GUARDCAP

Reflections & Insight

QUARTER TWO 2021

"The stock market is designed to transfer money from the active to the patient". –Warren Buffett

At the beginning of the year, the vaccine rollout was just beginning in some parts of the world, and there was uncertainty as to how it would affect the path of the pandemic. Since then, most countries outside Asia have experienced a further wave of infections and some shocking death statistics, with hospital services in many places close to collapse. Vaccination programmes have varied from those which have been well executed to those which have ended up stuttering and confusing people, and large parts of the world, principally in poorer countries, have tragically not yet been invited to the party. Given the way new variants evolve, the likelihood is that the pandemic will not be over until everybody is vaccinated.

Markets don't care about any of this, though.

Markets are discounting mechanisms and their pricing depends on what happens next, not on what's happening now. What will happen next in the places that markets think matter most, is that growth will be explosive. The combination of huge government spending, short interest rates anchored to zero, and large rises in savings as spending has been involuntarily curtailed point to extraordinary growth in the second half of 2021.

In the US, where the fiscal stimulus has been gargantuan, the prospect of higher growth has had the perhaps unintended consequence of unsettling the longer end of the bond market. Yields on 10-year bonds have more or less doubled this year, from a very low level to a different very low level. Bond markets are slightly spooked by the risk of higher inflation, and indeed the Federal Reserve has reiterated its policy that for the time being, growth and employment are a bigger risk than inflation. The rise in yields, to around 1.6%, is somewhat short of the market blowing a raspberry at the Fed, but it does represent a bit of nail biting.

These reviews have often referred to the potential headwind represented by valuation, which remains high in many markets. A sanguine view of this depends on the concept that very low interest rates 'justify' high valuations because share prices are the present value of future earnings and the lower the interest rate you use, the higher the price (in theory). The opposite should also be true, so you might expect that as 10-year yields go up, markets will go down. Unfortunately, the binary nature of this identity is not very reliable. While low interest rates in general explain high valuations, they are not causative. By the same token a reversal in interest rates does not of itself cause valuation to shrink. There can be offsetting factors.

The first of these is that short-term interest rates are still pretty much zero. It is often said that the most important price in the world is the price of 10-year US money – that 1.6% number – and in normal times that is undoubtedly true. Nevertheless, if investors can still access short-term funding close to zero, liquidity (the cash in the system) remains very plentiful. The second factor is that 1.6% is still not a very high number. There are plenty of erudite studies which will tell you that this 'price' only matters when it reaches a level of 2% or 3% or whatever. In reality, nobody knows. The third and arguably most important factor is earnings. Corporate profits this year are set to rise very sharply, albeit from depressed levels. When markets are exuberant, which they tend to be when money is very cheap, they will extrapolate to the moon, and on that basis valuations aren't very high at all.

Brilliant Yesterday, Now Ho-hum

The effect of higher rates has been more visible in what is known as market rotation. At times during the first quarter, the high-quality growth stocks which weathered the pandemic have suffered compared to more cyclical businesses which didn't do so well in 2020. The reason for this is that the expected earnings momentum (this is jargon for rate of change) for these companies is now higher than it is for growth names, including tech businesses. To quote Warren Buffett again, ″remember that the stock market is a manic depressive″. What was brilliant yesterday is now ho-hum, and vice versa. In practice, it hasn't been as simple as this, but this rotation does underline the tendency of market participants to feel the need to act when conditions change, when inactivity could well be the right reaction. The financial services industry is primed to act, to enjoy the endorphin rush of doing something and not to sit on the sofa.

During the first quarter, therefore, there was a rise in the price of 10-year money, which caused a market rotation, but did not derail the upward trajectory of stock markets. The other thing that rose as a direct corollary of this was volatility. A change of this ilk almost always leads to more activity and more volatility.

The markets also had to deal with some signs of excess. There were plenty of Initial Public Offerings, in particular in the technology sector, where venture capitalists were taking advantage of high valuations; and there was a rush of so-called SPACs (Special Purpose Acquisition Vehicles). These are a way for private companies to bypass the expense of listing on a stock market by reversing into a corporate shell. These vehicles are best left to specialists, as they are often a very effective way of transferring your money into somebody else's pocket.

Furthermore, the collapse of Greensill Bank and then the Archegos hedge fund were both indicators that traditional risk management had been overridden by lenders to these entities. Most old lags would have looked at these events and worried about possible contagion in other assets areas. In practice, this didn't happen, but both episodes are evidence that financial innovation can find ways to bypass regulation and that leverage has a downside in volatile markets. When there has been an extended period of very cheap money, it is all but inevitable that when the tide goes out, not everybody will be wearing a swimming costume.

