TierOne

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World Economic and Market Outlook

'It ain't what you don't know that gets you into trouble.
It's what you know for sure that just ain't so.'

— Mark Twain

SUMMARY

Investing is an art rather than a science and always embraced uncertainty. Uncertainty, however, does not mean an investor cannot prepare a portfolio for the future. Incorporating a degree of weather proofing is prudent as exiting a pandemic means there are no historical precedents for what will happen next. While equities have certainly performed strongly in recent years the earnings yield versus bonds has not really budged and looking at the valuations of all asset classes outside of equities it is hard to find investment choices which are likely to deliver on the aspirations of longer-term savers, especially pension fund savers, other than equities. In this environment, for those committed to markets for the long run it is usually best to remain more-or-less fully invested unless evidence to the contrary is absolutely compelling.

Investors should also think over their attitude to risk. Equity markets are inherently volatile from time to time and many of the sharp setbacks that have occurred over the last 50 years have not been easy for the majority of investors' to predict. Some have occurred at times of extreme over valuation by historic norms of equities in absolute terms, which has usually occurred at times of economic optimism 'justifying' the view in the eyes of the majority that 'this time is different'. In the 1970s the oil crisis ushered in a period of high inflation which proved to be something most economists found hard to explain, and therefore the success of Paul Volcker, US Federal Reserve Chair, in taming the inflationary tiger through raising interest rates dramatically caught most investors by surprise. Similarly, the TMT bubble, the Global Financial Crisis (GFC), Eurozone Crisis, to name but three have only been forecast by a minority of investors, otherwise the bull market would have ended before these factors impacted on economic fundamentals.

When setbacks occur at times of expensive valuations, there is always the potential for these to be severe and fast moving as was the case in 1987, 2000 and 2008 (where overvaluation was most apparent in credit). Covid-19 was a black swan event and completely unpredictable. While equities show periods of volatility, this can be a very different thing from risk which I define as the permanent loss of capital.

Martin Wolf, Chief Financial Times Economics Commentator, has written that equities have delivered long-term outperformance for investors despite World Wars, a Depression, a Global Financial Crisis, and now a

Pandemic. To deliver security in old age investors not only need to save for a pension but save in a manner that will give a positive real return, or in other words, provide a pot of money that grows in value faster than inflation. In today's low-rate world where the price of safe assets has been distorted by central bank policy, it seems likely the only sensible way to achieve this is to invest in risky assets. To reduce risk investors should focus and differentiate between short term price volatility and the possibility of serious impairment to the value of their capital. Ironically, actuarial considerations have forced many pension funds to move in the opposite direction, thus not capitalising fully on the post Financial Crisis bull market. Empirical evidence backs up this approach with, for example, the work of Elroy Dimson, Paul Marsh, and Mike Staunton in successive Credit Suisse Global Investment Year Books demonstrating that for longer than a century a portfolio of equities has done staggeringly well, especially if diversified globally. Thus, whilst investors in the UK market in the current millennium, and in Japan since the post 1990 period have only seen muted returns or worse, those with a truly global portfolio have fared far better. The UK FTSE ended 1999 at a then record high of 6,930 and was below this level during the last Monday of September. However, thanks to the reinvestment of dividend income nominal returns were positive with an annualised rate of 3.3% until 31st December 2020. In contrast, Wall Street which was also hard hit in the TMT blow up has seen the S&P 500 reach around three times its end '99 level. The UK (one of the less well performing markets in more recent times) since 1900 has delivered an average annual real return of 5.4% compared to 6.6% in the United States. In contrast, UK government bonds have given an average real return of 2.0% p.a. The argument for investors holding bonds is (as Wolf explains), wars or revolutions can ruin equities, but he adds very importantly, they also destroy the value of bonds. For most investors holding a widely diversified portfolio of equities, manged by a selection of top performing fund managers, offers the best long term investment strategy even, or perhaps especially in an uncertain world.

Today the world is seeing shorter term cyclical inflationary pressures which have led to periods of volatility. The medium to long-term prospects for the global economy suggest that structural forces I have previously discussed, Debt, Demographics, and Disruptive technological change, will return the world to an era of secular stagnation. Although inflationary pressures are likely to prove transitory, the definition of transitory will differ amongst market participants. Supply side problems, many of which are covid-19 related, look likely to persist for much or all of 2022 and the market will remain volatile until a clearer picture emerges of the path of inflation and interest rates. There is also the question of what the appropriate policy response to supply side rather than demand driven inflationary pressures should be. Whether tightening monetary policy would be the correct response is a moot point.

For investors with a sufficiently long-time horizon, prepared to sit through periods of volatility which history demonstrates is not the same as the risk of permanent loss of capital, there remains the potential to make excellent long-term returns. Investment is also about risk management. Extreme over valuation does run the risk of permanent impairment of capital especially if occurring in narrow areas of the market such as technology stocks in 2000 and Japan in 1989/1990. Even in the States the 'nifty-fifty' period resulted in the US seeing the Dow regain its 1969 level only in 1982. Often investors are over exposed to the most vulnerable parts of the market as these are the most fashionable and over owned which is why valuations are high. This again emphasises why some weatherproofing of portfolios is prudent. In the short-term the biggest threat to markets remains an inflation scare, even if it does not actually occur. If the US saw 10 Year Treasury yields see upward pressure towards the 2% level this could see equities suffer a period of volatility, although a major bear market looks unlikely.

It has been our consistent view that market returns are enhanced by skilled fund selection and that remains the case. For investors who utilise managers with a proven ability to deliver returns with lower than market levels of volatility, a portfolio with a high weighting to equities remains fully justified. If rising cost pressures impact on company margins and disposable income in 2022 resulting in a second half slowdown, quality equities would likely be the most resilient part of the market. The most significant threat to equity markets today would be a period of sustained higher levels of inflation with cyclical pressures strong enough to overturn today's strong secular disinflationary trends. As it is impossible to predict with any certainty that this is likely to occur, it is prudent not to significantly alter asset allocations in response to a macro scenario which may or may not occur. History demonstrates that equity markets offer the best option for growing the real (post inflation) value of investments in most circumstances, a view reinforced by the dearth of valuation opportunities in what are considered to be 'safe assets' and the consistently poor returns from most absolute return strategies.