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Reflections & Insights

"If you want a guarantee, buy a toaster"

– CLINT EASTWOOD

Starting with the obvious, it hasn't been a good quarter for risk assets. Global equity markets have fallen by more than 10% since the end of March and bond markets have also suffered as the world's major Central Banks continue to tighten monetary policy. Inflation continues to be at the root of the problem. Up until the end of last year, the greatest banking brains (forgive the contradiction in terms) believed that inflation was a temporary phenomenon mostly caused by supply interruptions from the disruptive effects of the pandemic and exit therefrom. These brains must have breathed a sigh of ironic relief when Vladimir Putin gave them an excuse to reassess the picture and come to the conclusion that, in fact, inflation was a problem in the process of embedding itself in the body economic.

Rising commodity and energy prices ran headlong into tight labour markets, particularly in the US, and the rhetoric from Central Banks turned decidedly

hawkish. Just like that, market commentators were running around trying to find anybody who remembers what stagflation is or even was just around in the 1970s. There is a range of prognosticators urging policymakers not to make the mistakes of the 1970s, but these alarms ignore the fact that just as today, the possible outcomes were multifarious. It is not completely frivolous to point out that one-third of people active today in financial markets have entered the field since 2008. These people have only seen one policy and one strategy. The reset is uncomfortable.

There is an argument that the tightening of monetary policy came late in the day and allowed the embedding of inflationary expectations, but the combination of a pandemic and a war is not something that crops up every day and a cautious approach was surely warranted. Having now fired the starting gun on tightening, Central Banks will likely continue with the policy until something breaks. This means that a tighter policy will probably continue for longer and the global economy may fare worse than is strictly necessary. Central Banks, though, need to prove they have the backbone to stuff the inflationary genie back in the bottle.

In the meantime, the economic numbers as reported are not too bad. Consumer balance sheets, post-pandemic, remain in decent shape and corporate balance sheets are very robust. While higher prices will cause a decline in the standard of living for most people, this balance sheet strength provides a cushion of sorts. This countervailing force is keeping the US economy (in particular) afloat and explains the fact that interest rates there have risen more than in other developed nations.

The picture around the developed world is of persistent inflation, rising interest rates, high energy prices, a strong dollar and widening credit spreads. This last measure is something to look at to see how much stress there is in markets. As spreads widen (bonds of risky companies go down relative to bonds of solid companies), it means that investors think the risks of bankruptcy have risen for the weaker toys in the store. This menu presents a big mountain for optimists to climb, and just now they are pitched at base camp and hunkered down.

Harking back to the 1970s

There are two other factors that compound the misery. The first is that, as yet, there has been no impact on profits. Given that economies are beginning to slow down and price pressures are insistent, both for labour and for raw materials, it is all but unthinkable that earnings will not come under pressure. The effect on profits will vary by sector, as some companies will be able to push through price increases to the end consumer, mostly where the product cost is either trivial or the product itself is indispensable, while others will not.

The general rise in the price level will also mean that even if profits do not fall in nominal terms, they are likely to suffer in real terms. Harking back to the 1970s, companies like Procter & Gamble or Johnson & Johnson produced revenue and profit growth in line with inflation. This did not stop their shares from falling, though, because the impact of higher interest rates caused a compression of valuation (i.e. P/E's fell sharply). Seen through this lens, equity markets have to contend not only with margin pressure but also with the effect on share prices of increases in the discount rate.

This piece of financial jargon, stripped down, means that equities have the capacity to be around for a long time – they are known as 'long duration' assets, and that means that they tend to be sensitive to rising interest rates, which reduce the future value of the cash flows to which shareholders are entitled, which leads in turn to a lower current value. In the financial environment which has prevailed since 2008, this aspect of investing has barely mattered. Very low interest rates have meant that the narrative hasn't really been about valuation but about growth.

Occasionally, you will have heard some Cassandra-like commentary that valuations were too high, higher than they had ever been, but until the interest rate environment changed, this was hollow doom-mongering.

When bubbles burst

The second and less easily quantified risk is what is generally known as a 'wealth effect.' As asset prices fall, so people feel less well off (maybe because they are...), and this has a direct effect on spending. This trickles down through the economic system and can lead to surprising weakness in consumer spending. The effect is more pronounced when it involves bubbles bursting. Over the last six months, we have seen bubbles pop in crypto assets, SPACs (don't ask – they are so-called blank cheque companies) and meme stocks. Unless you are addicted to Bloomberg TV, some of this will have passed you by. In 2008, the bubble that burst was much larger and pulled the banking system into a whirlpool. This time, banks are much more robust and the risk of systemic meltdown is much lower. The US Federal Reserve (Fed), which is by far the most important Central Bank, is trying to tighten financial conditions generally. It doesn't want to rely wholly on interest rates as its sole weapon against inflation. Falling asset prices are helpful in this regard, and it is not unreasonable to suppose that falling markets are a useful adjunct to rising interest rates and, therefore, welcome to the Fed.

