"Same Old, But Not Old Same"

Thanks to a kind reader who sent me this article to remind me how much hair I had in 1988. Nice one. Thanks. But the Japan Times article I wrote in Q3 1988 reminds us of some other truths too. Fretting about inflation is a constant in financial markets. The job of central banks, at least in large part, is to slay the inflationary dragon. Most of all, a 45% bond allocation –add the 15% cash and you get 60%- was once a credible alternative to equities in asset allocation. So I looked up the numbers. For 1988 as a whole, the average yield on 10-year USD treasury bonds was 8.85% and the average 12-month USD deposit yield was 8.41%. Allowing for compounding and capital gains, a bond investor would have doubled his money in under a decade, and made 60% total return after 5 years. Those are equity type returns minus the equity volatility. Nirvana.

Today, the 10-year yields 1.3% and "core" inflation is 4.5%, almost the same as December 1988, when it was 4.4%. "*Don't worry*" says the Fed. This 4.5% is "*transitory*". After the Covid distortions work their way out of the system, inflation will fall to more normal levels, Fed-speak for "about 2%". The chart is one that the Fed is watching closely. It shows that fully half of the 4.5% is explained by semi-conductor shortages (that's the green bar) and other Covid re-opening factors (that's the orange bar). "Core" inflation is, by this reasoning, barely above 1%.

The trouble about this reasoning –convincing as it might be on the numbers- is that it is backward looking. The high inflation years of the 1970s (inflation averaged 7% during the decade) were caused by reckless monetary policy (much as now) allied to other unforeseen factors, the most powerful of which were the OPEC energy shocks, estimated to have been about 3.5%, or half of the 7%. This shock was totally unforeseen. It was what economists like to call an "externality". An asteroid and Covid are of the same sort.

The inflation dragon stirs

On the Front Line

By IAIN LITTLE

Central banks around the world have chosen to tighten credit so as to reduce inflation. The raising of the discount rate in the United States is the latest example of this.

We are, after all, at the stage in the economic cycle when inflation worries usually surface. The U.S. has had nearly 70 months of growth and subdued inflation. Other economic problems seem to have been but on the back-burner in the meantime.

Inflation is the dragon that must now be fought, and interest rates are the weapon that central banks will use. In time, they hope, final demand will be choked off, growth will slow and interest rates will decline.

Failing any major mishaps, this policy should eventually be successful. The problem for stock markets is one of timing (how long will it take?) and extent (will central banks overdo it and cause a major recession?).

It may take longer than some people think for the stubborn U.S. consumer to burn his credit cards. Meanwhile nervous markets could get impatient with economic data showing continued strong growth.

Mr. Greenspan may have had his last chance to brake the expansion until after the November elections; he will not want to be seen as favoring either side.

Thereafter, consumers may have to take the medicine of higher interest rates or even higher taxes, a taboo subject these days.

This should eventually produce lower growth, lower rates and revived bond markets. Share rallies would follow bond rallies, though any tax increases would slow their advance.

With all these uncertainties, the best investment strategy now is a balanced one. Having increased shares in our clients' accounts twice this year already, we have now reduced them again. We have locked in some good profits in the process.

We have increased cash, which is now yielding high returns, and spread the risk fairly evenly between bonds and equities. We prefer bonds to shares because we think inflation will be subdued and resultant slower growth could produce some earnings disappointments. We can always increase shares again if bond markets rally and economic conditions warrant it.

In global accounts, we have returned to a balanced weighting of 45 percent bonds, 35 percent shares, 5 percent gold (as insurance) and 15 percent cash.

We continue to prefer shares in Europe, though some capital goods companies in the U.S. offer good value. Play it safe. Let central banks slay the dragon of inflation, but don't get caught in the battle yourself.

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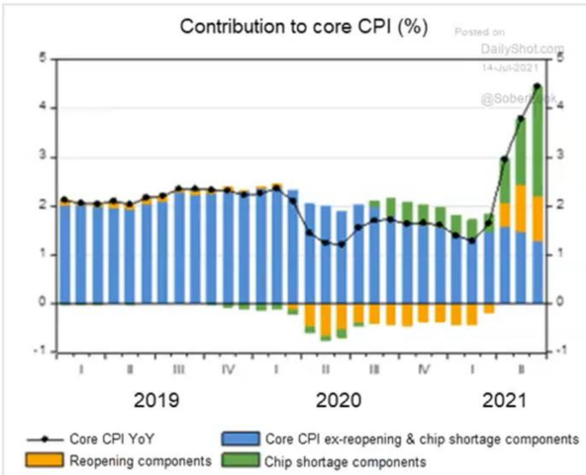
Today we risk another shock, another externality. The global "Climate Emergency" will entail higher carbon prices (an additional cost of production), higher carbon taxes (all governments need them), massive infrastructure spending (to placate populist outrage against inequality), a burgeoning usage of copper, cobalt, lithium and iron ore (the essential components of the energy transition), as well as mandatory and voluntary conversion of households to the Energy Transition economy.

I very much doubt that 1.3% yield on the 10-year bond will compensate investors for this external shock. Watch this closely. It's not in the chart.



Source: Bureau of Labor Statistics; data as of July 13, 2021
