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## FAITal Attraction

If I were to try and sum up investors' current preoccupations in just three words, they would be: Inflation, Duration and Rotation. As I have been writing about for the last few weeks, everything is perfectly set up for a sharp upward move in headline inflation indices during the second quarter of this year. The potential for this move to be persistent rather than transient is subject to much debate, but, on balance, it is generally accepted that the world has retreated from a deflationary cliff edge. Furthermore, the evidence from numerous fund manager surveys is that Covid (and, more importantly, the policy response to the effects of the virus) is expected to increase inflationary pressures in the medium to long term.

This sentiment shift is leaving its mark on government bond markets, with yields rising steadily over the past couple of months, and longer duration instruments experiencing sharp capital losses. Within stock markets, there has been a substantial rotation in favour of "short duration" stocks and sectors, which tend to be those more exposed to the incipient upturn in economic activity, and, notably, banks, whose profitability is enhanced by a steeper yield curve. This group's outperformance has come at the expense of longer duration sectors such as Technology, where current valuations are more dependent upon the expectations for growth and profits further in the future.

So far, so text book. Indeed, if one observes the relative movements within markets and across different asset classes it is hard to come to any conclusion other than that trading is dominated by computers that base their investment decisions upon historical correlations. I am not convinced that either individual or traditional institutional investors are sufficiently nimble to be able to navigate such twists and turns on what can be a daily, hourly or even minute-by-minute basis. That being the case, we are better served by standing back and taking a more strategic view.

Even so, there is one thing that cannot currently be modelled upon historical precedent, and that is the reaction function of central banks. What we do know is that, after more than a decade of being unable to

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generate sustainable inflation close to their favoured 2% target, they would be willing to allow economies to "run hot" for a period so that average inflation will be dragged up to 2%. The US Federal Reserve formalised this approach last year under the banner of Flexible Average Inflation Targeting (FAIT - hence this week's title. It's not a typo!). The clear message was that inflation risk is asymmetric. Deflation is more to be feared than inflation for two reasons. First, it threatens far greater financial dislocation in a highly indebted world where those debts might never be repaid. Second, the more that deflation sets in, the harder it is to reverse.

Inflation, on the other hand, offers a means whereby wealth can be transferred from savers to borrowers in a relatively painless fashion – indeed, it is often described as being the "boiling frog" policy approach (even if the concept that a frog will allow itself to be gently boiled remains disputed, and we are certainly not going to test it!). Also, central bankers remain relatively confident that they have the tools to restrain inflation if required, although what they are really referring to is the blunt instrument of higher interest rates.

Now things get more difficult. The Fed has not been altogether clear about just how hot it will allow the US economy to run, and for how long. Much of the emphasis appears to be on returning the economy to full employment, and within that the ambition to achieve a degree of levelling up within the labour market, thus helping to close the inequality gap. That's a laudable goal, but might have extreme financial market consequences. As Michael Hartnett, Bank of America's Chief Investment Strategist, put it in a conference call last week: "Will the Fed allow the S&P 500 to reach 5000 (+28% from current levels) to get unemployment under 3%?". That is not an impossible scenario if growth is allowed to rip while interest rates are pinned to the floor, but it would almost definitely set things up for a spectacular bust too.

Meanwhile bond markets continue to test the Fed's tolerance for higher bond yields. At what point, if any, will it step in and stop them rising further? It has alluded to "a tightening of financial conditions" as being a threat to the recovery that it might take into account. Goldman Sachs has provided the clearest estimate of what might constitute such a tightening that I have seen so far. The investment bank suggests that if its proprietary Financial Conditions Index (FCI) tightens back to levels previously seen last October this would force the Fed's hand. If it were purely a question of a rising 10-year bond yield, then it would require a punchy looking 3.37% yield, which looks a long way above the current level of 1.69%. But the FCI also includes equities (lower is tighter), short-term interest rates, the dollar exchange rate and credit spreads (for all of which higher is tighter). Therefore it will be some combination of all of these elements that the Fed will have to consider.

All of this uncertainty heralds the potential for markets to remain choppy in the weeks ahead. However, our underlying opinion, refreshed at last week's Global Investment Strategy Group meeting, remains that equity markets will continue to be underpinned by the recovery in growth that is supported by the combination of vaccinations (various delays and disputes notwithstanding) and generous fiscal policy. While the risk of a setback induced by higher bond yields cannot be dismissed, central banks have more cards to play and will do everything in their power not to allow the recovery to be derailed on account of financial markets. Should that policy approach create new excesses, we shall have to take account of them as they develop.

This commentary focuses once more on the actions of the US central bank because it is dollar interest rates and bond yields which have the greatest influence on global financial assets. However, the Bank of England's Monetary Policy Committee also met last week, and, of course, its decisions will have a greater direct bearing on our lives in the UK. Although it has no formal "FAIT" policy, there are strong echoes of the Fed's approach, with the MPC reiterating its position that it will not tighten policy until it is "achieving the 2% inflation target sustainably". There were no changes to interest rates or the asset

purchase programme, which will remain capped at £850bn, suggesting it will run out of firepower at the end of this year. The fact that there was no allusion to increasing capacity also suggests that the MPC is not overly concerned (yet) about the recent rise in Gilt yields, which, it is fair to say, has not been as violent as that experienced in the US.

As for the base rate, which is something I am regularly asked about, no sign of a shift here either, despite the fact that market expectations for the timing of a rise have been edging closer recently, to mid-2022. (Remember that it's not long ago that there was a lot of speculation that we would see a negative base rate in the UK this year.) Investec Bank's economics team does not envisage a rise until the fourth quarter of 2023. Capital Economics believes that the rate will be stuck at 0.1% until 2026! Not much solace for risk-averse savers, I'm afraid, but great news for those with mortgages linked to base rates.

As a Welsh rugby fan I am painfully aware following Saturday's events in Paris that nothing is to be taken for granted. At least when it comes to managing portfolios we are in a position to have some influence on the outcome rather than being nail-chewing observers!

**Last week's Economic Highlights**

FTSE 100 Weekly Winners

| | |
|---|---|
| Flutter Entertainment Plc | 6.9% |
| Entain PLC | 6.1% |
| BT Group plc | 5.9% |
| Avast Plc | 5.8% |
| British American Tobacco p.l.c. | 5.6% |
| DCC Plc | 4.6% |
| Rentokil Initial plc | 4.4% |

FTSE 100 Weekly Losers

| | |
|---|---|
| M&G Plc | -11.3% |
| Compass Group PLC | -7.1% |
| Anglo American plc | -7.1% |
| Just Eat Takeaway.com N.V. | -6.3% |
| Royal Dutch Shell Plc Class B | -6.2% |
| CRH Plc | -6.1% |
| Johnson Matthey Plc | -5.7% |

FTSE 100 Index, Past 12 months

Source: Factset

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