Investec

OUT OF THE ORDINARY

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Alternative perceptions of reality

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On Sunday I went to the Emirates Stadium in London to watch the final game of the Premier League season there between Arsenal and Everton. Long-time readers will know that I am an equally long-suffering Evertonian. While the result (5-1 to Arsenal) was never really in doubt, I still found it fascinating that opposing groups of supporters can be watching exactly the same events unfold before them but experiencing quite different perceptions of reality and emotions.

A foul is viewed by one group as a heinous crime deserving of greater punishment, by the other as a robust challenge for the ball. Penalty decisions, especially those ruled upon by the Video Assistant Referee, are particularly contentious. The reception given to an ex-Tottenham Hotspur player by the Arsenal fans (Spurs are Arsenal's deadly North-London rivals) was, to put it politely, somewhat hostile, while Everton's travelling supporters cheered him to the rafters.

Such bias is only to be expected in such partisan situations. We hope the referee can interpret the rules in such a way that a fair outcome is reached, although there are often situations when matches are decided on a controversial decision. Financial markets have no such referee. Bias and emotion can have a huge influence on short-term opinions and performance, although we believe that in the long-term the companies with the best financial performance deliver the best returns.

Looking beyond emotion

It is in such companies that we place our greatest faith. These are companies with sound balance sheets, skilled managers and strong market positions. Even more importantly, they tend to be companies with high returns on capital and the ability to reinvest at least a good portion of those returns into the business in pursuit of further growth. These are the "growth compounders" that form the core of our equity portfolios.

However, as captured by the sport-related aphorism that "form is temporary, class is permanent", there will always be times when the best long-term investments (at least in our opinion) don't thrive in the short term. We are going through one of those periods at the moment. While we never over-exposed ourselves to companies that make no profits today and which only have a limited prospect of turning a profit soon, our preference was still for companies which could be described as "long duration" assets – that is those whose net present value is largely a function of the profits they will generate in the future.

But these are not pie-in-the-sky profits that rely on the adoption of some new technology or the winning of a huge market share. These are profits generally expected to accumulate from the extension of existing trends. And yes, there is a risk that the future of these businesses will not look like the past, and we are always on the look-out for challenges, but the academic research shows that high excess returns on capital tend to be persistent. There is a virtuous circle of growth and reinvestment. By the same token, poor returns also tend to be persistent.

Net present value calculations are hugely affected by the discount rate (or cost of capital) used. This, in turn, is influenced mainly by bond yields and the equity risk premium (or the extra return that investors demand for holding riskier assets). The key global discount rate is the yield on the US ten-year Treasury bond, and that his risen from 1.51% to 2.82% just this year. The UK's Gilt equivalent has risen from 0.97% to 1.91%. Germany's ten-year Bund yield, which provided an extraordinary heavy anchor for global yields by being persistently below zero, has risen from -0.18% to +0.97%. This has strengthened a valuation headwind that has been pretty much impossible to overcome.

While the first few months of the year could have been described as encompassing mainly a “rates shock”, this has more recently evolved into more of a “growth shock”. Citigroup’s US Economic Surprise Index (ESI), which just a month ago hit a level of 70 (which, outside the extraordinary post-Covid recovery period, would be considered to be close to the top of the normal range) is now at -15. As you might imagine, China’s ESI looks equally horrible. And although the global measure remains in positive territory, it shows a sharp deceleration. We have also seen a renewed flattening of the US yield curve (a traditional warning of an impending slowdown), although it remains in positive territory.

Another concerning indicator is the US High Yield (HY) Credit spread (the extra yield demanded above that on Treasury bonds to compensate for the higher risk), which ended last week at a new high for this cycle, finally blasting through the peaks of the growth scare in the fourth quarter of 2018. In one respect, this is even more concerning, because one of the largest components of HY, namely Energy, is currently in very rude health. This time it is sectors such as retail and more immature disruptive technology that are doing the damage.

Equity market activity

From an equity market perspective, the really big hits to sentiment were delivered last week by some old-school companies in the US. Retail giant Walmart’s shares fell almost 20% as it witnessed some pressure on demand and also struggled to pass on higher costs, and shares in another general merchandiser, Target, dropped almost 30% in a similar vein. Tech giant Cisco was 13% lower over the week, although the blame for its disappointment was ascribed more to supply chain disruption. All this left Consumer Staples (of which Walmart is a major constituent) as the worst performing sector of the week in the US, down 8.6%, closely followed by Consumer Discretionary (-7.4%).

Accompanying this move to worrying about growth has been a distinct shift in the relationship between equities and bonds. During the “rates shock” period, which was driven by increasing inflation concerns and the prospect of sharply rising interest rates, equities and bonds sold off together, much as we had been worried they might. For now, at least, they are moving in different directions again. As equities have fallen further, bonds have rallied, with the US ten-year yield falling from a recent closing peak of 3.12% to a current 2.81%. On the worst day for equities last week, when the S&P 500 fell by 4%, a US 20-year+ bond ETF rose 2%, a massive 6% relative price swing in favour of Treasuries.

