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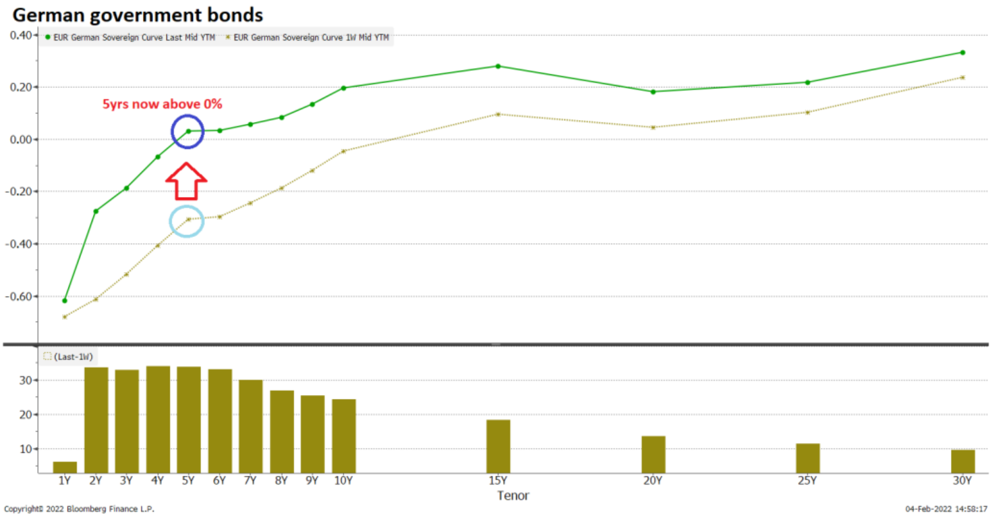
The Lagarde pivot hits insecure markets

We made the case last month that we disagree with the market maxim that "How January goes, so goes the year", at least for 2022. After a disappointing January for investors (see our January market review), February made a promising start, only to revert to last month's wild down and up trading pattern towards the end of last week. This was despite the week not having been dominated by the US Federal Reserve (Fed) or Russian manoeuvres (admittedly Boris Johnson was still big news – but only in the UK).

Nevertheless, what unnerved markets last Thursday and Friday followed the same playbook as the market turbulence in January: central banks announcing their determination to no longer ignore inflation pressures and markets reckoning with the idea that the growth slowdown is slowly morphing into a growth slump. The main protagonists last week were the European Central Bank (ECB) and Meta (aka Facebook). The ECB's president Lagarde (finally) declared that inflationary pressures had to be countered with a change in monetary policy towards a gradual tightening – not immediately, but in due course.

This followed the course prescribed by both the Fed and the Bank of England (BoE), and means that all major central banks, bar the People's Bank of China have now pivoted from an easing to a tightening stance – although only the BoE has raised rates so far. Even without any actual tightening action, bond markets were quick to respond, as the chart below vividly illustrates. It shows the upward yield movement over the course of a week in bonds with maturities between one and 30 years.



As regular readers will know, rising bond yields put downward pressure on stock market valuations, unless corporate profits (equities' earnings yield) can grow faster than the rising yield effect has on their share price valuation metrics. This would explain why US mega-tech companies are currently getting so extraordinarily penalised when they report disappointing earnings growth. Meta – formerly known as Facebook – lost about 25% last Thursday after reporting it expected next quarter's revenues to only increase somewhere between 3% and 11% (after last year's first quarter near 50% increase that was clearly seen as 'disaster territory'). The US S&P500 index fell 2.4% on the day, and commentators were quick to point out markets were pulled down by Meta's falling advertising revenues pointing towards a distinct economic slowdown.

We would note that of the 2.4% fall, 1.1 percentage points (or 45% of the decline) was attributable just to Meta's 25% slump – perhaps not surprising given we are talking about one the biggest of the US mega caps. Furthermore, Alphabet (Google) reported a 36% rise in advertising revenue for the same quarter – making Meta's revenue growth slump look far more stock-specific than a more general economic indicator (See our separate article this week).

