Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 31 January 2023

Written By A Human

John Wyn-Evans
Head of Investment Strategy

It seems to be de rigeur these days to begin all written pieces with some sort of disclaimer to say that this was not written by ChatGPT, the generative artificial intelligence application that is causing much consternation amongst white-collar workers. I'm not going to delve into the wider issues here, but I thought I would share my own initial experience. We asked ChatGPT to write a work-related biography for me. It miraculously awarded me a degree in Economics from Sussex University and an MSc from the London School of

Economics. Much as I would love to have them, I can only claim a Modern Languages degree from Exeter. And, apparently, I have worked for both Credit Suisse and Schroders, neither of which I recall...

How has the year started?

There's an old market saying that holds that "As January goes, so goes the year". The idea behind this is that January's market performance sets a tone and establishes a trend for the rest of the year. Well, if that's the case, investors can start ordering the champagne early, because this has been one of the strongest starts to a year that we have experienced this century, and that applies across a range of assets. If only life was so easy!

Still, there is no arguing with the facts. The strategists at Bank of America (BofA) have front run the usual end-of-the-month performance reviews. They point out that 14 of 15 asset classes that they monitor are in positive territory, with only the US dollar weaker (which generally turns out to be a good thing for all the other assets). Global equities are having their second-best January of the century so far, surpassed only by 2019, which followed a very poor fourth quarter and was driven by a Federal Reserve (Fed) pivot to looser monetary policy. Sound familiar? The big difference, though, was that US headline inflation was below 2% at the time versus 6.5% now, giving the Fed much more leeway to reverse its policy gears.

Why the positive mood? BofA goes on to list six key reasons: a de-risking of Q4 earnings expectations; limited probability of an immediate shock from inflation or employment data; collapsing cross-asset volatility; a weaker US dollar; China's re-opening; and, finally, plenty of liquidity support (more on which in a moment).

I would add technical factors to these. I wrote about the short squeeze last week and that is seen in a big relative win so far this year for last year's losers: a triumph for contrarian investors. But now there is increased buying from momentum-following funds too, especially as major indices break above key moving averages.

This reminded me of a piece of research from Citigroup that was published in December. It looked at the relative performance of momentum and contrarian strategies based on a sample of the top and bottom ten stocks for the year out of the largest 250 in the MSCI ACWI index. Based on buying-and-holding for the next twelve months in data going back to 1998, there were 16 wins for momentum and nine for contrarians. This might sound reasonably balanced, but the distribution of returns was such that the strategy of buying the contrarians every year reduced $100 of capital to just $4 over the twenty-five years. Food for thought there for punters piling into non-profitable technology companies in the hope of lightning striking twice in the same place.

Is there liquidity in the market?

Returning to the subject of liquidity, there seems to be more of it in the system than we and most investors were expecting a few months ago. This goes against the grain of the narrative of central bank tightening and quantitative tightening in particular. The two main recent contributors have been the Bank of Japan (BoJ) and the US Treasury. The BoJ has been buying bonds in huge size again to control the yield curve following the shift in the basis of its yield curve control, while the US government has been drawing down funds from its Treasury General Account (think of it as the government's current account) at the Fed. This is because of the limit on its ability to issue debt caused by hitting its debt ceiling a couple of weeks ago. The government is pumping that cash into the economy but not soaking up as much liquidity as it normally does via Treasury Bill issuance.

And there could be more liquidity arriving. There is more than $2 trillion tied up in the Fed's Reverse Repurchase (repo) facility, which is a safe place for banks and money market funds to deposit their cash. A lot of the increased use

of the repo facility is by Money Market Funds (MMFs), and investors have been piling into these because they offer a better return than cash deposits at banks (who are being slow to raise deposit rates in line with central bank rates, which has led to a nice boost in profits).

The MMFs fled the government bond market in favour of repos last year because of the increased volatility in bond markets. There are two things to suggest that this flow could reverse. One is the declining volatility in bond markets. The other is if banks start to offer more attractive deposit rates to secure funds, which they might have to do if the economy rumbles on as it has been doing.

The main caution here is that such a liquidity boost would make the Fed's job of damping down inflationary pressure all the harder and call for the Fed Funds rate to be higher for longer. Indeed, this is at least part of the reasoning behind the call for any US recession to develop later in 2023 or even early 2024 that is gaining traction in the market.

What can we expect from Central Bank policies?

