Investec

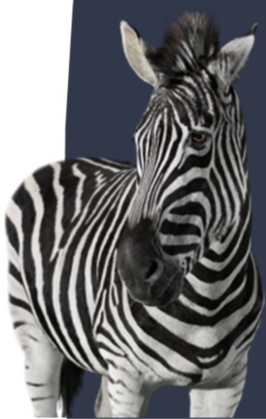
OUT OF THE ORDINARY

WEEKLY DIGEST | 22 November 2022

A Confusing Climate

John Wyn-Evans
Head of Investment Strategy

I have written quite a lot this year about the need to examine current circumstances when applying historical precedent to expectations. Until yesterday, no team hosting the FIFA World Cup finals had ever lost the opening game. The misfortune of being the first to achieve that dubious honour fell to Qatar, in what was also their debut match in the competition. At least their second game later this week against Senegal offers a chance of redemption.



Financial market participants seem to be equally confused about the investment climate at the moment, with expectations shifting from the potential for a blast of warm air from looser (or, at least, less tight) monetary policy one week to concerns about a cold front of weaker economic growth and corporate earnings the next. Our feeling is that this state of affairs could continue for some months as bulls and bears fight over territory. Why is this?

There remains a degree of tension in markets. On the one hand, the bull camp thinks it has seen the peak of US inflation and is calling for the Federal Reserve to relax policy (the famed "Fed pivot"). This will enhance the valuation case for risk assets, and, on the basis of precedent, signal the potential for a new bull market to develop. Meanwhile the bear camp continues to wait for the lagged effects of policy tightening to become evident in economic data and corporate earnings.

Perhaps one reason why people are struggling to get their heads around the latter scenario is that we have not experienced such conditions for a long time, conditions in which central banks are deliberately engineering a slowdown. The bear markets of 2020 and 2008/09 were the result of deflationary shocks. The current slowdown is the result of deliberate policy decisions to slow the economy, something not fully experienced since the late 1980s/early 1990s.

The strongest messaging last week came from the Fed, with several speakers pushing back on the pivot narrative and, indeed, suggesting that a peak Fed Funds rate of more than 5% will be required to tame inflation on a durable basis. We might find more colour in the minutes of the last Federal Open Market Committee (FOMC) meeting which will be published on Wednesday.

Whether they will be cause for Thanksgiving remains to be seen. It's worth looking back to the Dot Plot (of FOMC members' interest rate projections) that was published at that meeting on 21 September, which already feels like a market cycle ago. It was notable for three reasons, in my opinion. First was the big uplift in rate expectations since the June meeting, with the median dot rising from 3.40% to 4.40% for end-2022 and from 3.75% to 4.6% for end 2023 – the "higher for longer" approach.

Second was the greater consensus around members' projections, suggesting a firm hand from the Chairman to present a united front with a strong message. Hawkish rhetoric is credited with keeping longer term inflation expectations from becoming unanchored, and members seem to be sticking to their guns in current pronouncements. Even talk of a slower pace of increases is being tempered with the idea that there might be more of them.

The final feature of the dot plot is the complete lack of consensus for 2024, with the range of projections running from a low of 2.6% to a high of 4.6%, with a maximum of four members out of 19 alighting on any single point on the curve. That possibly illustrates the true range of members' opinions rather better, even if they remain in reasonable agreement that the longer-term neutral rate is still around 2.5%.

Futures curves suggest that the Fed will reverse gears during the summer or early autumn of next year, and it will be very interesting to see how it reacts either to a sharp weakening of growth if it occurs or to some sort of financial accident. But in the absence of either of those being imminent, we should expect rates to continue to ratchet higher for the next three or four meetings. That suggests that markets will remain choppy for the next few months.

Last week's market reaction to the UK Autumn Statement was covered in a special edition of the Weekly Digest that was published on Thursday along with commentary from our Financial Planning team. Suffice to say, it was reassuringly unexciting. However, it did rather torpedo one of my beliefs about how governments will choose to reduce debt burdens.