It's hardly surprising that market watchers are on the alert for signs of stress which might lead to a liquidity crunch, where a wide group of investors are forced to liquidate assets at fire sale prices. For now, this is a theoretical risk, but the landscape is not benign.

Canaries in the economic coal mine

As mentioned, reported activity is still OK, but the aviary full of canaries in the economic coal mine is beginning to cough, and in many cases, the birds have fallen off their perches. Data which anticipate future behaviour are almost uniformly weak. An awful lot of ink is spilled trying to determine whether the developed world is going to have a recession. This is a statistical construct – conditions will feel recessionary whether the data say you are in one or not.

One of the tenets of these reviews is that forecasting is a mug's game – indeed, it has been said that a forecast is either lucky or wrong. With the caveat, therefore, that nothing which follows is a forecast, it seems reasonable to argue that those parts of the world where energy is largely imported and where price pressures are causing significant pressure on standards of living are in worse shape than those where only one of those conditions prevails. That is, the EU is in bad shape, while the US is somewhat better, helping to explain why the Fed has led the

world in tightening policy – it has more heat to take out of the system, and this, in turn, has led to a strong dollar, for which read weak yen, Euro and sterling. This is another policy plank in controlling inflation in the US and the fact that it exports that inflation to others is just unfortunate.

One risk which is worth noting is that as rates rise in the EU, those peripheral countries which were in the eye of the Euro storm in 2013 could find themselves with spreads widening again. This seems particularly harsh for those who swallowed the deflationary medicine and committed to structural reforms, like Greece and Portugal, whereas Italy has continued to add debt. Italy is also the country where politics could take a populist anti-Euro turn next year. The European Central Bank has plans to address these risks but it remains to be seen how effective they will be.

Piling Pelion on Ossa

As has been the case for a while, the UK remains in its own particular bind, with shocking trade performance exacerbating a severe cost of living squeeze. It is still politically inexpedient to acknowledge that the chosen form of BREXIT has piled Pelion on Ossa (i.e., difficulty has been added on difficulty), and a more collaborative set of policies is required.

Elsewhere in the world, emerging markets have held their own in declining markets, a particular surprise given the strength of the dollar. China is pursuing somewhat easier policies to offset the zero COVID policy and reignite economic activity, while Japan is the only major economy that continues with zero rate policies, a stance it can pursue as it still faces structural deflation. This has led to significant yen weakness.

We have seen big falls in markets and there is a cacophony insisting that risk be reduced, now that prices have fallen. Whether prices have much further to fall depends wholly on whether the monetary medicine starts to work. There are signs that core inflation (ex-food and energy) might be peaking, but it is too soon to be sure and in any event, policymakers expect several more quarters where the numbers are not good. It is likely that they will wait

until they are very sure the foe is vanquished. In the meantime, markets wait. The ‘earnings recession’ has not begun, but some expectation of earnings decline is already in prices, and markets expect interest rates to rise further. If the global economy slows enough to take pressure off the inflationary accelerator, we could revert to a lower rate environment where valuation pressure is released and markets can move higher.

Bear markets typically last longer than investors expect and the damage is done through attrition rather than something blowing up spectacularly. It is a sign of age that this feels like a return to normality after a very unusual period post-2008. If that analysis is correct, portfolios may look to hold equities that are defensive in nature, which means those quality businesses with pricing power. These are not cheap in absolute terms, but they trade at more realistic valuations, and these are the businesses that will be there in the long run.

It is too late in the process of price adjustment to run for the hills. When things turn around they will do so with speed and vigour, and building large cash positions after a significant decline is a false comfort in the absence of a liquidity crisis, which we do not see. It is probably still too soon to move into bond markets, although that opportunity may well come. We believe gold remains practical insurance against catastrophe.

A different investing lens

Lastly, the world which emerges from the current downturn is going to require a different investing lens. A more polarised world will lead to a realignment of political blocs and priorities. It may mean the fragmentation of the current payments system as countries like China and Russia seek to find alternatives to dollar hegemony. For investors, this could well be a less stable background where money is no longer free.

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