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OUT OF THE ORDINARY

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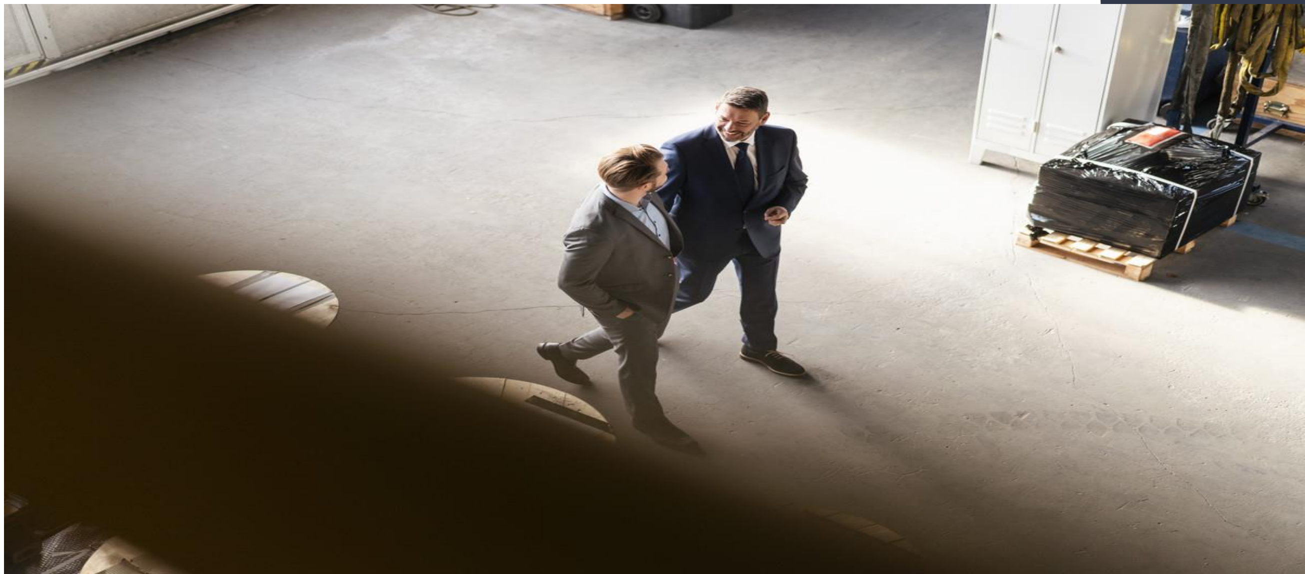
Great Expectations



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One of the things that often confuses non-professional investors is that markets can act in a way that appears to be counterintuitive. They can rise following what appears to be bad news, as easily as they can fall on what appears to be good news. One reason for this is what the news might imply for monetary policy. In a world where investment flows and the valuations of assets are driven by interest rates and bond yields, negative economic outcomes can lead to expectations of looser policy, the phenomenon sometimes labelled as "bad news is good news". By the same token, better-than-expected outcomes can suggest that central banks will be prepared to withdraw liquidity, which falls into the "good news is bad news" camp.

The Omicron outbreak falls into the former camp, it seems, because although it appears set to reduce activity in the short term, especially in more contact-heavy service sectors, it also means that central banks will be tempted to delay the withdrawal of monetary stimulus. For example, the December Short Sterling futures contract that is a measure of where market participants expect the UK base rate to be at that month's expiry has moved dramatically in recent months.

At the beginning of September, it was trading at 99.88. If you subtract that from 100 you get the implied base rate – in this case 0.12%, which is pretty much exactly where it was (0.1%). By mid-October the implied base rate was 0.55% (100 – 99.45) thanks to hawkish comments from Bank of England Governor Andrew Bailey in the face of rapidly rising inflation. The market was effectively pricing in two rate rises before the end of 2021, initially a 0.15% rise at November's meeting rapidly followed by another of 0.25% in December.

But that was not how things played out. The Bank's Monetary Policy Committee decided to hold off a rise in November, and then Omicron intervened. As we approach the December meeting this Thursday, Short Sterling has completed a round trip back to 99.9! It will now be a massive surprise if the policy rate is changed this week. But the market still expects rate rises only to be postponed rather than cancelled. The December 2022 future is pricing in a base rate of around 1.1%. The picture is directionally similar in the United States, with the Fed Funds future trading at 99.31 for a rate of 0.69% (versus currently effectively zero).

Do we really believe that the Bank of England is going to be capable of raising interest rates faster than the US? Headline inflation is considerably higher in the US than in the UK at the moment, although the respective consumer price indices are expected to cross over during the first half of 2022 as the US inflation rate subsides and the UK's accelerates (with a big jump expected in April when the energy price cap is raised again). But the US economy would appear to be more robust and therefore less vulnerable to higher rates, especially in the housing market. (US mortgages, for example, are priced off thirty-year bond yields, whereas the UK's are more closely linked to the two-year yield and therefore much more sensitive to moves in the base rate).

