

## Growth spurts

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The respected British economist Gavyn Davies has recently been noting that global growth may be significantly stronger than thought. Economic “nowcasts” attempting to take the real-time “temperature” of the economy point to global growth edging 5%. Moreover, this resurgence is broad-based and synchronous with all four corners of the globe contributing to growth. In another interesting twist, the newest member of the Bank of England’s Monetary Policy Committee – Silvana Tenreyro suggests that UK productivity, much discussed in these pages may be higher than previously estimated with the problem largely, though not exclusively, confined to the financial services industry. Ms Tenreyro expects productivity in both UK finance and manufacturing to improve in the coming year with positive attendant benefits to wealth creation.

The combination of global reflationary forces allied to local improvements of the type noted above has led some commentators to become uncharacteristically optimistic. The normally dour and famously bearish Jeremy Grantham of the Boston based group GMO has even been talking of a “melt-up” in equity markets. Euphoria is a very dangerous emotion in financial markets. Moreover, markets are prone to herd behaviour which can exacerbate trends leading to prices overshooting and then correcting, often violently. There is clearly some euphoria in certain corners of the financial world; bonds, perhaps, residential property and certainly, bitcoin. Recently, a newly listed “shell company” that contained only cash added bitcoin to its name only to see the shares soar 400% i.e. many times the value of the cash it held as its only asset. Investors were literally buying fivers for fifty pounds. Memories of dot.com flashed by!

Interest rate sensitives are vulnerable from stronger growth because with growth comes the prospect of higher i.e. “normalising” interest rates. Bonds are at or close to all time low yields and yields are likely to rise pushing down bond prices. Still, most people would regard equity as the riskiest of “risk-asset.” On many measures, equity valuations are high and therefore prospective returns low. In the capital structure of a company, equity is the junior component of capital employed. By definition it is “risk-capital.” Nevertheless, equity is the principal beneficiary of a growth surprise. Stronger growth makes it easier to finance fixed obligations, higher sales feed through to stronger earnings (at least in the short-run) and price/earnings ratios trend lower. Valuations decline via a higher denominator rather than a lower numerator.

Furthermore, the failure of “zombie” companies into an upswing removes inefficient firms, raising productivity. Eventually, this real cyclical improvement will lead investors to extrapolation and inflated optimism paving the way for perhaps, a serious correction.

In the meantime, though this is not a forecast as with Jeremy Grantham, it is possible to see why equities might still have further to run.

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