What do we make of the turbulent markets? Clearly investors are concerned central banks are pivoting towards monetary tightening exactly at the point when the economy is at risk of slowing further, sliding from a slowdown in growth that started after last year's activity bounce-back into a more serious growth shock. Should the central banks stick to their guns as growth turns negative this would clearly be seen as constituting a central bank error – historically the most common reason for economic recession.

Market nervousness is therefore understandable, given the economic outlook has become far hazier than it was a year ago as the cycle has gone from its 'early' to 'mid-cycle' phase. Moreover, investors have no experience with post-global-pandemic recoveries to ground them, which only increases the level of uncertainty and insecurity.

We remain optimistic for portfolio investors for 2022 overall, although we admit that the outlook for the first quarter of the year is no longer looking positive. The shock to disposable consumer incomes from energy price rises is going to have a knock-on effect on corporate earnings, which may slow companies' willingness to invest and spend. Interestingly, this dynamic makes aggressive central bank tightening action much less likely, as the job of curtailing demand to dampen demand-driven inflation pressure is taken out of their hands before they are forced to act. This is provided consumers are not able to compensate through higher wages – which would explain the BoE Governor's explicit warning to UK citizens last week to resist the urge to ask for wage increases (See our separate article this week).

Cleary, central bankers, just like us, have very vivid memories/knowledge of the wage-price-inflation spiral dynamics of the 1970s, and are therefore doubly alert to the potential dangers we are now facing. However, this vividness of memories does not apply to the average consumer, and neither do we still have widespread collective wage bargaining structures that encourage blanket wage hikes. We conclude that, while we cannot be entirely certain, we expect that the loud noises from central banks – together with the cacophony of the coming price shock or price-of-living-crisis – will see consumers tread more carefully with their spending plans, rather than all at once resigning from their jobs in pursuit of higher pay.

Spring still feels a long way away, and the next few weeks may continue to be both unnerving and somewhat unstable in capital markets. For now, all signs from the global economy point towards a blip, rather than a cycle-ending downturn. We have been in these situations before, and capital markets have tended to 'look-through' such periods when there were enough signs that the slowdown would ultimately prove temporary.

As always, we will be monitoring the developments, and will keep you informed about our latest observations and conclusions here.

January 2022: Capital market returns review

January was a difficult month for global equity markets, which declined 4.0% for £-Sterling investors, on the back of expectations of further tightening of monetary policy and geopolitical tensions.

The US equity market returned -4.3% for the month. The US technology sector significantly lagged other markets, down 8.1% following uncertainty over the valuations of growth stocks.

After increasing 27% in 2021, US markets opened the year significantly weaker, led by the prospects of higher interest rates and tapering of liquidity. The price to earnings ratio for the S&P 500 ended January at around 20x earnings, down from 27x in December. However, giant technology firms such as Microsoft and Apple continued posting strong earnings growth. The most exposed firms were those with high leverage and weak balance sheets, as well as those presenting a softer earnings outlook than analysts had expected.

Asset Class	Index	January	12 months	2021
Equities	FTSE 100 (UK)	1.1	20.7	18.4
	FTSE4Good 50 (UK Ethical Index)	1.6	16.0	13.0
	MSCI Europe ex-UK	-5.3	13.1	16.7
	S&P 500 (USA)	-4.3	26.2	29.9
	NASDAQ (US Technology)	-8.1	12.2	23.3
	Nikkei 225 (Japan)	-4.2	-0.2	2.6
	MSCI All Countries World	-4.0	15.9	19.6
	MSCI Emerging Markets	-1.0	-5.0	-1.6
Bonds	FTSE Gilts All Stocks	-3.8	-7.2	-5.2
	£-Sterling Corporate Bond Index	-3.1	-5.2	-3.2
	Barclays Global Aggregate Bond Index	-1.1	-3.6	-3.8
Commodities	Goldman Sachs Commodity Index	12.7	52.8	41.6
	Brent Crude Oil Price	15.9	66.0	51.5
	LBMA Spot Gold Price	-0.7	-1.1	-2.9
Inflation	UK Consumer Price Index (annual rate)*	1.2	5.6	5.4
Cash rates	Libor 3 month GBP	0.0	0.0	0.0
Property	UK Commercial Property (IA Sector)*	1.9	7.6	7.4

Source: Morningstar Direct as at 31/01/22. * to end of previous month (31/12/21). All returns in GBP.

