Market Commentary

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The tortoise and the hare

It is a year of fine margins. The unexpectedly excellent September has turned a potentially poor third quarter into an excellent three months for both equity and bond markets. For a change, the UK has led the way with the FT All Share rising by more than 12% since the start of July, though the US was not far behind after the 10% increase in the S&P 500 Index. The high single digits seen in many European bourses are also impressive. Emerging markets have again been impressive, led by the rise in the BSE Sensex, the main index in India, to over 20,000 for the first time since its brief nudge over this important level in early 2008. The lesson of the year to date though is to tread very carefully. Each time markets have given clear signs of being set for a significant move up or down, they have very quickly executed a volte face and our optimism is thus tainted with both scepticism and caution.

The trigger for the improved sentiment has been the promise of further quantitative easing in both the United States and the UK. The developed world has a collective Japanese phobia. The great economic enemy, the Beelzebub of the West, is deflation. The aftermath of the 2009 recession and the credit-fuelled expansion of the past decades have allegedly left the economies of the United States and Europe with such a degree of surplus capacity that deflation is seen as a clear and present danger. Both the Federal Reserve and the Bank of England have signalled their intention to re-open their currently mothballed programmes of quantitative easing (which we take to mean the use of the balance sheets of the central banks to buy up existing medium and long dated gilts and Treasury stocks). It is worth stressing that Japan still appears to be no closer to ending its persistent non-inflation. This is being exacerbated by the equally stubborn strength of the currency, both of which have combined to make both the quarter and the year to date very disappointing for equity investors. The Nikkei 225 has fallen by over 11% since the turn of the year in yen terms, although sterling returns have been significantly mitigated by the swing in the exchange rate. *(all data: source Thompson Datastream)*

It is not difficult to understand the rationale for so doing in the US. Inflation in the States is hovering around 1% and may well fall from there given the weakness being seen in number of areas of the economy, notably the housing market and job creation. It is less easy to understand the rationale here in the UK, where inflation is and has been persistently above target throughout the majority of this year. No matter, we are investors not central bankers and it is beholden on us to predict the behaviour of the markets rather than to pronounce on the likely rights and wrongs of policy. One interpretation of this by the market is that they are being given an insurance policy, or a put option. Either economic growth picks up, or else more money will be thrown at it. The problem is that this is a two-edged sword; it could be equally that the extra stimulus is already expected and therefore that better data will deter the central banks from implementing what the markets want.

Investors are not expecting the pro-inflationary measures to work. That much is abundantly clear. Bond yields around the world are at or near record lows. Equities generally provide a dividend yield well in excess of bonds; it is common in Europe, for example, for the equity of good quality international business to yield more than the corporate bonds of the same company. This is widely accepted as ‘the new norm’; in other words we are in an era where the aversion of investors to risk is such that they are prepared to accept negligible returns in order to sidestep the possibility of capital losses. To us, this is the explorer who studiously avoids the lions, but ignores the rhinoceros pawing the ground behind him. The obituary reads ‘at least I didn’t get eaten by the lions’.

Here the lions are of course another large fall in equity prices. The rhino is inflation. If the central banks are successful in any shape or form in reigniting the inflationary fires, or even if these are lit remotely by factors outside their control, then the relative valuation of bonds and equities is anomalous. It is challenging that the markets have chosen to take such a dogmatic position; the inflation conundrum was nicely summarized by Spencer Dale, the chief economist at the Bank of England and a member of the MPC, in a speech given to the Cardiff Business School on 22nd September:

“All we can do is set policy in such a way that balances the opposing risks to inflation and be ready to change policy decisively in either direction… I do not know when policy will next change or in what direction.”
(Spencer Dale, Remarks at Cardiff Business School, 22 September 2010).

Domestic investors and strategists alike have a tendency to parochialism. The doom and gloom is terribly western-centric and is in unnecessary isolation from booming developing markets, especially across the Asian continent. In the second quarter of the year, China officially became the second largest economy in the world, its quarterly GDP having exceeded Japan for the first time. India's rate of economic expansion is again approaching double figures, while the spill over benefits are resulting in almost every economy in the region growing in mid to high single digits. With one or two exceptions (notably India), nor is the usually associated inflation a problem. The implications of this are felt at several levels. Asian equity markets have and are likely to continue to outperform versus developed economies. Second, western corporate earnings growth will be well ahead of that that might be assumed to be consistent with the lacklustre economies as more and more companies successfully look to the East for their prosperity. Growth of profits is crucial to the performance of markets and will also be boosted by the high levels of mergers and acquisitions that are now being seen around the world; companies that struggle to grow their top lines are resorting to the traditional trick of buying in growth.

We thus have a world of several divisions. The divergence in growth rates of East and West is increasing, in favour of the former, a trend that will only need to get stronger in the balance in portfolios. And in Western markets, asset valuations are predicting long term disinflation verging on deflation. The form book says it should be close race, but the punters have backed the favourite down to odds on. The value is in the slight outsider. But this is a matter of degrees and the sensible and pragmatic course of action is to stay diversified. At this time the rewards for being right are uniquely small relative to risks of being wrong. As Spencer Dale said in his Cardiff address last month, it all depends on 'inflation, inflation, inflation'. With it, financial markets, especially equities, are inexpensive. Without it, the minimal returns from bonds are the best we can hope for. The jury will remain out for the foreseeable future, but the year thus far has proved that the time honoured virtues of caution and prudence have rarely been of greater value. We keep both at the centre of our process, an unashamed tortoise in a world of hares.

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