Which leads us inevitably back to central bank policy. We'll have another deeper dive into this subject next week following the latest round of meetings later this week. The Fed is expected to raise the Fed Funds rate by 0.25% on Wednesday, with the Bank of England and European Central Bank following up with a 0.5% increase on Thursday. But the focus will not be so much on the actual policy rate changes as on the statements and post-meeting speeches as markets look for clues as to what happens next. How many more increases will be signposted? How high will rates rise? And are there any specific criteria to catalyse either a pause or reversal in the current trend of increases? These meetings will probably set the tone for February.

Do we prioritise growth or value?

Finally, some observations about the respective merits of investing in "value" or "growth" stocks and funds. I think it's fair to say that our "house investment style" leans towards growth in its broadest sense, although I continue to believe that these designations make very blunt tools. I have preferred to use the labels "short duration" and "long duration" in the past as a better way to address how the market prices various sectors. Therefore, for example, it was clearer to see that companies with no earnings today (and not for a long time ahead in many cases) were much more vulnerable to a rise in the discount rate than those with healthy current margins and profits. I would also say that our investment process also leads us towards "Quality" as a factor, one that is often associated with growth.

I attended presentations by three external fund managers last week. Two are classified as "growth" managers and one as "value". Can you work out which is which from their respective investment objectives?

Manager 1: Company meets an economic need. Strong competitive advantage (wide moats or barriers to entry). Long history of profitability and strong operating metrics. Generates high levels of free cash flow. Available at a low price in relation to intrinsic value.

Manager 2: Quality first. Sharp focus on (a high) return on capital. Barriers to competition. Balance sheet strength. Look for earnings compounders. Sharp focus on (ideally accelerating) revenue growth. Ability to invest at the same, or better, rate of return. Buy companies changing for the better.

Manager 3: We aim to invest in high quality businesses. Seek to invest in businesses whose assets are intangible and difficult to replicate. Avoid companies that need leverage. The businesses we seek must have growth potential. Only invest when we believe the valuation is attractive.

How did you get on? The value manager is the meat in the sandwich – Manager 2.

Over five years, the growth managers' main funds are +60% and +62% respectively vs the MSCI All-Countries World Index +61% (all in sterling). The value fund is +100%. But then another well-known UK-based value investment trust (which really does what I would describe as contrarian/deep value) is only +11% over the same period.

Since the beginning of last year, things look quite different, although I would always caveat that by saying that one-year performance predictions are no better than a coin toss on a probability-weighted basis. Respectively, they are -12% (growth), -18% (growth), -4% (market), +14% (quality value) and +13% (deep value).

What about over a longer period? The available data on all of these funds on Bloomberg only goes back to December 2015, and reads +169% (growth), +174% (growth), +146% (market), +192% (quality value), +58% (deep value). So much for the era of growth, then? Not really. In the end it's all about the ability to sniff out good companies at reasonable prices, which takes a lot more skill than it sounds as though it should, especially if one is going to put reasonable risk management in place (that is, not to bet the farm on a couple of hail marys). The manager label really should be of little importance.

Another determinant of growth/value factor performance has been fund-flows, with passive flows into indices and Exchange Traded Funds (ETFs) a big driver. I spotted some interesting shifts in Standard & Poors' classifications (which drive index and ETF composition). A year ago, S&P's (US) "Pure Growth" index included Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia and Tesla. Now only Apple makes the cut. Netflix, Nvidia and Tesla are in "Growth" only, while, somehow, Alphabet, Amazon, Meta and Microsoft manage to get into both the Growth and Value indices!

You might be surprised by some of the names now in the "Pure Growth" index, of which the top eight are: Apple, Exxon Mobil, UnitedHealth, Chevron, Eli Lilly, Merck, Abbvie, and Pfizer. Yes, two Big Oil stocks.

The top eight in "Pure Value" are Berkshire Hathaway, Bank of America, Verizon, Wells Fargo, AT&T, Intel, Goldman Sachs, and CVS Health. Amazingly, Goldman Sachs has managed the rare and not so enviable feat of falling from "Pure Growth" to "Pure Value" in the last twelve months.

Obviously much depends on the criteria chosen to define growth or value, but it seems to me that one could end up chasing one's tail by being too prescriptive about one's allegiance.

Economic Commentary

FTSE 100 weekly winners

3i Group plc	9.9%
Ashtead Group plc	7.4%
Lloyds Banking Group plc	6.7%
Prudential plc	5.3%
International Consolidated Airlines Group SA	5.2%
Taylor Wimpey plc	5.2%
Admiral Group plc	5.1%

FTSE 100 weekly losers

Polymetal International Plc	-33.5%
Diageo plc	-7.0%
Fresnillo PLC	-6.2%
AstraZeneca PLC	-5.2%
Glencore plc	-4.8%
Just Eat Takeaway.com N.V.	-4.1%
Reckitt Benckiser Group plc	-3.8%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.