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Now And Then

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I was 14-months-old when the Beatles' first single, "Love Me Do" was unleashed upon an unsuspecting world. Although their songs were a key element of the background music of my childhood, it's fair to say that I didn't really understand their impact until the newspaper was delivered to our house in April 1970. The lead story was that The Beatles were breaking up. More than half a century later, and thanks to the progress of technology (with a bit of AI hype throw in for good measure), what is being billed their last ever single has been released. The "then" in their title seems to refer to the past. In my homage, it refers to the future.

But we'll start with the "now". Since the last Weekly Digest, equity markets have taken a turn for the better, with a rally in the US bond market being a primary driver. Indeed, it's hard to overemphasise the role of the bond market in driving financial markets at the moment.

The trigger was the last Federal Reserve Open Market Committee meeting on 1 November. Although the Fed Funds floor was left unchanged at 5.25%, commentary from the meeting and the subsequent press conference with Chairman Jerome Powell hinted at a more benign policy stance. Crucially, there were references to the opinion that the tightening in financial conditions created by higher bond yields and wider credit spreads (as well as a stronger dollar and weaker equity markets) was doing some of the Fed's work for it. Thus, it might be appropriate to take a breather in terms of raising interest rates. The market was set up for a rally, and this was the match in search of dry tinder.

From the point of view of bonds, there was an enormous short position in US Treasuries, where yields had been rising significantly on concerns about a wall of issuance to cover the government's spending. The 10-year and 30-year yields surpassed 5% for the first time since 2007. Such high rates deliver a higher cost of capital in terms of valuations as well as a higher cost of debt in the real economy, something that would be expected to put a brake on growth. The reversal in yields, as bond prices recovered, triggered a lot of short covering, taking yields down as low as 4.47% for the 10-year and 4.61% for the 30-year. These were epic moves in such a short period of time, especially with no crisis unfolding.

We have recently identified much better value in government bonds, with the US 10-year real (inflation-proofed) yield briefly topping 2.5% (2.29% today). That looked pretty attractive to lower-risk investors if held to maturity. UK Index-Linked bonds have also been offering positive real yields again, with the equivalent 10-year security providing around 0.6% real today, but that is definitely not as generous as the US version.

I use a very simple rule of thumb to orient myself in the bond market. Because of the historical link between 10-year bond returns and growth in the economy, I look at the potential range of nominal GDP growth as my starting point for fair value (or at least some sort of equilibrium yield). If we assume that trend real GDP growth in the US is between 1.5% and 2% then add that to future inflation expectations (which I pitch between 2%, which is the Fed's stated target, and 3%, which I think they might be prepared to tolerate in future), then the range is 3.5% to 5%. Anything over 5%, as we recently experienced, starts to look interesting.

For the UK, we are probably staring with lower trend growth, say 0.5% to 1%, but higher structural inflation (say 2%, in deference to the Bank of England's target, to as high as 4%). That gives a range of 2.5% to 5% for the 10-year Gilt yield. A recent peak of 4.74% was also enticing, even more so if you are more positive on the inflation outlook. There are other methods that, for example, look at the neutral base interest rate (where the economy is neither accelerating nor slowing from trend) and add a term premium (the extra yield above the equilibrium rate that investors demand to cover risks ranging from inflation and supply to outright default). These seem to be sending similar messages. Of course, yields can overshoot, as the did to the downside when we saw the 10-year Gilt yield close to zero in August 2020, but there are definitely some grounds for optimism at current levels.

On the equity side of the portfolio, we caught a brief glimpse of what might happen when the market really does believe that the turn in rates is here and when central banks signal a cut (as opposed to a pause at current levels). Longer duration stocks such as Technology ripped higher, but, more interestingly, they were outpaced by smaller cap value stocks (which have been pummelled by higher interest rates) and also unprofitable companies.

That initial rally has faltered a bit in recent days, partly because some of the sentiment and positioning imbalance has been addressed. There was also a speech from Mr Powell last week in which he threw some cold water on the idea of imminent policy easing. After all, the easing of financial conditions since the Fed meeting undoes the rationale for pausing rate increases.

This still feels like a challenging part of the economic and interest rate cycle to negotiate. On the one hand investors are petrified about missing the turn; on the other there are lingering concerns about the strength of economic growth, as seen in the recent weak price action in many commodities, notably oil, which is now trading below the level when Hamas attacked Israel. We are still not taking big bets directionally and retain a preference for companies with stronger cash flows and balance sheets.

And so, to the “then”. With a lot of investors fed up with recently lacklustre balanced portfolio returns, the lure of the “bird in the hand” of a 5%-plus cash deposit yield is high relative to the “two in the bush” potential of “riskier” assets. This short section, covering the subject of “time in the market” as opposed to “timing the market”, seeks to make the case for remaining invested for the longer term through the lens of compounding returns.

Albert Einstein declared compound interest to be the “eighth wonder of the world”, and he was no fool. Or maybe he was? He should, perhaps, have declared that the compounding returns of companies and the shares in those companies was even more remarkable. If savings are stored in cash under the mattress, no interest is accrued. It is the interest on the interest that drives the long-term returns that Einstein was praising. However, there is no guarantee that one would be able to reinvest that return from cash at the same level in, say, a year’s time. That is a bigger risk than many appreciate today if interest rates do fall. The same is true of bonds, although they can at least deliver shorter term capital gains if yields fall.

