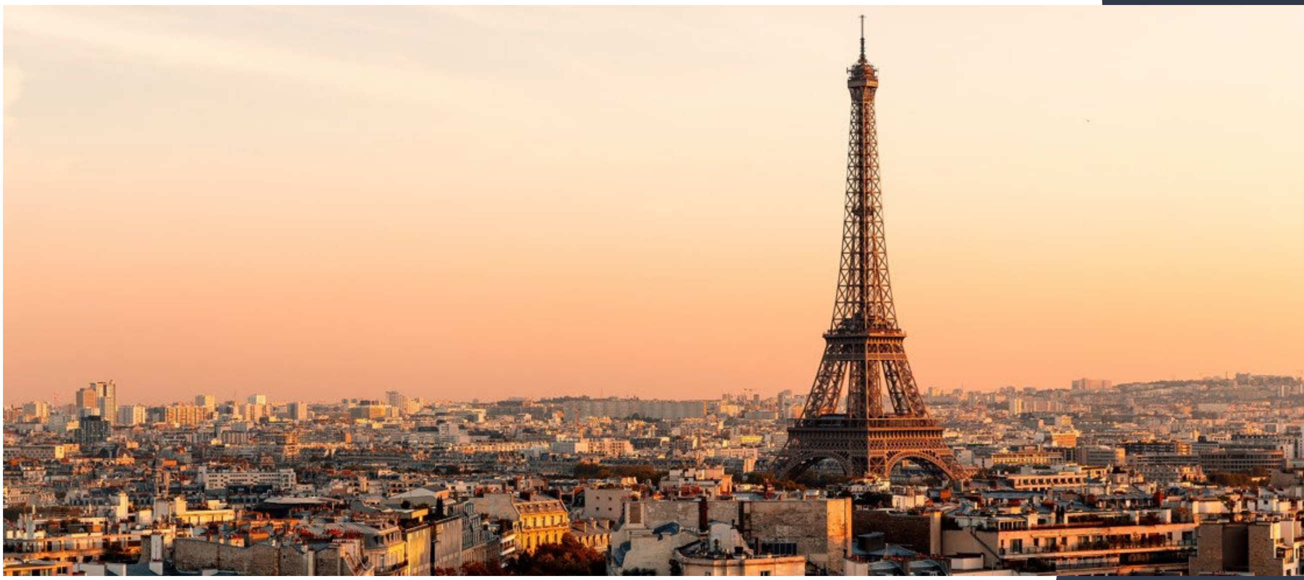
OUT OF THE ORDINARY

WEEKLY DIGEST | 25 April 2022

Liberté, Fraternité, Égalité… Normalité?



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The last Weekly Digest before the Easter break focused on the French Presidential election and the risk to markets from a possible victory for the far-right candidate Marine Le Pen. Investors will have been relieved - although probably not greatly surprised, given the polls and betting odds – that M Macron prevailed yesterday, and by quite a decent margin in the end. Thus, we can return to some state of normality when assessing market influences from the Continent.

Unfortunately, what counts for "normal" just now is hardly cause for celebration. Maybe that's why an initial rally for the euro was quickly reversed, and France's equity indices participated in the widespread falls that greeted us on Monday morning. We'll discuss more general market influences in a moment, but when it comes to France itself there is a lingering sense that Macron's victory could be a stay of execution rather than a full pardon. The more extreme candidates of the right and left, along with other non-traditional challengers, accounted for around half of the votes in the first round of polling. Other candidates from the "establishment centre" sank almost without trace.

Unless Macron follows the playbook of Presidents such as Xi, Putin, Erdogan and Orban by inflicting himself on the electorate in perpetuity by (allegedly!) nefarious means (which, I hope we can safely say, is not going to happen), then he will stand down in 2027, leaving a gaping void into which more populist contenders will rush. Who knows where we will be in five years' time? After all, think of all the action that we have packed into the last five years. But Macron is going to have to reverse a strong trend of increasing disenchantment with establishment government to prevent a possible upset and it's not clear that he will have the economic or geopolitical tailwinds required to assist him. Bonne Chance, M le Président. Oh, yes, and he still won't be fifty years old when he "retires"!

There are a few things getting up the market's nose at the moment, and we remain somewhat wary in the short term. Last week, indeed, there was absolutely nowhere for investors to hide in the mainstream asset classes, with government bonds, equities, corporate credit and commodities in aggregate all falling back. Cash was king, although there remains a distinct reluctance to hold much of it while short-term interest rates remain so far below current inflation. Evidence for that could be seen, perhaps, in the persistent inflows into equity funds so far this year, although that has finally ground to a halt.

