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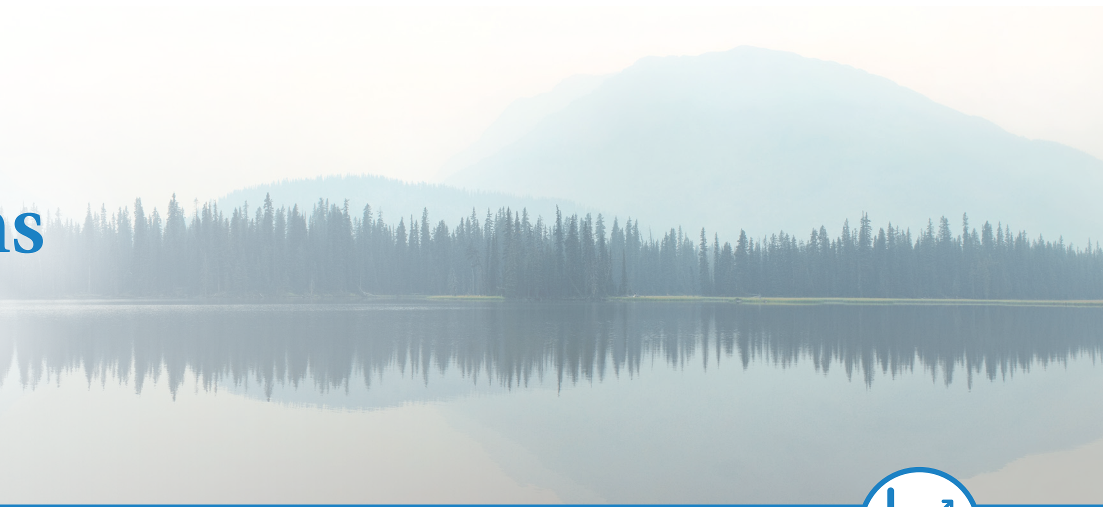

Reflections & Insight

QUARTER ONE 2021

“A desk is a dangerous place from which to view the world.”

–John le Carré

At the moment, a desk is the only available place from which to view the world. If you had had a crystal ball at the start of 2020 and had seen a misty vision of what would happen to markets if a pandemic rolled up and shut down the largest part of the global economy for most of the year, you would probably have smashed it against the wall. With the wisdom of hindsight, you can now see that the crystal ball understood what the prognosticators did not – zero interest rates and large amounts of government borrowing can outweigh a health and economic catastrophe.

As the year has progressed, most people have suffered varying degrees of lockdown: changes to working and travel habits and the pendulum swings between fear and hope. The rollout of vaccines and more effective therapies provide some light at the end of the tunnel, but the timing is still uncertain. Nevertheless, by mid-year, most advanced economies will probably be in a position where some semblance of normality can return.

The question for investors is what that normality will look like.

First, it is likely that the fiscal largesse, which supported employment and businesses, will continue in a more muted form—witness the stimulus package passed in the US in recent days. Any return to austerity would be a major policy error when economies remain fragile. This means more public sector borrowing than used to by the markets, but they are sanguine because, second, interest rates are likely to remain close to zero. Central banks are in effect putting the fight against inflation on the back burner. Instead, the policy focus will be on growth and employment.

Indeed, inflation is unlikely to be a major problem in the next year or two. We have talked about the secular trends of inflation in these reviews before. In sum, they do not support a significant long-term uptrend, perhaps with the exception of services provided to aging populations. The tactical view is also reasonably benign. The major negative factor is monetary—and there is indeed a lot of money around, but set against that is slack in labour markets and little prospect of a commodity boom. These are conditions which might generate price spikes in particular areas where the pandemic has led to supply disruption, but we are unlikely to see a generalised surge in inflation which would call into question the key monetary and fiscal policies.

This means that the conditions that led to asset price rises in 2020 will most likely persist through this year, even in the face of a rapidly accelerating global economy as things begin to open up. Growth is likely to be very strong in developed countries, but a lot of this is making up for lost time, reflecting pent-up demand. The tailwind will be strong.

When Your Uber Driver Tells You

There are two significant headwinds.

The first is how powerful the consensus is. There is almost no dissent from the view about the monetary and fiscal position expressed above. In financial markets, a very widely held consensus is often wrong. When your Uber driver tells you he or she has bought Tesla or Bitcoin, you may surmise that everyone who could possibly want that asset has already loaded up (ignore the fact that you probably aren't taking many Ubers at the moment). The strength of a consensus is a measure of the extent to which we see future expectations reflected in current prices. On this basis, a gnarled observer of markets should take the view that markets don't have much upside and may be vulnerable to disappointment, whether it be about earnings, the path of the pandemic or geopolitical shenanigans.