My list of four was as follows: Default (which is improbable for a developed country which largely issues debt in its own currency); Productive Growth (which is the optimal route, but more wishful thinking than likely); Financial Repression (which was my highest probability outcome); and, finally, Austerity (which I had thought was less probable following the voter backlash to the post-Financial Crisis experience and greater support for more populist policies). But I didn't fully reckon with the power of the Bond Vigilantes, and the populist approach has been rebuffed, for now, at least, in the UK.

Which leads us back to austerity with an element of financial repression. The latter comes now in the disguised form of stealth real tax increases by way of not indexing a range of allowances and tax thresholds in line with inflation. Financial historian and commentator Russell Napier describes Financial Repression as "stealing money from old people slowly". Maybe in this form you can add young people to those having their pockets picked. And if the pre-pandemic decade is any guide, the return to austerity suggests that growth will remain lacklustre, although this time possibly accompanied by higher average inflation levels.

Finally, COP27 came to a close on Sunday with little to report by way of progress from COP26. The headline agreement to set up a fund to pay reparations to countries vulnerable to climate change is laudable in its intent, but the substance, in terms of who pays how much, for what and to whom, is already being kicked down the road to COP28, which, ironically, is being hosted by Saudi Arabia and the United Arab Emirates.

We remain concerned that the aspiration to limit average temperature increases to 1.5 degrees above the pre-industrial base line is in danger of not being met. If, as we believe, effects on the climate are non-linear, then any incremental increases in temperature threaten even greater volatility in the weather and consequent disruption in the supply of commodities, to mention just one negative outcome. That adds to the risk of greater inflation volatility, which will make life harder for consumers, governments, central banks and investors alike...

Economic Commentary

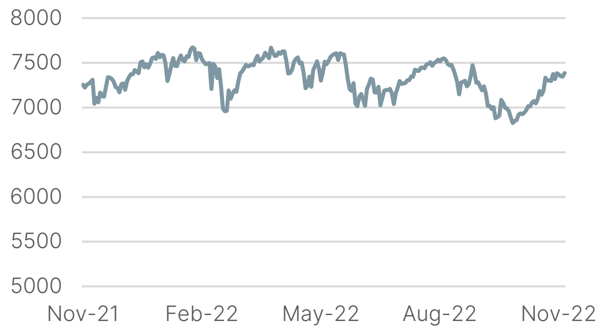
FTSE 100 weekly winners

BAE Systems plc	7.9%
Informa Plc	7.1%
Imperial Brands PLC	6.4%
Sage Group plc	5.8%
Phoenix Group Holdings plc	5.1%
Legal & General Group Plc	4.9%
M&G	4.9%

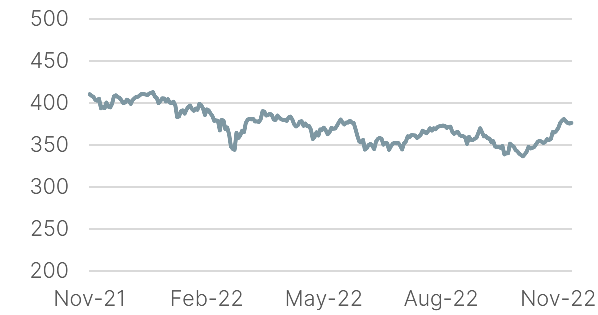
FTSE 100 weekly losers

Ocado Group PLC	-16.5%
Hargreaves Lansdown plc	-10.4%
Just Eat Takeaway.com N.V.	-8.7%
Antofagasta plc	-7.5%
Johnson Matthey Plc	-7.1%
Intermediate Capital Group plc	-6.1%
Vodafone Group Plc	-6.1%

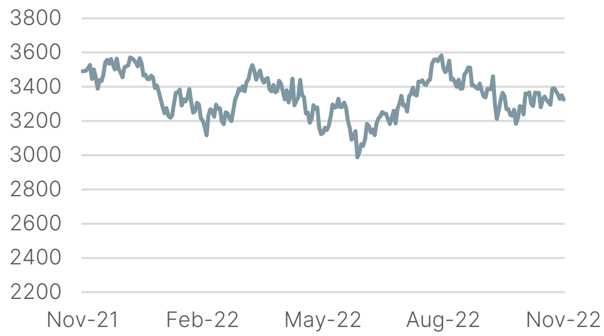
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

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.