momentum

weekly digest

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Fat Chance

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Little more than a month ago it seemed a near certainty that my tracker mortgage would be increasing again. Or at least that is what was implied by the rates market that embeds investors' expectation for future policy rates. On the 10th April 2018 the probability of the UK Monetary Policy Committee (MPC) increasing the base rate stood at nearly 90% having surged ahead since the start of the year (and somewhat resiliently through the market turbulence in February). By last Monday the chance of a hike had fallen back below 10%, an expectation not matched since the end of last summer; from hero to zero in just a few weeks and the chief reason for Sterling's 5% decline since. The hawkish guidance given by Mr Carney as recently as February showed him once again to be the 'unreliable boyfriend' and pricing today shows that not until Q4 is a hike more likely than not.

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So why focus on these implied numbers? Well, firstly it shows that trying to forecast policy change is not a reliable method to consistently generate market beating returns. The speed of the repricing of the May hike might have been fast, but the pattern looks similar to the rates curves of yesteryear. Forward implied rates are a poor predictor of future spot rates. What you can say though (ironically, with high conviction) is that when something is priced in or out with near certainty then you are paid little, if at all, for taking that consensus view. A contrarian investor would assess the value in taking the other side.

"Forward implied rates are a poor predictor of future spot rates"

Rates markets may be the purest expression of policy expectations but market prices across the board tell us a lot about what investors expect for the future. Equity prices currently imply nearly 25% earnings growth over the next 12 months in the US, 16% in continental Europe, 4% in Japan and even less in the UK. High yield bond prices imply around a 5% average default rate over the next 5 years ; 4% if you assume a poorer than average recovery rate; less again if you factor in a liquidity premium. Deriving headline numbers in this way though can be misleading as prices are skewed by a multitude of factors, not least sentiment and liquidity. Brexit weighs on the UK today while disruptors haunt our high street, and tax reform boosts US corporates. Low levels of current defaults may instil an overconfidence that it will remain that way.

"A speculator buys a stock with the sole objective of selling it at a higher price."

We don't know whether the shorter term market direction will turn out to be right or wrong, but as long term investors we do not want, or need, to predict the shorter term oscillations of markets. Money can be made there, but equally lost. By having an extended investment horizon we can position our portfolios to take advantage of elevated risk premia when market pricing appears to move too far one way or the other, letting time unlock the value as the mispricing fades. At times of heightened risk aversion this can provide a margin of safety against which to position, shifting the odds of success in your favour. Ultimately, that serves to improve the probability of reaching your desired financial goals. And you wouldn't want to bet against that.

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[i] - Derived from overnight index swap (OIS) prices. Source: Bloomberg

[ii] - Assumes 40% recovery rate

Market Focus

- Trump to withdraw from Iran nuclear deal
- Global stocks and commodities rise
- Brent Crude oil rose 2.9% to $77.2 a barrel
- Gold rose 0.7% to 1,322

US

- The US Dollar extends gains beating nearly every peer. Treasury yields remain at around 3%
- The US and China are making steps to avoid a costly trade war with China's vice premier travelling to Washington this week for talks
- The Dow Jones rose 2.3% to 24,831
- The Nasdaq rose 2.7% to 6952.6

UK

- U.K House prices fell the most in almost eight years in April, declining 3.1% from March
- Theresa May has met with a 14th defeat in the House of Lords over the EU Withdrawal Bill. This time the Lords voted to remain in the EEA and single market- It will now be referred back to the Commons
- UK interest rates remain at 0.5%. Continued disappointing retail and economic data was a large factor
- BT to cut 13,000 jobs to curb costs, the announcement failed to impress investors and the share price dropped 9% last Thursday
- The FTSE 100 rose 3% to 7724.6

Europe

- Germany, France, the UK and Russia have all pledged to work with the Iranian regime in an attempt to hold together the nuclear deal with Iran that President Trump has vowed to scrap
- A new Italian government looks imminent with the 5 Star and League parties in agreement on a radical agenda for tax and spending
- The Eurostoxx 50 rose 0.4% to 3565.5

Asia

- President Xi met with Korean leader Kim Jong Un for the second time in two months. Nuclear disarmament of the N. Korean regime, at least in part, seems the likely outcome
- The Hang Seng index rose 4% to 31,122
- The Nikkei 225 index rose 1.3% to 22,758

Past performance is not indicative of future returns.
Source: Bloomberg, returns in local currency unless otherwise stated.