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Consider You May Be Wrong

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To manage the funds that are entrusted to us we have to build a model of how we think the world economy is working. The inputs into that model are multi-variate; some are quantitative, and some are qualitative.

Quantitative inputs include the level of interest rates, cost of capital, expected inflation rates, implied discount rates, labour cost and supply and the level and rate of change of growth in the economy and, of course, there are many other variables that can impact the climate for investment and growth.

More qualitative inputs would include our assessment of the policy regime; it is accommodative, restrictive, "behind the curve?" Is economic policy supportive of growth and investment or is the economy subject to policy constraints, and are consumers, the primary drivers of growth in modern economies, both confident enough to spend and indeed, do they have the wherewithal to spend.

It is a complex picture and as always, a model is only a model and therefore can never capture the full picture. Consequently, echoing Cromwell who you may remember beseeched the Scots to "think it possible you may be mistaken," we constantly review our model of what we think will happen in the light of what does happen. Have we understood the currents driving financial markets or are we misinterpreting events and therefore do we need to recalibrate our investment horizon and asset allocations?

A synopsis of our basic view runs thus:

The world economy is battling a surfeit of debt, yet final demand has been insufficient to absorb the capacity of the global economy to supply cheap goods and services. Inflation has been too low, deflation in a period of excess debt is the greater evil, but the lowest interest rates in history have been unable to raise inflation or to bring supply and demand into balance. Growth, beginning with the great Japanese bust of the late 1980s has been weak and frequently below previous trends.

Consequently, and factoring in the simultaneous supply and demand shocks imposed by Covid, our "model" incorporates "easy financial conditions" for the foreseeable future. We expect the authorities to take a "benign" view of inflation and the new "flexible inflation targeting" policy introduced by the Federal Reserve is a nod in that direction. Moreover, given the failure of monetary policy to stimulate sufficiently, we expect fiscal policy to remain accommodative and supportive, again, for the foreseeable future.

Finally, our expectation or model of the world expects authorities to focus on nominal GDP, to allow inflation to run hot and therefore not to tighten policy until and unless lost output has been recovered.

It follows from that view, that growth assets should do well but that higher inflation and growth expectations should raise long-term interest rates – in the jargon – steepen the yield curve.

How is our view faring?

With one caveat but an important caveat, what is unfolding fits the views conditioning our investment policy. Joe Biden is about to agree a $1trillion infrastructure bill in the US underpinning investment in US productivity; in Europe, the ECB is gradually shifting to a similar flexible inflation policy as the US and the EU has agreed a sizeable fiscal acceleration via mutually guaranteed bonds and in the UK, both interest rates and fiscal policy remain exceptionally loose even as the Covid pandemic “appears” to be easing.

In our view, that should be pushing interest rate expectations higher, but that is not what is happening.

Long bond yields are falling: in the US the ten year yield has dropped from 1.7% in March to just 1.25% today. In the UK, ten year yields have moved from 0.86% in March to just 0.553% today. To put this into context, it means that investors believe that a return of less than 1% per annum is an investment worth buying in a world where inflation is currently averaging over 3%.

Whilst there are many lazy narratives that can be used to ‘explain’ this market pricing we believe that no one really fully understands what is driving these prices today. In the future, many books and articles will be written to explain why we are where we are, but today there is no way of knowing. At Tacit it is for this primary reason that we pay just as much attention to our Stabilisers in portfolios as we do to the more glamorous growth assets. No matter how confident we are in your analysis of the outlook; in markets, nobody really knows what drives short term price moves and we do not fall into the trap of believing we either know everything or, most importantly, we will always be right.