Investec

OUT OF THE ORDINARY

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A Good Shock

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Two weeks ago, I wrote about the potential for a central bank pivot, and investors started to price one in more aggressively at round 1.30pm UK time last Thursday. That was the moment that the Consumer Price Indices for October were released in the United States, and both the headline and core rates came in 0.2% below expectations. That might not sound like much, especially in the context of numbers that still printed at 7.7% and 6.3% respectively, but it was the first positive "beat" for several months and cemented the idea that annual inflation rates have peaked for this cycle, at least in the US. The peaks were 9.1% for headline in June and 6.6% for core in September.

That would certainly come as a relief to both consumers and policymakers, as well as to investors. Especially so if it allows the Federal Reserve to be less hawkish in its policy stance. The reaction in markets was instantaneous and aggressive. Indeed, there was no time to react. You had to be positioned in advance because equities were marked up and bond yields marked down within seconds. Moves in the US were possibly all the more extreme because Wednesday had been such a bad day, notably for "longer duration" stocks and especially for "non-profitable tech". Cathie Wood's ARK Innovation ETF hit a new cycle low on Wednesday and Amazon achieved the dubious distinction of being the first company in history to shed one trillion dollars of market capitalisation.

And so, one could say that markets were set up for a squeeze on Thursday, which duly occurred. The S&P 500 Index rose 5.54% and the NASDAQ, an even punchier 7.35%. The US 10-year Treasury yield fell 29 basis points and the DXY dollar index fell 2.1%. These are big moves, and for all the "long only" winners, there will have been a lot of other strategies howling in pain. Funds that trade on the basis of momentum (buy stuff that's going up and sell things that are going down) fell, on average, by 10% last week according to data from Goldman Sachs, who also point out that long/short equity hedge funds had their worst day for two years on Thursday.

Our judgement is that the direction of the reaction was certainly justified, but we are not going to get carried away yet. Much is being made of the "second derivative" effect of inflation rising less quickly than it was, but prices are still going up and faster than wages, which are rising uncomfortably fast (at least in the eyes of central bankers). It is by no means clear how quickly either inflation or wage increases will subside towards a level where the Fed is comfortable or even exactly what that level is, although inflation won't necessarily have to hit the 2% target. But it will have to appear to be on a sustainable path to 2%. Futures markets are still pricing in another full percentage point of Fed Funds rate increases between now and next May and that will have a negative effect on those who need to borrow or refinance short-term loans.

Even so, we still believe that the worst of the equity derating is behind us and that we may well also have seen the peak in bond yields for this cycle (the two are closely linked). That is one reason why we have been running with the slogan "cautious, not fearful" in terms of our approach to tactical asset allocation. But the caution remains driven by the murky outlook for corporate profits. This cycle is not the sort of deflationary bust where market sentiment can be turned easily by central banks injecting liquidity. The downturn has been deliberately engineered by central banks to tame inflationary pressures (many of which might well have been of their own making, but that's another story altogether). They appear intent on getting the job finished and there will be lagged effects running through economies, not least those from the huge rises in mortgage rates and what they will mean for housing market activity.

There are other wild cards, including how the northern hemisphere winter evolves and what effects that will have on energy prices. So far, so good (warm). There is also the ongoing situation in Ukraine and its downstream consequences. These tend to fall into the "difficult to forecast" category.

One source of greater optimism could be China. Last week it began, very gingerly, to loosen some of its Covid related restrictions. Unless one were to believe that China's government is in the process of permanently subjecting its population to stricter living conditions, then a further loosening would appear inevitable, although dependent upon a more effective vaccination programme. The authorities followed up over the weekend by releasing a plan to provide support to the country's beleaguered real estate industry, although the structural mess that it is in hardly suggests that a huge property boom lies ahead of us. Sentiment towards China is close to rock bottom and so any turn will be welcomed.

Why is cryptocurrency in the news?

I can't let last week go without a word on the gyrations in the cryptocurrency industry and the demise of crypto exchange FTX as well its related trading company Alameda Capital. It will probably take a while to get to the bottom of the story but in essence it looks like a good old-fashioned run on a bank, with depositors demanding liquidity that could not be met. The fun bit will be discovering exactly where all that liquidity had gone, but we should probably send a small thank-you to the FCA for deterring investors from getting involved in the unregulated Wild West of the crypto space. The good news is that it doesn't look as though any of this has the capacity to cause systemic fallout in the financial system, with the total crypto space now being valued at well below $1trillion having once been over $3 trillion. Even so, there are write-offs in the billions being taken across the venture capital industry, and this will decrease the availability of the "free money" that has supported so much speculative activity and unprofitable growth in recent years.

What are we expecting from the Autumn Statement?

Finally, a brief look ahead to Thursday's Autumn Statement, which is an event that neither of the last two Chancellors managed to hang around long enough to preside over. Jeremy Hunt will deliver this one, and the pain of tax increases and spending cuts is being trailed through the media to such an extent that it's hard to see there being any big surprises come the day. And that's exactly what we want. However, the fine details could be more painful, perhaps, for higher-rate taxpayers. We are looking at policy tightening of around 2% of GDP, amounting to around £60bn, with a £35bn/£25bn split in favour of spending cuts.

The situation is not helped by a new outlook from the Office of Budget Responsibility which suggests the need for £100bn of government borrowing in the 2026/27 fiscal year. This is up from £31.6bn when they last made their projections in March, and certainly gives Mr Hunt plenty of cover for an aggressive move (even if he might well backload the planned pain until after the next election). Half of the increased amount is accounted for by higher borrowing costs, with the other half the result of a weaker economy and therefore lower revenues. One has to assume that governments across much of the world are going to be facing a similar problem as pertains to the former factor, at least.

We will be publishing reactions to the statement from both a market and financial planning perspective as soon as we can following the event, so please look out for those.

Economic Commentary

FTSE 100 weekly winners

Ocado Group PLC	28.1%
International Distributions Services PLC	22.6%
Abrdn plc	20.0%
Hargreaves Lansdown plc	17.4%
Schroders PLC	17.0%
Just Eat Takeaway.com N.V.	16.3%
JD Sports Fashion Plc	15.8%

FTSE 100 weekly losers

BAE Systems plc	-10.6%
GSK plc	-8.4%
DCC Plc	-8.1%
Shell Plc	-6.6%
Imperial Brands PLC	-5.9%
Glencore plc	-5.6%
British American Tobacco p.l.c.	-5.6%

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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