Revisiting Inflation Risks

Returning to the rise in 10-year yields, it is worth revisiting the inflation risks. In these reviews, we have posited that excess labour supply and moderate capacity utilisation would keep a lid on inflation. As discussed, for the bond market the jury is still out. The pandemic has certainly led to various problems in supply chains and it is likely that there will be unpredictable spikes in price across a range of industries, products and commodities over the next couple of years. Indeed, commodity prices are already rising. Whether this becomes endemic will depend on whether inflation expectations begin to become embedded in unit labour costs through higher wages. For those of us who are long in the tooth, this is what happened in the 1970's, where a combination of misguided policy, strong labour unions and the OPEC cartel caused a significant global rise in inflation. These generalised episodes are rare and usually have multiple causes, although they require very stern medicine to correct, as happened with the very strict monetary policy of the 1980's.

In a Keynesian Period

Today we are in what might be termed a Keynesian period, where monetary and fiscal controls are relaxed in pursuit of growth. These policies have also led to an unpreceded expansion in Central Bank balance sheets through various forms of quantitative easing which show little sign of reversing, so this leaves little room for manoeuvre without triggering unfortunate consequences. Equally, money supply growth has been extraordinary, and, under the monetarist equation, is only non-inflationary because velocity is so weak. It remains to be seen what will happen if this measure picks up, as might be expected if nominal GDP accelerates strongly.

Typically, central banks would be wary of these policies allowing inflation expectations to become embedded and would pursue rises in interest rates to head off the danger. The question now is whether the economy

would be strong enough to take the medicine should it become necessary. The optimists believe that current policies will unleash a new era of capital spending on digitisation, automation, infrastructure and 'reshoring' of supply chains and that these will trigger an increase in productivity, which will allow wages to rise without unit labour costs following. This is possible, although the same script was written at the top of the dotcom boom. The flipside of the optimistic coin is that high levels of debt will tend to stifle economic activity as the economy tries to get back to a neutral setting, which means that the relatively anaemic growth of the last decade is set to repeat.

Evidence Thin on the Ground

These two questions about inflation and productivity will determine the investing environment in the decade ahead. The evidence to support one argument over another is still thin on the ground and it remains very difficult to forecast how the world will be different as we recover from the pandemic. In the near term, inflation might be a cyclical problem, but will not be systemic, and the economy will recover strongly and then fade in 2022. Longer term, rather than try and pin colours to a particular mast, we will watch for developments and act accordingly.

Headwinds Growing in Strength

What this means for portfolios is that the underpinning for equity markets is still robust, but the headwinds are growing in strength, which may mean periods of higher volatility. Diversification remains your friend, both geographically and by sector, with a bias to those areas where growth is more predictable. This includes areas like healthcare and technology as well as Asia, but is not limited to these. As interest rates rise, so will the temptation to re-enter bond markets. The uncertainty here, though, is the extent to which central banks will allow rates to rise to choke off economic excess. Gold remains a hedge against some of this going wrong. For us, Bitcoin, which is often touted as a proxy for gold, is still in a speculative phase of its development and does not have a place in our portfolios.

All seems clear for now, but in two years' time, things may well be different. It is not yet time to batten down the hatches, but clearing the decks for heavier weather makes sense.

This document includes information concerning financial markets that was developed at a particular point in time. This information is subject to change at any time, without notice, and without update. This commentary may also include forward looking statements concerning anticipated results, circumstances, and expectations regarding future events. Forward-looking statements require assumptions to be made and are, therefore, subject to inherent risks and uncertainties. There is significant risk that predictions and other forward looking statements will not prove to be accurate. Investing involves risk. Equity markets are volatile and will increase and decrease in response to economic, political, regulatory and other developments. The risks and potential rewards are usually greater for small companies and companies located in emerging markets. Bond markets and fixed-income securities are sensitive to interest rate movements. Inflation, credit and default risks are all associated with fixed income securities. Diversification may not protect against market risk and loss of principal may result. Certain information contained in this document has been obtained from external parties which we believe to be reliable, however we cannot guarantee its accuracy. This presentation is for general purposes only and does not constitute investment, legal, accounting, tax advice or a recommendation to buy, sell or hold a security. It is only intended for the audience to whom it has been distributed and may not be reproduced or redistributed without the consent of Guardian Capital LP or GuardCap Asset Management Limited. GuardCap Asset Management Limited is a wholly owned subsidiary of Guardian Capital Group Limited which is a publicly traded firm listed on the Toronto Stock Exchange. For further information on Guardian Capital LP or GuardCap Asset Management Limited, please visit www.guardiancapitallp.com or www.guardcap.co.uk.