tavistock WEALTH
REVOLUTIONARY THINKING

ROOM TO RUN

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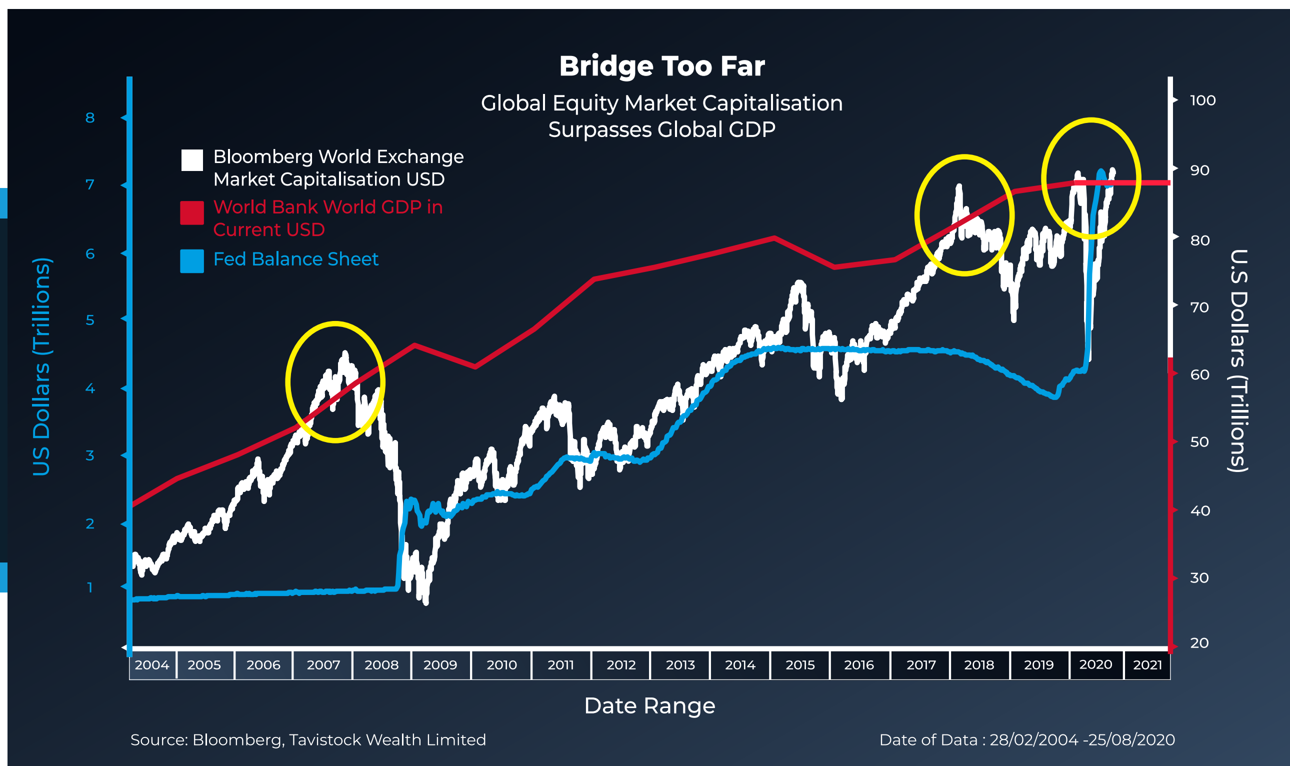
Despite the fact the coronavirus has plunged many countries into recession, global equity markets are now back at all-time highs, as measured by the Bloomberg World Exchange Market Capitalisation index.



This index has also risen above world GDP, something that has only happened a handful of times over the last two decades. The stock market capitalisation-to-GDP ratio is typically used to determine whether the overall market is under or overvalued and this metric is now flashing red. Prior such occasions, highlighted in yellow, have typically preceded subsequent bouts of risk aversion.

Whilst this remains a key risk, what differentiates events today, from those that came before, is the timing and sheer magnitude of fiscal and monetary stimulus deployed to support market prices. As the economy went into free fall, central banks started printing money like there was no tomorrow. The Fed, in particular, did so pre-emptively and on a much larger scale than prior occasions as shown by the blue line.

