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The pretence of knowledge

1 Precarious debt mountains.
2 Rampant inflation.
3 Elevated economic inequality.
4 Fragile (illiquid) markets.

As Hazlitt wrote "easy money creates economic distortions…. and ventures that cannot continue ***except under the artificial conditions*** that have given birth to them" …this is exactly the situation we now find ourselves in.

We cannot fight inflation, or address wealth inequality, or prevent continued capital misallocations whilst real rates of interest remain negative.

Having been actively encouraged to develop an "easy money" habit, investors are now well and truly "addicted" to negative real rates of interest.

The key point facing central banks in the US, EU and UK is the fact that markets/economies need low nominal interest rates just to be able to survive.

So, where are we now and how does a broken monetary system cope with the issues facing the global economy?

Most likely is a compromise where rates are kept below inflation to ensure "the patient does not die", but the price of this will most likely result in sub-par growth for a considerable period of time.

This raises the prospect/possibility of social unrest because as Hayek observed "the one thing a modern democracy will not bear without cracking is the necessity of a substantial lowering of the standards of living in peacetime or even prolonged stationariness of its economic conditions".

After 20 years of "artificial conditions" papering over many of the very real structural issues affecting the global economy, an inevitable day of reckoning has now arrived. Political and social risks are some of the hardest to hedge against, so we believe that right now discretion is the better part of valour when it comes to asset allocation. It has been said before but it bears repeating: "hope for the best, prepare for the worst and be unsurprised by anything in between".

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No protection to be found in Government debt

TAM Europe Asset Management discusses.

Intuitively clients think that holding sovereign debt is a secure and dependable way to protect your hard-earned assets. It is the Government's debt after all. Indeed, historically Government fixed interest securities have often been considered as the provider of protection for portfolios in times of stress. In a normal operating environment (whatever that is today!) market stresses, wars and economic turbulence usually lead to rising fixed interest prices and to this asset class acting as a source of protection for an investment portfolio.

In this economic cycle we are seeing the absolute opposite – and that is because the stresses and strains are a result of, amongst other factors, dramatically rising inflation and rising interest rates.

This has resulted in UK Government debt (Gilts), as an example being one of the worst performing assets in the financial markets with long dated UK government debt falling as much as 30% in 2022. That is a bear market for Gilts…although I have never heard that phrase before.

Of course, it's not only Gilts - almost all sectors of the debt market have also fallen, reflecting the same economic factors mentioned above - but Gilts in the UK are taking the brunt of debt sell-offs across investment books and at the present time huge swathes of institutional pension funds are taking a pounding as they are the "natural" holders of Gilts. In the present environment it is a tough task being a Gilt or fixed interest fund manager.

In short, government debt has been hit by a perfect storm. It has become almost unfashionable and is probably going to fall further before sanity prevails. Further inflation peaks and interest rate hikes will of necessity, cause the weakness of the fixed interest markets to continue. The ultimate asset that should provide protection is simply not working.

The behaviour of fixed interest and in particular Government debt, in current circumstances leads us inescapably to the conclusion that defence oriented accounts across the industry in 2022 have been no more effective at protecting client assets than accounts with high equity exposure. That is a situation that is both unusual and not the easiest to explain. The gyrations of the fixed interest markets often get lost behind the more exciting shenanigans of the equity markets but believe me, at this juncture the fixed interest markets are the one to get your volatility fix on.

Across the industry you will find a much closer correlation than almost ever before between the falls witnessed in defensive style accounts and the more growth-oriented accounts. It is a very unusual phenomenon but we believe it is likely to last at least until the end of 2022 and possibly into 2023. The sad thing is we do not see real value in Gilts at this level and in our view, they are likely to go at least 10% lower.

Yet again the industry has failed to spot what was going to happen in advance - the cathartic demise of one of its bastions of security in portfolio management.

It must be sobering for all the 'risk control' addicts to find their portfolios dented heavily by the most boring and stable of assets. You cannot foresee risk no matter how much statistical work you do. Investments that are risky become stable and stable investments become risky …… but that's a story for another day.

I hope the comments herein give you some helpful background as to why the industry has seen its lower risk accounts suffer generically almost as badly as balanced/growth-oriented ones.

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