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From Bust To Boom

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During one of the periodic tidying up sessions in my office at home over the weekend, I unearthed a couple of editions of a reputable financial newspaper dating back to late October and early November last year. Remember that this was around the time when market sentiment was at its lowest ebb during 2023. Equity investors were worrying about an economic slowdown while bond markets were more concerned about sticky inflation and a surfeit of issuance from fiscally incontinent governments, with the US in the spotlight. Bonds were in a

deep bear market, while global equities in aggregate had gone nowhere for two years and balanced portfolio investors were asking why they should bother when 5%-plus was available on cash deposits.

The weekly market commentary section of the publications in question (which I am not going to identify precisely because this is not an exercise in trying to besmirch someone else's reputation – glass house and stones, etc) focused on the risks to both equity and corporate bond markets. Earnings could come under pressure if the long-awaited recession developed and credit spreads (what companies have to pay for their debt over and above the yield on government bonds) were signalling rising distress. Any thought of central banks relieving the pressure by indicating interest rate cuts was dismissed as improbable.

Let's see how that has played out. Starting from the beginning of November, the MSCI All-Countries World Index has delivered a total return of 20.4% to a sterling-based investor (+24% in dollars). That's two-and-a-half to three years' worth of "normal" long-term returns in just over six months! Even the FTSE 100, helped by a recent pop, has managed 17.6% (all data to close of business on 10/5/24).

What about credit spreads? US High Yield spreads were 517 basis points at the end of October, meaning that the average highly indebted US company had to pay 5.17% more than the government was being asked to. I don't doubt that if spreads had stayed at that level a lot of companies would have run into trouble. But here we are today with spreads down to 336 basis points, which is about as tight as they ever get. And the fact that government bond yields have fallen a bit over the period has helped too, meaning that a representative High Yield ETF has gained around 10%.

It's very easy to get caught up in the moment in financial markets. There are times when there does not seem to be a shaft of light anywhere. Market movements become self-reinforcing and "pro-cyclical", with selling begetting more selling; momentum reverses and then accelerates in the wrong direction; leveraged investors are forced to reduce their positions as volatility increases. It even got to the point last year when market participants were seriously questioning whether the US would be able to honour its debts. And yet, as is usually the case, we found some way out of the mess.

No doubt, there was a helping hand from the US government itself in the form of the Treasury's November Quarterly Refunding Announcement. This took the pressure off bond yields by limiting the total issuance and skewing that issuance towards T-Bills. T-Bills are very short-dated funding instruments which can be mopped up out of existing cash resources and which demand minimal capital to be put up by banks who buy them, making them very user-friendly. Although the rally had already started, another institution, the Federal Reserve, gave it another nudge in December by suggesting that it might be willing to cut interest rates sooner rather than later. And this was in the face of another good quarter of corporate earnings as the US economy continued to hum along.

One piece of advice we were happy to hand out last autumn was the value of sticking with one's longer term investment strategy even in the face of short term disappointment and growing impatience with lacklustre returns. One never quite knows when the turn will come, but we were pretty sure that when it did it would be quite powerful, given past experience, especially after two years of no progress.

We are also sufficiently realistic to recognise that markets don't go up in a straight line either and so we would not be at all surprised by something of a pause in the short term. But one still has to stay in the game, even it means losing a few hands. The important thing is to continue to take an appropriate amount of risk, either in terms of tactical asset relative to benchmarks or in terms of stock selection. We maintain a bias towards higher quality stocks in

the recognition that there will be times when the market's preference is for more dubious enterprises. We're happy to let those trains go by.

One such train has been NatWest, the banking group (and please bear in mind that this is market commentary, and I am not allowed to dispense stock recommendations. Neither am I accusing it of being a "dubious enterprise"). Going back to the same publication, I noted a column describing the reaction to its third-quarter results which had resulted in a 17% share price fall. The column concluded that bargain hunters should think twice. Amazingly, the shares have returned 88% since then including dividends. It turns out that the UK economy, even if in a shallow recession in the second half of 2023, was not a basket case after all. And NatWest, along with other banks, has been rewarded for promising big capital returns to shareholders in the form of dividends and share buybacks. Still, even the best-in-class "plodder" that we favoured in illustrative portfolios instead has returned 40%, which is not to be sniffed at.

We have maintained for several years, often in the face of scepticism, that a rerun of the Global Financial Crisis (GFC) was an improbable outcome. For one, banks are much better capitalised and regulated. Second, central banks and other authorities learned some very harsh lessons about maintaining liquidity in the financial system during the GFC and have since applied those lessons pretty consistently when threatened. Maybe we had to get through a few of those cycles for a lot of investors to believe that banks were actually investible again.

And never underestimate how many people want to climb aboard an accelerating bandwagon. It seems to me as though investment narratives (as opposed to forensic financial analysis) have become the key drivers to many sectors and shares in the shorter term. This fits with Ben Graham's idea of the market being a "voting machine" in the short term, but a "weighing machine" over longer periods – in the end you always need the earnings to come through to justify the valuation. Indeed, what looks like a move one might have missed often turns out to be just the beginning of a much bigger one. In the last couple of years, we can see evidence for this in the huge runs for shares involved in Artificial Intelligence, Defence and appetite-suppressing drugs, for example. One that seems to be firing up again is the "electrification of everything" and the associated boom in the demand for power, if only because I note that a leading investment bank has just issued a custom basket of stocks that could benefit from such a trend.

That's not say that you can safely buy things that have disappointed just in the hope of a bounce. At the same time last year there were ugly headlines reporting results from Danish container shipping company Maersk, the French pharmaceutical giant Sanofi and cognac producer Remy Cointreau, all of which experienced share price falls of more than 10% on the day. They have since returned -3%, +7% and -12% respectively. Later this week I will be heading off on my annual visit to the London Value Investor conference, where I'm sure a few of the managers presenting will be doing the investing equivalent of putting their hand into a bucket of dung in the hope of pulling out a gem. I will present my usual report anon.

Finally, I also noted that the same financial publication's commentary this weekend was about the recent burst of energy from the FTSE 100, attributed to reasons ranging from cheap relative value and increasing bid activity to the hope for interest rate cuts from the Bank of England. We don't really subscribe to buying "the index" but have no reason to disagree with those sentiments and are very happy to buy individual UK shares when they offer the best solution to populating a portfolio that has a more global perspective. However, if the UK really is coming back into fashion for the reasons listed above, that will probably mean even better gains for small and mid-cap indices. Anyway, I'm going to keep this weekend's article and see how it looks in another six months or so.

Economic Commentary

FTSE 100 weekly winners

St. James's Place Plc	11.6%
Prudential plc	10.0%
Berkeley Group Holdings plc	9.2%
Persimmon Plc	9.1%
ITV PLC	9.1%
CRH public limited company	8.3%
Taylor Wimpey plc	7.9%

FTSE 100 weekly losers

Just Eat Takeaway.com N.V.	-3.4%
BP p.l.c.	-1.9%
HSBC Holdings Plc	-1.3%
Entain PLC	-0.6%
Ocado Group PLC	-0.5%
Melrose Industries PLC	-0.3%
Evraz PLC	0.0%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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