Weekly Digest

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Bond Yield Resurrection

There is so much going on at the moment that I feel as if there is enough subject matter to fill at least a month's worth of Weekly Digests. And yet, in the end everything seems to lead back to the bond market, specifically the US Treasury bond market. Once again it is proving its power over pretty much every other asset class. You might have heard the following quote before, but it bears repetition. It was uttered by Bill Clinton's political advisor, James Carville: "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope, or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." (He is also credited with coining the phrase "It's the economy, stupid", which helped Clinton win the 1992 Presidential election in the aftermath of the Savings & Loans crisis-induced recession)

Mr Carville's revelation came to him during one of the worst periods for bond performance we have witnessed in recent decades. The yield on the 10-Year rose from 5.16% to 8.03% between October 1993 and November 1994 in response to concerns about a burgeoning fiscal deficit. Sound familiar? That delivered a loss (total return) to holders of 12.9%. That might not sound too bad in the context of equity bear markets that we have experienced, but it still came as a horrible to shock to those who thought they were invested in a safe asset. As it happens, the Clinton administration's perceived excesses were reined in by Congress, the economy boomed, and by the end of the decade economists were beginning to worry about how a US government would be able to spend an unprecedented surplus. Hard as it is to believe now, bond market investors fretted about a lack of supply, and investment bank bond departments were at risk of being shut down. Just a reminder of how quickly things can change. Since the peak of S&P's total return index last August, investors in the US 10-year Treasury have experienced a loss of 8.6% (all current market data to close of business on 5th March). So far, not as bad as 1994, or as during 2013's "taper tantrum" (-10.3%) or when President Trump was elected in 2016 (-10.1%).

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What most connects today to 1994 is fiscal deficits, but this time topped up with the promise (or should that be threat?) of a tsunami of pent-up consumer demand, and potential for increased corporate capital expenditure. The combination of these three forces meeting disrupted supply chains could push inflation up sharply. On the deficit front, for example, the Democrats continue to push their $1.9 trillion stimulus package through Congress. And when that's done, they will start on their green investment-led infrastructure initiative, which could amount to another $10 trillion over the next decade (assuming they remain in power). Given their lack of a majority of seats in the Senate (with Vice President Kamala Harris currently holding the balance of power with a deciding vote), they are determined to push through as much as they can before the mid-term elections in 2022, hopeful that they can get the economy back close to full employment and thus be rewarded with continued control of Congress. They don't want to make the same mistakes as President Obama, who lost the House of Representatives at the first hurdle in 2010 and struggled to pass any meaningful legislation for the next six years.

This phenomenon is not confined to the US. Here in the UK, Chancellor Rishi Sunak delivered a bonanza Budget, with handouts calculated to be around £65bn. Not that we were surprised, or even critical. Needs must. It's all part of building the economic bridge to get businesses and individuals to the other side of the Covid chasm. Voters have made it clear that austerity no longer fits the bill. Spend now, tax later is the mantra… although I am prepared to have a sneaky bet that some of the proposed £25bn clawback via taxation might be tactically postponed should we be approaching an election. But a plan for prudence looks good. Saint Augustine would have approved.

With vaccination programmes incomplete and social and travel restrictions of some degree still largely in place in most regions, the expected consumer boom remains, well, just expected. While it is clear that not all households have sailed through the pandemic unscathed, aggregate data is much more encouraging. For example, Empirical Research has calculated that, in the main developed economy regions of the world at least, excess savings equivalent to around 10% of normal annual household expenditure were accumulated during 2020. And that pile is still growing if the latest consumer credit figures are anything to go by. Even if some of those savings remain saved – as maintained by the theory of Ricardian Equivalence, whereby people save more now in the expectation of having to pay more tax later – it still leaves a huge pool of potential spending money.

I listened last week to an economics professor from a top Canadian university who specialises in analysing transactional behaviour through "big data" sets. Working back through everything that could be deemed a "crisis" over the last couple of decades, he has concluded that despite persistent fears that behaviour might be permanently changed by events ranging from terrorist attacks to meteorological disasters, humans return remarkably quickly to their previous habits. No doubt there will be some modifications ahead, but he's pretty certain that consumers will go back to consuming with a vengeance as soon as they can.

As far as companies are concerned, it was informative to see that in Bank of America's latest fund manager survey, the most popular response to the question "What would you most like to see companies do with their cash flow?" was "Increase capital spending". The most popular answer from March 2020 through to January 2021 was "Improve balance sheets". If such capital spending can enhance productivity in the long run, so much the better. However, in the short term it spells yet another source of increased demand.