The second headwind is valuation. The valuations of parts of the markets are very high. Of course, this is explained by very low interest rates – after all, a share price is just (in theory) the present value of the future cash flows, discounted by an appropriate interest factor. As rates fall, so that factor falls and the 'justified' valuation rises. Alongside high equity valuations, the market dispersion has been enormous. What this means is that a very small number of companies have done exceptionally well, while the majority have languished. Unsurprisingly, the winners are those deemed to have benefited from the pandemic and the long-term trends it has accelerated. Technology is the most obvious example. Its weight in global benchmarks is now around 20%, with a total value of around $15 trillion. This weighting is slightly lower than at the peak of the dotcom boom in 2000, when the number was 25%. It is worth noting though, that of this 25% the bulk comprised companies involved in mobile telephony, which are nowhere to be seen nowadays. Fame is not forever.

Warning Shots Fired

Digressing briefly, investors in technology can hardly imagine what might derail the juggernaut. The most likely cause is governmental involvement. The Chinese government has already fired warning shots across the bows of some of the country's most important technology firms, reminding them, in effect, who's boss. As the technology giants have broadened their reach into areas like finance and have exploited monopoly power to neuter competitors, so they can expect more scrutiny. This is particularly true of those entities that control data and social media. The argument that they are just platforms rather than publishers, with attendant responsibilities, looks increasingly thin.

There is another bubble out there, hiding in plain sight. It is probably the largest valuation anomaly ever seen in financial market history. This is the $17 trillion of government debt around the world trading at negative nominal interest rates. It is the result of policies taken to mitigate the effects of the pandemic, but it also has the scale to cause a major problem should policy reverse or confidence crumble. Central banks will want to manage the exit from this bubble over an extended period, so avoiding a burst is a necessary part of avoiding a global bust. They do have the tools to do this, although it may make the eventual reckoning more painful.

Recent developments in the US, with the Senate now effectively handing Joe Biden a freer hand than looked likely a month ago, do not mean the execution of a wholly progressive agenda. There are too many marginal contests in two years' time and this is likely to temper the urge to raise taxes beyond what is already expected. Nevertheless, bond markets have reacted to the likelihood of further stimulus and bigger deficits by pushing rates up. The rise in yields is likely to be held in check by the forces described earlier, but there is no doubt that a reset in bond markets poses a significant risk to capital markets generally.

Enough to Frighten the Horses

High valuations in bond and equity markets, combined with a powerful consensus that this is intellectually justified and underpinned by conditions which are indeed likely to continue, should be enough to frighten the horses. History suggests that something will go wrong. This may not be economic-speak, but the tension in the elastic is high, so markets will be sensitive to minor course corrections. Casting around for likely culprits, the most eye-catching are also the most mundane. Expectations for the trajectory of the pandemic and the growth path that will follow are baked into markets but are hugely uncertain. Weaker growth than expected, earnings shortfalls, problems in the tech sector—any of these could cause a significant market setback, and it is unlikely that we will navigate 2021 without experiencing at least one such episode. The scale of any setback will probably be mitigated by central bank action, as these institutions remain very concerned about the fragility of the global economy.

Roaring Twenties or Soft Hairshirts?

Looking further out, two schools of thought are emerging. The first of these, christened the 'Roaring Twenties', posits the thesis that people, bowed down by the restrictions under which they have been living, go on a multi-year debt-fuelled binge, in a weirdly symmetrical echo of the post-Spanish flu period in the 1920's.

The second might be called 'soft hairshirt', where the high level of debt leads to slow growth and a long climb out of the economic hole into which the pandemic has tipped us. This would not be a repeat of the post 2008/2009 experience, but one in which policy settings are geared towards a long-term rebalancing of the economic books.

Of course, while it is amusing to speculate about this, most governments will do their best to avoid imposing austerity and have become comfortable with higher levels of debt (especially at negative rates). The years ahead are likely to see ambitious infrastructure investments and, at last, a genuine attempt to do something about the climate crisis. These are conditions where the twenties might not roar, but they will probably rumble.

Any look at the longer term also has to take into account the fact that China has weathered the pandemic well and has adjusted its policies to much more normal settings. It will continue to grow and, regardless of trade tension, will become an important destination for international investors. This does not mean that everything is plain sailing, but it is possible that the returns in local currency in China (and Asia more broadly) will be very attractive in the decade ahead.

Goodbye to the Awkward Squad

In Europe—finally rid of the awkward squad in the shape of Britain—the collective borrowing and debt mutualisation structures agreed to, in order to deal with the pandemic are a step forward on the road to a more sustainable continental fiscal policy and should help avoid future Euro crises. In Britain, the country has awoken to a hard exit from the EU, which will both diminish its international standing and, over time, erode prosperity. In the immediate aftermath of BREXIT, any economic impact will be dwarfed by the pandemic, and the UK government will undoubtedly hide behind the major economic rebound the country will see in the second half of the year in order to 'prove' that BREXIT has worked. Sad times in lockdown London.

Insurance Policy

Putting all this together, investors may well see gains in markets this year, but it could be a volatile ride. In general, policies are likely to be accommodative and stay so much longer than they should. This is not an attractive environment for bonds in particular, although it may well be a couple of years before we see the impact. In the meantime, it makes sense to add exposures to the parts of the world where policies are sound (Asia), as well as look to diversify sources of return by looking at alternatives. Gold or a proxy should be used as insurance against the risk that governments attempt to inflate their way out of their problems.

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