thenavigator

Autumn 2021

> Some might say sunshine follows thunder,
> Some might say we should never ponder on
> our thoughts today cos they hold sway over time
> Some might say we will find a brighter day"

SOME MIGHT SAY – OASIS

ENDGAME

As we enter our second winter of living with Covid-19, I have great empathy for those who feel we are in a never-ending situation and cannot see the light at the end of the tunnel amidst worries about increasing infection rates (mostly in Europe today), the curtailment of freedoms and the frustration of taking two steps forward and one step back.
I can't think of anyone who doesn't want us to return to a normal, pre-Covid situation. This is perhaps the only common thread in humanity, which has to a great extent failed one of its biggest tests in being unable to present a united front against the virus.
Governments seem to be at a loss over exactly what to do, with those once basking in glory now flailing around in the dark. In reality, we will only know who (if anyone) was successful in their strategies years after the pandemic has subsided.

Taking several steps back, we need to prepare ourselves for the endgame of Covid-19 when the pandemic turns into an endemic; the endgame of the easiest monetary policy both in terms of stimulus and interest rates; and perhaps the endgame of being able to generate significant returns without too much thought by buying market indices.

NORMALISATION

Looking at this holiday season compared to last year, although not perfect it is better, and I have no doubt it will be significantly better again in 12 months' time. Looking at the destinations I have visited this year – different regions of Germany, the UK, Italy, France, Austria and the USA, this time last year it would have been hard to imagine that this would be possible.
The one common thread amongst all the destinations that I have visited is that – where allowed – people are having fun without a thought for the cost, and there is a genuine feeling of a zest for life despite the challenge that some things you might want may not be immediately available. While I do believe that supply chains will get better over time, this is unlikely to happen in the blink of an eye, and a good part of the inflationary pressure we are seeing at the moment is also being driven by excess demand as people try to make up for the last, lost two years. We should also take into account the psychological impact of inflation versus deflation. In a deflationary environment consumers hold back on spending – after all, why buy something today if it is going to be cheaper tomorrow? Japan offers a prime example of this. In an inflationary environment consumers bring spending forward as they are worried that prices will only be higher in the future. Now combine this with supply challenges and you get to the heady cocktail we are seeing today.

One smart solution which I wouldn't be surprised to see happening in the not-too-distant future is the normalisation of free trade. Now that the contentious Airbus/Boeing dispute has been resolved, I fully expect the abolition of tariffs between the EU and the USA followed by a trade truce with China (when it is politically expedient to do so). This would have the double impact of easing supply bottlenecks and reducing inflation.

The normalisation of monetary policy with the Federal reserve tapering (reducing) QE is also a good first step towards getting back to normality. I now fully expect the Fed to accelerate its timeline for winding down its QE programmes as this will give the central bankers optionality on when to raise interest rates depending upon incoming data and their specific objectives.

My base case scenario is for three interest rate rises next year, which would still leave monetary policy at a very easy level but at the same time signal that the US economy is in good health and is making nice progress. These will, of course, be clearly telegraphed to the market to try and keep turbulence to a minimum, and there will probably then be a pause to allow time for digestion. In 2023 I foresee two US interest rises.

