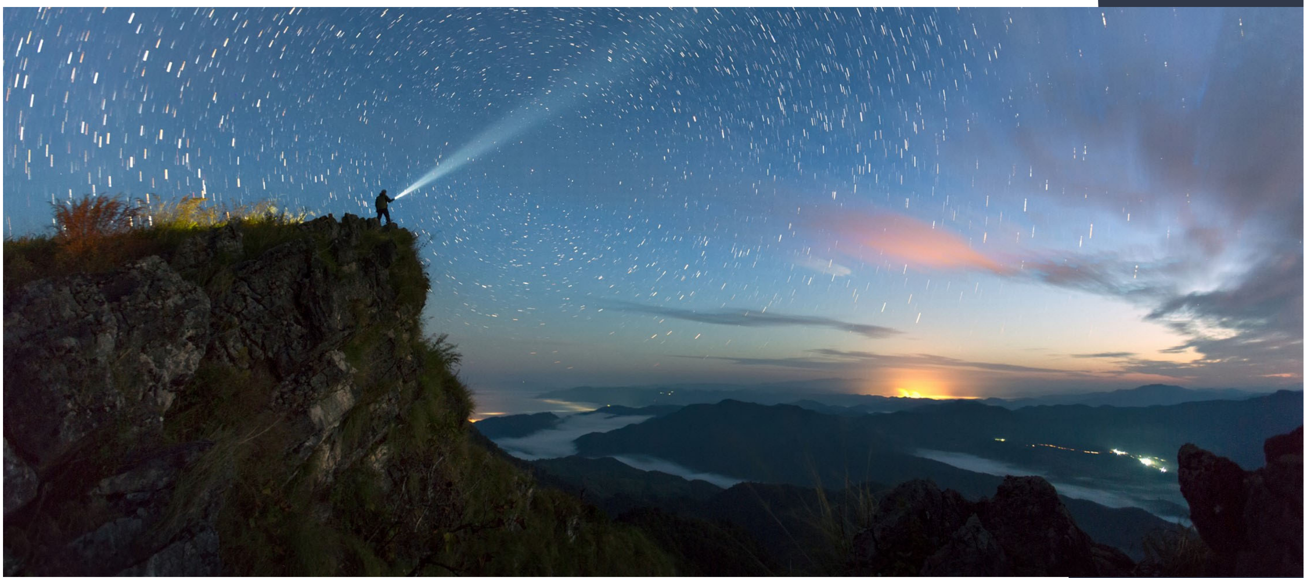
OUT OF THE ORDINARY

WEEKLY DIGEST | 13 February 2023

The Virtue of Patience



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In the Monthly Commentary that was posted last week, I wrote that the economic and market environment currently “resembles what one imagines a Jackson Pollock painting session might have been like. There are a lot of things going on, none of them linear, and it is a challenge to interpret what it all means.” I’m glad to discover that somebody reads this stuff and, furthermore, someone who felt motivated to respond. Obviously a client well educated in art, he wrote: “Just to note that on close inspection most of Jackson Pollock’s works do have patterns!”

In a way, I think he made the point I was trying to make more clearly. Often markets do have an appearance of being totally random in their reactions and movement, but, on closer inspection, there is always a reason behind them.

As I embark upon a new round of presentations to clients and advisors, there seem to be three key questions about the overall market environment. The first two, requiring an interpretation of past events, are much easier to deal with: why were things so bad last year (especially in terms of a balanced portfolio)? And: why has there been such a dramatic bounce so far this year? The third – "what happens next" – is a tougher nut to crack.

Let's have a quick recap of 2022. Much of this is ground we have already trodden, but it might help to create the right perspective (to keep the painting metaphor going). While economists can argue until the cows come home about the source and nature of the inflation shock that unfolded last year, it was the response to that shock which undid investors; a response which, according to market pricing, at least, was totally unforeseen.

Interest rate increases

At the beginning of the year, the expectation for interest rate increases from major developed world central banks in 2022 was somewhere between zero and minimal. The reality turned out to be a pace and magnitude of increases not witnessed in decades. This elicited two major reactions. One was a fear that the rate increases would stifle economic activity to such an extent that a recession would occur (especially when combined with the effects of Russia's invasion of Ukraine). So far, to be fair, the worst fears on that front have not been met, although there remains concern that the effects of rate rises are lagged and so we still have the slowdown to come.

Valuation of financial assets

The other reaction was to the valuation of financial assets. Higher interest rates and higher bond yields served up big losses to bond investors, with very low starting yields failing miserably to compensate for the destruction of capital. Then the resulting rising discount rate reduced the net present value of future earnings, pushing down the valuation of equities in aggregate. Within that, "longer duration" companies (those with valuations predicated on profit streams stretching a long way into the future) fared a lot worse, notably those with no profits at all today.

They key point in all of this is that bonds and equities fell in tandem, and that has been a rare event, especially in the past twenty or so years. Thus, balanced portfolios were caught in an unavoidable crossfire.

Markets reached their nadir in mid-October and have rallied nicely – and even more broadly – since the start of this year. And so, what changed? As we have pointed out before, it's as much an absence of expected nasties as anything extremely positive developing. Europe appears to have avoided a punitive recession thanks to a combination of warmer-than-usual weather and an efficient response to the threat of energy supply shortages. China, rather than persisting with its zero-Covid policy, decided to throw caution to the wind and re-open its economy. That seems to have gone remarkably well. And, even though corporate earnings estimates have been gently declining, we are far from seeing the bottom fall out of profits.

