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Reflections & Insights

“Markets fluctuate, Lisa. Who knows how much a quarter will be worth next week?”

– MILHOUSE VAN HOUTEN, THE SIMPSONS (TAPPED OUT)

GuardCap Asset Management Limited authored the following commentary.*

Financial conditions have continued to deteriorate. Year-to-date, the S&P 500 Index is down 23% (all returns are stated in USD terms), which is its worst performance through three quarters of a year since 2002 (-28%) and the fourth worst since 1928 (-33% in 1974, -34% in 1931 are the others). Bonds (using the 10-year US Treasury note) are down 16%, which

is by far the worst performance over the last 95 years — the next closest is 1987 (-9%), while 1981 and 1994 saw declines of half this years’ (-8% in each).

In previous reviews, we have focused on the drive by the Federal Reserve (Fed) in the US to combat inflation. Rising interest rates are the most visible tool in the Fed’s armory, but it also considers other factors. Two of the most important of these are the dollar and the price of financial assets. Having pushed interest rates up at a faster rate than the banks of any other developed countries, the Fed has created the conditions for a very strong dollar. Because the vast majority of international trade is denominated in US dollars – it is the so-called reserve currency – a strong currency exports inflation as the prices of everything rise when converted into local currencies. As many countries and companies have borrowed in dollars, it also increases the costs of servicing that debt.

This set of policies has led to particular weakness in the yen, euro and sterling while emerging markets have been selectively affected, determined principally by the state of their own monetary conditions. Currency weakness, in turn, has led to interest rate rises in the EU and UK (although not in Japan), although, hitherto, these increases have not been enough to turn the tide.

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Combined with supply-side issues caused by the Ukraine war, all this has meant a very uncomfortable increase in inflation, leading to a set of policies that are all but guaranteed to trigger recession across the EU and the UK. The US also looks headed for a significant economic slowdown, although this is only intermittently observable. US commentators spill much ink over whether the country is headed for a soft (i.e., meh) or hard (i.e., ouch) landing.

This brings us to the UK

Not for the first time in these reviews, the UK offers a warning to the rest of the world of how easy it is to turn a drama into a crisis. The Bank of England has been somewhat behind the curve in pushing interest rates higher but is, at least, on the case. Inflation is a major problem, employment conditions are very tight and, despite economic frailty, harsh medicine is required. Into this mix comes a 'new' government with a set of unfunded tax cuts supposedly balanced by a list of supply-side ambitions. The focus is to be on growth. The markets did not take kindly to the fact that the costing of the fiscal changes was ignored and sterling and the bond market duly collapsed.

Bad enough, you might think, but the sting in the tail was a liquidity crisis that risked toppling the whole financial system, and which the UK Treasury appears not to have anticipated. This revolved around complex products used by pension funds to hedge the risks of failing to meet their liabilities. These go by the reasonable-sounding acronym of LDI or liability-driven investment, surely a good thing? Unfortunately, these were (mostly) leveraged products, and as gilt prices fell, out went margin calls. At this point, the pension funds found themselves forced into raising the cash from anything that offered liquidity. First among these assets were their long gilt positions. Thus, the pension funds were forced into selling these gilts at declining prices, which then triggered further margin calls – a truly vicious circle. Fortunately, the Bank of England stepped into the gilt market to stabilize things. Nevertheless, this particular crisis is not over yet as the pension funds are still raising cash from other assets and may yet have to turn to selling less liquid investments, such as private equity.

LDI was encouraged by UK regulators and packaged and sold by investment banks and asset managers, inter alia. The premise behind the concept is counterintuitive but weirdly logical. Leveraged long

positions in gilts most closely match the promises made by pension funds to their members. Those promises are very expensive in an era of very low rates (such as that which has characterized the last several years) because the discount rate applied to the liabilities is very low. As interest rates go up, the asset values will fall, but so does the quantum of the liabilities because the discount rate rises. Pension funds hold collateral against rising rates, but, as it turns out, not enough to deal with cataclysmic market moves such as those which followed the fiscal package announcement. It will be interesting to test whether other pension systems use similar products.

Almost free money

In one sense, this liquidity crisis is another manifestation of the very long period of virtually free money, which looks now as if it is ending. Investors with contractual liabilities have sought guaranteed returns, which have been accessible in the era of ultra-low rates. This has encouraged the use of leverage or of strategies that magnify returns. Over many years where this hasn't been a risky approach, it has come to seem normal to gear up. This is not a remark aimed at any particular group. It applies equally to the mortgage market and to companies that have been able to tolerate large-scale losses because the equity market has always been there, since, in turn, money was almost free.

What we see through one lens as normalization of monetary conditions, through another, looks like a trigger for further liquidity crises. Markets are skittish currently, jumping at shadows and trying to price these risks. The UK experience is a measure of the low tolerance for reckless policymaking and a warning bell for other populist governments, which may be tempted to throw around some fiscal largesse.

We are expecting continued upward pressure on interest rates and recessionary conditions across the developed world. However, inflation is likely to prove stickier than the optimists allow, partly because monetary tightening was slow out of the gate for perfectly understandable pandemic-related reasons and partly because there isn't (yet) much slack in labor markets. Furthermore, the underlying drivers of the very benign inflationary environment of recent years are absent. Wars are inherently inflationary and the need to build greater resilience into supply chains is a reversal of the lowest-cost model, which operated hitherto. This means that central banks will need

to keep applying the brakes until such time as core inflation falls back into range and stays there. This will, in turn, cause a squeeze on standards of living – the prospects for which are politically difficult and lay behind some of the attempted fiscal incontinence in the UK.

The declines in markets are a sign that these economic conditions are now being discounted to some degree. As a result, corporate earnings are likely to come under pressure, and, while it is impossible to know the extent that prices reflect this, valuations in markets are not yet cheap enough to signal the bottom of a bear market.

A habit of muddling through crises

When prices are falling, it is always easy to see the pessimistic story. For example, the geopolitical environment seems likely to be less stable than recently. This is not just about the great power rivalry between the US and China, or the Ukrainian war, but also the risk of greater populism in Western democracies, itself a function of that instability. This could mean greater market volatility as sound economic policy takes a backseat to political expediency. On top of that, the period of very rapid growth in China is coming to an end. This is partly to do with demography and partly due to the fact the low-hanging fruit has been plucked. Further, the wary relationship building with Western countries is likely to make China more self-reliant – a process that requires adjustment from the export-led model, which lies behind so much prosperity. An attempt to annex Taiwan is unlikely but ever present; however, if it happens, financial markets will melt down.

We could add doom-laden prognostications about the need for the EU to reimagine its energy policy or any other number of concerns about supply chains, technology, climate change or the emergence of new geopolitical blocs.

The point is that this type of uncertainty has always been with us. Markets have a repeated habit of muddling through crises. Away from the big picture and the noise, the most important change is that Central Banks are engaged in the attempt to normalize monetary policy and to assert control over inflation. Beyond slowing down the global economy, the effect of this will be to force out of business a lot of enterprises that need free money to exist – in essence, a reassertion of the forces of creative destruction which characterize the cycle of capital and which have been suspended since the Great Financial crisis.

This is an environment where investment rewards certainty. It is probably still too early to add riskier bonds to portfolios, although at the less risky end of the spectrum, prices and returns are beginning to look more attractive. We believe that in equities, for now, avoid risk and stick to businesses that have pricing power.

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All figures in USD, unless otherwise stated. For definitions of the indices mentioned in this document, please contact Guardian Capital LP at insights@guardiancapital.com.

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