The UK equity market ended the month positively with a return of 1.1% and thereby one of the very few positive markets during the month. Equities were supported by strong returns in the energy, financials and mining sectors, benefiting from global commodity inflation. Dropping coronavirus case numbers without tighter restrictions also helped boost optimism surrounding the UK economy, with growth and equity valuations increasing as the UK government reverted to ‘Plan A’ and the economy reopened.

European equities ended January in negative territory, delivering a return of -5.3% as investors worried about upcoming European Central Bank (ECB) decisions, supply chain issues and growing tensions between Russia and Ukraine. While markets typically do not price-in geopolitical risks which threaten to upset progress temporarily, tensions over Ukraine have added fresh momentum to concerns over energy. Russia is the dominant supplier of natural gas to Europe, making up anywhere between 40-50% of European gas imports. Any conflict and resulting sanctions imposed by the West would be damaging. Oil prices increased by 15.9% in January over concerns around tighter supplies.

Emerging Markets (EM) were more resilient over January, dropping just 1.1%. China, the main driver of performance in the EM index, saw its central bank cutting interest rates and bank reserve requirements in an effort to stimulate demand, while also pledging to further ease its monetary policy.

Government bond yields climbed higher as stock markets fell, while corporate bonds also declined. However, despite the apparent growing wall of worries, investors might find comfort from what is shaping up to be yet another solid quarterly reporting season, with companies posting robust sales and profits growth. This could provide the support the market needs to ease some fears.

UK leads the monetary tightening charge

In the UK, last week saw policymakers launching a coordinated offensive against surging prices. Andrew Bailey, Governor of the Bank of England (BoE) led the front line on Thursday, announcing the decision to raise interest rates by 0.25% to 0.5%. It marked the BoE's first back-to-back rate hikes since 2004, and officials do not plan on stopping there. The entire Monetary Policy Committee (MPC) stressed the need for "further modest tightening […] in the coming months". While the BoE looks to fight inflation head-on, the Treasury will tend to the wounded. To offset the cost-of-living crisis hitting households, Chancellor Rishi Sunak promised £9 billion toward energy prices, including a £200 government financed electricity 'discount' (repayable over four years) and a £150 council tax rebate for 80% of English homes.

Both the bank and the Treasury recognise that monetary and fiscal policy must work together in the face of Britain's biggest price shock in decades. Markets are probably more affected by the monetary policy implications, but we will look at the other side first.

On the same day as the announcements, energy regulator Ofgem raised its price cap. Households on default tariffs will on average see a rise of £694 from £1,277 to £1,971 per year. As a result, millions of households will see their energy prices increase in April by 54%. Those using pre-payment meters for gas and electricity – which tend to be worse-off households – will be hit with an even larger average annual increase of £708.

The Chancellor's planned increases to tax and National Insurance will come into effect at the same time, just when the BoE expects overall inflation to reach 7.25% year-on-year. This cocktail of price rises will result in the biggest disposable income squeeze in decades. Charities have warned that millions of Britons could be pushed into poverty, with four million homes unable to afford energy bills even before the latest hike.

The Treasury's aid package is designed to "take the sting out of a significant price shock for millions of families." Any fiscal support is better than none, but the £350 total per head only accounts for half of the energy price rises alone. There are tax rises to come amid inflation in other areas. Justina Milienyte of price comparison service Uswitch described the Treasury's cost-of-living policy as "sticking plasters on a long-term problem".

In terms of the wider economy, the BoE expects the disposable income squeeze to bring down soaring inflation eventually – but it will most likely also slow growth down to an annual 1% by 2024 in the process, and that does not just come from increased borrowing costs from higher interest rates. Indeed, according to Bloomberg Economics, if the BoE was to get inflation back to the current 2% within a year, rates would have to rise by 4.5% and 1.2 million people would lose their jobs – in other words it would kill the economic cycle in an instant.

