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OUT OF THE ORDINARY

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Timeless Truths

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Last week was notable, perhaps, for the fact that 'nothing happened', at least when viewed in a broad market index context from 30,000 feet. Weekly changes for most equity and bond markets could be measured in basis points. There was little factor spread between, for example, Growth and Value indices. In the US, a slight defensive bias was betrayed by Consumer Staples (+1.7%) being the best-performing sector, while Communications Services (-3.1%) and Energy (-2.5%) lagged. The anti-cyclical theme was reflected in the UK, with the

bottom four companies in the FTSE 100 all being Miners (Rio Tinto, Antofagasta, Anglo American and Fresnillo).

What is shaping investor behavior?

The very simple narrative remains that the majority of investors are expecting a US recession, but that it is so well telegraphed that it will come as no surprise when it arrives. We continue to believe that investors are being too relaxed about the outcome and how it will affect markets, with the famous 'long and variable lags' of monetary policy yet to make themselves fully felt. We also maintain our belief that analysts are underestimating the negative operational leverage associated with the margin compression that will come from a combination of weaker revenue growth and sticky costs. Even so, there remains plenty of short-term fear of missing out (FOMO), and we cannot rule out further upside in equity markets.

The main price conflict that needs to be resolved is the difference between what the bond, equity and rates markets are saying. US equities are trading at around 19x 2023 earnings, which has historically been the stuff of cyclical peaks. On the other hand, bond yields, despite a recent bounce, have come well off their highs of 2022 and are signalling a potential recession. The same goes for interest rate futures markets and yield curves. The problem is that if growth remains strong, it is probable that yields and rate expectations will reprice higher, exerting a downward influence on risk asset valuations. If the economy weakens, then there is probably at least a 10% downgrade to earnings expectations required. We could be stuck in this twilight zone for a while yet.

What trends might we see?

And yet... lurking in the back of my mind is the ninth of the ten rules of investing set out by legendary Wall Street trader Bob Farrell: "When all the experts and forecasts agree – something else is going to happen". Well, maybe not everyone agrees about the recession call, but it is a broadly held view. In my own engagements last week (to add to all those from the previous week), pretty much the same message emanated from BCA (twice), Jefferies, Fidelity, Morgan Stanley, Deutsche Bank, JP Morgan and Citigroup.

But one could also recruit some of Mr Farrell's other rules to cement the bear case – a bit like an astrologer, he seems to have found a way always to appear correct in hindsight. Thus, Rule 8: "Bear markets have three stages – sharp down, reflexive rebound and a drawn-out fundamental downtrend". Could we be in that 'reflexive rebound' phase now?

What about Rule 7: "Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names". That is precisely the story of the S&P 500 so far this year, with almost all the positive returns generated by just seven stocks (Apple, Microsoft, Meta, Amazon, Alphabet, Nvidia and Tesla). There's a five-point performance gap between the market cap-weighted and equal weighted versions of the index.

And then there is Rule 6: "Fear and greed are stronger than long-term resolve". Back to FOMO again.

For those of you unfamiliar with the rules, they are worth a look and at least to bear in mind as part of one's investing road map. The other ones are:
Rule 1: "Markets tend to revert to the mean over time".

Rule 2: "Excesses in one direction will lead to an opposite excess in the other direction". This resonates with Howard Mark's theory of the market and sentiment "pendulum" which I have written about in the past.

Rule 3: "There are no new eras – excesses are never permanent". Worth bearing in mind as we head into the Artificial Intelligence hype cycle.

Rule 4: Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.

Rule 5: "The public buys the most at the top and the least at the bottom". We are certainly beginning to see lower market volumes overall, but no real sense that retail investors have abandoned the "buy the dip" mentality. Bear markets tend to die of neglect.

Perhaps the only one we could all agree on is Rule 10, which states that "Bull markets are more fun that bear markets."

Are there any developments on the US debt ceiling and its impact?

Last week we discussed the US debt ceiling and the worry that the US government will run out of funds before Congress can reach an agreement on raising the ceiling. Developments on this front last week were not especially helpful. The US Treasury General Account (effectively the government's current account at the Federal Reserve) benefitted enormously from an expected influx of tax receipts, with the coffers expanding from $88bn to $265bn, which is an increase of $177bn. But is that enough? Tax receipts are running around 35% lower than in 2022, mainly owing to much-reduced capital gains liabilities. The data runs through to 20 April, which tends to capture the three biggest payment days at the start of the process and just over half of all payments expected. This increases the probability of an earlier 'X-date', the day on which the US government runs out of funds, but the base case for most economists still seems to be in late July or early August, with the wide range running from the beginning of June to the end of September, depending upon delayed tax receipts and the ability to rely on 'extraordinary measures'.

We also discussed Credit Default Swaps last week, the means by which investors can insure against default (or, equally probably, speculate on such an event). The five-year US Sovereign CDS spread jumped from 40bps to 54bps. We have not seen such levels since 2011, which was the period of the last big Congressional ding-dong over the debt ceiling. There was a downgrading of the country's credit rating at that time too. The spread has only been substantially higher than this during the financial crisis in early 2009 when it briefly touched exactly 100bps. (Bloomberg data only goes back to late 2007, and these instruments were not really a feature of the market during the 1996 budget crisis)

The one-year spread is even more elevated, hitting 129bps, up from 92bps a week earlier and a fairly normal 16bps at the start of the year. The spread had never been higher than 80bps before March this year.

What could this mean?

By no means is any of this saying that a default is inevitable. Indeed, markets only tend to start to panic when the spread goes over 1000bps. Even so, it's a sign of potential stress to come, and there is plenty of debate about the Republican Party's motives in the negotiations. Are they to keep the country's best interests at heart or to create as much chaos as they can while trying to discredit the Biden administration ahead of next year's Presidential election?

Much as US politics has become an increasingly unedifying spectacle, we cannot afford to ignore it. For now, a potential US default goes into the box marked for events that screen as 'low probability/high impact'. These tend to be the sort of tail risks against which it is difficult for mainstream investors to insure, not least owing to the cost of paying insurance premiums which have a habit of putting a big dent into relative performance if the event does not happen. But it does have an impact on our overall appetite for portfolio risk, which remains subdued.

Economic Commentary

FTSE 100 weekly winners

Company	Change
Polymetal International Plc	9.3%
Melrose Industries PLC	9.0%
International Distributions Services plc	8.3%
Entain PLC	8.2%
Flutter Entertainment Plc	6.9%
Smith & Nephew plc	5.6%
Ferguson Plc	5.5%

FTSE 100 weekly losers

Company	Change
Rio Tinto plc	-6.1%
Antofagasta plc	-5.8%
Anglo American plc	-4.6%
BHP Group Ltd	-4.6%
Fresnillo PLC	-3.2%
Barclays PLC	-2.9%
Scottish Mortgage Investment Trust Plc	-2.9%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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