CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

June 2021

We've thought about it …

Last month we wrote that the Federal Reserve (Fed) in the US had struck a very cautious tone in May, that they were merely *thinking about, thinking about* the tapering of their asset purchase programme (also known as QE). We cautioned that the market gets very sensitive whenever there is even a whiff of a withdrawal of monetary stimulus - which has been irresistible to equity and bond investors over many years. But in June they had little option but to accept that inflationary forces and the speed of the economic recovery may not only instigate a reduction in stimulus, but also bring forward the potential for interest rates to rise.

Central banks – such as the Federal Reserve (in the US) and Bank of England (in the UK) - are well aware of the important role they play in the price stability of markets. However, in recent months the Fed has become more unpredictable, with markets clearly sensitive to change in rhetoric - as we saw in mid-June, when Fed chair (Jerome Powell) began to recognise inflationary pressures and suggest interest rates may need to rise sooner than expected. Whilst all recessions are different, the COVID induced recession has no modern precedent and so even central banks are in unchartered waters. On inflation, this has finally been recognised by the Fed as being something to monitor more closely which has, in turn, lowered the chance of runaway inflation. Had the Fed not recognised inflation at the latest meeting, inflation sensitive assets would have been in high demand - as it is abundantly clear (from our everyday lives) that there is, at least in the short term, acute inflationary pressures. Our base case is that inflation in the UK and US will average 3-5% (higher end in the US) over the next 12 months.

Whilst historically this inflation rate has been a good environment for equities, what makes it different this time round is the base level (near zero) of interest rates, and so any significant and sustained increase in inflation will need to be tempered by raising interest rates. Given that the world is awash with debt since the COVID crisis, this can have a material effect on borrowing costs. Rising interest rates can also have an effect on *growth*-focused stocks in the equity markets, that have been elevated to lofty valuations, with ultra-low rates. When this begins to reverse, these valuations could come tumbling down. In this environment, high growth sectors, such as technology and healthcare become vulnerable. So, investors would be prudent to avoid blue sky companies (e.g. Tesla) on very high valuations as well as companies that have high portions of debt, such as utilities,and focus rather on quality businesses, able to pass on costs to customers, trading on fair valuations and with relatively low debt.

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