# thenavigator

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## "WHY, SOMETIMES I'VE BELIEVED AS MANY AS SIX IMPOSSIBLE THINGS BEFORE BREAKFAST"

*Lewis Carroll, Alice's Adventures in Wonderland*

As we move beyond the first anniversary of the emergence of COVID-19 (probably without many champagne corks being popped), it is perhaps a good time to take stock and reflect upon some of the more surprising events given the very surreal world we live in. Some may even call it a fairytale – albeit a very dark one.

If I had told you this time last year (which I did) that the markets would recover strongly, you would have thought that I was akin to the Mad Hatter in Lewis Carroll's famous book.

Who would have believed that the Americans and the Brits would be more efficient in their vaccine rollouts than the Germans and the Swiss?

Would you have imagined it possible to have so many vaccines available with such high efficacy rates in such a short space of time, or that the global population would have been so patient without any major issues arising given the draconian lockdowns in many parts of the world?

Would you have thought it possible that governments and central banks would have been so generous, or that the price of gas would be close to USD 3 per gallon (given that the oil price was negative not so long ago)?

Surely you wouldn't have thought that we would be worrying about inflation, interest rate rises, tapering and a pronounced upward slope in the US yield curve?

"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see? – *Lewis Carroll*

### SEX, ANIMAL SPIRITS, FRUSTRATION, BOREDOM, HAMMERS AND NAILS ...

While I know it sounds more like a tabloid headline than the usual financial market commentary, we do live in a rather exciting period of time, the likes of which none of us have ever experienced before and will hopefully never experience again.

I find market indices dull and perhaps for some indices (especially in the USA), we may have already seen a good proportion of this year's gains.

**BUT**

I really like stocks and could not be more upbeat about economies.

I remember around this time last year when Italy went into a strict lockdown and the BBC interviewed an elderly gentleman who smiled and predicted a subsequent baby boom. In fact, we have actually had a baby bust on a global level, with birth rates declining sharply.[1] Who would have thought Netflix and takeaways would be more interesting? But again, thinking in a slightly different vein, I would not at all be surprised to see a surge in the global birth rate (possibly including some unplanned babies) once a degree of normality returns.

While I have talked about animal spirits returning in previous Navigators, I think I may not have been bold enough! The level of frustration, boredom, pent-up demand and savings rates is abnormally high and I now expect the tsunami of spending to be greater both in monetary terms and in terms of duration. People will go from WFH (working from home) to WTH (what the heck). Ten-day cruises will be extended to 20 days and economy flights upgraded to business class. And so on. I am of course talking about revenge and catch-up spending. In simple economic terms, I expect demand to significantly outstrip supply as companies in the real economy struggle to recruit enough staff to meet demand. Returning to the simple, tried and trusted economic formula, prices will have to rise in order to lure people back into the workforce given the very generous government support they are currently receiving. The other major problem is the huge disruption we have seen to supply chains as a direct result of the tariff/trade wars, which cannot be fixed overnight.

This will of course be inflationary, but in a positive way, as a sign of rapidly healing economies and possibly a return to an environment we have not seen for over a decade: the resurgence of the real economy.

I now expect the US economy to grow by around 7% in GDP terms this year. Although we are obviously coming from a low base, this is the type of headline growth number that you would expect to see in China – not in a developed western economy.

While there is a lot of misinformation about the pandemic, which may be due to our thinking being somewhat awry given the unusual circumstances, it is my strong belief that what matters is actually the drop in hospitalisation rates and death rates – not the fall in infection rates. We should perhaps get used to COVID-19 being around for some years to come, although it will probably be less fatal and debilitating, allowing civilisation to return to normality. Of course there are worries about future mutations, but viruses do not grow exponentially forever. Looking at it from a different angle: given the number of variants already circulating, new variants will become less frequent, meaning that science will be ahead of the curve.

So why am I lukewarm on some indices? Well, it is the other side of the coin.

Economic comparison figures are likely to be rather wild in the near term, with inflation possibly jumping to the 4–5% level, pushing global government bond yields higher. My guess is that the 10-year US Treasury yield will have a 2% handle on it this year, before moving upwards again next year. This will be challenging for US equity indices, especially given that 10-year bonds now yield more than the dividend yield on the S&P500 (negative reverse yield gap). While I would hardly call bonds an attractive alternative, the fact remains that they are now a little less ugly.

Moreover, the overall make-up of the US indices may prove to be somewhat challenging, with investors heavily exposed to stocks that rise steadily in low-growth environments or stocks that emulate bond-like returns (bond proxies). With rising bond yields, increased scrutiny and taxation in these sectors and difficult earnings comparisons (the pandemic brought a lot of demand forward) the environment is challenging. I do however expect more cyclical parts of the market to do well, the question is whether they will rise enough to offset losses or flatlining in other areas and how disruptive it will be when investors shift from one side of the boat to the other. This is very difficult to predict.

Europe as a region does not suffer quite the same issues, with bond yields falling significantly short of equity yields. European indices in general have greater exposure to cyclical sectors, which in the vast majority of cases have accepted government support, but also used the pandemic to streamline operations (i.e. cut costs). As a result, these sectors could have significant operational leverage once the recovery arrives. Thinking again from a slightly different perspective, given the absolute mess that Europe has made of the vaccination rollout, it is worth considering whether a future opportunity may arise when it gets things right – which it will.

The secular bull market in bonds and ETFs is probably over, but that's ok as we do like to work for the fees we charge.

## EVERY PROBLEM LOOKS LIKE A NAIL IF ALL YOU HAVE IN YOUR TOOLBOX IS A HAMMER!

The current debate between growth and value makes great financial TV, but to me it seems rather nonsensical. What about the concept of value for money? After all, what is the point of buying a stock just because it is cheap – surely you need a catalyst to ensure that it becomes expensive?

Conversely, why pay a high price for guaranteed growth if everything is growing strongly and future growth comparisons are going to be challenging?

It wasn't so long ago that Apple was almost bankrupt and was a high-risk value stock, or owning Microsoft was considered a speculative investment. While there is no doubt that technology will continue to be impactful on our lives, in reality this tells us absolutely nothing about a company's share price. Just look at the examples of Cisco, which still hasn't regained the levels it reached in 2000, or Micron, which has only just returned to those levels after 20 years.

While I have touched on the upcoming spike in inflation, the difference may well be that due to large government infrastructure plans, rampant consumer demand and supply constraints, inflation will actually be sticky and stay with us for a significant period of time, exceeding the target rates of central banks amid a greater focus on social issues such as unemployment rates. I don't expect a type of inflation such as than seen in the 1970s or aggressive rate rises by central banks, but we may have to get used to higher inflation for a period of time, with the central banks allowing economies to run hot before eventually falling behind the curve.

In this environment, cyclical stocks are likely to be the best performers, while the real economy and the man on the street will benefit.

It really is a case of going back to the future.

[1] https://www.bloomberg.com/news/articles/2021-03-14/global-baby-drought-of-covid-19-crisis-risks-population-crunch

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