Weekly Digest
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Investec
Wealth & Investment

The weekly insight into world stock markets

Two Tribes

Last week I outlined our portfolio scenario analysis for a chaotic "hard Brexit". Our theory was tested on Friday when Mrs May launched her attack on a recalcitrant EU and threatened a "no deal" departure, and I'm happy to say that everything went according to plan. The pound fell, UK equities rose (with the more internationally oriented FTSE 100 outperforming the FTSE 250), and gilt yields also dipped. Of course, this was more a fire drill than a Towering Inferno moment, but we were happy to see that our sprinklers worked.

I don't plan to dive further into the Brexit pit today other than to say it is one of several instances in which tribal instincts and the concept of "sticking to one's beliefs" appear to be more important to some of the main protagonists than a pragmatic outcome. This is especially the case in politics, but there are opposing camps in financial markets too. For example, "Value" investors are experiencing a torrid time while "Growth" investors are having it away, at least on certain definitions of the categories.
Another big battle is raging in the world of economics, with one camp predicting sharply higher inflation ahead and the other much more relaxed. This is not necessarily a classic battle between Keynesians and Monetarists, but there are certainly elements of it present. Here, at least, one side or the other will be proved right in the end. At our Global Investment Strategy Group meeting last week inflation was highlighted as a key determinant of future investment outcomes. However, reaching a conclusion is not that easy.

First of all, we have to decide which inflation rate to look at. Although UK consumer prices are important to our everyday lives, it is US inflation that is viewed as being the key indicator. The US remains the world's largest economy (for now) and dollar interest rates underpin the cost of capital for global financial markets (which they will probably continue to do for some time even after China inevitably becomes the world's largest economy). Very simply, rising inflation tends to be a sign of "overheating" in the economy, and the theory is that excess demand for goods and services pushes up their prices, with the first symptom often being higher wages. Remember that it was a surprisingly high January wage data print in the US that sparked the market turmoil at the start of the year. The market response is to raise the yield (and therefore lower the price) of government bonds as investors demand a higher return to compensate for the loss of real income; the central bank policy response is to raise interest rates to dampen demand. All other things being equal (which they rarely seem to be!) higher bond yields lower the value of other financial assets through the discount rate effect; higher interest rates reduce demand by making borrowing more expensive. Historically the US Federal Reserve has continued to raise interest rates until the economy rolls over, and it is the ensuing recession that tends to create the most damage as corporate profits fall – indeed, it is the "double whammy" of falling earnings and lower valuations that is most destructive.

Where is this "crunch point"? The Fed defines the equilibrium interest rate as "R-Star" (R*), the point at which interest rates are neither stimulating nor curtailing economic growth. R* has itself been falling over the years as the potential growth rate of the economy has fallen. Currently it's around 3% in nominal terms, or 1% in real terms. That would suggest that the Fed can raise rates by a further 1% before the brakes begin to bite (starting with another 0.25% this week). I received a note from one research house this morning proclaiming that very view, and expressing the opinion that it's still far too early to abandon equities. In their analysis the positive boost to earnings from a stronger economy convincingly outweighs the negative valuation effect of a higher discount rate. Last week I attended a presentation given by a well-respected economist from a top fund management house and heard a similarly positive view. He was extremely relaxed about the outlook for inflation, and comprehensively dismantled the Phillips Curve theory which posits that low unemployment is an inevitable precursor of higher inflation. He was also adamant that rising fiscal deficits, such as that being run in the US at the moment, are not inflationary per se. Other experts take into account the deflationary effects of new technology and the influence of ageing populations.

Most recently, Deutsche Bank has released its annual Long-Term Asset Return Study, and the authors argue that higher global inflation has been very much a (second half of the) twentieth century phenomenon, with the main drivers being unprecedented population growth, the widespread adoption of fiat money systems, and the deregulation of financial services (leading to an explosion in credit growth). Their conclusion is that governments will remain under intense political pressure to relax austerity and increase deficit spending, and that this will in some way be monetised by central banks, meaning that higher inflation will ultimately reduce the real value of the debt - so inflation by political choice. That would be a very challenging environment for investors, for which, in general, they are not currently prepared. For the record they see a long-term backlash against this policy, which, combined with flattening population growth, would lead us back to another long period of low inflation. But we are potentially talking years, if not decades, for this to play out. For now, a bit like the Fed, we will have to evaluate the data as it evolves.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Antofagasta	14%
Anglo American	14%
Evraz	13%
Glencore	12%
BHP Billiton	10%
Rio Tinto	9%
Fresnillo	9%

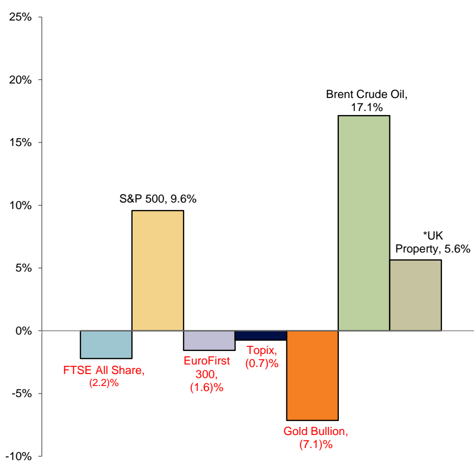
Source: FactSet

FTSE 100 Weekly Losers

NMC Health	-8%
Burberry Group	-7%
GVC Holdings	-6%
ITV	-5%
JUST EAT	-4%
Smiths Group	-4%
Next	-3%

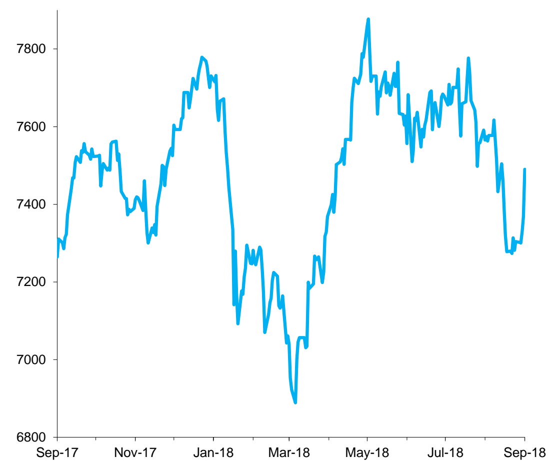
Source: FactSet

Year to Date Market Performance



Source: FactSet
*IPD Total Return to July 2018

FTSE 100 Index, Past 12 Months



Source: FactSet

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