FACETOLOGY

May 2018

"You got an ology?" – Maureen Lipman as "Beattie" in BT's 1987 commercial.

Ology: Noun (*humorous, informal)*: A subject of study; a branch of knowledge – Oxford English Dictionary

We are today publishing a new newsletter to keep clients up to date with our current thinking on markets of all kinds from stocks and bonds to property and commodities. We hope you will find them interesting and informative, and maybe sometimes light hearted or thought provoking as we share our thoughts on some of the issues of the day. Today's technology allows us to take our news from anyone and anywhere but also bombards us with "crisis chatter" which, from an investment perspective, is largely irrelevant. Daily, the various TV stations and online media offers up any number of explanations for every twitch and turn in stock markets and vacuous words like "sentiment", "uncertainty" and "confidence" have found mainstream use. At FACET fund management, we aim to maximise returns by making investments consistent with our long-term view and this involves looking through such short term noise and deciding what is, and what is not, important.

A good example of this is the 12-month performance of the US stock market from which other developed markets take their lead. By mid-January, US stocks were trading at all-time highs (Fig.1) despite some lingering geopolitical concerns from 2017 and the fact that stocks and bonds were, to put it simply, expensive.

As is usually the case, political disputes, such as Trump vs North Korea, the Middle East or the troublesome Brexit negotiations, make for interesting headlines and can be an immediate distraction for markets. But the one thing that really matters most is the action of central banks. Any unexpected thing that could force central banks - most importantly the Federal Reserve - into making changes to interest rates is of deep and legitimate concern to long-term investors but also preoccupies the short-term trader.

That "unexpected thing" turned out to be statistics showing wages rising in America at the fastest rate since 2009 after many years of stagnation. This is emblematic of the paradox which has dogged markets since the Great Financial Crisis of 2008, whereby good news on the economy is bad news for stocks and bonds because of the implied hike in interest rates.

Investors wasted no time in selling both, as US 10-year bond yields rose swiftly towards 3% and nearly 300 points was knocked off New York's S&P 500 index of leading shares, a fall over 10% from the historic highs of a week or so earlier.

As it happens, the February wage growth figure of 2.9% was revised lower the following month to just 2.6%. This provided some relief to markets but the scare nevertheless ensured there was no return to the euphoric levels of late January.

However, March was not without its drama - this time of the geo-political kind. Global markets were spooked again over fears of a trade war between the USA and China after the US administration announced new trade tariffs on imports of steel and aluminium. The US and China then hit one another with tariffs on other goods, but the scale of the issue turned out to have little meaningful impact and the 4.5% hit to the S&P 500 was soon recovered.

This episode of market volatility confirms, in our view, how markets can react in equally dramatic fashion to events that are important in the long term and those which, relatively speaking, are not. At the root of it is a recognition of the historically unprecedented factors that have propelled stocks and bonds through their respective bull markets since 2009.

Fig.1: S&P 500 Index – Source Bloomberg

The major central banks of the USA, Europe, UK and Japan have run near-zero interest rates for nearly a decade. Deemed necessary to help dig the global economy out of the Great Financial Crisis of 2008, it presented investors with an opportunity so long as one had faith that it would ultimately work (despite it not working in Japan for 20 years – a conversation for another time). Constraining the impact of this extreme emergency measure was the fear that the sheer amount of money being printed would quickly fuel a spike in inflation, thereby, resulting in a reversal of the policy. This would've been calamitous for stock markets.

So for several years, stock markets climbed a wall of worry. Money was flowing into markets but the party could end whenever the Federal Reserve removed the punchbowl of free money (hence, bad news on the economy paradoxically became good news for the stock market as it meant interest rates staying lower for longer). Meanwhile, central banks got on with the business of trying in vain to create a bit of headline inflation in order to help inflate away high corporate and national debt. This proved rather elusive and reminds one of the character Sallah in Raiders of the Lost Ark who utters in dismay "They're digging in the wrong place, Indy!".

If one was looking for inflation, it would ultimately be found in international assets: everything from stocks, bonds and property to classic cars, fine wines and luxury watches shot up in value as cheap money found a way into something with a yield or scarcity value. Headline inflation remained stubbornly low as did wage demands which averaged around 2%, an extremely low level far below the growth in company profits and economic growth.

So nearly a decade on from the Great Financial Crisis, we find ourselves with stock and bond markets trading near all-time highs while only now are we seeing a pick-up in inflation. Therefore, the central banks must now tread the familiar delicate path of raising interest rates in a measured way so as not to destabilise asset prices which, after all, underpin the viability of the financial system.

At FACET our investment team has constructed portfolios to minimise our exposure to assets that are most directly exposed to a sudden rise in interest rates. In most cases, this is done by investing in well-researched funds where we believe the returns are modest but predictable, or where we see an opportunity that clearly outweighs the risks. The resulting mix of investments gives our funds what we believe to be the optimum balance of risk versus reward over the long term. A belief supported over the long run by our performance.

This does not constitute advice, please refer to your investment advisor regarding your individual financial circumstances. The value and the income derived from them can go up as well as down.