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OUT OF THE ORDINARY

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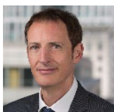
# The Quest for Wisdom



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I have in my PowerPoint archives a presentation entitled 'An Introduction to Investment Strategy', which I have given in the past to newly arrived graduates. One of the slides sets out the Journey to Wisdom, a journey which begins with data and passes through information and knowledge. Today, we have more data available to us than any humans who have ever existed, and yet it doesn't seem to prevent us from making poor decisions. Neither, sadly, does it seem to have led to sustainably better returns from financial assets than those enjoyed by our forebears.

Readers will recall that I have questioned the approach of using big data sets to inform investment decisions, at least without setting that data into the current context. There have been two prime examples this year. The first was when Russia invaded Ukraine. There was a plethora of studies showing that "on average" it would benefit investors to buy equities on the outbreak of war (or, more widely, at the occurrence of a major adverse geopolitical event). While such studies did help to calm nerves and possibly contribute to the initial rally, we can see today that markets are lower. The MSCI All-Countries World Index is 9.4% down from the close on invasion day (24 February), 5.8% down from the initial trough in early March, and 14.7% down from the peak of the late-March rally. As a reminder, one of the studies that I referred to at the time suggested that the average return on a six-month view for the S&P 500 Index was a positive 5.5%; another (using slightly different events) offered 2.5%. I guess I can't deliver the final verdict for another month, but the S&P 500 is currently down 7.6% since 24 February.

The second was when the US yield curve inverted. This is when the yield on ten-year Treasuries falls below that available on two-year bonds. It is a signal that bond investors smell an imminent downturn in economic activity which will eventually force the central bank to start cutting interest rates. The long-term record shows that equities continue to rise for around nine months, on average, after the inversion begins. The US yield curve (which is the most-closely followed) inverted initially on April Fool's Day. Maybe it was a spoof, because it rallied back into positive territory almost immediately before inverting again on July 5 and staying inverted. The S&P 500 Index is down 12.8% since the beginning of April, but up 3.4% since July 5. Take your pick.

### How to apply context to investment decision-making

With context, I believe, you can start to turn information into knowledge. There were various elements of context missing from the afore-mentioned studies: for example, the supply chain disruption associated with a curtailment of commodity exports from both Ukraine and Russia. This is still playing out, not least in the provision of natural gas to Europe via the Nord Stream pipeline from Russia. This is evident right now in wholesale gas prices. German buyers are paying 70% more than they were at the start of the year and an incredible 12 times the amount that prevailed at the beginning of 2020 (which tells you that something was afoot in gas supply markets even before Ukraine was invaded, much of which was to do with the imbalance of supply and demand in electricity generation from renewable sources). There is widespread talk of energy rationing and real concern that gas supplies will be very short come the winter heating season.

At least some of the fate of natural gas prices lies in the hands of Russia's President Vladimir Putin. There is a fierce debate in geopolitical circles about how aggressive he might be in holding Europe hostage to Russia's gas supply. One theory is that by depriving Europe of energy he can drive a wedge into the current anti-Russia consensus and reach agreement to consolidate his territorial gains in eastern Ukraine. I don't pretend to have any special insight into this, and the lack of consensus amongst the experts suggests we should be wary about taking either side of the bet in terms of investment allocations.

The other big piece of missing context was interest rates. To my mind, no analysis of past events is vaguely meaningful without reference to the prevailing monetary policy environment. The provision of ample liquidity can paper over a lot of big cracks. However, we are currently in a liquidity tightening cycle, and one thing I have learnt (sometimes the hard way) over the years is to respect that fact. As I have repeated previously on several past occasions, I believe that equity market cycles are, at their most basic level, driven by the confluence of liquidity and growth. Rising liquidity and improving earnings expectations is the quadrant that provides the most favourable environment while shrinking liquidity and deteriorating earnings is predictably unpleasant. When the two forces are opposed, markets tend to be choppier and stuck in narrower trading ranges.