We identified two major concerns for the second quarter and have been waiting for them to play out. The first is the ongoing tightening of monetary conditions being executed by central banks. The second is the risk to corporate profits from rising costs. Central banks have, somewhat belatedly, recognised the threat of inflation expectations becoming embedded at higher levels and are now scrambling to catch up from being "behind the curve". The market has anticipated much of the tightening in futures markets and the repricing of bonds (where yields have risen sharply), but reality has not yet bitten much in the real world. It's a bit like knowing your gas and electricity bills are about to go up a lot, but nothing really prepares you for the reality of the money leaving your account (just when your monthly pay has gone down thanks to higher National Insurance contributions).

There was a brief moment of optimism in the United States when the last Consumer Price Index was printed, with many economists suggesting that it would constitute the peak. And given all I have written about "rates of change" and the "second derivative of change" in the past, I can see why this was identified as light at the end of the tunnel. But it is increasingly clear that inflation is not going to fall swiftly back to the Federal Reserve's 2% target and the Fed will probably have to continue to find a way to tighten financial conditions even more to achieve that goal. That brings with it the risk of weaker economic growth, a possible recession, weaker profits growth and greater market volatility. And nobody is quite sure just how much market pain the Fed is willing to bear before it steps in and deploys the "Fed put", by which it will signal a policy reversal and lend renewed support to financial assets.

We know that interest rates and bond yields are crucial components of the valuation of equities, with higher rates tending to lead to lower multiples of earnings, and so that's one source of downward pressure on equities identified. But what about the earnings themselves? The prevailing opinion about this year back in January was that the valuation de-rating effect of rising rates would be broadly countered by earnings growth of mid-to-high single digits, leaving markets to make limited gains, but gains nonetheless. Since then, we have seen rate expectations push higher, cost inflation exacerbated by the war in Ukraine and, most recently, the ever-expanding lockdowns in China putting more stress on global supply chains. This makes for an unusually uncertain results season, the meat of which we will tuck into this week.

We don't expect the first quarter earnings, in aggregate, to have been too bad, although rates of growth will have decelerated from the heady levels of the post-pandemic recovery, especially if one looks at quarter-on-quarter numbers as opposed to year-on year. The key details will be in references to current trading and in the outlook statements, especially with regard to cost increases, wage trends and the ability to pass these on to customers. And the irony of any ease in passing on cost increases will be captured in the risk of inflation being more elevated and persistent.

In the UK, US and Europe, there are more than four hundred large companies reporting this week, and so we should have a much clearer picture in just a few days' time. The US probably holds the fate of global markets in its hands, and there we have around a third of the constituents of the S&P 500 Index reporting, although close to a half when measured by market capitalisation. That's because the big guns such as Alphabet (parent of Google), Amazon, Apple, Meta (formerly Facebook) and Microsoft all report this week.

Investors have clung on to the shorthand acronym of FAANG (or FAANG+ to include Microsoft) despite divergent performance of late between the members of the group. Can Netflix continue to enjoy such lofty company following last week's disaster when it reduced its subscriber estimates and executed various strategy U-turns, which saw the shares lose more than a third of their value, taking the year-to-date losses close to two-thirds? Suffice to say that we have never been influenced by these faddish groupings and continue to prefer to invest in companies based on their individual merits.

I am not going to (and am not allowed to) opine on the investment merits of Netflix, but its results did leave us to ponder a number of questions and to debate whether this was an early warning "canary in the coalmine" for the rest of the results season, or a more idiosyncratic event. Was this a sign of consumers retrenching in the face of falling real incomes? Was it more to do with streaming fatigue in a world where we are spending less enforced time at home (unless you're Chinese)? What about the competition between streaming services, leading to an ever-expanding number of monthly subscriptions? How often these days do you find yourself apologetically asking someone if they subscribe to XYZ service before recommending a film or series? It was possibly an unpleasant cocktail of all of the above. (And if you can find a way to watch it on Apple TV or in the cinema, I could not recommend highly enough the film CODA). All will, I hope, become clearer in the days ahead.

Economic Commentary

FTSE 100 weekly winners

Smith & Nephew PLC	8.2%
Smurfit Kappa Group Plc	7.8%
Royal Mail plc	7.3%
CRH Plc	6.6%
International Consolidated Airlines Group SA	6.4%
Weir Group PLC	6.4%
Ferguson Plc	6.4%

FTSE 100 weekly losers

Anglo American plc	-16.6%
Just Eat Takeaway.com N.V.	-11.7%
Antofagasta plc	-10.4%
Glencore plc	-10.2%
Ocado Group PLC	-9.7%
Rio Tinto plc	-8.4%
Fresnillo 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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