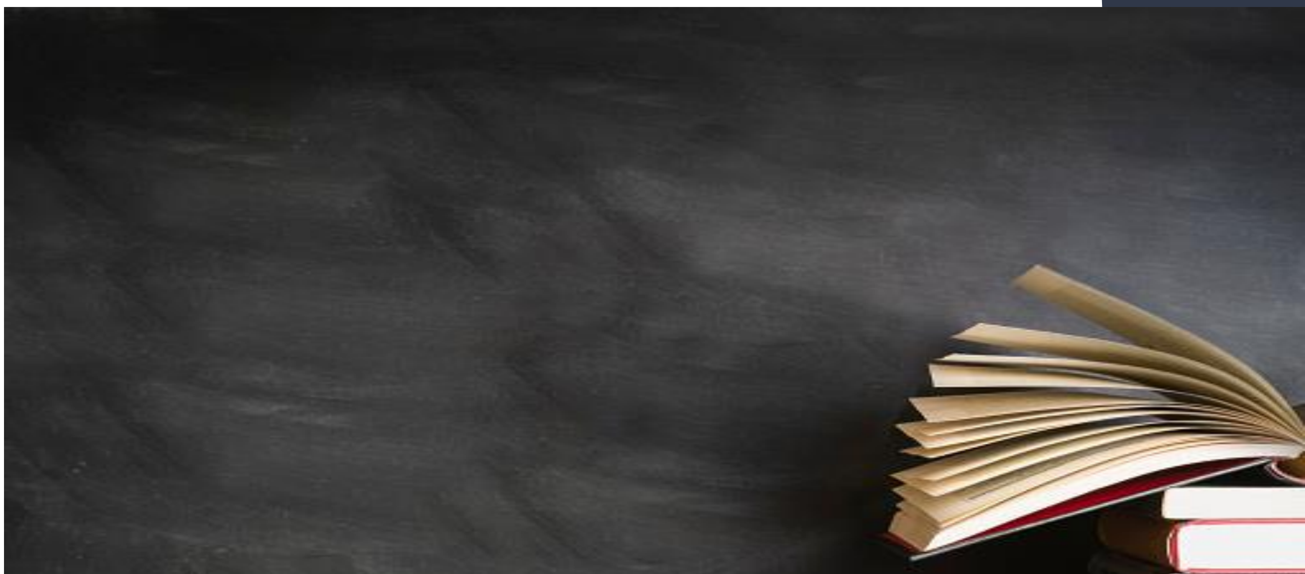
Back To School



John Wyn-Evans
Head of Investment Strategy

When I signed off for the summer holidays a few weeks ago I recalled how August was blissfully devoid of school during childhood. By the same token, the passing of the August Bank Holiday delivered the prospect of the return to the classroom and the mix of anticipation and trepidation that came with that. Funnily enough it feels little different forty-plus years later. There is the promise of seeing colleagues again after a long break, as well as the fact that I have

a few client events in my diary, but at the same time the threat of COVID is far from negligible. We are not planning to operate back in the office every day, but other firms are taking a different line. Mrs W-E departed early this morning with her backpack on to cycle to her office. Maybe I should have made sandwiches for her. Meanwhile, even though financial markets have not succumbed to the risks posited by doomsters ahead of the thinly-traded holiday season, there remain plenty of matters to exercise us over the remaining months of the year.

Before I launch into the timetable and syllabus for the Autumn term, though, a word of gratitude for Zane, Suzanne and Jimmy who stepped in to write the Weekly Digest in my absence. I hope it showcased for you the talent that we have in the Research team, and the depth in which we analyse companies and markets. And with the appointment of Stacey Parrinder-Johnson as our new Chief Investment Officer, we can look forward to further initiatives to bolster our output.

In reality, the syllabus for the foreseeable future is not much changed from last term. The main focus is still on COVID, inflation and central bank policy. There will also be much attention paid to climate change, carbon reduction and all matters ESG (Environmental, Social and Governance). But although the market thinks it has a reasonable idea of the final destination on all of those journeys, the route and duration remain uncertain, to say the least. And what is the market currently discounting? In terms of COVID, the expectation is for an eventual return to normality driven by vaccine distribution. The current spike in consumer (and other) prices is forecast to be transitory, although with inflation settling at higher levels than before the pandemic. Central banks are expected to tighten policy, but only on an appropriate and cautious basis. And we are almost inevitably heading towards some sort of "carbon neutral" world because the alternative is too awful to contemplate. So where could the market's current expectations become misaligned with reality?

The COVID Delta variant has shown us that we cannot afford become complacent about the threat from the SARS-CoV2 Virus. Indeed, the biggest concern is that a new variant appears that is able to sidestep the protection offered by vaccines. Not only would that constitute a huge obstacle to the return to former levels of activity, but it would also drive another big wedge between the prospects for industries and companies exposed to either the online or more traditional physical economies. Jimmy wrote very eloquently on the medical and scientific situation a couple of weeks ago, and I am unable to add to his insights at this stage. Suffice to say that we can only continue to monitor the news and (re)act accordingly.

