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OUT OF THE ORDINARY

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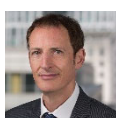
New Eras



John Wyn-Evans
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It seems like a long time since I last penned a Weekly Digest on 1 August. Indeed, in my absence we have moved into new eras, welcoming a new King and a new Prime Minister. One of the privileges of making these written communications is that they provide a platform to say a few words related to current events, a privilege that I can assure you is not taken lightly. At the danger of being too reductive, there are two words that I would use that could encapsulate two of

the Her late Majesty Queen Elizabeth's greatest virtues: consistency and adaptability. She was a beacon of light through both good and bad times; but with sufficiently well-tuned antennae as to be able to move with the times as well.

Both virtues are worth striving for in our line of business. These are difficult markets for investors to endure and they look to us for certainty and guidance, as well as for some hope for the future. At the same time, we must continue to adapt to evolving circumstances.

Despite all the changes, the markets' key areas of focus have not evolved dramatically over the last six weeks, although the tidal reach of emotion and expectation has been wide, as have been some of the trading ranges for financial assets. Investors remain focused on the following main factors: what is the outlook for inflation? What will that mean for monetary policy? Will central banks achieve a "soft landing" or send their economies into recession? What will that mean for company earnings? What happens to those factors will define the outcome for both equities and bonds. Let's take them in turn.

Inflation

Inflation has been the bugbear of markets this year, with global inflation expectations for 2022 rising from 3.9% in January to 7.2% now, but some countries have fared much worse than the average. Forecasts for the UK were well into the teens before last week's government intervention, for example. Even so, there is some confidence building that headline inflation indices are close to, or may even have passed, the peak. This is down to several factors. It is hard for inflation to continue to compound at exceptionally high rates in a vaguely normally functioning economy. Not only is there a higher base for future prices to rise from, but there will often be some sort of combination of demand destruction and increased or alternative supply.

There is also the question of what drove inflation higher. Some of it has been down to excess demand, especially for goods, some of it down to supply bottlenecks (both Covid and Ukraine-related). In turn, excess demand was driven by a combination of fiscal generosity (especially in the US) and a shift in purchasing preferences (for "stuff" as opposed to experiences, although that pendulum might now be swinging the other way, creating a different set of problems in tight labour markets). The good news is that estimates of future inflation do suggest it is going to fall, although quite how fast remains open to debate.

Monetary policy

Which leads us to monetary policy. Everyone is looking for the "pivot". At what point do central banks decide that they have done enough to reduce inflation and to rein in expectations of future inflation? There is certainly some evidence that expectations are contained. In the US, the Federal Reserve's favoured indicator, the five-year breakeven rate (which infers from the bond market what the level of inflation is expected to be in the second half of the next decade) is back down at 2.27% from a peak of 2.56% in April. The retrenchment in the two-year breakeven rate is even more spectacular, falling from 4.93% in March to a current 2.27% also. Circumstances are slightly different in Europe owing to the energy price effect, but even there the German ten-year breakeven rate is a relatively benign 2.24% (which actually might be quite welcome considering that

the European Central Bank spent so long trying to engineer a return to 2% inflation from incipient deflation). Ten-year breakevens remain elevated in the UK at 4.11%, although some of that is down to the construction of the inflation indices, with a number around 1% lower being more meaningful.

And so, the central banks do appear to retain some credibility. But, at least to some extent, that is dependent upon tough talk and delivering as promised. Should they back off too early, it is quite possible that inflation expectations would become unanchored once more. That was very much the message from the central bankers' symposium at Jackson Hole, Wyoming at the end of August, and the message provided a rude awakening to those who were betting on lower interest rates sooner rather than later. And as long as the Federal Reserve is on message, so do other central banks have to be. If not, then watch out below as far as your currency is concerned, as has been experienced by Japan this year. Our opinion is that central banks will not back off soon, although this is now more recognised in futures markets.

Recession

And if they stay tight, will they induce recessions? Recession looks like a much more probable outcome in Europe and the UK than elsewhere, and one can see that reflected in the performance of more domestically oriented small and mid-cap stocks, which have fared much worse than their more globally (especially US) exposed peers. In the US, there is a wider range of views. Some say that the country is already in recession, others that one is imminent and even others who suggest it will happen later in 2023. And that's not to mention those who believe that the US will sail through this monetary tightening with no decline in economic output at all. We certainly see a slower economy, but would emphasise that any recession should not evolve into a bigger financial crisis given our view of some of the more structural elements of the US, including the housing market and the financial system – at least in the absence of some unforeseen new shock.

Earnings

And that leaves the risk to company earnings. We have described this for some time as the "last shoe to drop"... and it still has not, although earnings momentum is decaying and there now seem to be more downgrades that upgrades from stock analysts. There is no doubt that the second quarter results season exceeded (very low) expectations. Maybe we were too quick to ascribe inventory problems at some of the big box US retailers to weakness in overall demand. And the more recent fall in petrol prices (or gasoline in the US) will have alleviated some of consumers' pain. On the other hand, though, there will be a lagged effect of prior price increases through supply chains and also the effect of sharply higher mortgage rates on the housing market to contend with.

Our stance

Our attitude to risk is little changed from early August. Markets have generated quite a lot of heat since then, but a limited amount of light. The phrase I keep coming back to to describe our stance is "cautious, not fearful". We are looking forward to introducing more equity risk into portfolios, but still not yet. Sometimes that can be a bit painful when markets are squeezing higher.

This was a very high-level piece to kick off proceedings for the autumn session. I should be able to dig into a few more local issues in the weeks ahead.

Economic Commentary

FTSE 100 weekly winners

Antofagasta plc	8.5%
Glencore plc	7.8%
Ocado Group PLC	7.5%
Anglo American plc	6.4%
SSE plc	6.3%
Admiral Group plc	6.1%
Rentokil Initial plc	6.1%

FTSE 100 weekly losers

Associated British Foods plc	-9.8%
B&M European Value Retail SA	-5.8%
Vodafone Group Plc	-4.7%
Melrose Industries PLC	-4.6%
BT Group plc	-4.3%
Tesco PLC	-3.1%
Intermediate Capital Group plc	-2.5%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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