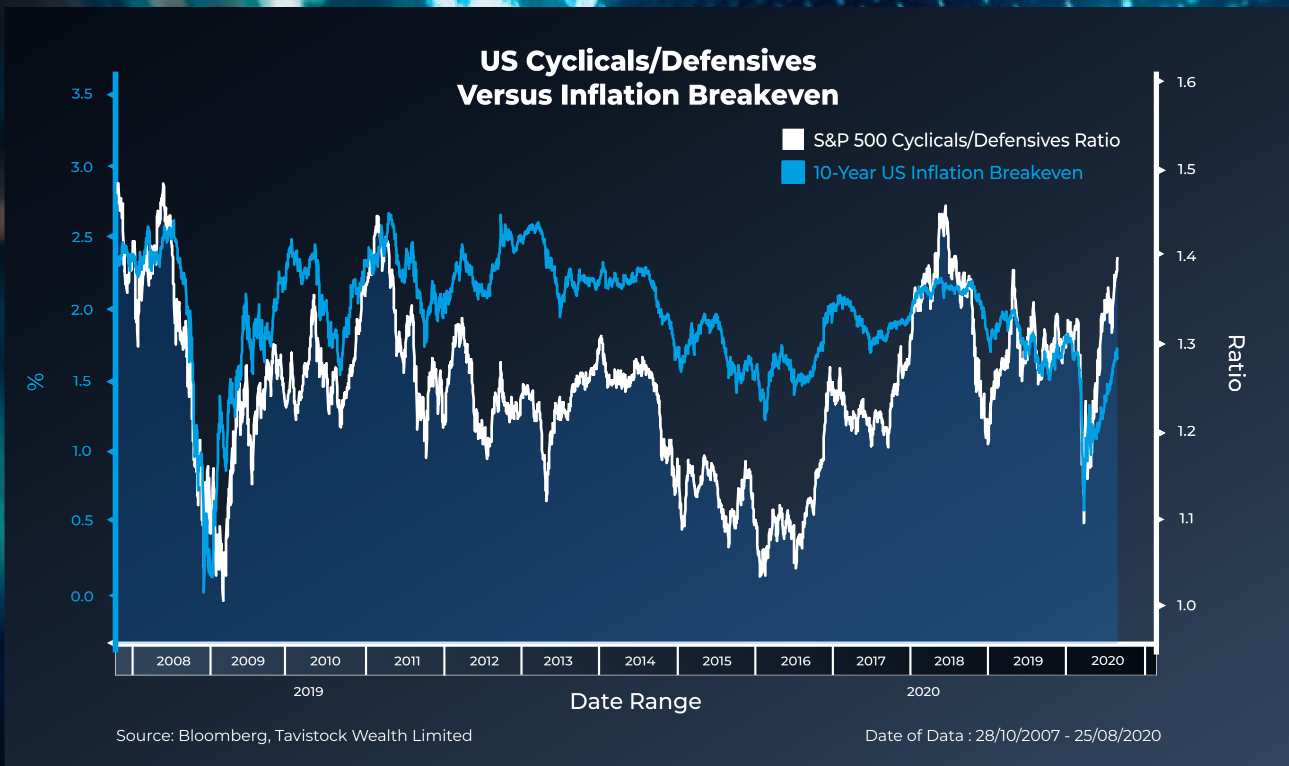
This huge increase in the money supply should continue to support markets going forward. So even though the S&P 500 market cap-to-GDP ratio is at extreme levels (now above the peak of the tech bubble in early 2000), when compared to the money supply, in blue, valuations are far from prior highs. This tells us that if the money supply is the key factor driving markets higher, there is room to run.

Indeed, the Fed signalled as much in its latest minutes (published Wednesday) stating "it might be appropriate to frame communications regarding the Committee's ongoing asset purchases more in terms of their role in fostering accommodative financial conditions and supporting economic recovery." This implies a shift in purpose from the original intent of quantitative easing during the early stages of the crisis, to sure-up liquidity in the system, to a tool that can be used to stimulate the economy.

