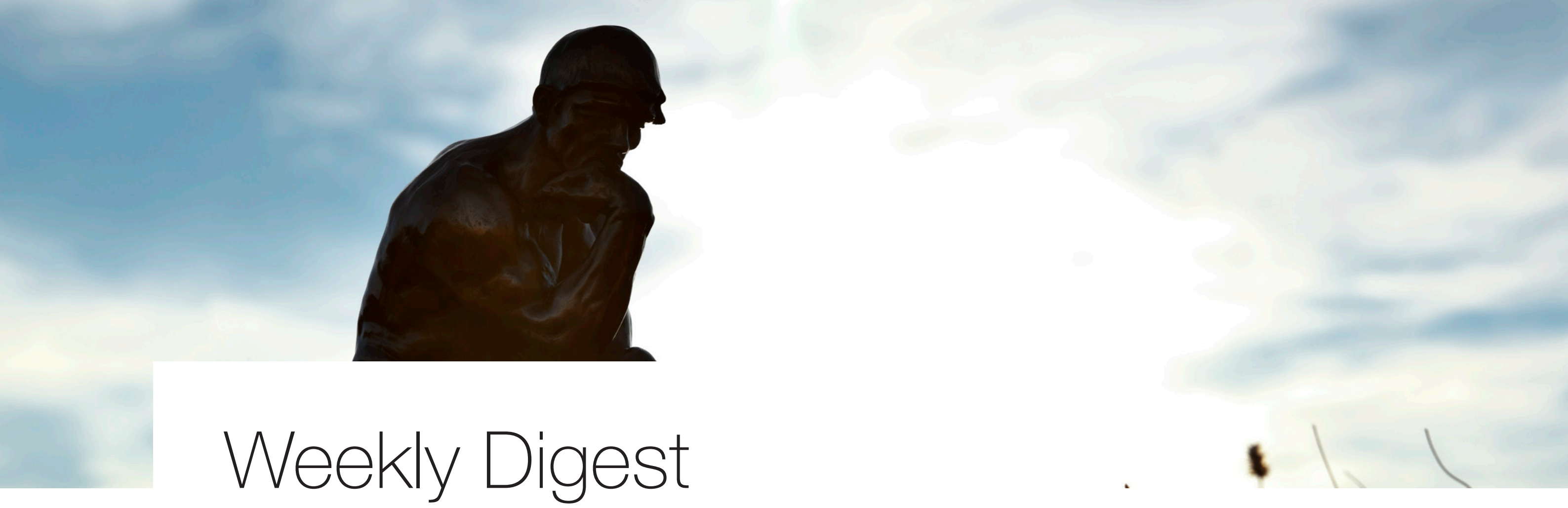

Weekly Digest

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Thinking the Unthinkable

Last week we were visited (virtually) by another excellent external speaker, the thought-provoking strategist and stock market historian Russell Napier. Owing to the fact that he is best known for his book Anatomy of a Bear, he is often seen as something of a prophet of doom, although the book set out as much to identify the excellent long-term buying opportunities in equities at bear market troughs as the causes of those bear markets. Unfortunately, because the last secular bear market bottomed in 1982, just before his career began, he has had limited opportunities to test his theories to the full.

He began by asking us a question that he himself was asked recently with respect to investing: “What do you wish you had known thirty-five years ago?” His four answers were: 1) Where we stood in the long-term valuation cycle; 2) Where we were in the inflation cycle; 3) The influence of money and credit; 4) The role of psychology in markets (both behavioural in the individual, and that of crowds). I would agree that this is a pretty timeless list that would apply to any period you might care to look at.

In addition, I would have added the power of compounding, and knowing who the big compounders would be. That could be either the benefit of reinvesting dividends to deliver total returns well in excess of nominal index returns, or, even more powerfully, the reinvestment of profits earned above the cost of capital by companies that generate high returns on capital. I will admit to having spent far too much time early in my career chasing short-term capital gains based on a fleeting valuation opportunity, a cyclical shift or a hot tip, rather than just buying good quality companies and sticking with them. (Unfortunately, the fact that revenue was driven by trading commissions was not exactly conducive to telling a client that their portfolio was optimal – and I’m talking about my career on the institutional stockbroking side).

So what is Russell thinking now? And how does it fit in with our thoughts? His main concern currently is how we will deal with the huge mountain of debt that has been accumulated by both the private and public sectors – a veritable Himalayan mound that has only been heightened by the Covid crisis. He is not alone in worrying about this, by any means. Neither is he alone in thinking that it might demand a huge shift in the thought processes of investors, as well as in portfolio construction. They key driver would be a shift in the inflation regime.

The last great secular bear market ended when central banks, led by Paul Volcker of the US Federal Reserve, finally tamed the rampant inflation of the 1970s. Yes, there were inflationary echoes through the ‘80s and even the ‘90s, but it took many policymakers and fund managers a couple of decades to come to terms with the regime change, by which time the “easy” money had been made. I did some research a few years ago which showed

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that the period from 1980 to 1999 delivered owners of a typical medium-risk private client portfolio (based on our own Strategic Asset Allocation benchmark at the time) returns way in excess of anything achieved in any other twenty-year period since World War II, and yet many still seem to believe (or perhaps hope) that those sorts of returns remain within easy grasp. That's a tall order with bond yields close to zero.

So how does this inflation regime shift in the other direction come about? First he lists the various ways in which debt-to-GDP ratios can be reduced. The first is by growing out of the debt, but that would require real growth of 4% or more, which will be hard to achieve from the current indebted state, especially when influences such as demographics and low levels of productivity growth are taken into account. Second on the list is default. Just don't pay back the borrowings. But that would be an extreme route, and one that rarely needs to be taken by countries with debt issued in their own currency. Third is austerity, but that option is fast becoming politically unacceptable (and there isn't much fat left to cut anyway). Fourth is hyperinflation, but that would too destructive to whole societies to be worth pursuing with intent.

