

State of Play



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Ever since the financial crisis in 2008 the US market has dominated all others, driven by innovation from technology companies that have now become household names.¹ Given the latest inflation numbers and the political uncertainty leading into the US mid-term elections later this year, has the bubble finally started to burst? Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Success driven by innovation

The US market has been a long-standing leader in the world of investment markets with innovation and technological advances changing not only the makeup of markets but much of the way we live, work and play. If you reflect over recent history, it is not that long ago that we would pick up a phone connected by a wire to the socket in the wall to speak with a friend or loved one or use a paper map to navigate an unfamiliar route. Everything has changed, from how we communicate through using just one product (to call, text, research, navigate, or buy a product or service) to where and how we buy goods and services. My reflections are that the innovation behind this change in some ways has been driven by a small number of pioneering companies, the FAANGs plus Microsoft (Meta formerly known as Facebook, Apple, Amazon, Netflix, and Alphabet formerly known as Google,) and supported by a small army of followers who noticed the new ideas and helped develop these into a roaring success. However, is this success

sustainable, especially given how favourable the financial environment has been in allowing the possibility of change in the first place, and the extraordinary returns taking their share prices to record levels¹? Let's look at where we have been and whether the outlook has changed sufficiently to make a repeat of this success unlikely.

Unprecedented solution to an unprecedented crisis

The first real signs of trouble brewing was arguably as early as 2007, when Bear Stearns, a global investment bank heavily exposed to mortgage-backed securities due to their business model, sought a bail-out loan from the Federal Reserve (Fed) after posting the first financial loss in their history and faced bankruptcy as their balance sheet became almost worthless². Eventually, the bank had to be saved by a deal with J.P. Morgan who bought Bear Stearns supported by a loan backed by the Fed. This began a series of extraordinary decisions, both in the US and globally, saving the financial system from collapse but not averting a severe global recession which reverberated for many years to come. Arguably, the most important consequence of this crisis was a decision by central banks to embark on an enormous an unprecedented financial experiment called quantitative easing alongside deep cuts in interest rates to record lows.

What is quantitative easing?

Quantitative easing is where central banks create new money and use this to buy debt from commercial banks - exchanging their debt for cash with the intention that this money be lent to businesses and individuals, enabling the economy to recover from the logjam and financial uncertainty. Importantly, this approach tips the investment balance by pushing up the value of assets like shares. According to economic theory, this should also increase prices through inflation, as too much money chases too few goods, eventually forcing interest rates to rise to curb this.³ However, several factors have played a part over the last decade in broadly keeping inflation artificially low until very recently. Technological advancement and globalisation have helped keep a lid on price rises over this period, in part because innovation helps make the economy more productive and more efficient, but also cheap labour allowed many corporations to house their manufacturing in developing countries like China helping to keep costs lower than they would have been.

The longest bull market in history

This programme of low interest rates and financial support was due to be wound down just before the pandemic struck. At the time of global lockdowns and financial uncertainty the metaphorical printing presses began to move even faster than before, enabling financial stability and saving many

businesses from failure and many millions from losing their jobs. Throughout this 15-year period we have witnessed the longest bull market run ever recorded with stark differences in investment returns from various markets around the world. The world index from MSCI⁴ which is made up of over 1,500 different constituent companies across international markets delivered total investment returns including dividends of 292% since February 2007¹. The most popular UK measure, FTSE 100, which is made up of the largest companies listed in Britain, returned 111% over the same period.¹ In contrast the wider US market best captured by measuring the S&P 500 Index, returned 455% and the technology dominated NASDAQ Index delivered 1,265%!¹ The closest international market to the US was China with 300%, but some way behind the NASDAQ.¹

I think it is important to recognise a few pivotal factors when assessing this specific period. Firstly, the unprecedented financial support and low interest rates helped grow businesses as borrowing was cheap and easily available. The innovation and consumer trends changed beyond belief disrupting the marketplace as the pace of change was arguably the fastest in our modern history. The other major factor is with such low interest rates and lower bond yields, investors have an increased risk appetite when lower risk assets offer much lower returns than in the past. This environment encourages new ideas and new investment thus driving the pace of change and to some extent leaving more traditional or value businesses behind. The pandemic has been the final enabler. Even when markets fell sharply when the consequences of the pandemic became clear, subsequent shutdowns and restrictions forced the already changing world into fast forward. Those innovative companies gained an even bigger advantage as consumers buying more goods and services online coupled with many older people having to communicate using modern technology to stay connected, which drove the shares of these companies even higher.

Is the environment changing in favour of more traditional value companies?

I have observed that growth stocks have enjoyed a unique golden period with the financial environment tilting the scales in their favour. However, there appears to be a shift in this balance driven by a change in the outlook, but what are the drivers of this change? Last week saw US inflation hit a 40-year high as rising prices for the last 12 months hit 7.5%, which was above forecasts⁵. Whilst this is expected to fall over the coming months, many are now forecasting a 0.5% rise in interest rates in March instead of the initial 0.25% expectation, when the 12 members of Federal Open Market Committee (FOMC) meet on 15 March to discuss their next steps.⁶ This has driven 10-year yields on US Treasury bonds to hit just over 2% for the first time since July 2019, triggering further falls in US markets as investors again start to re-evaluate current share prices with worries about the future earnings of companies knowing higher interest rates in response to sustained higher inflation will hurt revenues and profits.⁴

Also, when you reverse, even gradually, the quantitative easing experiment this means less money chasing the same number of goods and the availability of future financing for innovative companies with a great idea becomes more challenging. Typically, tighter financial conditions tilt the market backdrop arguably back in favour of larger, traditional, and profitable companies seen as value companies. Finally, the political backdrop remains hugely uncertain. Later this year the US mid-term elections take place against a backdrop of poor approval ratings for the key political incumbents pointing to a potential shift in power which has wider ramifications for the final two years of President Joe Biden's tenure.⁷ If this is coupled with the rising tensions over Ukraine, investors become increasingly twitchy. Investors hate uncertainty more than anything as it is impossible to model the potential outcomes with any confidence creating different assessments of asset values, future paths for interest rates and economic growth prospects. At times like these it pays to be diversified to help smooth a journey, cushion short-term volatility and navigate a bumpy road to long-term investment horizons.

Find out more!

Click [here](#) to read our latest A Month in the Markets, where our Head of Systematic Research for TAA and Alpha, Stefano Amato, looks at how key themes impacted markets in January.

Note: Data as at 14 February 2022.

¹ FE Fundinfo 2022, 14/02/2022

² History, Bear Stearns collapses, sold to J.P. Morgan Chase, 16/03/2008

³ Investopedia, Quantitative Easing (QE), 15/10/2021

⁴ MSCI, MSCI World Index (USD), 31/01/2022

⁵ Investing.com, 14/02/2022

⁶ BBC Business, US consumer prices rise at fastest rate since 1982, 11/02/2022

⁷ Reuters Graphics, President Joe Biden approval holds near lowest levels of his presidency, 15/02/2022

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