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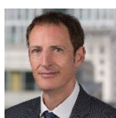
OUT OF THE ORDINARY

WEEKLY DIGEST | 21 June 2022

All Medicine, No Sugar



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The first film that I saw at a cinema was Mary Poppins. It was showing in the now defunct Luxor in Llanfairfechan, North Wales. I have found a poster online which promises matinee performances on Bank Holidays and "each day in season if wet" – which would have been quite often. The film was released just before Christmas 1964, meaning that I would have been about three-and-a-half years old. According to family lore, I was ready to leave at the end of the Movietone newsreel, and as a result was not allowed back into a cinema until 1969 when Chitty Chitty Bang Bang came out.

One of the most famous songs from Mary Poppins claims that a "spoonful of sugar helps the medicine go down". Central bankers around the world are apparently unaware of this advice, doling out copious doses of monetary medicine at the moment without being able to locate the sugar bowl. The latest round of central bank meetings was last week and came hot on the heels of a shockingly high US inflation print the previous Friday. Indeed, the headline Consumer Price Index increase of 8.6% was of such concern that the Federal Reserve (allegedly) contacted its favoured reporter at the Wall Street Journal and shared a story that it was going to raise rates by 0.75% rather than the 0.5% that it had alluded to at the previous meeting. That caused some big ripples, but at least cushioned the shock of the official announcement on Wednesday. In fact, because markets had subsequently started to price in the possibility of a full 1% increase, 0.75% seemed almost benign, triggering a rally in equity markets.

Base rate rises

That turned at to be another false dawn, as further commentary made it clear that the Fed is making the containment of inflation (and rising inflation expectations) its priority, even if that means sacrificing growth and employment. And the Fed was not alone. Here in the UK, the Bank of England's Monetary Policy Committee raised the Bank Rate for the fifth consecutive meeting, again by 0.25%, to 1.25%, a level last seen in early 2009.

And they are far from done. The Fed's "Dot Plot" of members' expectations of future rates has a median projection of 3.375% by the end of this year (versus an upper bound of 1.75% now) rising to 3.75% at the end of 2023. Given that the Fed's current opinion is that the neutral rate of interest (where the economy will grow pretty much on trend) is no higher than 2.5%, that points to very restrictive policy ahead. The Bank of England does not provide such projections, and so we have to rely on markets for a view of the future. Here, the expectation is that the Bank Rate will be 3% after December's meeting and will continue to rise into 2023.

Elsewhere, the biggest surprise of the week emanated from the Swiss National Bank (SNB). It was not expected to change rates at all. Inflation in Switzerland is running at "only" 2.9% and the country has a resilient currency, but it was impossible for the central bank to justify maintaining rates at -0.75% in the face of rising inflation forecasts. At least the SNB is being pre-emptive. Part of the problem for other central banks is that they believed for too long that inflation would be "transitory" and kept the monetary taps wide open. People often ask if there are policy mistakes in the making, but the biggest mistake could have already been made.

The challenge for the Eurozone

Two weeks ago, the European Central Bank (ECB), while not actually raising rates, made it abundantly clear that that it was about to start. Futures markets project a rise from -0.5% now to more than 1% by year end, rapidly advancing towards 2% by mid-2023. We were quickly reminded that the "one-size-fits-all" character of eurozone monetary policy comes with its own, idiosyncratic challenges. Individual economies in the zone are running at different speeds, have different inflation levels and, crucially, have very different levels of debt. What is appropriate for Germany, say, might not be so for Italy, and thus it proved, with the yields of Italian government bonds rising much faster than Germany's as concerns resurfaced about the ability of Italy to meet its liabilities in a higher interest rate environment.

As a result, the ECB was forced to convene an ad hoc (for which read "emergency") meeting on Wednesday to announce plans for tools to avoid "fragmentation". Although the tools have not yet been forged, they will probably involve a form of asset purchase scheme aimed at the bonds of weaker countries. If that sounds a lot like selective Quantitative Easing, it's because it is. The consequence is that the ECB will be free to raise rates. This policy of driving with one foot on the accelerator and the other on the brake is testament to a flaw in the single currency, and (assuming that it is impossible for all countries' growth, inflation and debt levels to converge) that won't be fixed until there is full fiscal and banking convergence across the region. "Good luck with that," comes the cry from German taxpayers.

Leaving aside China (which is in its own self-made economic and interest rate cycle) and Turkey (which is taking a highly unconventional approach to domestic inflation running at 73.5%), the only major central bank to be clinging to a zero-rate policy and infinite Quantitative Easing is Japan. At its meeting last week, it held rates at -0.1% and confirmed its policy of "yield curve control", by which it pins ten-year bond yields at zero (or, in practice, at 0.25%). Markets have been testing the Bank of Japan's resolve recently, but it stood firm. However, this does not come without consequences. The Yen has been extremely weak as interest rate differentials against other countries have widened. While that might be welcomed in some circles as a boost to manufacturers' exports, it also puts upward pressure on costs of imports for consumers, especially fuel. It also devalues non-Japanese investors' holdings in the country when translated into home currency.

Even if Japan is able to bear this pressure for now, largely thanks to the fact that its debt is mostly owned domestically, this is a cautionary tale for other central banks. You can control either your bond market or your currency – but not both. That might not be an immediate problem, but if western central banks are forced to suppress bond yields in the future owing to high government debts, even in the face of persistently high inflation, then watch out below in the currency markets. If there was ever an argument for holding gold as an uncorrelated diversifying insurance asset in a balanced portfolio, this is it.

The outcome of all this central bank activity was that equity, bond and commodity markets in aggregate all fell last week. At some point that pain in financial markets and the increasing weakness in real economies will force a policy pause or even U-turn. The message from central banks last week was that we are nowhere near that point of capitulation yet. Even so, a lot of damage has been done. The MSCI All-Countries World Index is down 23% in capital terms from last November's peak while, perhaps more shockingly for many, the Barclays Global Aggregate Bond Index is down 17.5% on a total return basis from last July's peak. Even one of the more bearish investment bank strategists that I follow (who has called the market very well this year) is now inclined to be thinking in terms of investment opportunity from here. Even if markets have one final leg down, now is not the time for longer-term investors to bail out.

Economic Commentary

FTSE 100 weekly winners

Coca-Cola HBC AG	7.2%
Fresnillo PLC	7.1%
B&M European Value Retail SA	4.8%
Pearson PLC	2.0%
HSBC Holdings Plc	1.9%
Avast Plc	1.6%
Aviva plc	1.4%

FTSE 100 weekly losers

Just Eat Takeaway.com N.V.	-20.3%
BP p.l.c.	-13.3%
Shell PLC	-12.6%
Persimmon Plc	-11.6%
Antofagasta plc	-11.1%
Ashtead Group plc	-10.6%
Entain PLC	-9.7%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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