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OUT OF THE ORDINARY

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Golf With Einstein

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Albert Einstein reputedly claimed that compounding (interest) was the eighth Wonder of the World, but it can also work against you. I rediscovered that at the weekend while playing in a two-day golf competition. A bad shot that put me in brutal rough would often lead to another that left me in an equally bad or even worse position! I wondered if Einstein played golf. Apparently, he did not, although he is reported to have tried. There are references to him becoming

confused by the barrage of instructions being given to him. His response was to borrow some balls from the teacher. He threw one back, which the teacher caught with ease. He then threw four simultaneously, none of which went to hand. Point made!

We often invoke the power of compounding when talking about companies that we describe as "Growth Compounders". These are the preferred components of equity portfolios as far as we are concerned. Perhaps not quite the "one decision stocks" that you buy and forget about forever, but at least businesses that are capable of generating high returns on capital and then reinvesting some portion of the return above the cost of capital back into the business to create more growth.

Another strong generator of substantial long-term returns is the reinvestment of dividends, although this is not necessarily a route open to those who need to spend their income to live – but great for those in the accumulation phase of investment. The point cannot be made much more starkly than by looking at the size of the "wedge" between the capital-only returns of the FTSE 100 Index since its (then) peak on the final trading day of the last millennium and the total returns. After almost twenty-two years, the index is just 1.97% higher, which is mostly a testament to two main influences: first, the egregious overvaluation of the Technology, Media and Telecommunications sectors at the peak of the dotcom boom; and second, the huge value destruction wrought upon the banking sector by the financial crisis. But the total return is a much more respectable 112%.

Before I reveal what the compound annual return is, hazard a guess at what you think it might be. My suspicion is that a lot of people (certainly those not that comfortable with maths or investing) will guess substantially higher than the actual answer, which is 3.5%. Those little numbers add up to a lot over time.

But compounding a loss of value can be equally destructive to one's wealth. Right now, there remains a huge focus on the gap between what can be earned by savers on low-risk investments and the rate of inflation. If you can only obtain a return of (let's be generous) half a percent on cash or government bonds when inflation is running closer to 5%, as it is in the United States, then your wealth is falling by 4.5% per annum in real terms. Even if inflation levels out at 3% and interest rates drift up to 1% in the next couple of years, that's still a 2% shortfall to make up. Over ten years, £100 becomes worth less than £82 after inflation. That is one reason why investors are taking (and need to take) more risk with their portfolios currently.

If inflation does remain elevated, much will then depend upon the reaction of central banks. Historically they have raised interest rates to counter inflation, but there is much less certainty that this is what will happen now. Vertiginous levels of debt make it much harder to raise rates very far without creating a severely negative impact on economic activity and solvency. As we have written about before, a regime of "financial repression", by which central banks hold bond and interest rates below their natural levels, is widely cited as a way to reduce the burden of debt in real terms, with borrowers being favoured over cautious savers.

Even though there are plenty of market commentators who claim to know exactly how this will play out, we don't have that confidence. If you are going to settle on a single outcome as a central investment case, then you might as well go to a casino and choose black or red at the roulette table. We are going to continue to weigh the probabilities and adjust the balance of portfolios accordingly.

But there is little doubt that inflation is causing a bit of a stir at the moment, and that will be reflected in consumer price indices scheduled to be published on both sides of the Atlantic this week. The headline number in the US tomorrow is forecast to be 5.3%, while in the UK on Wednesday, the market is looking for 2.9% (and heading higher in the months ahead).

Returning briefly to the weekend, another trait of golfers is to rue all the missed putts, duffed chips and unlucky bounces that contributed to them not winning the prize (your correspondent included!). If it hadn't been for those aberrations, my name would now be inscribed on the big silver cup and the winners' board for posterity. But it isn't, because my game is flawed and mistakes will be made (not to mention the fact that those who did better than me will have made their own howlers too).

Economists are currently indulging in the same mind games with inflation, stripping out all sorts of influences from used car prices to the ravages of the mountain pine beetle in British Columbia to reach a "normalised" level of inflation. And in the same way as the old (and heavily flawed) golf handicapping system conveniently used to ignore one's extremely bad holes, we are now being asked to focus on inflation data excluding all sorts of factors that are currently deemed to be transitory.

We do believe that there is merit in this approach because the pandemic is playing havoc with supply chains and the availability of labour. And, for now, we are also in the camp that sees the current inflation spike as being transitory. But it is more persistent than we might have expected, and the Delta variant is playing a big part in that. And there is always the risk of more variants. The good news is that longer-term inflation expectations are, in general, not breaking higher. This is reflected in market-derived inflation breakeven rates, although we note that Germany's 10-year inflation breakeven rate ticked up last week to levels not seen since 2013 – but still "only" 1.62%.

The market will be keeping a very close eye on the University of Michigan Consumer Confidence Survey, which is released on Friday. This survey includes a forward-looking (US) inflation component, which has been trending steadily upwards this year, with a reading of 2.9% last month for the average over the next ten years. What's "in the market"? The latest Deutsche Bank client survey shows that a strong majority of respondents (79%) believe that inflation will settle at a higher rate in the post-COVID world (or at least in one where we learn to co-exist with the virus) than before, and in the 2-3% range in the US and 1-2% in Europe. I think we (and central banks) could live with that. But danger will arise if expectations start to move away from those anchors.

Economic Commentary

FTSE 100 weekly winners

DS Smith Plc	3.3%
Rightmove plc	3.1%
Experian PLC	2.7%
Rentokil Initial plc	1.9%
Evraz PLC	1.9%
Scottish Mortgage Investment Trust Plc	1.9%
Ashtead Group plc	1.7%

FTSE 100 weekly losers

International Consolidated Airlines Group SA	-6.7%
Coca-Cola HBC AG	-6.7%
Melrose Industries PLC	-6.3%
Polymetal International Plc	-6.0%
Land Securities Group PLC	-5.3%
Ocado Group PLC	-5.3%
Taylor Wimpey plc	-5.2%

FTSE 100 index, past 12 months

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