As I wrote last week, markets are struggling to work out exactly where these forces are right now. Although interest rates have only just started to rise in two of the largest economies (in March in the US and only last week in Europe), markets are already trying to price in when they will start to be cut again in response to slowing activity and the threat of recession. Futures markets currently suggest as soon as next February in the US, next June in Europe and next March in the UK. There again, 12 months ago the same markets were saying that rates would be unchanged today from a year ago.

As for earnings, it remains our opinion that they are vulnerable to a margin squeeze, but that this might not become immediately evident in the second quarter numbers. The current reporting season is in its infancy, with about a fifth of S&P 500 Index constituents having released earnings and fewer of their counterparts in Europe. So far, the average US “beat” amounts to 4.7%, which is about in line with the pre-Covid experience (and so not really a beat at all). In Europe and the UK (STOXX 600 Index), earnings so far have missed expectations by 3%. Let’s see how things evolve over the next two week as the bulk of constituents report.

There are a host of other contextual factors that could and should be taken into account, ranging from inflation to valuations, from market sentiment and positioning to aggregate levels of debt. All of these will make today’s circumstances different to the past, if only in subtle ways. And so, while I am happy to use historical context as a referential starting point, it cannot be the sole indicator of future performance.

Another subject that we continue to grapple with is sustainability, especially in the context of climate change. We are presented almost daily with data and information, often in the form of new records of the sort that we don’t really want, with temperatures in the UK being a case in point last week. The thematic team at Bank of America send out a weekly email which always contains a few thought-provoking “facts” (which I put in inverted commas because they arrive without acknowledgement of the source and could sometimes be more accurately described as “opinions”). Anyway, bearing in mind that caveat, one that caught my eye last week was the following: “In 1971 the probability of the UK hitting 40C was once every 1000 years... by 2090 the chances of hitting this temperature will be once every four years”. Sobering stuff, even if the chances of a 130-year-old me being around to witness it are slim (but I’m working to improve the odds!!).

There are all sorts of objections one can raise to this assertion, not least the efficacy of the normal distribution curve of probability. Surely, we have learnt enough in recent years about "fat tails" and non-linearity to mistrust any such "fact". But having said that, and given the cumulative evidence, one feels the underlying trend direction is correct. This will have all sorts of implications for long-term investment (let alone lifestyle choices and social politics), and we continue to build them into our process.

And so, there's a lot of data and information and a bit of knowledge packed into this week's piece. Where's the wisdom? The first definition of wisdom that pops up on Google reads as follows: "the quality of having experience, knowledge and good judgement; the quality of being wise." I would say that a key component of wisdom is acknowledging what you don't know and tailoring your actions accordingly. This could be either because you just don't know – I'm not going to undertake open heart surgery because I'm not trained to do it – or because there is insufficient information available to make a firm prediction. Yes, accumulated experience and judgement can be brought to bear, but, and certainly from an investment perspective, it calls for the right balance to be made between risk and expected reward. We would need a compelling valuation and information advantage to "bet the house" on a single outcome.

# Economic Commentary

## FTSE 100 weekly winners

| | |
|---|---|
| Just Eat Takeaway.com N.V. | 37.3% |
| Polymetal International Plc | 22.0% |
| Weir Group PLC | 10.6% |
| JD Sports Fashion Plc | 9.9% |
| M&G Plc | 9.7% |
| Ashtead Group plc | 9.3% |
| Standard Life Aberdeen | 9.3% |

## FTSE 100 weekly losers

| | |
|---|---|
| Admiral Group plc | -7.8% |
| Avast Plc | -5.3% |
| DS Smith Plc | -4.6% |
| AstraZeneca PLC | -3.1% |
| Reckitt Benckiser Group plc | -2.4% |
| Mondi plc | -1.7% |
| BAE Systems plc | -1.6% |

## FTSE 100 index, past 12 months

## EuroStoxx 600 index, past 12 months

## S&P 500 index, past 12 months

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