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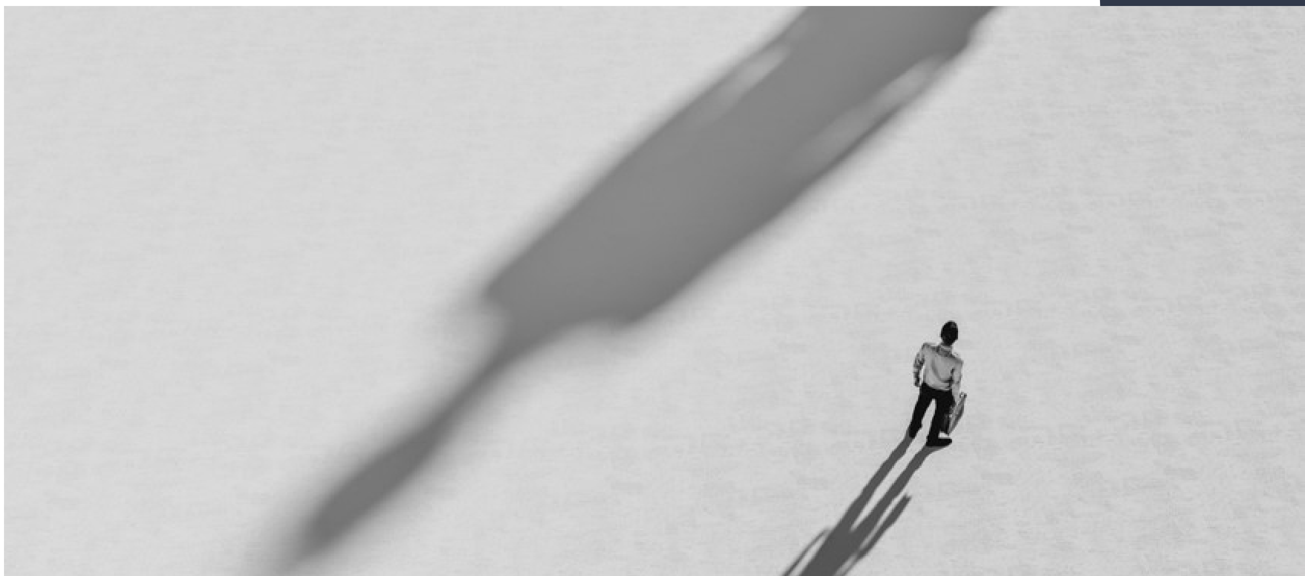
False Friends



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In the study of languages, a “false friend” is a word that looks exactly the same in two languages but means something completely different. One of my favourites is the word “burro”. In Italian it means “butter”, but in Spanish it means “donkey”. Hard to confuse, I know, but it could make for some hilarious outcomes.

In financial markets, the consequences could be more severe. There is a well-worn aphorism which states that "the trend is your friend". The theory, which seems to play out well in practice too, is that once a financial instrument or indicator is moving consistently in a certain direction it tends to continue moving that way. The further it goes, the more it becomes accepted and followed, which can lead to dislocations when the trend reverses.

We are going through one of those difficult periods at the moment. From the second half of last year until a few weeks ago, the prevailing market narrative was that inflation was gently subsiding and that interest rates would be coming down sharply this year, dragging bond yields lower too. That belief was cemented by comments in December from Jerome Powell, the Chair of the US Federal Reserve Bank, in what was described as another of his "policy pivots".

Now, following strong activity data and three consecutive US consumer price index readings that have come out higher than expected, many market participants have been wrong-footed. Bond yields are rising once more and expectations for interest rate cuts are being pushed back. Indeed, there is now even talk of the next move being an increase. The US 10-year Treasury yield has risen from 3.88% to 4.65% so far this year, whilst the UK 10-year Gilt yield has gone from 3.53% to 4.24%.

The initial move upwards in bond yields was not taken too badly by the market. This reflected the view that "good news is good news". A stronger economy reduced the probability of a nasty recession developing and was indicative of a healthier outlook for corporate profits. It might even help government revenues (taxes) to grow enough to allay fears of fiscal deficits becoming unsustainable.

But there is often some undefinable moment at which the view flips and suddenly "good news is bad news". Too much strength in the economy raises fears of inflation and the need to keep interest rates higher for longer. Not only does this higher rate environment create a headwind for financial assets from a valuation perspective, but it also has the potential to undermine profits if overall economic activity is reduced by higher rates.

