# The value in diversification

Watching Trump take off from the White House in Marine 1, peacefully I might add, has gotten me musing about the notion of the changing of the guard. I, for one, am going to welcome the return of policy coming from the Oval Office rather than Twitter and eternally grateful not to have a president using 1.00am tweets to influence the direction of the stock market. Like the White House, I think this market is, ironically, in the middle of a similar changing of the guard. Specifically, from stocks geared towards lockdown's austerity, to those exposed to the likely exuberant spending when the tiers are lifted.

Investors have been, since November 2020, snapping up cheap stocks with depressed earnings over expensive stocks with high growth targets. Ironically, it is a complete about face from the first six months of 2020 when investors wanted the safety of high growth and the newly coined "stay at home" stocks. Primarily, the catalyst for this investment switch has undoubtedly been the vaccine roll out and the market, true to form, buying the rumour of an expected rise in consumer spending once inoculations start to depress the R rate. I am inclined to agree with those reflation bulls who think discretionary spending is going to be aggressive, and we have taken steps to reflect this in our clients' investment positioning, primarily via investments into high quality value and commodity funds, which have, to date, proved very successful.

One of the supporting views to this anticipated spending splurge is a belief that a large subset of consumers, lucky enough to have saved during this pandemic, will have a burning desire to get on the first flight headed towards the equator and, with larger than usual level of savings, keep spending on almost anything else they have been unable to access since this pandemic started. This spells a sharp move higher in revenues of the airline, hotel, leisure, entertainment, construction and retail industries. As a result, sequentially, one can expect to see positive earnings revisions in these companies becoming reflected in their stock prices as investors, keen to rotate away from "stay at home" stocks, keep buying into the recovery of these depressed sectors.

'Where is the evidence?!' I hear you ask, well, the "M2" money supply is a measure of consumer cash in the economy, defined as current accounts, savings accounts and anything else, which is readily convertible into hard cash. At the end of 2020, the M2 cash measure peaked to a level not seen in over 100 years. That fact is about as succinct an indicator to show the firepower sitting in people's savings accounts ready to be injected into the economy. Indeed, it's exactly this type of M2 measure which goes some way to explaining the mind-blowing rally in bitcoin and Tesla, as consumers use these vast cash savings to support an asset class they believe in.

So we know consumers have money to spend, but are they willing to start spending? Well, to answer that, let's look at shipping. Currently, there is a crisis in shipping as global retailers and manufacturers are putting in orders for overseas goods at such a pace that the cost of a 40ft shipping container has gone up from $2,000 a year ago, to $12,000 today.

Yes, great news demand is back on the charge, but it won't surprise you that retailers in the UK have openly said they can't import goods with a 300% rise in shipping costs and still make a profit at the till, without raising the price to the end consumer, aka inflation. Likewise, it's going to be tempting for an airline this summer, desperate to repair its lost earnings and repay its debtors, to hike the cost of its airline seats above a year ago, as demand turns from lacklustre to excessive.

Whilst inflation isn't going to derail the party right now, it's going to get tricky for the stock market if it becomes excessive. Let me explain why. One of the metrics which the stock market uses to discount future earnings and thus price stock in today's market is the rate of inflation, so a steady increase in inflation is going to be a natural discount factor to the equity earnings, notably growth stocks and especially the "stay at home" growth stocks. Hence, a rotation to cheaper value stocks with less reliance on future growth numbers to sustain their stock prices.

Secondly, the central bank last year dropped interest rates to record lows and vowed to keep them there in an attempt to pour money into the economy and boy did it work. This commitment from central banks was almost solely responsible for the mind-blowing recovery in the market last year. The one metric which central banks have said would cause them to think about reversing this commitment and raising interest rates would be an acceleration in inflation past 3% for a prolonged period of time.

Inflation sharply accelerating in 2021 could spell a wave of panic as investors begin to sell down stocks with big future earnings, whilst selling government debt as quick as they can in anticipation of a rate hike. We saw this in 2013 and it was coined the "taper tantrum". One stage further than this is "stagflation", where unemployment rises at the same time as the cost of goods, which will prove very tricky for central banks to navigate without causing another bear market.

Given how aggressively the entire market has rallied in 2020, it is undeniably fragile and historically, markets like this, have been prone to break. Now, some might say a sell off down to more normal levels would be a good thing and there is merit in that view, but it's still a risk to client portfolios and therefore something we need to be prepared for as we move further into 2021.

Yes, buying the COVID reflation story in 2021 makes a lot of sense as I have outlined above, there is real firepower to make it happen. Given this, we have added inflation protected government debt to insulate portfolios from a sudden rise in inflation. Alongside this we have moved clients into more "actively" managed funds in attractive sectors that capture the COVID reflation story. Taking advantage of active management in this environment will prove critical in distilling the quality which remains in this market. Sadly, something passive investors remain unable to access.

It remains critical, more so now in the face of all this bullish sentiment, to keep a disciplined, well-balanced and diversified portfolio. Because if the economy runs too hot too quickly, we need to make sure our clients are well protected from any fall out.

My finishing thought is this, I have a friend who went through a rigorous army selection process and through all the misery, he kept telling himself, "one day this moment will just be history". I think we can all look forward to a time when we can say that about this pandemic. Until then, stay safe.

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