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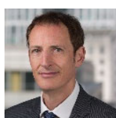
OUT OF THE ORDINARY

WEEKLY DIGEST | 20 September 2022

# Caution Not Fear



John Wyn-Evans
Head of investment strategy

Last week was another tough one for investors, with a higher-than-expected inflation print in the United States triggering the latest bout of selling of both equities and bonds. It's not necessarily the inflation per se that's the problem, more the fact that it means that the US Federal Reserve (Fed) is going to have keep its foot on the brake pedal harder and for longer than was hoped for just a few weeks ago. Remember that central bankers as a group did

their best to disabuse markets of the notion of an early "pivot" to looser policy at the Jackson Hole gathering at the end of August, which snuffed out the summer rally. The latest data supported that conclusion.

And inflation is not a phenomenon confined to the US. It is hovering around double-digits in most of Europe and in many other countries around the world (with China and Japan being the notable exceptions) as a result of sky-high energy costs as well as rising food prices. The US's inflation problem was probably exacerbated by excess demand resulting from extremely generous fiscal and monetary policy during the pandemic, whereas in Europe the blame is more on constrained supply, with natural gas being the biggest problem thanks to dwindling flows from Russia. But monetary policy is a blunt tool and raising interest rates is pretty much all that the central banks can do to signal their intentions to keep inflation expectations anchored.

### What could happen next?

This week there are policy meetings of the central banks of the US, UK, Switzerland, Norway, Sweden and Japan. The futures market is pricing in a US rate rise of between 0.75% and 1%, and it is going to be very hard for any of the others (bar Japan) to resist the upward trend, even in the face of weakening economic data, such as seen in last week's disappointing UK retail sales figures for August. For those that do resist, the example of Japan serves as a warning. The yen has lost a quarter of its value against the dollar this year as the Bank of Japan steadfastly refuses to tighten policy.

And so, with currencies facing volatility, it was poignant that last Friday was the 30th anniversary of Black Wednesday, the day in 1992 when the pound crashed after being hounded out of the European Exchange Rate Mechanism. I spotted more than one article suggesting that a replay might be on the cards, and it is not unusual now to hear commentators predicting imminent parity with the dollar. But the set-up is not the same. The government and the Bank of England (the Bank was not independent in 1992) are not artificially keeping the pound pegged at an unsustainable level and so there is no peg to break. Neither is there likely to be a sudden terms-of-trade shock on a par with the Brexit referendum result. That doesn't mean that the "cable" rate cannot decline further, but I would be extremely surprised to wake up one morning and suddenly find sterling trading, say, ten percent lower.

### The impact of a new UK Prime Minister

However, there is the Liz Truss government to contend with, and there is speculation that an emergency mini-budget will deliver unfunded tax cuts and/or fiscal support measures in excess of the estimated £150bn that it will already cost to suppress household energy bills for the next two years. By supporting consumption in this way, the government is effectively pressing the accelerator on the economy while the Bank of England is applying the brakes. It will be very interesting to see how the Bank resolves this conundrum at Thursday's meeting. Market expectations have been climbing from a near-certain 0.5% rise in the base rate towards 0.75%.

This all comes in the face of a sharply decelerating economy. It was my belief earlier in the year that UK households would allow themselves to enjoy the summer holidays (often booked months earlier and well before the cost-of-living crisis developed) but that reality would begin to bite as we entered autumn. I see no great

reason to change that opinion. Some enquiries amongst local retailers at the weekend suggested that the squeeze is only just beginning. The launderette has just renewed its electricity contract at 49p per unit as opposed to the previous 14p. The dry cleaner is waiting to be informed of his new contract terms but expects a similar rise. He is working out how to optimise the use of his machines and even contemplating closing for one or two days during the week. At least these two businesses are on council premises and not facing rent increases. A café nearby is facing energy and ingredient price increases as well a rent rise imposed by a private landlord. The owner is considering letting staff go to keep the doors open. I know it's dangerous to extrapolate a national trend from anecdotes, but the press is also full of stories of small businesses facing such difficulties, both here and abroad.

