FACETOLOGY

FACET

May 2022

It’s May. But think before selling and going away…

Even those investors without a superstitious nature cannot have failed to notice that some of the biggest drops in the US market happened in the first week of May. The old adage “Sell in May and go away” seems to have struck again. Readers will know that we have looked at the statistics behind this often-quoted anomaly and found it inconclusive although, in normal times, there can be seasonal factors at play.

However, these times are far from normal or seasonal, and the factors at play (inflation, Ukraine and economic slowdown) are compounding to unsettle stock and bond markets.

This latest fall means that the US index is down around 15% year-to-date. A lot of the drop is due to falls in the share values of the infamous FAANG stocks which now loosely means social media companies, Netflix and Tesla, or rather the more speculative end of the spectrum where huge profits were more easily taken. However, in the UK, things aren’t quite so bad. The UK stock market index is relatively more heavily weighted to the oil & gas and banking sectors. Both have benefitted either directly from higher energy prices or the indirect benefits of rising long-term interest rates.

The rise in global energy costs does, of course, go hand in hand with the rise in inflation, which rose 6.2% in March in the UK. But as we all know, inflation is affecting all aspects of life from food to services. At 5th May meeting of the Bank of England’s Monetary Policy Committee (MPC), it was announced that interest rates would rise from 0.75% to 1%, a 13-year high. This was in line with most economists’ expectations although of the votes cast (6-3 in favour of a hike), the other three members were in favour of a bigger hike of 0.5%.

MPC meetings are accompanied by a post-meeting conference where the gathered press assemble to try and read between the lines of the carefully chosen language offered up to give future guidance to markets. Often lacking the sort of clarity one would hope for, this latest session was unusually contradictory and confusing.

On the one hand, Governor Andrew Bailey repeated his Christmas message that inflation represented the biggest threat to the economy while, on the other hand, suggested that bond markets were pricing for much higher rates than he thought necessary to fight it. By way of demonstrating what he meant, he presented the Bank’s own forecasts showing that inflation could go as high as 10% by year end before returning to a target rate of 2% as early as next summer.

Whether this reflected the MPCs conviction (most of them) that the factors fuelling inflation are transitory it wasn’t clear. One mathematical certainty is that, given that inflation didn’t really get going until the fourth quarter last year, there will be a base-effect which will bring down the year-on-year headline figure even if prices stay stubbornly high.

It’s easy to criticise the Bank of England, indeed all the central banks, for issuing vague messages at times. There is a lot that is out of theirs and government’s control. But it also sends the message that they are following markets and events like everyone else. The confused messaging is unhelpful and only adds to the short-term unease in stocks and bonds.

One thing that is certain is that a big gap has grown in interest rate forecasts between the USA and the rest of the world. The yield on 10-year UK Gilts is around 1.8% but the equivalent government bond in the USA is nearly 3%. The US Federal Reserve has struck a much more aggressive tone in its willingness to row back on the monetary largesse from Covid, as well as hike interest rates quickly. If they do, their housing market, which operates on much longer dated rates than the UK mortgage market, will be far more insulated from a hike in base rates. The US economy is also notoriously more robust in the face of a stronger US dollar that results.

The Bank of England knows full well the risks of raising rates right now, particularly as tax rises kick in. It may be why they are blowing hot and cold on policy. In the EU, the European Central Bank is even more hesitant to raise interest rates, mindful of the past Euro crisis or two. Bank of Japan? Not a chance.

And so, against this policy backdrop, and with governments too exhausted to offer much in the way of fiscal stimulus, the US dollar is reaching relative highs not seen for decades. Parity with Sterling is already being spoken of openly; something unthinkable only 6 months ago.

What this all adds up to is that if headline inflation falls faster than expected, it will kill the appetite of central banks to raise interest rates as far and as fast as the bond and currency markets are currently pricing for. That in turn could put a floor under the recent falls in both stocks and bonds and, as such, is a warning to even the most bearish minded who wish to sell out and take profits now.

As we repeated many times before, trying to time markets during periods of uncertainty like Covid, and the invasion of Ukraine, is nigh-on impossible. It is worth remembering that the US stock market doubled from the point of maximum gloom in the middle of the Covid pandemic in March 2020. If an investor had been out of markets, and too cautious to jump back in, it is unlikely there would be any profits worth taking today.

DISCLAIMER: The views, opinions and expectations expressed in this newsletter are those of members of FACET Investment Management and do not constitute investment advice nor taken as an offer or recommendation to invest in any of the products referred to. We do not guarantee the suitability or performance of any assets mentioned and past performance is not necessarily a guide to future performance. FACET Investment Management Limited is authorised and regulated by the Financial Conduct Authority. FRN: 131372.