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CHARTERED FINANCIAL PLANNERS

SKERRITTS VIEW – AUGUST 2019

Has Simple Maths Become More Important Than Economics?:

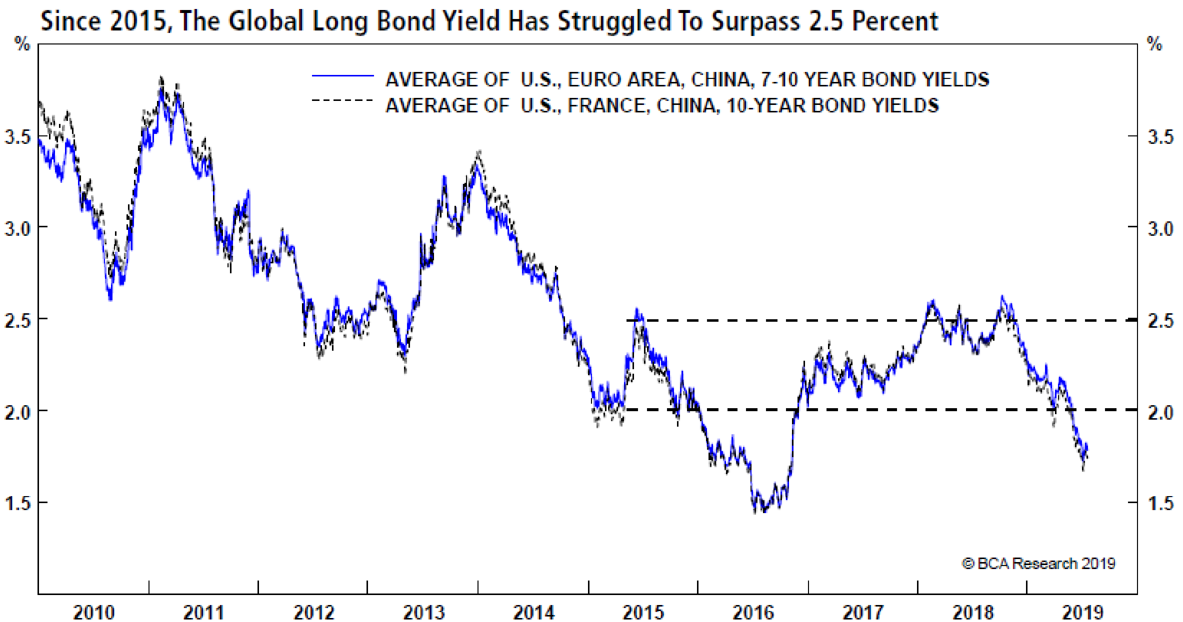
Ever since the Financial Crisis of 2008, traditional economists have been struggling to make sense of the new world in which we find ourselves. The chapters on “The Effects of Universal QE” were nowhere to be found in the many reference books that economists of the current era were studying at their universities through the 70s, 80s and 90s, with the consequence that they are collectively struggling to come to terms with its effects today. Their rule books don’t provide them with answers about what to do or recommend when global bond yields everywhere fall, in many places, to zero and lower – and then stay there.

Since 2008 we have had numerous forecasts of interest rates “normalising” (that means the forecasters’ normal, not the new normal); statements that rates will rise when unemployment falls to 7%, then 6% (it now stands at around 3.7% in the US); Bill Gross the bond fund manager warning that “UK gilts are sitting on a bed of nitro-glycerine” (they weren’t); and various portrayers of doom confidently predicting that the results of QE would be stagflationary, “Soon we may again find ourselves watching a rising “misery index” of inflation and unemployment together” (*The New York Times* Paul D Ryan, Feb13th 2009) and “What is perhaps worse, laid on top of the stalled output in goods and services, I predict Americans are in store for the worst price inflation in US history” (*Mises Daily Articles* Robert P Murphy 15th June 2009).