### What is the challenge for investors?

The predicament for investors is slightly different. Having suffered a lot of pain already, we must ask what is already priced in? It is notable that UK and European small and mid-cap indices have performed far worse this year than large caps (which have themselves derated substantially owing to a higher discount rate), and so there is recognition of domestic economic stress. Small-cap focused investment trusts are sporting wide discounts to net asset values (NAV). Quoted private equity funds are trading at around half of current stated NAV in some cases. Meanwhile a fund such as BH Macro, whose trading strategy benefits from higher volatility in bond and foreign exchange markets, trades at a substantial premium to NAV.

Then we have the latest round of investment bank fund manager surveys. Those released last week from Deutsche Bank (DB) and Bank of America showed that investors are very pessimistic by historical standards and cautiously positioned. In terms of market level expectations, the ratio of DB's respondents expecting the S&P 500 Index (currently 3900) to hit 3300 before it reached 4500 again was three to one. A similar number thought that the US 10-year Treasury yield (3.48%) would hit 5% before 1%.

Next, I will cite an article in Monday's Financial Times that reported a survey of 44 "leading academic economists". Seventy per cent of those surveyed believe that the Fed Funds rate will peak between 4% and 5%, with a further 20% expecting it to rise above 5%. The futures market currently sees Fed Funds topping out at 4.5%. I thought I should look back at the same survey a year ago to see how good this group was at forecasting. Even allowing for the effects of Russia's invasion of Ukraine, I would judge "not great". Fewer than 20% envisaged a rate rise in the first half of 2022 (the Fed started in March and delivered two more by June), while a good third did not see rates rising until 2023. Now nobody sees rates being cut before 2024. And so, an extended period of tighter monetary policy is largely expected.

I make this comment not to criticise, but to emphasise the difficulties of forecasting such matters in a complex, adaptive system such as an economy. Economists tend to make linear predictions, but economies and markets tend not to oblige. It is not impossible that central banks will find themselves forced by much weaker activity to start loosening policy far earlier than the majority of economists taking part in that survey believe.

Finally, another anniversary was marked last week, although it slipped by relatively unnoticed. That was the demise of Lehman Brothers on 15 September, 2008. Ever since then, there have been concerns that any cracks in the economy or substantial weakness in markets could lead to another financial crisis. Although one could never be ruled out entirely, the current circumstances lead us to believe that the current probability is low. Banks are much better capitalised and the central banks are far more aware of their responsibility to support the system than they were in 2008. For all the talk of overpriced houses, the scale of speculation is nothing like the same and many more owners are protected by fixed-rate mortgages. While individual companies and even smaller asset classes might get into trouble, the chances of a systemic meltdown appear to be much lower.

Our Global Investment Strategy Group, which recommends equity risk exposure relative to benchmarks, met last week and, as it has done all year, remains underweight equity risk. I would continue to characterise the tone as “cautious not fearful”. It’s difficult to judge when exactly markets will bottom out. They tend to do so well before the economy does, but also not before central banks are done with their policy tightening. If history is any guide, then some time within the next six months looks entirely plausible.

# Economic Commentary

FTSE 100 weekly winners

| | |
|---|---|
| Polymetal International Plc | 9.5% |
| NatWest Group Plc | 4.6% |
| Lloyds Banking Group plc | 4.0% |
| AVEVA Group plc | 3.7% |
| Admiral Group plc | 3.2% |
| Kingfisher Plc | 2.1% |
| Barratt Developments PLC | 1.6% |

FTSE 100 weekly losers

| | |
|---|---|
| Melrose Industries PLC | -12.9% |
| Royal Mail plc | -11.3% |
| Ocado Group PLC | -11.3% |
| Spirax-Sarco Engineering PLC | -7.3% |
| Halma plc | -7.3% |
| Auto Trader Group PLC | -6.7% |
| Croda International Plc | -6.4% |

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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