Investec
Wealth & Investment

Return of The Toaster

Early in my career at Investec I wrote a Weekly Digest in which I suggested that monetary policy works a bit like a hotel toaster, and it seems like a good time to reintroduce that analogy. I apologise to those of you with long memories, but I suspect many will have forgotten, and there are also a lot of new readers. I'm sure you have all encountered on holiday or a business trip one of those "conveyor belt" toasters. Almost invariably you load up the bread and it reappears, what feels like an interminable period later, in much the same state – just a piece of cold bread. Repeating the process produces the same result, so you turn the heat up a notch, which leaves the bread lightly tanned, but still not toasted. By now, getting rather agitated, not to mention the impatient queue growing behind, you turn the dial to "max" and send the bread on another voyage. By the time smoke starts to billow from the machine, the bread is too far in to retrieve, and it is not unknown for it actually to be on fire by the time it emerges.

Conducting monetary policy has similar challenges. In response to, say, a financial crisis, central banks will cut interest rates and even, as in this cycle, roll out unconventional policies such as Quantitative Easing (QE). Unfortunately, consumers and companies are in no mood to borrow and spend, and commercial banks are constrained in their ability to provide credit anyway as they deal with bad debts and rebuild their capital. In fact, following the last financial crisis banks were forced to raise much more capital than previously, exacerbating the effects. Seeing little economic progress, the central banks press on with their policies, which in this cycle amounted to more than $10 trillion of QE and zero, even negative, interest rates. But even this failed to raise growth to pre-crisis levels, so the dial was turned up further. Now we have finally reached the point where global economic growth is vaguely respectable, although not before smoke is visible in overheating financial asset markets.

The Federal Reserve has already reached for the fire extinguisher, having raised interest rates five times and also started to reverse its QE. But that is no match for the central banks of Europe and Japan who still want their toast properly browned. The aggregate global central bank balance sheet is still growing, and will continue to do so for the rest of 2018 on current projections, even if at a slower rate than historically. It is this endless tide of liquidity that promises (threatens?) the possibility of a euphoric "melt-up" in equity markets. While we might all profit, it would, in all probability, leave equities worryingly overvalued and vulnerable to a sharp reversal.

In tandem with developments in financial markets is the evolution of economic growth. As I reported last week, growth forecasts are rising across the world. So far, this has been well received. "Good news is good news", as we say. But there is a niggling concern that all this growth will finally create higher inflation - a traditional "overheating" economy. The jury is out on this, but it feels like the equivalent of sending the bread on its last ride – it could go from unacceptably pale to crisp cinder very quickly. If wage inflation accelerates as jobs markets get tighter, this can quickly feed through to price inflation. And we have already seen many commodity prices rising sharply, which puts more upward pressure on prices.

As I commented last week, we are not convinced of the direction of inflation, noting the deflationary effects of demographics and technology developments. But we do think that an upside inflation surprise is not priced into financial assets. Moreover, the majority of market participants have never experienced a proper inflation cycle, and even more have never dealt with a bond bear market. So we are looking out for the point when good news becomes bad news, when too much growth signals more aggressive monetary tightening and higher bond yields.

I can't emphasise enough how tricky it is to negotiate this stage of the cycle (and I'm not just trying to get my excuses in early!). On the one hand we want to maximise returns; on the other we don't want to overstay our welcome and find ourselves fighting for the exits with a panicking crowd. Thus our Global Investment Strategy Group, which has an eighteen month investment horizon, recommends taking a little risk off the table. GISG is our investment "supertanker", so needs to touch the tiller a long time before it makes a turn. Our Asset Allocation Committee is more nimble, and so is keeping a neutral risk position to take advantage of the current positive momentum of economies, earnings and markets. We aspire to be heavily underweight risk when markets turn for the worse – and they will - which inevitably means that we will have to get there early and miss the last drops of juice to be squeezed from markets. After several years of very good returns, often better than we had expected, investors should not be concerned about leaving a few unclaimed chips on the table at the end of game. That will also leave us with a full belt of ammunition to take advantage of the better value that will once again emerge. In the meantime, pass the marmalade!

Finally, Frank Sinatra had a UK number one hit with Strangers in the Night in 1966. This week, in which country did the battle of Mengo Hill take place?

John Wyn-Evans
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FTSE 100 Weekly Winners

London Stock Exchange Group	7.3%
easyJet	6.6%
Next	6.5%
Kingfisher	5.4%
Barclays	4.7%
Sky	4.6%
ITV	4.1%

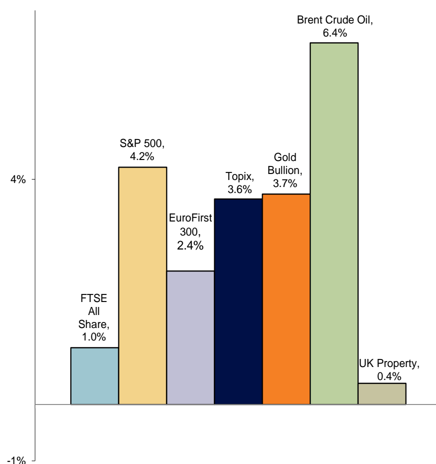
Source: FactSet

FTSE 100 Weekly Losers

Sage Group	-7.3%
WPP	-6.6%
Rentokil Initial	-6.0%
Antofagasta	-5.3%
RELX	-5.2%
Halma	-4.9%
Paddy Power Betfair	-4.4%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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