It is hard to separate the government's fiscal support from the current political context. With continuing pressure on Prime Minister Boris Johnson from the 'Partygate' scandal, the government have brought a series of announcements forward. Both opposition MPs and Tory backbenchers have called for April's £12 billion national insurance rise to be suspended, which Johnson was reportedly considering. Sunak has long insisted tax rises are needed to pay for the substantial public debt pile built up during the pandemic, and the two recently defended the tax rises in a joint column for *The Telegraph*.

Regardless, Boris Johnson is undoubtedly more beholden to the demands of his backbenchers than before. The government will want visibility in easing the cost-of-living crisis, so we should not be surprised if further measures are announced in the coming weeks or months.

However, the Treasury's difficulty is balancing the need to ease the income squeeze with the need to minimise inflation pressures. Proactive fiscal policy staved off disaster in the height of the pandemic and provided vital support for household savings and incomes. But in the process, it contributed to surging demand when economies reopened which, when combined with global supply pressures, sent prices skyward.

Supply chain disruption has now continued for so long that inflation expectations have become embedded in the economy – leading to higher wage demands and fears of spiralling inflation. The BoE is desperate to prevent this spiral, but the uncomfortable truth is that – without a dramatic increase in global supply – this requires at least some level of demand destruction. That is precisely what rapid rate rises are designed to do. The Treasury's job in this is pain management - allowing some demand destruction while easing the pressure on the worst-off and avoiding long-term scarring for many parts of the economy. Partygate aside, this process is what the government will be judged most for in the medium term, and politicians can expect considerable scrutiny after recent events.

BoE officials will likely be pleased with the Treasury's cooperation on the issue. Traditional monetary tools can be a little 'fat-handed' in these circumstances; interest rates and balance sheet changes affect aggregate outcomes, but have little control over distributional effects. Current inflation pressures are by and large on the supply side – prompting a cost shock for businesses and consumers. That raises some questions over the effectiveness of rate hikes, but the MPC is pushing ahead with a hawkish agenda nonetheless. Not only did it raise rates for the second month in a row, but the committee surprised analysts by nearly voting for a 50 basis points increase that would have brought the base rate to 0.75%.

The MPC likely feels the need to get ahead of the cost shock to stop inflation expectations from embedding. The fear of a 1970s-like wage-price spiral abounds, even if the jobs market is fundamentally different now.

Still, the MPC's fears are understandable, but in the face of continued supply-side pressures, the only way to fully tame inflation pressures would be to step on demand, and cause pain for consumers and businesses in the process. This poses a risk to growth further down the line – as the BoE acknowledged in lowering its medium and long-term growth projections. In his press conference, Bailey noted the rate hike was not so much down to economic strength as the clear inflation risks.

Policymakers in Whitehall and Threadneedle Street want to plot a course of strong but stable growth. A coordinated response to inflation will help, but achieving both will be extremely difficult. The policy response may well change in the coming weeks, but with a significant disposable income squeeze now unavoidable, spiralling inflation at least seems unlikely.

Tech stocks brought back to (virtual) reality

The last two years have been good to America's technology giants, but last week's market action had a ring of 'the bigger they are, the harder they fall'. Meta, formerly known as Facebook, plunged 25% in stock market trading on Wednesday afternoon. Chief executive Mark Zuckerberg warned investors that the current quarter would probably be Meta's worst on record, prompted by competition from TikTok and a prolonged slowdown in user growth – culminating in the first-ever drop in active users. The plunge in value meant $200 billion was knocked off the company's market capitalisation in a single trading session – the most any company has lost in one sitting.

Investors' visceral reaction to Meta's woes is astounding. We have written much recently about the less favourable backdrop for big tech: post-pandemic changes and withdrawal symptoms from monetary tightening dampen the outlook for Silicon Valley, and make episodes of volatility more likely. But Meta's eye-watering drop is about much more than background conditions. Both last quarter's earnings and the future guidance came in below expectations. Thanks to the popularity of TikTok's short-video format, Facebook now looks behind the curve of social media trends, while changes to Apple's privacy rules threaten the core of its advertising model.

