Weekly Digest

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John Wyn-Evans
Head of Investment Strategy

Happy Anniversary

Remarkably, it is now a year since I (and many of my colleagues) have set foot in our offices. Everybody will have their own memories of that extraordinary period last March when the panic set in, both in financial markets and the real world. Looking back at my diary, it's hardly a surprise that I retreated home on the afternoon of Thursday 12th, my newly-acquired Boots digital thermometer beeping furiously, with a soaring temperature. In the previous ten days I had attended four conferences; gone out for dinner three times; been to a reunion event at my old school which featured around seven hundred people singing as loudly as they possibly could indoors; had one trip to the theatre; and sat in any number of internal meetings with ten or more colleagues in relatively small rooms. Not to mention all the trips on the Underground. Covid tests were not available, and, subsequently, between my ordering an antibody test and it being delivered, the government banned them being sold. Therefore to this day I have no idea whether I had Covid or not. If I did, it certainly was not a particularly bad case, thankfully.

Looking at a pre-Covid diary emphasises how little one is doing now, at least in terms of extramural activities. No wonder, then, that reports abound of pub gardens being completely booked up for three months once restrictions are lifted, and that holiday bookings are soaring. The prospect of a burst of activity fueled by pent-up demand is real, and remains one of the key drivers of relative performance within financial markets. How long this will persist remains to be seen. Much is being written about the potential for a repeat of the "Roaring Twenties", although, in some important respects, the background is quite different. As economist David Rosenberg points out (more with reference to the United States, but the UK is similar), the private sector was much less indebted a century ago, and interest rate trended lower. Certainly one can draw parallels in the realms of innovation, with the benefits of widely available electricity and the development of mass manufacturing echoed today in the adoption of digital technologies. However, one can also see how those benefits (and the profits that they generate) might not be evenly distributed. The General Strike of 1926 represented a roar of a different kind. We should not necessarily fall easily for the historical allure of jazz parties, flapper girls and Merchant Ivory visions of the past.

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Returning to the present, the "reflation trade" remains the focal point for investors. Having written at some length about it last Monday, today I will provide an update. The main development last week was the release of February's US inflation data, and, in the event, it turned out to be relatively benign, with the headline Consumer Price Index up 1.7% year-on-year, exactly as expected. That provided some relief, and a not insignificant rally in many of the "long duration" stocks that had been battered previously. Even so, after a period of consolidation, bonds ended the week in decline, with yields pushing up to new highs for this phase of the cycle in many countries, most notably the US at 1.62%, and the UK at 0.85%. That move was underpinned by the signing of the latest $1.9 trillion stimulus package by President Biden. Furthermore, the Democrats' attention is already shifting towards its follow-up multi-trillion dollar infrastructure spending plan, promising yet more petrol on the fire.

Despite that non-threatening inflation print, though, we all know that the big test will come in a few months' time, when the figure will spike up owing to the low comparative figure in 2020. Thereafter, of course, there remains the big debate about how quickly it will subside again, if at all. And just to complicate matters further, nobody can be absolutely sure how central banks will react, and for how long they might be prepared to let economies "run hot". We might receive further guidance on the subject this week, as the central banks of the United States, the UK and Japan meet to deliberate on policy. The US Federal Reserve meeting on Wednesday will top the bill. The Chairman's statement and the "dot plot", which represents the forecasts of the future level of interest rates of individual members, will be subject to intense scrutiny. There is potential for plenty of volatility in bond, equity and foreign exchange markets, but, for all the noise, it's not the sort of event that lends itself to being traded as far as our clients' funds are concerned.

One thing that I want to follow up on from last week concerns bond yields. I referred solely to nominal bond yields, which take no account of inflation. And although the majority of reporting on bond markets refers almost entirely to nominal yields, it is real yields - the difference between nominal yields and inflation expectations - that have a much greater influence on other financial assets. It's instructive to look first at what happened in the first quarter of 2020. Even as investors were beginning to worry about Covid, many equity markets were still making new all-time highs in February. Apart from the general insouciance about the virus, a key driver was that real bond yields were still falling. Indeed, the US real interest rate had been propelling equities, especially long duration stocks, throughout 2019, by falling from 1% to zero. By the end of February it was down to minus 0.5%, as nominal bond yields continued to fall, but inflation expectations remained relatively sticky. In detail, the 10-year breakeven rate (the market-derived expectation for average inflation over the next decade) had remained in a range of 1.5% to 2%, while the 10-year Treasury yield had gone from 2.5% to 1%.

What happened next was even more interesting, and helps to explain the precipitous market collapse in March. Inflation expectations collapsed as the demand destruction of lockdowns was priced in and "caught down" with bond yields. The effect was briefly exacerbated by a (lack of) liquidity-driven sell-off in Treasury markets as leveraged investors rushed to raise cash. That resulted in the real bond yield spiking from minus 0.57% on 6th March to plus 0.62% on 19th March, which represented a very aggressive tightening of financial conditions. Markets would struggle to deal with such a tightening over twelve months, let alone two weeks. The peak of the spike marked the worst of the market panic, and the real yield was back down to -0.56% by early April. Subsequently, Federal Reserve bond purchases on the one hand and some normalisation of inflation expectations on the other combined to push the real yield to a low of -1.08% during the summer.

And it was still below -1% as recently as 10th February, but then started to move higher as bond yields began to rise faster than inflation expectations. This was a function of markets beginning to fear a

central bank monetary policy tightening cycle. All other things being equal, such a policy move would tend to rein in inflation expectations as the prospect of higher interest rates started to bite. The real bond yield is currently minus 0.62%, which, relative to history, remains extremely accommodative. That's one reason, at least, why financial markets have not totally collapsed in the manner predicted by some. Indeed, there are plenty of strategists who believe that as long as real rates remain negative we have little to fear. But if real rates do continue to head higher, it will extend the rotation that we have seen in favour of more cyclical, short-duration assets. What the central banks have to say this week will have a large bearing on how that plays out.

Finally, it is worth pointing out, using market data going back to 1910, that periods when inflation (or these days inflation expectations) has been below 1% and rising have, on average, delivered the best performance regime for equities, in both absolute return terms and relative to bonds. This is because investors have gratefully backed away from a deflationary precipice with all its negative implications debt-repayment capabilities, economic activity and corporate profits. In that respect, the last year's divergence of "Wall Street" and "Main Street" should be less surprising. According to the data collated by Robert Shiller and Goldman Sachs, the trouble only really starts once inflation is over 3% and rising.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Company	%
Just Eat Takeaway.com N.V.	14.8%
Burberry Group plc	13.8%
Scottish Mortgage Investment Trust Plc	12.9%
M&G Plc	12.9%
Kingfisher Plc	12.8%
Ashtead Group plc	9.0%
Flutter Entertainment Plc	8.0%

FTSE 100 Weekly Losers

Company	%
Standard Life Aberdeen PLC	-6.7%
London Stock Exchange Group plc	-6.4%
Rentokil Initial plc	-3.2%
BT Group plc	-3.0%
HSBC Holdings Plc	-2.1%
Evraz PLC	-2.1%
Rio Tinto plc	-1.9%

FTSE 100 Index, Past 12 months

Source: Factset

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