Maybe reports of the death of the 60/40 Equity/Bond portfolio have been exaggerated. An ETF that mimics a risk-parity portfolio* in the US has actually risen 2% from its trough on 9 May, although it is still down almost 17% year-to-date. Much will depend on where inflation settles in the longer term and also on how volatile it remains. The good news for now is that inflation expectations, as measured by breakeven rates, have come off the top.

Views on inflation

However, there is still a very wide range of views about inflation and pinning one’s hopes at the extremes would be a risky all-or-nothing strategy. I listened to two podcasts at the weekend illustrating this divergence. Remember, that like the football fans referenced earlier, these are views from two market participants evaluating exactly the same data.

At one extreme, the renowned economist and strategist David Rosenberg (on Real Vision) remains of the opinion that we will be staring deflation in the face in 12 months' time as Covid-related excess demand and supply chain disruptions are normalised. He is a buyer of longer duration bonds, but hedging with gold in case he is wrong. On the other hand, Barry Norris of Argonaut Capital (interviewed on the MoneyWeek podcast) is all in on secular inflation and heavily invested in commodities. Somewhere between these extremes we have to stitch together a portfolio that is resilient to the worst outcomes but that can still participate in the rosier scenarios.

One suspects the outcome will not be clear for a while yet and so more volatility is to be expected. Certainly, much depends on how far and how fast inflation declines and on how aggressive the central banks choose to be. There is no sign that the US Federal Reserve is contemplating backing off any time soon, with a tightening of financial conditions and therefore a hit to wealth rather than to employment being its key strategy to bring inflation under control. The Bank of England might blink sooner, but with inflation not expected to peak until later in the year it would risk destroying its own credibility.

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*At its simplest level, a risk parity fund is one that balances its risk between equites and bonds, but also utilises leverage dependent upon the level of volatility. Such funds have produced exceptional risk-adjusted returns during the two-decade-long period of negative correlation between equity and bond prices but have really struggled since the correlation turned positive earlier this year.

Economic Commentary

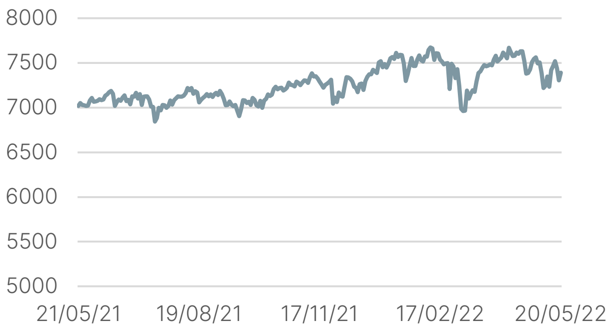
FTSE 100 weekly winners

Fresnillo PLC	8.4%
Glencore plc	7.8%
Anglo American plc	6.6%
Antofagasta plc	5.5%
Imperial Brands PLC	4.9%
Prudential plc	4.8%
British Land Company PLC	3.5%

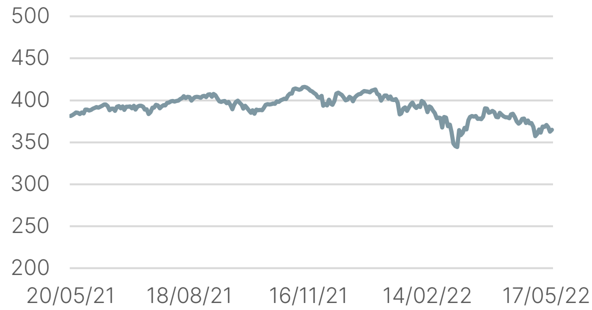
FTSE 100 weekly losers

B&M European Value Retail SA	-9.6%
Scottish Mortgage Investment Trust Plc	-8.5%
JD Sports Fashion Plc	-7.6%
Tesco PLC	-7.4%
Spirax-Sarco Engineering PLC	-7.1%
Ocado Group PLC	-6.9%
3i Group plc	-6.8%

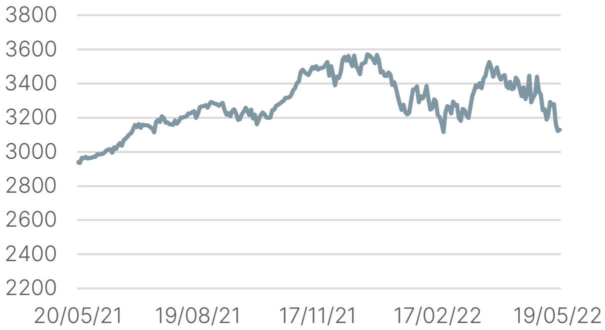
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



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