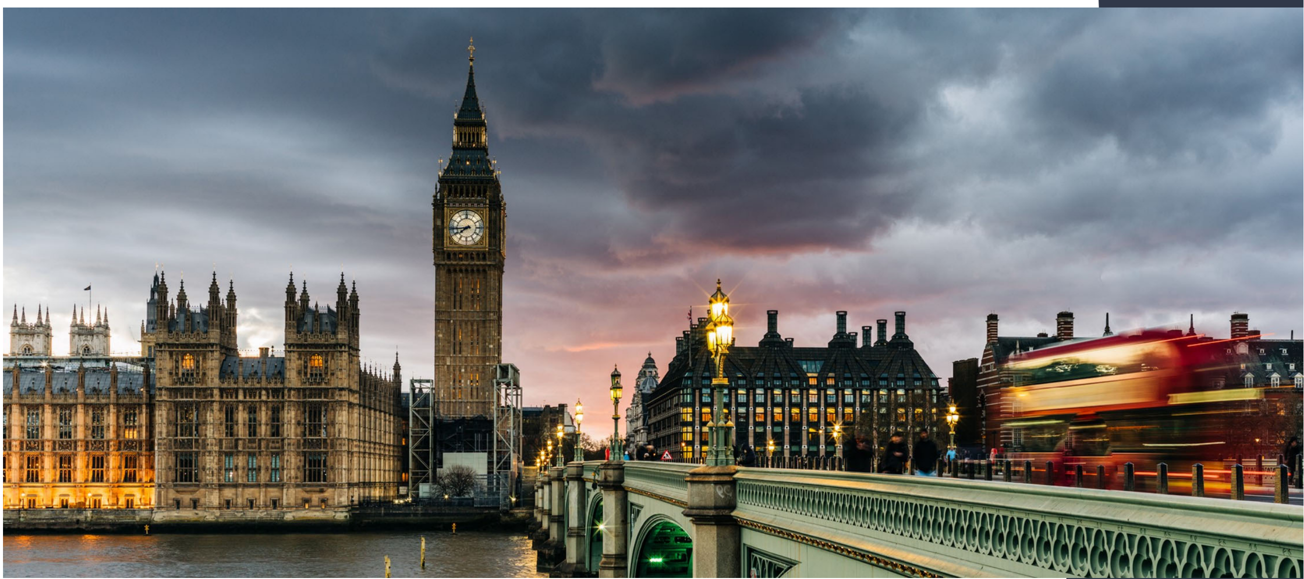
Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 27 September 2022

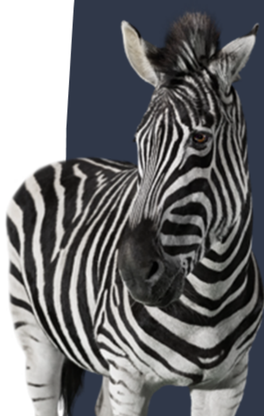
Pounded!



John Wyn-Evans

Head of investment strategy

Last week I made the point that I would be surprised to wake up one morning to find that the pound was ten per cent lower than when I went to bed. Well, that didn't happen, but, as I write, it is almost six per cent lower against the dollar than it was at the beginning of last week, and that is alarming. It is also 2.5% lower against the euro, having decisively broken down from the €1.15 to €1.20 range that had contained trading since early 2021.



Although much of the pound's weakness this year can be attributed to a strong dollar, the mood changed materially at the end of last week, leaving the pound weak against all currencies – even the Turkish lira, which is the victim of nonsensical monetary policy, with interest rates in Turkey being cut last week against the background of 80% inflation. Things must be bad. What triggered this?

We had two major policy events in the UK last week. The first was the Bank of England Monetary Policy Committee's (MPC) latest gathering, at which it delivered another 0.5% increase in the base rate to 2.25%. Although this was in line with expectations, it was still viewed as a bit half-hearted in the light of double-digit inflation, and also following the US Federal Reserve's (Fed) 0.75% increase the night before – not to mention a full 1% raise by Sweden's central bank on Tuesday. One has to look serious in this environment. And although three members did vote for a rise of 0.75%, the newest one, Swati Dhingra, opted for just 0.25%, introducing a new dovishness to proceedings.

Even so, the market managed to absorb this slight disappointment. However, it did introduce some rot into the floorboards ahead of Friday's mini-budget, setting up sterling for a nasty fall. And so, what was wrong with a policy statement that slashed taxes and claimed to set the economy on a path for 2.5% growth? Well, quite a lot, in the market's eyes.

