OUT OF THE ORDINARY

WEEKLY DIGEST | 20 December 2021

Balancing Acts

John Wyn-Evans
Head of investment strategy

For exactly a year now I have been wearing a Whoop strap around the clock. For those not familiar with the device, it is one of the new breed of wearable biometric monitoring devices that measure various aspects of one's physiology such as heart rate, heart rate variability and sleep patterns (Fitbits, Apple watches and Oura rings offer similar functions and there are plenty more on the market).

My Whoop delivers a recovery score every morning based upon its observations. There are some things that have become abundantly clear from the data compiled over the last twelve months and foremost amongst them is that the consumption of alcohol, eating large meals late in the evening and going to be bed later than normal are not conducive to a good recovery, and that these behaviours tend to lead to sub-optimal performance the following day – that can be mental performance as much as physical. I think most of us will have experienced the difficulty of staying focused during an early morning meeting after a night out.

Slavish adherence to a regime of early bedtimes, abstinence from alcohol and light meals eaten before 7pm would seem to be the prescription, but this would exclude one from many of modern society's pleasures. And so, I have tried to manage my commitments around the desire to have a bit of fun. It's an imperfect balancing act at the best of times, and sometimes you just have to live with the consequences. But, overall, I think that at least knowing what effects various activities allows one to make proactive decisions. And I certainly believe that I have become more productive as a result.

That's a bit of a long personal share to kick off the final Weekly Digest of the year, but I offer it in the context of considering how maintaining the right balance is crucial in many aspects of life, government, the economy and investing. There are always bound to be some wobbly moments as well as the odd catastrophic tumble.

Whether we like it or not, we are currently faced with difficult decisions about how to act during the latest Omicron variant-driven wave of the COVID pandemic – the balance between maintaining a relatively normal lifestyle (especially over Christmas) and being more cautious. And also whether we like it or not, some of these decisions are going to be taken out of our hands by government decree. If you thought Brexit was divisive, the response to government measures with respect to COVID has ratcheted hostilities up to new levels, and this is no longer just a UK-centric phenomenon.

It is not for me in my professional capacity to agree or disagree with what is decided, but to deal with the outcomes. Right now, it certainly looks as though greater restrictions are going to lead to more pain for certain sectors of the economy, especially if no new financial assistance is offered. It is almost inevitable that some businesses that have been clinging on to solvency by their fingernails will fail without further injections of capital. That might be easier to achieve for companies with stock market listings, even if it does mean diluting the interest of existing shareholders, but it will be a struggle for many privately-owned entities.

Although the knee-jerk reaction of the market to Omicron was to mark up the shares of "stay-at-home" winners, it is hard to see such companies making a quantum leap forward as they did during the first wave and the 2020 lockdown. This period ahead of us is, in all probability, going to lead to a reduction in overall activity, and that's before we consider the potential further disruption to supply chains. We are already seeing downgrades coming through.

All of this will cause a lot of head-scratching in the corridors of central banks. As we head into 2022, investors are of the opinion that a central bank policy error is the biggest risk to financial market equilibrium. Although some might contend that the policy error has been a decade or more in the making owing to the persistent utilisation of quantitative easing (QE) and low interest rate policies, it's the potential scale and speed of withdrawing such monetary largesse that jangles the nerves. As we have commented on many occasions in the past, tightening liquidity conditions tend to represent a headwind for financial assets in aggregate, and the worst outcomes tend to arise when monetary tightening meets falling growth expectations.

Will central banks continue to tighten in the face of Omicron and its effects, or will they hit the pause button? There were certainly limited signs of hesitancy last week when several central banks released the results of their latest deliberations. Starting closest to home, the Bank of England (much to the surprise of many, including me) raised the base rate by 0.15 percentage points to 0.25%. The expectation remains that it will raise again to 0.5% during the first quarter of next year, which will allow it to begin running down its balance sheet, initially by not reinvesting the proceeds of maturing debt.

The US Federal Reserve opted to accelerate the tapering of its current asset purchase programme. Once that has ended in March 2022, it will be free to start raising interest rates, with the market expecting this to happen in May. Of the three main Western central banks, the European Central Bank (ECB) will be the laggard in terms of tightening policy, although there was a definite tweak in that direction with the announced running down of its Pandemic Emergency Purchase Programme and some lightening of its non-pandemic related QE. But ECB President Christine Lagarde stood out from her peers in maintaining that there is no rise in interest rates contemplated during 2022.

On the other side if the world, the Bank of Japan has reasserted that it won't be tightening policy any time soon, while the People's Bank of China is gently loosening policy having spent the last year in tightening mode. One key reason for China rowing against the global tide is that it is having to manage the demise of several large real estate companies that are teetering on the brink of default.