Another way of judging what is "priced in" to markets is to look at the results of client surveys. I regularly refer to those conducted by Deutsche Bank and Bank of America, and the latest from the former bank was conducted last week. I have picked out a few topics that might give us a clue as to where markets are more vulnerable to a shift in expectations.

Let's get COVID out of the way first. This survey was timely in that it captured the first reaction to the Omicron variant, even if we are still in the dark about what the exact implications will be. Eighty-one per cent of respondents agreed with the proposition that COVID "will become endemic and be a part of everyday life, to which we will adapt" by the end of 2022. And so, yes, Omicron is an

aggravation, but is not expected to throw us off the longer-term path to a return to a reasonably normal existence. The same sentiment is likely to prevail should further variants and/or waves evolve, although, as we have long maintained, a variant that can completely escape the current vaccines would be a negative surprise. A more positive surprise would be if a dominant variant emerged that led to only very mild symptoms in the vast majority of cases.

In terms of the current risks that are perceived to be the highest, the runaway winner was "higher than expected inflation", which does suggest a degree of recency bias amongst respondents. After all, inflation is front page news these days, and consumer price indices are rising everywhere. Even so, as is apparent from market-derived measures of future inflation (such as breakeven rates), the market still believes that there is a transitory element to today's spikes and that central banks retain some credibility when it comes to controlling inflation in the longer term.

The negative surprise would be if higher levels of inflation turn out to be more persistent. While we are pretty sure that much goods price inflation will be subject to the usual market forces of mean reversion – driven as it is by a short-term surge in demand to replace spending on services meeting supply chain disruptions – much larger uncertainties are apparent in the labour market, with wages edging higher in many parts of the economy. This is partly the result of people leaving the labour market and is also (whether tacitly or more overtly through the raising of minimum wage levels) supported by many governments as a vote winner with the less well-off segments of the population.

An "aggressive Fed tightening cycle" is the second-highest ranked risk, and that is closely allied to the inflation cycle. The market is reasonably comfortable with expectations of a tapering of asset purchases, which it thinks the Fed will have completed by the second of quarter of 2022 at the latest, but if inflation does persist at higher levels, then expectations of higher interest rates will start to bite.

Other snippets include the fact that two-thirds of respondents envisage a US recession developing before the end of 2024. That doesn't seem to square with inflation and interest rate expectations, nor the probabilities given for some sort of exogenous shock. It compares to current consensus economists' forecasts of GDP growth of 3.9% for 2022, and 2.5% for 2023 (2024 is not yet published, although I have yet to see any credible individuals forecasting a recession in that year). Anyway, the survey does suggest a degree of pessimism about the persistence of this cycle. And given that the usual reason for a recession is tighter monetary policy (admitting that events such as financial crises and pandemics are very difficult to predict), a policy-driven recession is very much in people's minds.

The outlook for President Biden is not pretty, with 79% of investors in the survey of the opinion that the Democrats will lose control of Congress in next November's mid-term elections. I think the only surprise here is that the number is not higher. What will it mean? Basically, that very few policies will be enacted during the second half of Biden's term, and certainly nothing as impactful as his stimulus package or the currently progressing "Build Back Better" package. There are plenty of people who believe that a policy logjam is in investors' interests as it lowers the risk of nasty surprises, such as tax rises or tighter regulation, and so we should not be too worried if this is the outcome. However, the world (or ex-Republican Party members) might take a dim view if a Democrat loss points towards the return of Donald Trump to the White House in 2025.

As for markets, the average return expectation for the S&P500 Index in 2022 came in at 4.2%. If that were the case, we would not sniff at it, especially if dividends and share buybacks (accounting for about 3%) are added to the total return figure. But does the collective brain of the market really have any great predictive skills? In the same survey a year ago, only 21% of respondents saw the S&P500 being "much higher", with 46% saying "slightly higher". The other 33% called it flat to lower. (No average level forecast was given last year for direct comparison) The outcome with two weeks of 2021 left? Up 25%.

Therefore, surveys such as these are very useful for tapping current sentiment and for estimating what the market has already factored in, but I'm not convinced that they should be used as predictive tools.

Economic Commentary

FTSE 100 weekly winners

Informa Plc	8.2%
Anglo American plc	7.3%
Ferguson Plc	6.8%
British American Tobacco p.l.c.	6.8%
Sage Group plc	6.3%
Croda International Plc	6.0%
BT Group plc	5.8%

FTSE 100 weekly losers

Just Eat Takeaway.com N.V.	-3.1%
Ocado Group PLC	-2.6%
Fresnillo PLC	-2.5%
Barclays PLC	-2.2%
Polymetal International Plc	-2.0%
Rolls-Royce Holdings plc	-1.7%
3i Group plc	-1.1%

FTSE 100 index, past 12 months

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