And so, after years of trying to generate more inflation, central banks are now faced with the prospect of more of it than they might want. Thus the sell-off in bonds, as investors reposition for the possibility of tighter policy. This could be achieved initially by tapering asset purchase programmes, but there are no hints of that so far. Indeed, unlike the "taper tantrum" of 2013, the latest rise in bond yields is being described as the "taperless tantrum". Similarly there are no suggestions of shrinking central bank balance

sheets or raising interest rates. But the market is making its own statement. Such a move is often described as being the work of "bond vigilantes". It's a fun concept, but in reality there is – to the best of my knowledge – no group of masked fixed income fund managers working in concert to send a message to fiscally incontinent finance ministers. But you can bet that they will be getting a lot of press in the weeks ahead.

Where does this leave us from an overall market perspective, then? There have certainly been some pretty punchy movements in equities, notably in the fall from grace of more highly valued shares and funds exposed to technological innovation. This has been countered by the rise of companies more exposed to the demand recovery outlined above. Cyclicals winning over defensives, or Value versus Growth remain the main terms used to describe this rotation. We continue to prefer to describe it as "short duration" assets beating "long duration". Investors now feel more confident in buying into the incipient recovery than in placing bets on an uncertain, but potentially rewarding, distant future. The mathematics of rising interest rates and their effect on the net present value of future cash flows means that valuations are under pressure for those sectors and companies that have led the markets higher in recent years. At the other end of the scale, banks, in particular, are deemed to be winners from higher interest rates and a steeper yield curve, in that their net interest margins can be enhanced.

If the concept of "duration" is a little difficult to grasp, let's look at it through the lens of two different government bonds with distinctly different maturity dates. Things can get a bit confusing here, because maturity and duration are both words that can refer to a fixed period of time. However, in bond markets, duration specifically refers to the time it will take, in years, for an investor to be repaid the bond's price by its total cash flows. That will be a function of the time to maturity and the interest rate. Duration tends to rise with more distant maturity dates and lower rates.

The yield on a UK Gilt due to be repaid in 2026 (therefore with a simple maturity of five years, and a similar duration) has risen from -0.1% to +0.35% since the turn of the year. But with the duration (or sensitivity to the rate of change) being quite short, the capital loss has been just 2%. What if we look at something with a much longer maturity (and duration), the Austrian government bond due for repayment in 2120, for example? The yield on that bond has gone up by roughly the same amount, from 0.37% to 0.86%, but the capital loss is a gut-wrenching 28%. Bloomberg calculates the duration of this bond to be 66 years. The longer the duration of any bond you hold, the greater the sensitivity of the capital value to the change in the yield. This works both ways. Investors who sought higher returns through longer duration are now dying by the sword by which they lived last year.

In a very crude way, then, we might be able to infer the "duration" of any number of shares and funds. Or, put another way, how far into the future are investors projecting their expectations to justify current valuations? Perhaps the most famous beneficiary of low discount rates and a desire to invest in potential "hypergrowth" technologies has been the stable of funds run by ARK Invest in the United States. They certainly captured the zeitgeist of 2020. ARK's flagship ARK Innovation ETF returned an impressive 212% (i.e. it more than tripled in price) from the beginning of 2020 through to its peak on 12th February 2021. It has since fallen 25%. That's not too far away from the performance of the Austrian 100-year bond. Were its investors really looking more than half a century ahead to justify the performance? OK, I know this is just a bit of fun, and one also has to take growth rates and profit margins and returns on capital into account, but hopefully it helps to clarify what we are talking about and to explain the huge movements in the prices of certain shares and funds recently.

The good news about all this rotation, though, is that overall markets and balanced portfolios are much less volatile. If you are concerned by headlines about crashes, things need to be put into context. The MSCI

All-Countries World Index is only 4% down from its high on 15th February; the S&P 500 -2.4% (compared to -8.3% for the Tech-laden NASDAQ); and our own FTSE 100 is -3.6%.

Interestingly, whereas not so long ago investors were Fearful Of Missing Out on gains in those long duration companies, now the FOMO trade is all about short duration cyclical recovery. Funds that latch on to share price trends are also jumping onto this theme, and the support from them is forecast to become stronger as we move through the first anniversary of the Covid market trough during the second half of March. As some would have it, Value becomes the new Momentum.

How long this can continue remains to be seen, but the potential for further upgrades to estimates for the pace and scale of economic recovery suggests a while yet. The multi-trillion dollar question remains whether any associated spike in inflation will be "transient" (as Federal Reserve Chairman Jerome Powell continues to assert) or more persistent. An informal poll of those participating in a large UK fund manager's debate on the inflation outlook last week had 66% of respondents thinking inflation would rise and then fall back, with only 16% saying that it would remain elevated. 15% thought that it wouldn't even get to 2%. And even if you know inflation is coming, how do you hedge against it? A poll on that subject also showed relatively little consensus, although Commodities topped the list at 32%. The other choices on offer were Index-Linked bonds (21%), Gold (21%), Equities (11%), Real Estate (2%) and Cryptocurrencies (13%).