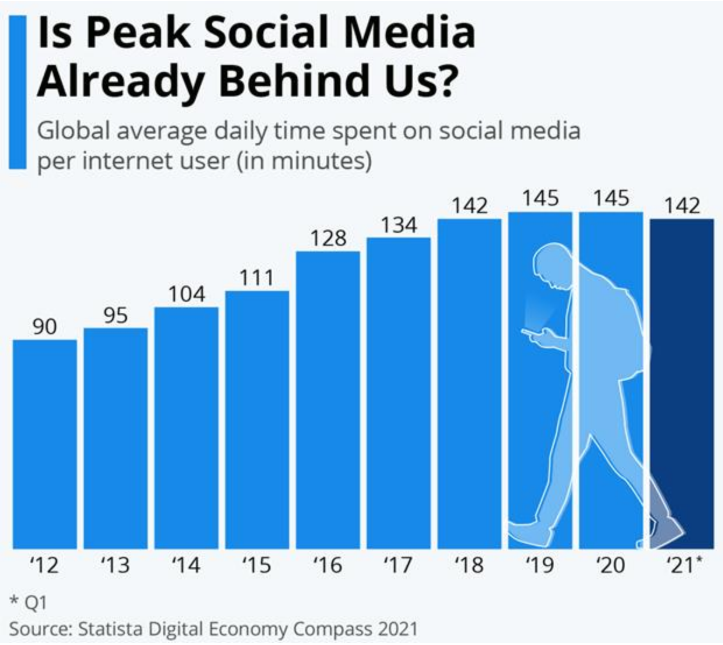
While old revenues dry up, new sources look bleak. 'Watch', Facebook's long-form video feature, has been a flop so far, while its ambitious foray into cryptocurrency came to an embarrassing end last week, after regulatory hurdles forced Meta to abandon its much-publicised digital currency. Zuckerberg used a big chunk of the earnings report to formally unveil his "metaverse" project: an online virtual reality that he believes will one day replace the mobile internet. But even if investors bought the lofty vision of the future, few see how it could become profitable any time soon.

Meta is facing its own specific problems, but they speak to wider trends for big tech. Online platforms were boosted by the pandemic's stay-at-home orders, but as populations emerge from lockdown, habits are clearly changing. Streaming service Netflix released disappointing data on new subscribers a few weeks ago, and was promptly punished by stock traders.

There is some notable dispersion within the tech space. More traditional players like Microsoft and Apple recently beat earnings expectations, while Alphabet (Google) and Amazon boosted their share prices the same day Meta sold off. This is likely because of their more transparent, or predictable, revenue streams.

Apple sells high-end tech hardware, while Microsoft is a dominant player in the software market – distinct from Meta's more intangible assets.

Markets are also likely reacting to a shifting medium and long-term picture. Over the last two decades, social media has grown from a fringe novelty to a ubiquitous part of work and social life. As platforms reach saturation, growth inevitably slows down. It makes sense this would coincide with the pandemic. The push toward online accelerated through lockdown, but ran out of steam as restrictions relaxed. The chart below shows the global average of time spent on social media fell in 2021, for the first time on record.



Facebook and similar platforms have arguably entered this saturation phase. That does not mean it will go the way of Myspace, but it brings a change of business model, and therefore a change in the way it is valued. Investors might now view Meta as a utilities (like) company – one with reliable cashflow, but less potential for growth.

Zuckerberg and his team have long been aware of this, hence their focus on the metaverse and other future plans. But long-term 'big ideas' projects are inherently hard to value, given the underlying uncertainty over future behaviour and regulations. At the height of central bank monetary support, markets may have given these long duration plays the benefit of the doubt. But higher interest rates and tighter financial conditions make speculative bets less favourable.

The future regulatory environment is also deeply uncertain. Big tech companies flourished in the 'wild west' days of the internet. But politicians' understanding of social media's benefits and pitfalls is now catching up with the rapid development of the technology itself. So too is their desire to regulate it. Facebook has faced numerous crises over the past decade, from Cambridge Analytica and privacy worries to tax evasion and complaints over corporate culture. Governments across the developed world are eager to address the problems posed by the likes of Facebook and Amazon. Indeed, taking on big tech is a rare point of bipartisan support in Washington.