That's the "fundamental" side of things, but there are also more "technical" issues at play. Investor sentiment was at rock bottom in October and has improved materially. There has also been a big squeeze of short positions held by hedge funds, positions out of which they had done extremely well in 2022. Year-end tax-related selling pushed that particular beach ball even further under water and it is has bounced back up with extra force.

Financial market liquidity

Financial market liquidity has also improved. While it looked as though we were going to remain under the cosh of higher interest rates and shrinking central bank balance sheets, the reality turned out to be a lowering of peak rate expectations and bigger liquidity injections. The Bank of Japan has bought the equivalent of more than a quarter of a trillion dollars' worth of Japanese government bonds since the middle of December to control the domestic yield curve. The Chinese government has also added funds via the credit channel. In the United States, central bank Quantitative Tightening has been offset by the government drawing funds down from the Treasury General Account, effectively leaving the banking system with excess liquidity because the government is not issuing T-Bills as normal owing to reaching its debt ceiling.
Counterintuitively, the US government's parlous financial position is boosting the market.

Markets did finally pause for breath last week, and therein lie some of the clues about how things will play out from here. The key development over the last couple of weeks has been a shift upwards in traders' interest rate expectations. The prime catalyst for this was a blowout employment number for the United States in January, but there has also been resilience in other economic data. And even though inflation indices are retreating from their peaks, there remains uncertainty about how long it will take them to reach central bank targets (around 2%) on a sustainable basis.

If we look at the US interest rate futures (these being a key factor for global investors), they have moved back towards a "higher for longer" rate narrative. Last week, peak Fed Funds priced up another 16 basis points to 5.18% in June, with the January 2024 rate backing up from 4.41% to 4.74%. The latter was at 4.17% at the start of this month, and so the market has removed more than two 25 basis point cuts from its expectations in just seven trading days. The US 10-year Treasury yield has gone up from a February low of 3.39% to 3.74%. The real yield has gone from a low of 1.14% to 1.41%.

Countering that has been some respite on the earnings front, with latest corporate results proving to be relatively resilient in aggregate. This has helped to limit the negative impact on valuations.

It feels as though the next few months could well turn into a tug-of-war between inflation outcomes and expectations, the resilience of economic growth versus the potential for the lagged effect of past interest rate increases to make themselves felt, the timing of central bank and government liquidity responses and the animal spirits of investors themselves. That still does not feel like a time to be making big bets either way. The risk of being too underweight risk as the (economic and market) cycle turns for the better is too great for us to exercise a surfeit of caution. By the same token, the risk of a final leg lower for risk assets encourages us to keep some powder dry.

The nature of this cycle is very different to anything we have experienced for perhaps as long as thirty-plus years. The Asian Crisis (1997), LTCM (1999), the Tech Bust (2000-2002), the financial crisis (2008), the commodity bust (2015-2016) and Covid (2020) were all the result of some type of deflationary shock. Policy is currently aimed at defusing an inflationary bomb. This is tricky and time-consuming. More patience is required.

Economic Commentary

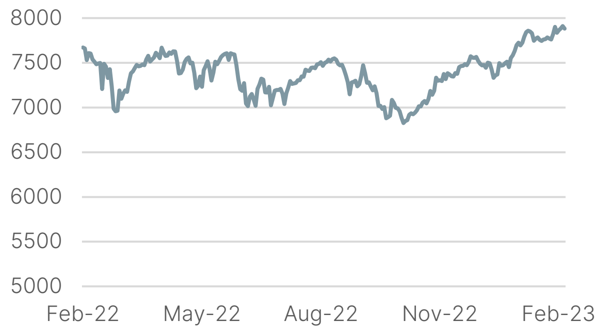
FTSE 100 weekly winners

Standard Chartered PLC	7.9%
AstraZeneca PLC	7.7%
Shell Plc	5.2%
Shell Plc	5.2%
HSBC Holdings Plc	2.3%
GSK plc	2.3%
ITV PLC	1.3%

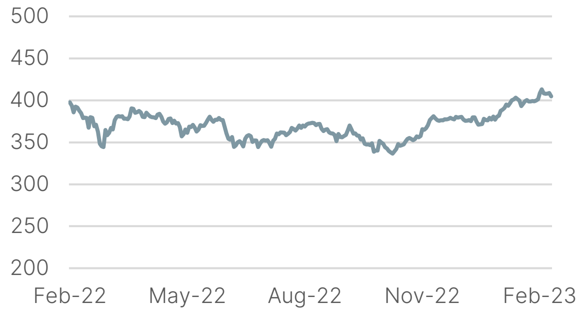
FTSE 100 weekly losers

Entain PLC	-17.4%
Ocado Group PLC	-14.0%
Just Eat Takeaway.com N.V.	-12.4%
Polymetal International Plc	-10.9%
Smurfit Kappa Group Plc	-10.7%
Mondi plc	-9.0%
Scottish Mortgage Investment Trust Plc	-7.9%

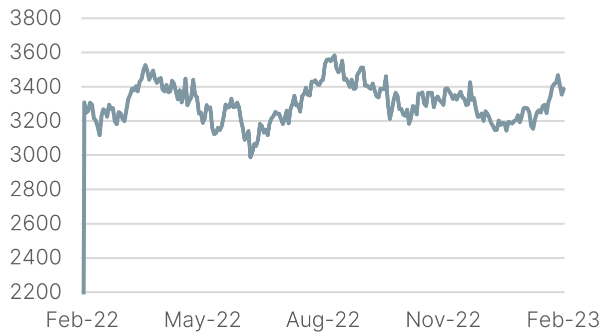
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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