Rathbones
Look forward

Review of the week

12 April 2021

A chill wind blows

A week of Fed watching cooled the recent rise in US Treasury yields, sending the dollar and sterling lower. Then British flags followed suit.

Spring was beaten back by the last cold snap of winter last week. Sadly, the week also took the Prince Consort.

Prince Philip, Duke of Edinburgh, hailed from a different time. His passing reminds us of how much has changed over the nigh on 100 years since he was born into a Danish family that ruled over a Mediterranean nation. By that point, in 1921, it was beyond midnight for that Victorian era. He was only a baby when he had to be evacuated from Greece in an orange crate because of a republican revolt against the monarchy. That uprising can be traced directly from the aftermath of the Great War, when Greece tried to occupy parts of the Ottoman Empire promised to it by the Triple Entente. Turkey's stiff resistance in a largely forgotten conflict defeated the Greek army, humiliated the country and led to many horrors of war. It was one of the first cracks in the inter-war order that ended in the conflagration of World War II.

A boy without a home, Prince Philip found one in Britain. He joined the Royal Navy, fought in the sequel to the Great War and then married a princess. That union spanned 73 years, and it arguably helped the monarchy change with the times. At Prince Philip's suggestion, debutante balls were out and more egalitarian informal palace lunches were in. He saw early the tremendous power and importance of television and grasped how the royal family would have to embrace it, for good and ill.

He spent his life working hard at a truly extraordinary number of charities, causes and associations. He had a full life. And the world he left, for all its challenges, looks more promising than the one he was born into.

Fed watching

The US government 10-year bond yield fell back last week after months of climbing higher. The benchmark borrowing rate had reached a post-COVID high of 1.74 at the end of March and since retraced its steps in early April, trading at 1.66% Monday morning.

We have talked before about how much impact changes in the US government borrowing rate have on the stock market. When government bond yields rise, it tends to send 'growth' companies lower and 'cyclical' companies higher. When yields fall, cyclical companies often fall with them as growth company share prices rise. This see-saw phenomenon in stock markets is likely to continue throughout the year as news and data drip out about inflation, economic growth and central bank policy. Interestingly, it was the latter that drove bond investors' decisions last week.

The minutes for the US Federal Reserve's (Fed) March meeting were released last week. They showed that the Fed committee is split about the path of inflation. Half the members think that roaring consumer demand and supply bottlenecks will send inflation higher than anticipated, while the rest think that longer-term deflationary trends will win out and keep a lid on goods and services prices. US CPI inflation is due Tuesday, with economists forecasting that it will jump to 2.5% from 1.7%. The official Fed expectation is for headline inflation to reach 2.4% this year and then moderate toward 2.1% over the following two years.

Where all Fed members agree, however, is that they believe they won't be raising interest rates until the end of 2023. They also said that they won't be adjusting the huge monthly bond purchases they are making until there is "substantial further progress" on higher inflation and fuller employment. There is one other arcane yet pivotal part of the Fed's stance: it is making its policy decisions based primarily on "observed outcomes rather than forecasts". It has long been a tenet of modern central banking that policy should run ahead of the actual economy because it takes a good year or two for those policy changes to feed through and make a difference. The Fed has explicitly said it will abandon that principle.

All this this led the dollar to its worst week of the year so far, falling 1% against a collection of major currencies. However, the yield-drop-driven boost to growth companies - which include the tech titans and other large sections of the American stock market - sent American stocks almost 3% higher in dollar terms last week. In sterling terms the increase was much more, because the pound weakened considerably against the dollar but especially against the euro and yen (-2% and -1.9% respectively). The reasons for currency movements are difficult to nail down, but the slump in sterling could be due to a slowing vaccination programme and concerns that next month's Scottish elections may provide impetus for the nation's independence. Or it could simply be down to the bond yield move and the switch from the value companies that stack the FTSE to growth ones.

Adding to the soup, US economic growth expectations have been revised higher by everyone from investment banks and shop owners to the Fed itself. Increases in expected economic growth should *increase* bond yields, not lead them to fall. Investors appear to be banking on demand for safe-haven government debt holding strong regardless of the economic backdrop.

This forecast surge in American GDP is based on a quicker-than-expected recovery as vaccinations are doled out at a swift pace and states continue barrel forward from their earlier reopenings. A Wall Street Journal survey of economists found GDP is expected to rise 6.4% in 2021, which would be the nation's fastest annual expansion since 1983 (+7.9%). After that initial surge, the growth rate would settle to 3.2% in 2022, according to the survey, which would still be greater than any year since 2005. There's a lot going on under the surface though. Despite headline unemployment still at 6%, fast food chains and manufacturers are reporting that they are struggling to fill open jobs. The real unemployment rate is estimated to be in the realm of 10%, because at least 4.2 million workers appear to have dropped out of the workforce because of fear of contracting COVID. That's about half the total number of American jobs lost since the pandemic began.

This means the US economic trajectory - and inflation - should be very tightly tied to the speed and success of its vaccination drive.

Julian Chillingworth
Chief Investment Officer, Rathbones

Rathbones
Look forward

rathbones.com
rathbonefunds.com

Important information