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Reflections & Insights

"We all know what to do, we just don't know how to get re-elected after we've done it."

– JEAN-CLAUDE JUNCKER
FORMER PRESIDENT OF THE EUROPEAN COMMISSION

GuardCap Asset Management Limited authored the following commentary.*

At the end of 2021, it was all so obvious. Valuations high, interest rates low. It was bound to go wrong, and markets were going to fall. Oh, for the beauty of hindsight. Going back a year, of course, none of this was obvious, or if it was, the forecasting fraternity was guilty of wilful blindness. For sure, short-term interest rates were expected to rise, but by 0.75% (in the US).

Actually, they rose by more than 4%, which is the most aggressive rate increase since the early 1980s. Valuations were high, of course, but they were 'justified' by the level of interest rates and expectations. In fact, profits continued to rise, but prices fell, underlining the little secret of financial markets that interest rates matter more than profits in determining the price level of stock markets. In fact, the tech-heavy NASDAQ Index fell by more than 30%.

Something else that was obvious was that bond markets would provide a haven from equity market turmoil, as has usually been the case in the past. Oh dear. Instead, bond markets had the temerity to fall, and those investors with balanced portfolios (e.g., 60% equities/40% bonds) had one of their worst years on record. The fact that bond markets had gone up in lockstep with equity markets over many years was an artifact of a distorted monetary system where borrowing was free, and all risk-taking was rewarded. That they dropped in lockstep is, perhaps, a harbinger of the fact that the era of free money has come to an end.

Well, OK, so maybe 2022 was not the acme of the forecasting profession, but it's all the fault of Putin for invading Ukraine. Yes, and of the bounce back from COVID creating all sorts of temporary inflationary pressures, all of which meant that commodity prices

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soared and interest rates had to go up by more than the models suggested. It is indeed true that the best place to hide over the past year was in energy stocks. Obvious, really, apart from the fact that we all expect(ed) energy businesses to suffer as the move to alternative energy supply gathered momentum.

The point of all this is to underline that spending a lot of time trying to work out what will happen in the next year is pretty futile. Many people make a spectacular living doing just that, but to succeed, accuracy is a poor second to creating a logical narrative. It is much easier to live with yourself if you have a picture of the world that makes intuitive sense. In reality, the world is a messy place, and financial markets add volatility to that mess. There is evidence from the forecasting world itself of this. We have a divergence of expectations about the year ahead that is the largest on record, all of which tells you the awful truth. Nobody knows what will happen.

Herculean difficulties ahead perhaps

Instead, maybe, we should think about what investment is actually about. To listen now to those who were wrong a year ago, it was obvious you should have switched all your technology stocks into oil and otherwise gone liquid. For most investors, that would have been impossible, and indeed the number of people who did so (as opposed to saying they did) is vanishingly small. That advice, had you followed it, would have been trading advice, not investment. Yet, here you are now, with lots of cash and a lot of oil stocks. What do you do now? Is 2023 going to be like 2022? Or something else? Catching the next wave is possible but of Herculean difficulty. What's more, it's not investment.

Investment is really about holding assets that deliver returns to you as an investor because the underlying business produces returns. It is a long-term activity measured in years or decades, not weeks or months. The share price of the business you invest in will go up and down with its own prospects, and its valuation will change because of interest rates. Do serious companies change their business models because their valuations are high or because Ukraine has been turned into a dystopian quagmire? They do not. That is not to say that there aren't significant geopolitical trends that will shift the emphasis of a business. For example, the risks of a supply chain that is too centred on China have become more apparent, and the process of reshoring or (even more

jarringly) 'friendshoring' has been gradually gathering steam. That will continue. Equally, the influence of demographics on corporate strategy is well understood, and those businesses that ignore it won't be there in the long run.

Not arguing for dart board investing

Over the past year, the prices of almost all companies have fallen, sometimes precipitately. This is not an argument for dart board investing. Picking the right businesses and sectors still matters. Analysis of a company's prospects is very valuable, but it is a better time today to invest than it was a year ago. It might get better still if prices fall further, as indeed they might, but at some point over the next six months, it may be right for long-term investors to commit more money to equities.

Investment in government bond markets is no different. The requirement is for countries to follow reasonably sound monetary and fiscal policies that minimize the risk of inflation and social upheaval in such a manner that the investor earns a real return and gets the money back. Today it is difficult to argue that the policy mix is right. Inflation remains stickier than originally expected, real interest rates are either low or negative in many countries, and we are heading for an economic reckoning which will cause a cost of living crisis in many developed countries. A tricky path between bringing inflation under control and providing relief to consumers (who are also voters) means that political calculation is everywhere presently. The policies of the last decade, combined with the effects of the pandemic, have left developed countries with very high debt levels, which in turn, with higher rates, leads to servicing costs rising and becoming potentially unaffordable. In the battle between sound money and politics, this is a recipe for low growth, lower rates than are needed to bring inflation under control, and higher inflation than markets like. This means headwinds for risky assets, but they will not be as severe as over the last twelve months. For bond markets to be compelling, the trajectory of that trade-off needs to be clearer.

Required recalibration

In the broader sense, and in the interests of almost everybody, the era of free money should be behind us. Most of the commentariat are reading the tea leaves to guess when the Federal Reserve will pivot,

by which they mean start to let interest rates fall. The implication is that the markets are headed back to the post-pandemic period of free money for all. This is not in the long-run interests of capitalism or social cohesion. Without money having a price set by a market, bad businesses survive beyond usefulness and new businesses doing stupid things blossom at stupid valuations. In an era of free money, chances are that a lot of money will be thrown down the drain. The collapse of FTX is an example of how these things come unstuck. The crypto industry was supposed to be uncorrelated to other asset markets because it offered sound money in an era when currency debasement was rife. In practice, it has turned out to be correlated with risky assets because it relied on free money and huge leverage. There is probably the kernel of something genuinely useful in the crypto world. Still, the way in which it was promoted as an investment opportunity and the way it attracted huge participation from the public is utterly scandalous.

The world faces some very serious problems. While companies may not adapt strategy to bumps in the road, there are some factors that require recalibration. As discussed, reshoring and demographics are but two. The elephant in the room, though, is climate change. Carbon emissions globally are not falling, with the single (and quite minor) exception of 2020, for obvious reasons. The world is not on the path to reducing emissions by the quantum required to limit warming to 1.5 degrees C (in fact, quite the opposite), and the will to do so is frayed. The consequences of failure here are hard to overstate. A lot of faith is pinned on technological change, but a combination

of electoral cycles, political grandstanding and ignorance have all weakened the debate. From an investment perspective, companies have to think about the challenges, both as consumer tastes and requirements change and as the opportunities for new technologies open up. In the past decade, the investment landscape was dominated by digitization, new media and software. While those are not going away and disruption of 'legacy' businesses will continue, the next decade will see other opportunities gather momentum. Climate science is obviously one of these, but so are the avenues for change presented by the use of artificial intelligence, particularly in fields like health care, where the developments already underway are changing how medicines are developed and how data is used.

There is an old Wall Street saying which goes, 'bull markets climb walls of worry'. What this means is that when everything is rosy, you can be sure that all the good news is in prices – witness the end of 2021. When all you can see is woe, then there is almost no good news discounted. Clearly, we have plenty to worry about today, but as explained, prices are lower, valuations are lower, expectations for economic activity and inflation are quite bleak, and investors are on the sidelines. These are the preconditions for better markets, although the catalyst is as yet hidden.

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