

Regime Change in Financial Markets – different, but still the same

Published on: 27 May, 2022 | Author: Investment Team

Those of us of a certain age will remember the time in the 1970s when inflation both in the UK and the US was running at more than 20%. Recent inflation prints; +9% in the UK and +8.3% in the US in the year to April 30 echo those earlier difficult and stagflationary years. The question for investors is how to interpret recent data and what to do about it.

Since the foundation of the Bank of England in 1694 (the Bank has the longest data set available), there have been four “great” inflations. The Napoleonic wars took inflation to 36%, after which the British Empire generated a long period of much lower but volatile inflation.

The first and second world wars took inflation over 20% but post-war reconstructions repaired the damage to the supply side infrastructure degraded by war allowing prices to moderate and, of course, most people are familiar with the Great Inflation of the 1970s, driven by the fuel price shocks that also echo with today.

However, the average rate of inflation in Britain in the whole of the period since the foundation of the Bank is 2.27% indicating that price stability is not only the norm but that the current Bank target of 2% inflation is quite close to the long-run historical record.

Readers will know that we think, despite protestations to the contrary, that the current inflation target is between 2% and 4% and not strictly 2%. Flexible inflation targeting is designed to lift the economy away from the zero bound and to allow lost output to be recovered, raising nominal GDP. The Bank will tolerate inflation within those bounds but like the Federal Reserve in the US, that will not run to toleration of inflation prints of 7%, 8% or 9%.

The good news is that prices tend to decline following a rise. It is quite likely that the recent bout of inflation will abate particularly as supply-chains impaired by Covid and war in Ukraine reopen. Nonetheless, the bad news is that the medicine required to bring inflation under control is “inflation” in the cost of money i.e., Increases in the bank rate.

Financial memories tend to be short and generally we extrapolate our views of the future from our experience in the present. The problem for investors is that recent experience is atypical with respect to the longer run of financial history.

The great inflation of the 1970s was as rare as the great deflation of the 2000s; it just doesn't seem that way to those of us who lived through those periods. This is particularly relevant and worrying for younger people since their experience of the cost of money is essentially “free.”

The zero interest rates and quantitative easing that have been used in the last decade to fight deflation and which have driven the cost of borrowing down to record low levels are extremely unusual. In fact, they are unprecedented.

Paul Volcker sparked the great recession of the early 1980s by raising US interest rates to 22%. He succeeded in ending the inflation of the 1970s and the entire forty-year period succeeding 1980 has been characterised by falling interest rates and, by extension, falling bond yields.

A rising tide lifts all boats, but it is becoming clear that the flood has given way to the ebb and both investors and borrowers need to pay attention.

What should you do?

Borrowers should certainly fix their borrowing for as long as they can. Company treasurers by now should have transformed the maturity of their borrowings from short to long securing low-cost financing well into the future.

Investors should do the opposite. We should focus on shorter duration assets to manage the transition from zero rates to more “normal” levels of financing costs. The recent rotation out of tech unicorns, SPACs and even, dare one say, bitcoin and crypto is, in part, driven by the desire to shorten portfolio duration.

Above all, investors should focus on assets that can deliver sustainable and rising income streams. Investments that offer fixed future cashflows look rather exposed in the current and expected environment.

The only asset that can transform price risk is equity. Valuations are exposed to a rising cost of capital but only companies can, in the long run, offset rising input prices with higher output prices.

The historical record shows that persistently high inflation is unusual. Current elevated levels of inflation are the result of unexpected and tragic turns of events but will probably ease over time. Equally, the “new normal” of ultra-low interest rates is also highly unusual and both borrowers and investors should gird themselves for a return to what might be described as the “old-normal.”

We have recently altered our strategies materially and the attached short video provides a more in-depth overview of our investment thinking and views on how we are using the current environment to take advantage of market mispricings....

Strategy Update – May 2022

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