

Are you sitting comfortably?

by Richard Parfect

As I write this there is a good news story of a B777 executing a successful diversion and emergency landing following the dramatic loss of one of its two engines. Somewhat unnervingly for passengers the remnants of the burning engine were clear to see. More seriously there was fuselage damage too, however the pilots' frequent rehearsed emergency procedures and risk controls prevented a catastrophic outcome.

Passenger unease is understandably common on aircraft, particularly if the aircraft enters clear air turbulence. Whilst even significant buffeting is normally well within design limits of the aircraft, passengers can become alarmed that something catastrophic will befall them. However, the best thing passengers can do is sit back, try and relax and trust in the professionalism of the pilots and engineers; the turbulence will pass.

As we near the anniversary of the UK economy entering lockdown and the associated collapse of markets around the world, it is almost unbelievable that markets have staged the swift recovery that they have. The market volatility (or turbulence) passed and recovery ensued. For markets such as the UK (which had already endured prolonged weakness post the Brexit referendum), some investors saw the logic of looking past the near term costs of lockdown and appraised the opportunity presented to them to purchase many years' worth of future profits for the bargain basement prices of 2020.

While markets do not follow any known laws of physics (not least because of human participation), investors who seek to remove emotion from their process or, better still, exploit the over-reaction of others, can profit from the principle of "mean-reversion". This is the basic premise that once the temporary effects of a transient event are removed (a war, a pandemic, the initial shock of leaving a trade-bloc); naturally adjusting and compensatory forces take hold and restore the system to something approximating to what went before.

Extrapolation of past and current observations is a natural human trait. However, unfortunately memories are short and many market participants place heavy emphasis on recent experience and much less weight on events several years (or decades) past.

This is why people find it hard to sell when markets have been recently strong or buy when the markets are similarly weak.

Ever since the global financial crisis (GFC) when Lehman's failed, central banks have been trying to accelerate economic recovery by various "quantitative easing" means, which in simple terms collectively amounted to printing money. The recovery certainly materialised, but instead of it being felt in the real economy, it was centred around asset prices such as capital markets. The reaction of authorities to the COVID19 pandemic has seen a degree of money printing that has dwarfed that of the GFC response.

Most market participants have not seen a prolonged bear market in fixed income (credit) markets. Their natural horizon has been of central banks buying government debt to maintain low interest rates whilst a low level of inflation has afforded such largesse. Extrapolating indefinite low yields, of even sub 4% for so called "high yield corporate debt" and now negative yields for increasing amounts of sovereign debt, requires the continuation of many things, not least the persistent absence of inflation.

Doom-mongers have warned about the return of inflation for almost as long as quantitative easing commenced; and to date they have been wrong. However, such risks cannot be so easily dismissed now. There is a collective incentive for authorities to allow inflation to rise above target for a prolonged period, if for no other reason than to deflate the huge amounts of debt that has built up. Pent up demand and substantial accumulations of household savings from the last 12 months, as well as the loss of spare capacity in some quarters, could see a material over-shoot of inflation, which may prove to be less temporary than people expect.

The multi-decade rise in bond prices (and associated fall in interest rates) could finally be severely tested in a way that proves to be significantly longer lasting than the market effects of COVID19. We will then see whether the central banks are certain of their position on their economic flight plan and whether they have planned for an emergency diversion airport. Otherwise the resulting economic turbulence may find investors reaching for their parachutes.

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