First, £45bn of unfunded fiscal stimulus (which was never run past the Office of Budget Responsibility) puts more potential demand into an economy with an existing inflation problem. This puts the ball straight back into the Bank of England's court, because the Bank is trying to dampen inflation. Indeed, the market immediately pushed up the whole interest rate curve, with the two-year tenor rising an extraordinary 69bps on Friday alone as the market priced in more rate increases.

But there's more. Rising rates increase the government's funding costs, putting more pressure on finances and the need for yet more issuance (on top of what is needed to pay for the tax cuts). And if persistent tax-cut fueled demand leads either to more domestic inflation or to a further widening of the trade deficit, that just exacerbates the situation.

Hence the pressure on the pound, as economic historians reached for the Barber Boom playbook of 1971 and 1972. Back then there was a similar fiscal splurge, although it was initially accompanied by cuts in the base rate in the days when that lever was pulled by the Chancellor. It was only when inflation started to bite in 1972 that rates began to rise, from 5% to a peak of 13% in 1973. For now, the Bank of England remains independent. Indeed, we saw calls over the weekend, including from former MPC members, for an emergency rate rise of at least 1%.

Another somewhat different factor in the early 1970s was the deregulation of financial services and credit, with Money Supply growing 25% in 1972. That is unlikely to be replicated now. The Conservatives might have got away with it back then (although probably not) if the Arab oil embargo had not dumped further fuel on the inflationary flames in October 1973. To make matters worse, last Friday's mini-budget hit on the day when UK Consumer Confidence, as measured by GfK, hit its lowest point since 1974. Quite the multi-decade round trip concluded with immaculate timing.

Another parallel being drawn is with the “Reaganomics” boom of the 1980s, when President Reagan cut taxes aggressively in his first term of office. But he was blessed with a productivity boom that probably had little to do with his tax-cutting policies and more to do with the rise of global trade, the demise of union power and fuel efficiencies forced on the country by the oil crises of the previous decade.

I have to admit I did not expect the extent of fiscal loosening that was delivered on Friday. No doubt parity with the dollar will act as a magnet for traders, although there is no fundamental magic to the number. But it would not sit well with either the government or the current members of the MPC to preside over the moment when a pound was worth less in nominal terms than a dollar.

Better news is that the UK issues debt in its own currency and does not have huge liabilities in foreign currencies. Thus, expectations of an emerging market-style crisis are probably overdone. Valuation is of limited assistance in the short term, although long-term models suggest that the pound is cheap on a Purchasing Power Parity or Real Effective Exchange Rate basis. Even there though, it somewhat depends on whether you use consumer prices or input prices as the deflator – the valuation looks a lot less favourable on the second measure.

Investors continued to vote with their feet, with market movements reflecting a resounding disapproval of the latest policy developments. Current evidence suggests that the lady and the gentlemen at the centre of the debate are not for turning. Indeed, Mr Kwarteng stated at the weekend that he wanted to deliver more tax cuts, which might have exacerbated Monday’s early falls. But calmer heads have prevailed, and the pound has recovered from the worst. But be in no doubt that the fault lines in the country’s finances (as seen in historically enormous fiscal and trade deficits) have been exposed for all to see, and that a very clear message has been sent to Downing Street from the City.

What is happening in the USA?

In a different week, the meat of this commentary would have been about the Fed’s meeting last week. It, too, was market-moving, inflicting further losses on equities and bonds, mainly owing to the updated “Dot Plot” in which each member’s projections for future interest rate levels are revealed. The median dot in the Summary of Economic Projections now narrowly shows a funds rate midpoint of 4.375% at end-2022 and a midpoint of 4.625% at end-2023 (vs. 3.875% in June). This probably corresponds to a 75bp increase at the November meeting, another 50bps in December, and 25bps in January. The key point here is the end-2023 number, which is now around 80bps higher than it was in June and points to no reduction in rates until 2024. The committee’s view was close to consensus for the 2022 and 2023 projections.

There were cuts projected from 2024 onwards, but this is where the consensus breaks down. The lowest projection is 2.6% and highest 4.6%, with the median around 3.9%. That’s a huge range, reflective of great uncertainty. Crucially, nobody thinks that Fed Funds will return below what is currently deemed to be the Neutral Rate, which, in the longer-term projections remains anchored at close to 2.5%.