On much the same theme, a Financial Times webinar discussion on the future merits of the standard 60/40 Equity/Bond portfolio in a rising inflation/bond yield/interest rate environment elicited a similar lack of agreement on alternative constructions. Asked about favoured diversifying assets, the audience replied as follows: Real Estate/Infrastructure 23%; Absolute Return/Hedge Funds 23%; Commodities 20%; and Other Alternatives 34% (I assume the last category could include anything from Structured Products and Music Royalties to Crypto assets).

Two things strike me from these surveys' results. First that there is huge amount of uncertainty both about the outlook for inflation and how to deal with it in portfolios. That alone suggests plenty of scope for more volatile markets in the months ahead as investors react to data as it is released. My experience is that the market, from time to time, becomes obsessed with one particular data set, and this year's obsession will be with anything concerning inflation. Second, if Commodities is highly ranked as an asset class to hedge against inflation and to diversify risk in a balanced portfolio, there will be some element of the "self-fulfilling prophecy", as purchases of commodities as hedges help to drive up inflation.

As for James Carville, his wish to be resurrected as the bond market has yet to be fulfilled, mainly because he is still alive and well. I haven't managed to track down his thoughts on the latest episode, but I suspect that his ambition will have been strengthened.

Last week's Economic Highlights

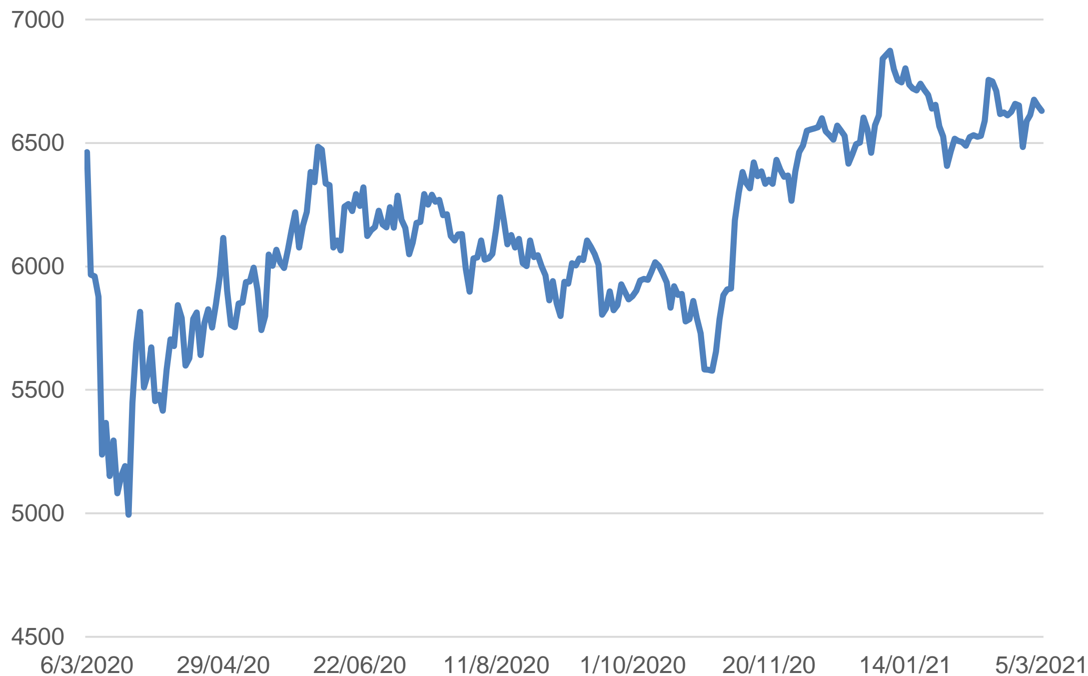
FTSE 100 Weekly Winners

Company	Change
BT Group plc	14.5%
Persimmon Plc	12.2%
Pennon Group Plc	9.3%
BP p.l.c.	9.3%
M&G Plc	8.7%
Taylor Wimpey plc	8.4%
Standard Chartered PLC	8.1%

FTSE 100 Weekly Losers

Company	Change
London Stock Exchange Group plc	-15.5%
Scottish Mortgage Investment Trust Plc	-10.4%
Just Eat Takeaway.com N.V.	-7.7%
JD Sports Fashion Plc	-6.0%
Rio Tinto plc	-5.4%
Ocado Group PLC	-5.1%
Admiral Group plc	-4.2%

FTSE 100 Index, Past 12 months



Source: Factset

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