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OUT OF THE ORDINARY

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Don’t Look Up!

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It’s hard to believe that four weeks have skipped by since I last put pen to paper. Quite a lot has happened in the world during that period, not least the peaking of the Omicron wave of Covid in several countries including the UK, although it’s fair to say that the worst might be yet to come elsewhere. But the unequivocally good news is that hospitalisations and fatalities are a much lower proportion of case numbers than seen in past waves.

One of the delights of the Christmas and New Year holiday period is having the time to settle into some long reading. On a work-related theme, I read Boom and Bust. This provides accounts of ten different financial market bubbles stretching back to the 1700s, and attempts to ascertain what creates them. The authors, William Quinn and John D. Turner, are academics at Queen's University in Belfast. In the light of continuing claims that many financial assets are in a bubble today, it is worth reviewing their key conclusions.

The authors summarise these bubbles into one simple principle, that of the "bubble triangle". The sides of the triangle, which must be in place to create the conditions for the bubble, are marketability, money/credit (liquidity) and speculation. And once all the fuel is gathered, there needs to be a spark.

Marketability is perhaps the element that is most overlooked in the formation of bubbles. It refers to the ease with which investors can trade in and out of an asset. This can be a function, for example, of innovative new products, and remember that shares in companies were an innovation in their day. Now it could be anything from Exchange Traded Funds (which give investors handy and low-cost access to indices and themes) to Non-Fungible Tokens (which can give investors anything from a share of an artefact to outright ownership of some digital creation).

Another feature of marketability today is the ease by which financial products are available at the touch of a screen and often with minimally onerous due diligence requirements. And this route can also be pretty much free of costs, which removes a major impediment to extremely active trading. Add in the gamification of trading apps, and it's hard to ignore the influence that they have had on behaviour in certain areas of markets, for example unprofitable technology companies, meme stocks and cryptocurrencies.

Liquidity pretty much speaks for itself. Freely available credit is a key driver of bubbles, and one can certainly point to record levels of margin debt in the United States as a symptom. Low interest rates on cash and bonds have also historically been a driver of greater risk-taking as investors move further up the risk curve to achieve the returns either that they need to meet liabilities or that they aspire to. It goes without saying that we are in precisely that situation currently. However, we also know that monetary largesse is destined to be reined back in the coming year. Liquidity tends to be the most pro-cyclical element of the bubble. It encourages more participants on the upside and the use of leverage can amplify both economic activity and financial gains. But its withdrawal can trigger a spiral of losses as debts are paid off, margins are called, and asset sales become a matter of necessity as opposed to want.

The authors characterise speculation as the purchase of an asset purely with the intent of making a (usually short-term) capital gain. Although this is a widespread trading practice in normal market conditions and helps to provide liquidity to markets, it tends to be a lot more pernicious when it becomes a mass participation event, especially in the hands of novices as opposed to seasoned traders (who are not infallible by any means).

There are two main bubble triggers that the authors identify – technological innovation and government policy. There is no end of compelling stories in the tech world today and there are also opportunities to invest in companies that will be at the forefront of the transition to a greener economy. Furthermore, much activity in both these segments is strongly backed by governments searching for enhanced productivity and to address a green policy agenda. Sounds like a perfect recipe for bubbles to form.

The truth is that we are only able properly to identify bubbles in retrospect, because they have popped. If one looks at the share prices of some of the work-from-home winners, there is some evidence that they were in bubbly territory a year ago, with many share prices halving and more since then. Certain ETFs associated with technology disruptors have also taken a beating. That doesn't necessarily mean that the companies involved won't be successful. But it does suggest that investors were not applying a realistic current valuation to their prospective earning capabilities.

Even so, for the last year we have steadfastly held the view that equities overall are not in a bubble. We continue to believe that market composition and individual company profitability can justify a lot of today's apparent excess. Furthermore, there is little to suggest that we are in the throes of the type of speculative activity that can undermine the whole financial system as we saw in the run-up to the financial crisis in 2008. We really don't care that much if a few cryptocurrencies, NFTs or more speculative equities go to zero.

That's not to say that we are oblivious to risk. There have been a few bumpy days in markets already this year, none more so than when the Fed revealed the minutes of its December 2021 meeting. They contained evidence of much greater concern about inflation than was previously thought to be the case, and with that came comments that more Fed members were contemplating a swifter and more aggressive tightening of monetary policy. This would involve an accelerated end to asset purchases, a more immediate interest rate rise, and, most surprisingly, a much earlier beginning to balance sheet reduction. This triggered a sharp sell-off for both bonds and equities, although the headlines equity indices failed to capture the rotation in favour of shorter duration "value" stocks at the expense of longer duration "growth" stocks.

Apart from the timing, perhaps, none of this really should have come as a massive surprise. In my last Weekly Digest of 2021, I highlighted the risk of policy tightening and the balancing act that central banks will have to perform to achieve their goals this year, namely, to perpetuate the economic recovery while reining in inflation and expectations of future inflation. We continue to see a tighter monetary policy environment developing over the course of the year, and this will create a headwind for financial assets. But we also believe that this policy shift will create more dispersion of returns within markets, allowing skilled asset allocators and stock-pickers to add value relative to strategic asset allocation benchmarks. The worst thing would be to allow one's longer-term investment goals to be sacrificed to the short-term vagaries of market sentiment.

Which, somewhat belatedly, brings me to this week's title. When I didn't have my head buried in a book, there was some time for TV, and I thoroughly enjoyed the Netflix film Don't Look Up. I am not going to give the game away for those who have yet to see it, but it does involve a scientifically based warning about an impending global catastrophe and the reaction to that threat. Are warnings of equity bubbles and market crashes the equivalent of the discovery of a comet hurtling towards earth? Are we being too blasé? Or even just powerless in the face of inevitable doom? We certainly don't think so.

But we also acknowledge that investment returns will, in all probability, be lower and harder to achieve henceforth than they have been for most of the era since the end of the financial crisis. Bearing that in mind, the final words of Leonardo DiCaprio's character, Dr Mindy, ring true: "We really did have everything, didn't we? I mean, when you think about it."

Economic Commentary

FTSE 100 weekly winners

British American Tobacco p.l.c.	7.6%
Standard Chartered PLC	7.4%
BP p.l.c.	7.2%
HSBC Holdings Plc	7.1%
London Stock Exchange Group plc	5.0%
Barclays PLC	5.0%
J Sainsbury plc	4.9%

FTSE 100 weekly losers

Spirax-Sarco Engineering PLC	-11.7%
Taylor Wimpey plc	-11.0%
Croda International Plc	-10.9%
Halma plc	-10.7%
Experian PLC	-9.9%
JD Sports Fashion Plc	-9.8%
Rightmove plc	-9.4%

FTSE 100 index, past 12 months

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