All of which leads us to his most probable outcome – a long period of "financial repression", a phrase which hides the true destructiveness of its purpose. Russell puts it another way: "Stealing money from old people slowly". The key is to get the inflation rate running higher than savings rates (at least those available on government bonds and cash). It doesn't have to be huge, just a couple of percent. This would be make the loss of real wealth barely perceptible in the short term, but would accumulate enormously over, say, a thirty year period. This is what economists mean when talking about "inflating away debt". Sounds innocuous, doesn't it? It just means that the economy grows faster in nominal terms than the debt, thus reducing the debt levels in real terms (delivering a lower and more sustainable debt-to-GDP ratio). Good for borrowers; awful for savers.

There are two components to financial repression. The first is raising inflation, something that central banks have struggled to achieve since the financial crisis despite extreme monetary policy. One theory for this failure is that even though huge amounts of quantitative easing have expanded the balance sheets of central banks far beyond levels previously deemed suitable, the money that was created has piled up in the excess reserves of the banking sector rather than being lent to customers. Whether that is an unwillingness to lend or to borrow is a moot point. The consequence has been insufficient demand relative to supply to tip the inflationary scales. What has changed, thanks to Covid, is that fiscal stimulus is being transmitted through the banking sector by way of government-guaranteed loan programmes as well as, in some countries, cheques being sent to citizens to boost consumption. With potential disruption to supply chains ahead (from Covid and more nationalist trade policy), the stage is set for potentially higher inflation.

Inflationists have been caught out before, and so there is no guarantee that this will be the outcome. The first main objection is that the current fiscal stimulus packages only serve to replace demand that has been destroyed by Covid. Will they persist once some sort of normality returns? Maybe yes, and the emergence of Modern Monetary Theory as politically acceptable supports that view. But I can assure you that the opposing inflation and non-inflation camps are as far apart as ever. What we might see in the short term is bouts of localised inflation as demand patterns shift. For example, domestic holiday homes are "bid only" in northern climes, but you could probably book out a whole hotel in southern Europe for the same price. (If nothing else the experience has told us that our crowded little island is no longer big enough for all of us to go on a staycation at the same time).

The other component to financial repression is keeping down bond yields. In a pure market environment this should be impossible. Savers would demand higher yields to compensate for higher inflation and the market would adjust prices accordingly. There are a few ways of subverting the market. One is for governments only to issue very short-dated securities paying less interest than inflation. Another is to make sure that the central bank caps yields by buying in the market – a tactic known as "Yield Curve Control" in Japan, but which seems to have morphed into the less interventionistsounding "Yield Curve Targeting" in the United States. (The Federal Reserve is openly talking about allowing inflation to "run hot" for a while to allow inflation to average 2% across a longer period, and this is expected to be the subject of a major policy review due out this autumn).

Finally, and perhaps most perniciously, regulators (for which read the government) can force financial institutions to buy government bonds at sub-market rates of interest. If that sounds far-fetched, it's already happening. Banks are required to hold a certain amount of their capital base in domestic government bonds, and insurance companies and pension funds have solvency constraints that compel them, for example, to keep buying index-linked gilts that guarantee a negative real return if held to maturity. (I might add that this puts a huge onus on the riskier element of portfolios to generate sufficient returns to deliver promised outcomes). There are also well documented examples from history, notably in the United States and France after World War II.

So where does that leave us? Our own central view is that inflation represents a higher long-term risk now than it used to, although demand destruction will be more deflationary overall in the short term. We can see that inflation might well be the only way out of the current debt situation, but we can also see that the status quo could persist for a long time given that funding rates remain so low – effectively there is no immediate need to address the debt problem. Certainly that is more probably the case for countries with high domestic savings and current account surpluses, although neither the US nor the UK score well on those fronts, which makes their currencies more vulnerable. Thus our stance has been to increase the elements of inflation insurance in portfolios while not (yet) positioning for all-out inflation. But it looks as though the inflation discussion and all its ramifications will remain high on our agenda for the foreseeable future.

As has become the tradition at this time of year, I will be handing over the reins of the Weekly Digest to some of my colleagues for the next couple of weeks while I take break.

Last week's Economic Highlights

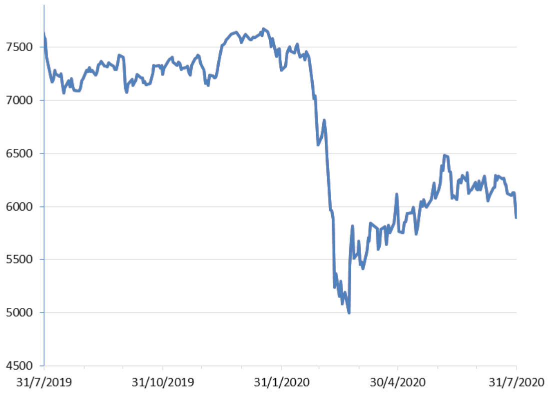
FTSE 100 Weekly Winners

Land Securities	6.1%
Next	5.9%
Polymetal International	5.0%
SEGRO	4.8%
Fresnillo	3.4%
Smurfit Kappa	3.0%
BAE Systems	2.6%

FTSE 100 Weekly Losers

Melrose Industries PLC	-18.3%
IAG	-17.0%
Rolls-Royce	-13.6%
BT Group	-12.3%
Lloyds Banking Group	-11.5%
Barclays	-11.5%
GVC Holdings	-10.4%

FTSE 100 Index, Past 12 Months



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