Effectively, then, we have moved from a situation a month ago where many investors were looking (or should I say hoping) for a Fed "pivot" as early as this autumn, to one where the Fed is unequivocally saying that there will not be one until 2024 (although a pause will come after the likely last increase in Q1 2023). One reason for such a long pause is that the Fed's economic projections still show remarkable resilience in the overall economy, and that is probably going to be the subject of greatest debate, with upcoming data analysed for signs of any flaws in that thesis. Having said that, there were downgrades to GDP growth forecasts, with higher unemployment also in the pipeline. But nothing that looks like an actual recession. Neither headline nor Core PCE Inflation gets back to the target of 2% until 2025 at the earliest in their crystal ball.

Given the Fed's track record, especially on forecasting inflation recently, it would not be unreasonable to take all this with a pinch of salt. However, the rhetoric from Chair Powell remained very clear and hawkish, and that is the key to keeping inflation expectations under control. But market pricing of future interest rates can't quite bring itself to catch up with the Fed's projections, and I have a sneaky feeling that the market will be right. The Fed might well be forced to pivot earlier in the face of a weaker economy and inflation that comes down faster than it currently believes. But that won't happen before a bit more china is broken in the markets.

What could the impact on investments be?

In this moment of stress, it's important to emphasise that there will be better times ahead. Economies and markets are cyclical, and the latter have already priced in quite a lot of change, even if we haven't yet reached the turning point. And even though some of our favoured companies have suffered painful deratings in the face of a rising discount rate, they are generally still in great financial health and accruing long-term value for shareholders.

On a final note of cheer, I was pointed last week towards an article that stated that many Fortune 500 companies were founded during recessions or times of stress. That included companies like Fortune Magazine itself, Walt Disney, Hewlett Packard, Charles Schwab (out of the wreckage of the bear market of 1974/5, interestingly), Costco, Revlon, GM, Procter & Gamble, United Airlines, Baxter, American Airlines, T Rowe, Mattel, Constellation Brands, ADP, Manpower, Loews, Burger King, Visa, Danaher, UPS and Fedex, Bain, Microsoft, Linked-In, Adobe, Activision, Just Eat, Salesforce, Square, Slack and even Uber. (Sorry, it was US-centric article!) It will be fascinating to see what great companies of the future are taking root today.

Economic Commentary

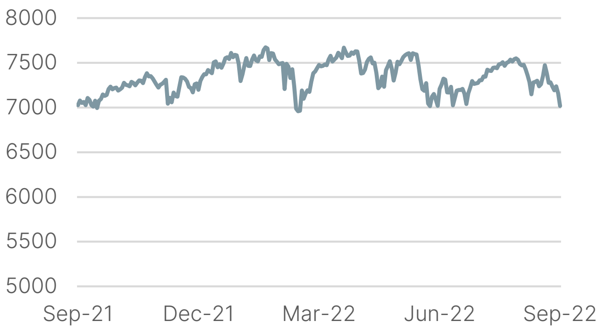
FTSE 100 weekly winners

AVEVA Group plc	4.3%
BAE Systems plc	2.7%
Unilever PLC	1.4%
Halma plc	1.1%
Diageo plc	0.2%
Avast Plc	0.0%
Evraz PLC	0.0%

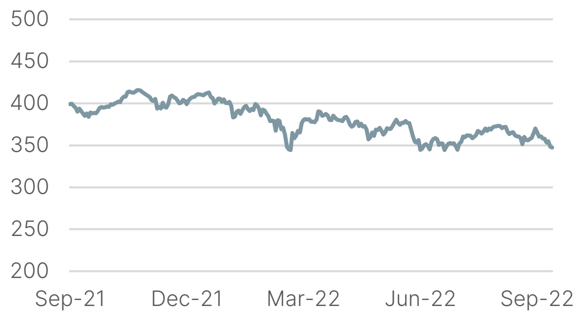
FTSE 100 weekly losers

Royal Mail plc	-21.4%
JD Sports Fashion Plc	-17.4%
Just Eat Takeaway.com N.V.	-15.2%
Ocado Group PLC	-14.9%
Intermediate Capital Group plc	-13.4%
Land Securities Group PLC	-13.4%
Polymetal International Plc	-13.0%

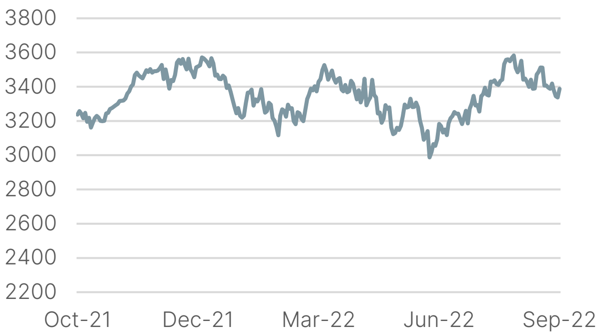
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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