Of course, this was what was supposed to happen last year in the US, with widespread forecasts of an imminent recession at the beginning of 2023. However, it turned out that the transmission mechanism for monetary policy did not work as expected and the US economy grew strongly. Even now, nobody can be sure if it was a case of a delayed effect or whether the economy is, in fact, much more resilient than was thought. It's the key reason why we have not been willing to take big directional bets on specific economic outcomes in our asset allocation process.

The weakness in bond markets reflected in those higher yields has spilled into equity and credit markets during April. "Long duration" stocks, that is those whose net present value is largely a function of expected future profits, have succumbed to profit-taking owing to the higher discount rate. Specifically, within those companies that have been buoyed by the enthusiasm about generative artificial intelligence (AI), we have seen some doubts creep in about just how much one can extrapolate recent growth trends. Comments last week from semiconductor equipment manufacturer ASML were construed to be somewhat cautious, and although the company pushed back against that interpretation, they were enough to knock around 10% off the share price. Market darling Nvidia, the semiconductor chip designer, is some 20% down from its closing peak, which was less than a month ago; but to put that into some context, the share price is still almost three times what it was a year ago.

Another potential false friend in financial markets is correlation, or the relationship between two different asset classes. The longer it remains stable, the more investors come to believe that it is immutable; but we know correlations can shift, and that when they do the movements can be violent. One of the tried and tested relationships that has broken down recently is the

one between bond yields and gold. Gold is an asset that produces no income, and so, in theory, its value should be closely (and inversely) correlated with the yield available on other safe assets, notably the real yield available on US 10-year Treasury bonds which takes into account inflation expectations – gold being viewed as a long-term inflation hedge owing to its long history of maintaining its pricing power.

Recently, though, models tracking the theoretical price of gold against bond yields have completely broken down, with gold performing a lot better than it "should" have done. There are a number of reasons why this might have occurred, none of which are definitive, but all of which are plausible. In no particular order: central banks' potential capitulation to higher residual inflation; the threat of debt monetisation by governments and central banks (and the ensuing devaluation of fiat currencies versus real assets); safe haven buying in the face of geopolitical threats; EM central bank reserve diversification having seen the freezing of Russia's dollar assets; Chinese retail buying in response to weak housing and equity markets and a weak yuan; Japanese retail buying in response to the Bank of Japan's "dovish hike" leading to a weaker yen.

Some people view a divergence from trend or a breakdown in correlations to be a blip before a reversion to the mean. I am more inclined to ask what has changed. Implicit in the strong run in the gold price seems to me to be a dawning realisation that there are several challenges ahead that need a different sort of tail risk hedge when applied to a balanced portfolio.

Such a dynamic shift is also possible in the long-term relationship between bonds and equities, as we have discussed before. 2022 provided the nightmare scenario for the traditional 60:40 portfolio of 60% equities and 40% bonds because the shift higher in inflation expectations and required interest rate changes caused both bonds and equities to fall sharply. The "easy win" environment that had prevailed since 2000 (and which had become an article of faith for many investors), that bonds tended to rise when equities fell and vice versa, leading to fabulous risk adjusted returns, was blown out of the water.

The good news, as I alluded to last week, is that higher rates now at least deliver an income and have the potential to be reduced. Even so, in what potentially looks like a world of structurally higher and more volatile inflation, a "set and forget" 60:40 portfolio looks more vulnerable. This puts a greater onus on more agile tactical asset allocation and good stock picking to generate returns, something that our new combined business will, I believe, be well placed to deliver.

Economic Commentary

FTSE 100 weekly winners

International Distributions Services plc	20.8%
Mondi plc	6.6%
International Consolidated Airlines Group SA	4.2%
Imperial Brands PLC	3.4%
Croda International Plc	2.5%
Severn Trent Plc	2.4%
Admiral Group plc	2.4%

FTSE 100 weekly losers

DS Smith Plc	-13.0%
Just Eat Takeaway.com N.V.	-9.6%
CRH public limited company	-6.7%
Rentokil Initial plc	-6.7%
Pershing Square Holdings, Ltd. Public Class USD Accum.Shs	-6.6%
Scottish Mortgage Investment Trust Plc	-5.9%
Intermediate Capital Group plc	-5.8%

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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