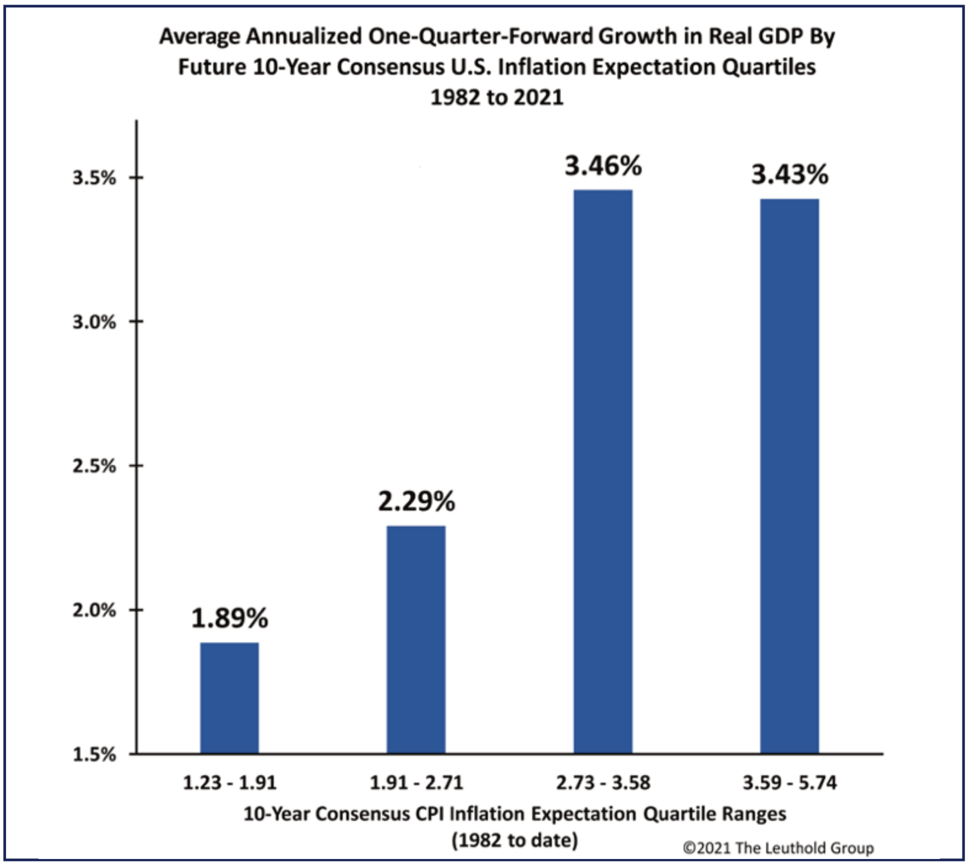
However, one area that could cause turbulence is that I see US interest rates finishing at around 2–2.5% at the end of this economic cycle, which has not been fully priced in yet.

These relatively small interest rate moves (in a historical context) would allow the Fed to soothe market nerves as to whether it is taking inflation seriously. If you think of the economic cycle as a motor race, then there are different styles of driving – one is to approach a corner at full speed and hope that you can make it round. The other, more prudent, style is to brake slightly beforehand to ensure you get the best racing line and accelerate out smoothly. Less flamboyant for sure, but also significantly less dangerous.

While interest rates and bond yields are likely to rise in the years ahead, they will probably remain lower than in past economic cycles and below inflation.