But it is the Fed's decisions, owing to the scale of its global influence, that will be crucial next year, and investors are mindful of the market shake-out that occurred during the fourth quarter of 2018 when the Fed refused to be diverted from its stated policy-tightening objective. This did lead to the "Powell pivot" of early 2019 when policy was loosened again, but not before a lot of pain had been inflicted upon investors. Nobody can be sure at what market level the "Powell Put" will be exercised next time.

The pace and extent of policy moves will depend to a great deal on what happens to inflation, and it remains impossible for economists to reach a consensus on this, much as has been the case for the last few years. I have just read a well-argued white paper from Bridgewater Associates asserting that elevated inflation is here to stay, driven by what it describes as a positive "demand shock" resulting from overenthusiastic fiscal stimulus. But then I have also read an equally passionate paper from the bond fund managers at Allianz arguing that inflation indices will be undershooting central banks' 2% targets by this time next year as supply chain bottlenecks ease and demand weakens.

We can make no claim to be better at forecasting economic outcomes than anyone else, and in the absence of a strong opinion this year we have not made a big bet on the inflation outcome. Even so, we took out some insurance in the form of a preference for index-linked bonds, for example. It is clear to us that the possibility of inflation being higher for longer (assuming a tightening response from central banks) presents an asymmetric threat to investors because higher rates will tend to dampen demand while also putting downward pressure on equity valuations. Lower-than-expected inflation would, we believe, struggle to produce a great upward surge in growth expectations or valuations.

There are a number of other finely balanced situations that could fall either side of the tightrope next year, which, in the interests of getting this piece finished before Christmas, I will outline more briefly. But they will have the capacity to create more volatility in markets. There is the ongoing problem in the wholesale natural gas market, with prices spiking as constrained supply meets excess demand, especially if we get high pressure cold snaps during the winter and the wind doesn't blow. On the geopolitical front, the simmering tension between Russia and Ukraine could boil over at any moment; and there are also China's continuing threats towards Taiwan as well its deteriorating relationship with the United States.

Which brings me to the final balancing act, which is the construction of portfolios. Very few of the client portfolios that we manage are one hundred percent invested in equities, with the majority being in the "medium risk balanced" category. This type of portfolio tends to deliver an attractive return per unit of risk over longer periods, but, as we are seeing right now, will be subject to short-term market volatility. We are also able tactically to trim the sails to reflect our current market outlook, and, as I reported a few weeks ago, we have been slightly more cautious approaching the year end. That leaves us well positioned to ride out the current squall and also to take advantage of any price dislocations that the more thinly traded holiday season markets might offer us.

The last two years have been extraordinary, but the COVID pill has at least been sugared by some decent investment returns. Could the trade-off in 2022 be much welcomed better news on the COVID front but lower returns? We will return with more insights in the New Year, but, in the meantime, I wish you and your families the most peaceful and enjoyable Christmas that the current circumstances will allow, and thank you, as ever, for your support and engagement this year.

Economic Commentary

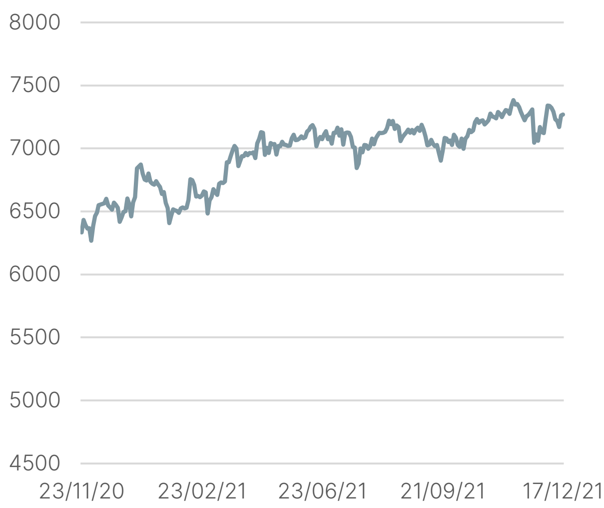
FTSE 100 weekly winners

DCC Plc	6.9%
Fresnillo PLC	6.2%
AstraZeneca PLC	3.9%
Smiths Group Plc	3.2%
Ferguson Plc	3.2%
Aviva plc	2.6%
Rio Tinto plc	2.6%

FTSE 100 weekly losers

Rentokil Initial plc	-14.2%
JD Sports Fashion Plc	-9.9%
Rolls-Royce Holdings plc	-6.9%
BT Group plc	-6.2%
Next plc	-5.8%
Croda International Plc	-4.7%
Whitbread PLC	-4.5%

FTSE 100 index, past 12 months



investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.