For equities, there is more than one stream of compounding. Even while equity markets are rising and falling through valuation cycles, the underlying companies are going about their business, and the better ones continue to grow by reinvesting profits. Most will also pay dividends. Investors who do not need to take that income today can reinvest those dividends, ultimately earning dividends on the dividends. The longer one stays invested, the greater the compounding effect.

There will always be a temptation to finesse those returns. While we advocate the use of tactical asset allocation overlays to take advantage of cyclical swings and relative valuation gaps, nobody has perfected the art of knowing when to be “all in” and then “all out” of markets. Certainly, there will be times when it feels much more comfortable to be sitting on a pile of cash, but markets often run on far beyond what seemed like a sensible time to exit. Similarly, they tend to bounce from lows when even the optimists are hard-pressed to see a recovery. Those missed returns are lost opportunities to create a base for future compounding.

My Bloomberg terminal tells me that the capital return from the S&P 500 Index since the day Love Me Do was released has been 7,636% (UK market data does not go back that far). The Total Return (with dividends reinvested) is an extraordinary 45,347%! Of course, one might assume that even Paul and Ringo have dipped into their pensions by now, losing some of the compounding benefit, but I think the difference between those numbers sends a powerful message, especially to those with a longer investment runway ahead of them.

Last week's question: What was F. Scott Fitzgerald’s first name?
Francis Scott Key Fitzgerald

This week's question: Which football team paid £1m to sign Trevor Francis in 1979?

Economic Commentary

This Week's Forthcoming Events

US	Treasury Budget NSA
US	CPI ex-Food & Energy SA M/M
US	CPI NSA Y/Y
US	NFIB Small Business Index
US	Export Price Index NSA M/M
US	Import Price Index NSA M/M
UK	ILO Unemployment Rate 3-M
UK	CPI Core NSA Y/Y
UK	CPI EU Harmonized NSA Y/Y
EU	GDP SA Y/Y (Second Preliminary)
EU	Industrial Production SA M/M
EU	Trade Balance SA

UK – Recession is an emotive word. Whether the UK is in one is debatable; that the economy is very sluggish is not. Growth of 0.0% was the headline figure for Q3, but that was rounded up from -0.02% (or the equivalent of a measly £173m). Still, it beat the consensus expectation of -0.1%, and growth in September was a heady 0.2% over August. Consumer spending saw the first fall (-0.4% quarter-on-quarter since Q4 2022, suggesting that higher interest rates are biting, and residential investment was also weak (-1.7% quarter-on-quarter). A fall in business investment (-4.2%) might have been a function of demand having pulled forward into Q2, ahead of the expiration of the super-deduction tax break. A falling trade deficit (exports rising and imports falling) was beneficial to growth. No doubt the Bank of England would like to cut rates, were it not for the fact that inflation remains well above target.

US – The latest Senior Loan Officers' Opinion Survey confirmed that bank lending standards in the US remain tighter, although the balance was slightly lower than in July's report. There has not been an appreciable increase of caution since the bank bankruptcies in March, which is a relief, and that has contributed to the better-than-expected economic performance. But neither are aggregate bank loans growing yet, which will continue to hold back growth. Consumers on average remain downbeat, with the latest University of Michigan Sentiment Survey reading dropping from 63.8 to 60.4 against an expected 63.7, with both the current and expected readings falling. Inflation expectations also rose, from 4.2% to 4.4% on the one-year horizon, and from 3% to 3.2% on the five to 10-year view, both of which reading exceeded forecasts, possibly driven by concerns about higher fuel prices given events in the Middle East, even though fuel prices have not risen.

Europe – Falling Producer Prices are (one would hope) a harbinger of lower inflation. The Eurozone Producer Price Index is now running at -12.4% year-on-year. There is little doubt that Europe is struggling to grow that the moment. The latest Retail Sales print (for September) showed a contraction in sales of -2.9%. Even so, there are no signs of potential leniency from the European Central Bank yet, with most communications still emphasising the need to ensure that inflation is properly conquered.

China – China fell back into deflation in October, with the headline Consumer Price Index reading -0.2% year-on-year. One might have thought that the fact that the greatest influence on inflation at the moment is falling pork prices (-30% year-on-year) would be taken positively, as it eases the strain on consumers' finances. Instead, there seems to be more concern about the optics of deflation and how that reflects on overall consumer confidence (which is, to be fair, very weak). Core CPI (which excludes food and energy) fell from 0.8% to 0.6% year-on-year. If this persuades the government to boost its stimulus, so much the better, at least as long as it is well constructed and targeted.

Economic Commentary

FTSE 100 weekly winners

Associated British Foods plc	9.7%
Auto Trader Group PLC	9.1%
NatWest Group Plc	5.4%
Melrose Industries PLC	5.1%
Rolls-Royce Holdings plc	5.0%
RELX PLC	4.2%
CRH public limited company	4.1%

FTSE 100 weekly losers

Flutter Entertainment Plc	-12.3%
Diageo plc	-10.7%
ITV PLC	-10.6%
Anglo American plc	-8.6%
Fresnillo PLC	-7.6%
International Distributions Services plc	-5.9%
Standard Life Aberdeen	-5.8%

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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