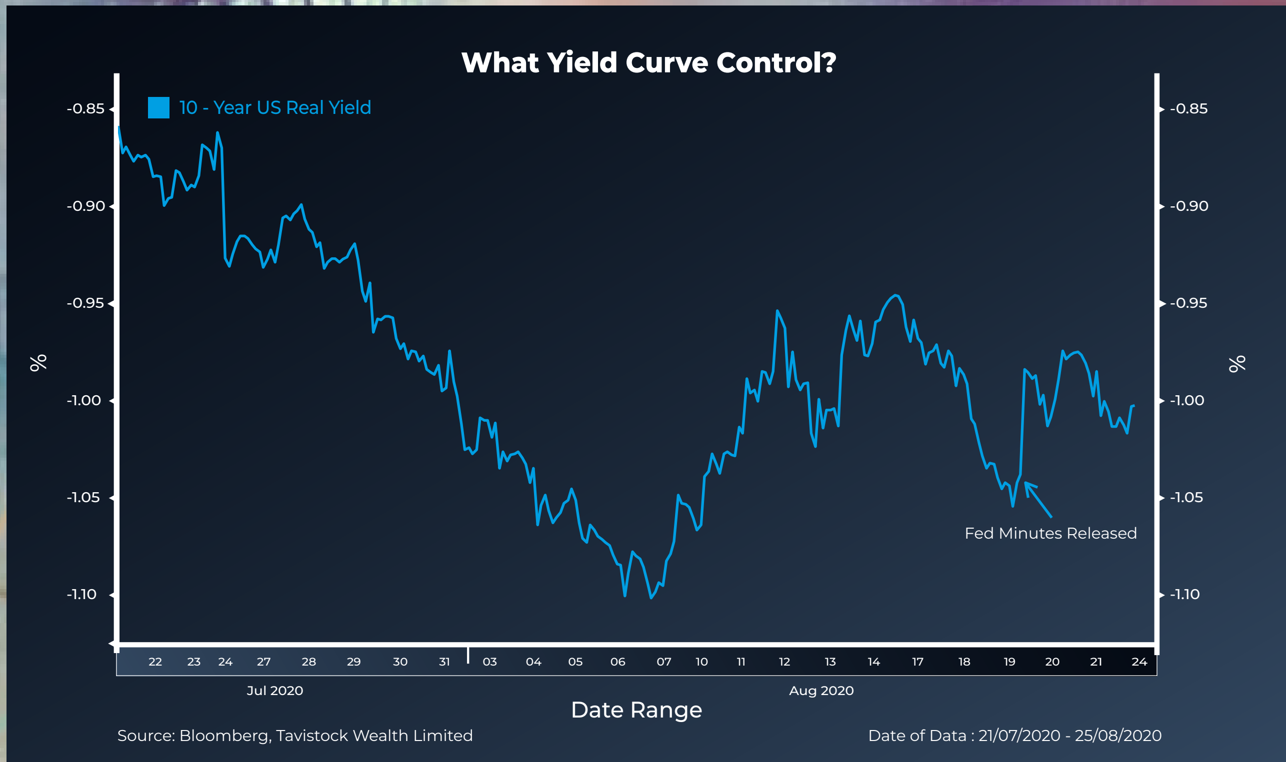
On that, the key event this week with be Fed Chairman Jerome Powell's speech at Jackson Hole, during which he will discuss the central bank's long-awaited policy framework review. The highly anticipated new inflation strategy will likely adopt a more flexible approach that allows inflation to 'run hot' above 2% to ensure it averages at that level over the longer term. We believe the Fed will announce its intention to keep policy accommodative for years and markets have already started to price this in via higher inflation expectations (in red) even as nominal Treasury yields, (in blue), remain subdued. This has contributed to the notable decline in real yields, which at -1% is not far from record lows.

As shown in the chart below, falling real yields in blue (axis inverted) have benefited US equities relative to the rest of the world, technology stocks relative to other sectors and commodities, such as gold. Our house view is that real yields can continue to fall over time, and we have positioned the funds accordingly to benefit from these key themes and others.

For example, as inflation expectations drift higher, we would expect cyclical stocks to continue to outperform defensives.



The key risk to our house view, therefore, is rising real yields, either via faltering inflation expectations or rising nominal yields. These risks rose to the fore last week following publication of the latest FOMC minutes which seemed to rule out the prospect of yield-curve control, to keep nominal yields subdued, which many investors had assumed was on the cards, if not already in place. Under YCC, the Fed would target a long-term rate and pledge to buy bonds to keep the rate from rising above that target level in an attempt to stimulate the economy. The official minutes stated that "of those participants who discussed this option, most judged that yield caps and targets would likely provide only modest benefits in the current environment." As a result, real yields jumped slightly, as shown in the chart below. However, the move higher was not decisive and whilst YCC may be off the table for now, the option remains down the line.



Whilst we expect greater clarity on Fed policy later in the week, Congress remains unable to reach an agreement on further coronavirus relief measures. With the Republican convention kicking off this week, and mounting political pressure on Nancy Pelosi to restart talks, we believe a deal will eventually be reached. This is because easier financial conditions are required to ensure the sustainability of the recovery, and higher equity markets. It is interesting to note, therefore, that US financial conditions are actually tighter now than before the start of the crisis (a reading above zero is accommodative whereas below zero is not). This is something we will be keeping a close eye on over the coming weeks, not least due to the recent divergence between underlying financial conditions index and the S&P 500.

Ultimately what this tells us is more stimulus is required, and that should be bullish risk assets over the medium term.

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