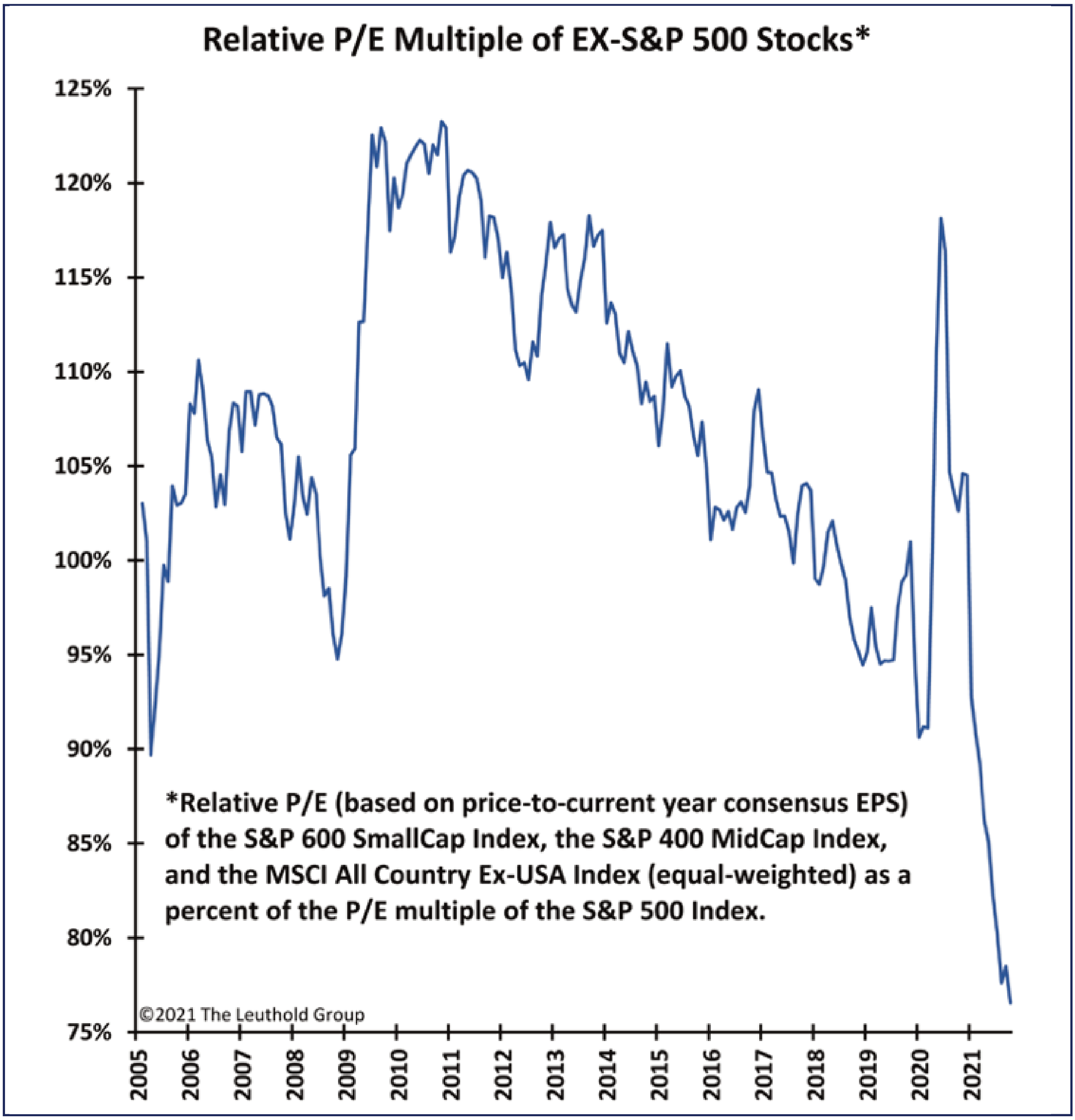
One trick that central bankers could perhaps use is to increase their target inflation rate from 2% to 3% given that they have gone for a decade without hitting their inflation targets.

From a historical perspective, economic growth has been significantly stronger when inflation expectations were above 2.73%.



Source: The Leuthold Group Research 2021

In this new economic environment, which has not been seen for decades, while economic growth is likely to be higher for an extended period so will interest rates and inflation compared to the most recent past. Investors would be wise to think outside of their most recent comfort zones and pay attention to the price they are paying for an asset.



Source: The Leuthold Group Research 2021

Perhaps the decade of relative outperformance of US stocks compared to the rest of the world is drawing to a close, or will at least be less pronounced.

We might also witness a return to the halcyon years of 2003–2007 for eurozone stocks given their relatively cheaper valuations, negative investor sentiment, easier relative monetary policy, and significantly better growth from the Club Med countries.

It is worth noting the relatively small weighting of economically sensitive stocks (cyclicals) within US indices when compared to the eurozone, for example.

Source: The Leuthold Group Research 2021

This could provide another reason for a period of relative underperformance by the US market.
Factors such as quality and growth stocks are likely to experience an extended period of multiple compression as investors finally wake up to the fact that maybe all the good news has been priced in (similar to the Y2K phenomenon of the 2000s[1]) as Covid-19 has brought forward earnings expectations for these sectors to unsustainable levels, as a group they are over-owned and their valuation metrics are somewhat sporty.
Giving up on what has worked for the last decade will not be easy for investors and will most likely lead to some stomach-churning volatility as the new reality dawns on them.

The Navigator
has been written by:
Peter Ahluwalia
Chief Investment Officer

**"Hold on, don't be scared,
you will never change
what's been and gone"**

"STOP CRYING YOUR HEART OUT" – OASIS

[1] https://en.wikipedia.org/wiki/Dot-com_bubble

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