It is possible that regulation will be diluted or introduced slowly to avoid any sudden disruption. Much like banks in 2007, tech giants likely see themselves as ‘too big to fail’, assuming regulators might go easy on them. But with fractious politics across the western world, there is no guarantee that will be the case. What’s more, with public opinion generally negative on tech companies’ privacy standards, newer competitors could emerge that drive industry standards higher naturally.

In the European Union, initiatives aimed at regulating big tech are on the way, and US legislators have stepped up their efforts in this area recently. With President Biden’s flagship policies (like ‘Build Back Better’) struggling to make their way through US Congress, we have seen a distinct shift of strategy toward antitrust legislation. We have written before that these factors, combined with the ongoing monetary tightening cycle, dampens the outlook for the big pandemic winners.

The struggles of Netflix and Meta show specific signs that fortunes are changing. These may have been less of a problem for investors while markets were awash with liquidity. Now that money is expected to be harder to come by, investors are re-evaluating tech’s prospects. This is far from the end for them, but it may well force the pandemic’s ‘big winners’ to adapt to the post-pandemic world.

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7th February 2022

Global Equity Markets

Market	Fri 15:54	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7504	+0.5	+38	⬀	⬀
FTSE 250	21745	+0.5	+102	↘	→
FTSE AS	4204	+0.5	+22	→	⬀
FTSE Small	7139	+0.8	+53	→	→
CAC	6944	-0.3	-22	→	↗
DAX	15091	-1.5	-228	⬂	→
Dow	34860	+0.4	+134	→	→
S&P 500	4459	+0.6	+28	⬂	⬀
Nasdaq	13948	+1.3	+178	↘	→
Nikkei	27440	+2.7	+723	⬂	⬂
MSCI World	3053	+1.6	+47	⬂	→
CSI 300	4564	-4.5	-216	→	↘
MSCI EM	1210	+1.6	+19	→	↘

Top 5 Gainers

Company	%
Renishaw	+9.8
Vodafone	+5.5
Compass	+5.3
BP	+4.9
Smurfit Kappa	+3.5

Top 5 Decliners

Company	%
Antofagasta	-9.1
Admiral	-7.1
Johnson Matthey	-5.7
AstraZeneca	-5.7
Next	-5.7

Currencies

Pair	last	%1W
USD/GBP	1.353	+1.0
GBP/EUR	0.846	-1.6
USD/EUR	1.14	+2.6
JPY/USD	115.25	+0.0
CNY/USD	6.36	-0.4
Bitcoin/$	39,782	+5.4

Commodities

Cmdty	last	%1W
Oil	93.01	+3.3
Gold	1804.5	+0.7
Silver	22.41	-0.3
Copper	444.2	+3.1
Aluminium	3050.0	-1.6
Soft Cmdties	227.3	+0.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.7	14.2	12.3	14.3
FTSE 250	2.6	14.5	15.7	16.2
FTSE AS	3.5	14.2	12.6	14.5
FTSE Small x Inv_Tsts	2.4	11.0	12.8	15.7
CAC	2.2	19.5	14.2	15.2
DAX	2.2	14.1	13.4	13.7
Dow	1.8	17.6	18.4	16.7
S&P 500	1.4	22.5	20.1	18.0
Nasdaq	0.7	25.5	28.2	23.6
Nikkei	1.7	14.4	16.3	17.7
MSCI World	1.8	19.4	18.2	16.9
CSI 300	1.8	15.6	13.5	12.7
MSCI EM	2.5	12.3	12.3	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.41	+0.17
UK 15-Yr	1.54	+0.14
US 10-Yr	1.92	+0.15
French 10-Yr	0.65	+0.28
German 10-Yr	0.21	+0.25
Japanese 10-Yr	0.20	+0.03

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.53
3-yr Fixed Rate	1.53	1.52
5-yr Fixed Rate	1.59	1.54
10-yr Fixed Rate	2.49	2.51
Standard Variable	3.63	3.62

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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7th February 2022

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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