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Anticipating events. Investment Strategist Peter Lucas considers the impact of expected growth and inflation, key inputs into our investment process, on investment markets.



A common mistake made by inexperienced investors is to equate what is happening in the markets to what is happening out there in the real world. The problem for them is that markets are always several steps ahead of them, anticipating events that have yet to happen. That is why you often hear experienced practitioners saying: “buy the rumour, sell the fact”. When a story has been widely shared and discussed, the markets have typically moved on to the next big thing. The front cover story of the Economist magazine is a celebrated ‘contrarian indicator’, which has picked market tops and bottoms with uncanny accuracy, and not in a good way.

I learnt this lesson early in my career. America had assembled the coalition of the willing to eject Iraq from Kuwait in 1990. I was bearish, expecting markets to go down when the fighting began. When they announced on the radio that planes had started bombing Iraqi forces, I was shocked to find that the Nikkei had closed 4.4% up on the day. “Buy on cannons, sell on trumpets”.

So, the macro investor faces two main challenges: (1) knowing how the economic environment is going to evolve (“skate to where the puck is going to be”) and (2) understanding how different assets behave under different circumstances. Although there are many factors that influence markets, two of the most important are growth and inflation.

Combining these two variables, one is left with four possible scenarios:

1. Rising inflation, rising growth (inflationary boom)
2. Rising inflation, slowing growth (inflationary bust)
3. Falling inflation, rising growth (deflationary boom, the natural state of capitalism)
4. Falling inflation, falling deflation (deflationary bust)

We have already covered the issue of inflation and how it affects asset prices in an earlier article (see *Investing for inflation*, October 2020). We explained that unless you are coming out of deflation, rising inflation is bad for equities because of what it does to equity valuations. Lucky for us, once inflation turns, it tends to trend for a while and so the key is identifying the change of trend. Moving average crossovers work well in that respect; for example, equities tend to outperform cash when the average rate of inflation in the past 12 months has been lower than that for the past 10 years.

Slowing economic growth, or more particularly negative growth is bad for equities because of what it does to company profitability. One way to identify when growth is going to fall on a cliff is to monitor the gap between corporate bond yields and inflation, because when real yields rise beyond a certain point, economic recession almost always follows with a lag.

By now, it will hopefully be clear that the best environment for equities is a deflationary boom, when inflation is falling and there are no red flags for growth. That is where we are today. No surprise therefore that equities are beating pretty much everything.

With corporate real yields close to historic lows, there would appear to be little likelihood of a bust scenario any time soon, at least not as defined above. Conversely, with commodity prices rising strongly, there is every chance that the inflation indicators will switch from deflation to inflation in the next few months. If that is the case, the environment will be less favourable for equities and bonds, and more supportive of commodities and commodity-producing countries and companies.

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With fiscal and monetary policies set to remain supportive for the foreseeable future, the bust scenario looks a distant prospect. However, high debt levels mean that economies are now more sensitive than ever to rising borrowing costs. Bond yields are now trending higher and short-term interest rates will no doubt follow, albeit perhaps with a long lag. Eventually, yield curves will flatten and invert, and the bust scenario will come onto the radar. But will the bust be deflationary (buy government bonds) or inflationary (buy hard currencies backed by prudent monetary policy)? I am inclined to the latter scenario, but it will be fascinating to see how the weight of evidence shifts.

Peter Lucas

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