Inflation is, if anything, even more complicated, given that there are a number of different influences. For now, investors are relatively unfazed by the current spike in consumer price indices owing to the fact that we are moving through a period when we are cycling through some very low comparative prints from a year ago, pretty much as forecast many months back. Yes, it looks as though prices will remain elevated for somewhat longer than previously expected, mainly as a function of COVID-related supply chain disruption (with one-off events such as the blockage in the Suez Canal adding to the pressure), but this too is considered to be temporary. But there are also other more worrying inflationary pressures, and it remains to be seen how they play out. Amongst them

is the fact that many workers in lower paid industries are no longer willing to accept low rates of pay and poor working conditions, which is leading to higher wage bills. But at this stage it is still impossible to know whether this is the beginning of a secular shift or the result of short-term inefficiencies in labour markets. And then we have to consider how much of the hit is taken at the corporate margin level and how much passed through to prices. Or even, if one is more optimistic, could increased productivity leave everyone better off?

In the UK we have some home-grown labour shortage problems, with the finger of blame largely pointed at Brexit and the subsequent departure of a large cohort of European workers. This morning's press was full of stories highlighting the squeeze. UK hotels are not changing bed linen and towels as frequently while also delaying check-ins owing to staff shortages; Marks & Spencer is warning of disruption to food supplies; the boss of Wagamama says he can't find enough chefs or front-of-house staff to open all his restaurants fully; trucking company Wincanton is calling for lorry driver training to be shortened to get more lorries on the road; the Confederation of British Industry is calling for more visas for overseas workers to alleviate shortages; and even John Lewis faces staff unrest amid complaints of "poverty wages". An optimistic line would be to point towards burgeoning demand as a reason to cheer, but that won't help if longer-term inflation expectations start to rise.

Which leads us onto central bank policy. We have had updates on the potential path for policy tightening in recent weeks from the US Federal Reserve (Fed), the Bank of England (BoE) and the European Central Bank (ECB). For both the Fed and the ECB the first step will be to reduce the pace of asset purchases (the act generally known as "tapering"). With investors ever fearful of a repeat of 2013's "taper tantrum", in which bonds and equities sold off in response to the Fed's unexpected announcement of tapering, central bankers have been bending over backwards to ensure that the forthcoming taper is anything but unexpected. But it's coming; we're just not sure when. The ECB could announce something as early as this week, while last week's weak US employment data has pushed back expectations for an announcement by the Fed until possibly December. In any event, both central banks will still be making net purchases well into 2022.

The BoE has taken a different approach, saying that interest rates are its primary tool (although its authorised asset purchase ceiling will be reached within the next few weeks, and so it should automatically stop buying bonds then anyway). But the first rate rise, when it does arrive, is expected to be only 0.15%, taking the base rate to just 0.25%. For the record, Investec Economics' team currently has the first interest rises being delivered as follows: UK - May 2022; US – Q1 2023; Europe – December 2023. So hardly imminent.

Again, where might the surprises come? There's not much scope for cutting rates from here, and so any loosening of policy would probably come in the form of more asset purchases if required. That could be to facilitate liquidity in the event of some sort of market melt-down (which we don't envisage – or at least it would need to be the result of a serious exogenous event, perhaps something like a Chinese invasion of Taiwan if you want a potential example) or to underwrite the issue of more government debt in the event of another economic slowdown (again, something that is not a central view). More

probable at this juncture is higher rates sooner if inflation blows out to the upside or, at least, expectations for future inflation become unanchored. In these cases, there would be a severe examination by the market of central banks' tolerance to allow inflation to run hot. Again, we are not forecasting this, just highlighting the risks to consensus views, because a shift away from consensus (in either direction) tends to be what creates more volatility.

Finally, on the ESG front, the big event this November will be COP26, the landmark climate change conference in Glasgow (COVID permitting). Climate change is an increasingly important topic for investors, who, after all, provide capital to the economy. The importance was underlined by August's report from the United Nations' Intergovernmental Panel on Climate Change (IPCC). While, in our opinion, the report did not provide much new information to those well versed in the subject, its tone was distinctly gloomier than previously, conveying a need for stronger and more immediate action. We continue to take the threat of climate change extremely seriously in our analysis as part of our initiative to integrate even more fully ESG factors into the investment process. This extends from asset allocation to the evaluation of individual stocks. It is impossible to overemphasise the challenges that lie ahead. While it is widely recognised that behavioural change is necessary and inevitable, this will, in all probability, only be achieved by policy-led enforcement and economic incentives (a yet-to-be-determined mix of carrot and stick). There are likely to be nasty surprises as well as attractive new opportunities for investment.

As you can see, then, plenty to keep us on our toes between now and Christmas (only 109 shopping days away!). But as long as monetary policy remains accommodative (which it is, especially if judged by the continued existence of negative real interest rates and continued central bank balance sheet expansion) and economies and corporate profits continue to grow (as we expect them to), we are very happy to remain fully invested in equities relative to clients' benchmarks.

Economic Commentary

FTSE 100 weekly winners

Melrose Industries PLC	12.2%
St. James's Place Plc	5.2%
Weir Group PLC	4.4%
Ferguson Plc	3.7%
Prudential plc	3.5%
Anglo American plc	3.2%
Legal & General Group Plc	3.2%

FTSE 100 weekly losers

BHP Group Plc	-5.1%
J Sainsbury plc	-5.0%
B&M European Value Retail SA	-4.9%
Admiral Group plc	-4.6%
BT Group plc	-4.3%
Rolls-Royce Holdings plc	-3.8%
International Consolidated Airlines Group SA	-3.7%

FTSE 100 index, past 12 months

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