This is not to be overly critical, but observational. We are experiencing a period about which the rule book is being re-written, yet people of influence are finding it difficult to come to terms with the fact that what they had learned to be fact is no longer the case. By their very nature, most politicians, bankers, economists and fund managers exist within a framework, and their framework is being torn down and replaced. Many “star” fund managers have seen their star wane, sometimes terminally, and mostly those who invest on a “value” basis have struggled to succeed in a decade where the environment has only fleetingly matched their strategic outlook.

We generally like to keep things simple here so we are constantly looking for help in navigating the ever-noisier world of economic forecasting and analysis. This is particularly true when it is relevant to our investment vehicles through which we manage peoples’ future financial wellbeing. Most people accept that the value of their investments will fall from time to time. With today’s short termism dominating the previous long term investment strategies, it is increasingly important to try to assess whether these short term losses are simply “corrections” (in which case it will tend to pay to remain calmer and not make many major changes to the investment strategy) or if they are likely to morph into an entirely more damaging longer term bear market. With the higher level of volatility caused by algorithmic trading processes and wayward tweets, this can be a very difficult assessment to make.

We therefore like it when a visual clue such as the chart below comes along.



So does this tell us something useful or are we just easily pleased?

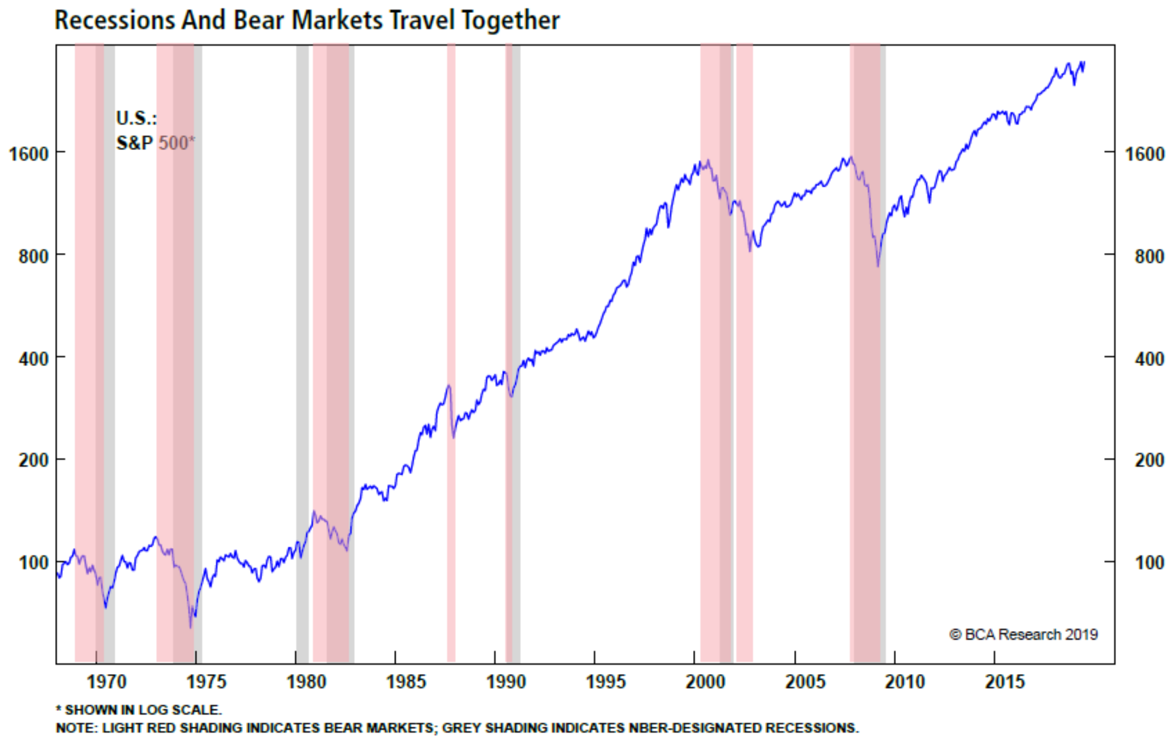
It gives us a very clear, visual clue that, under current conditions (since 2015), a simple mathematical guide can help far more than a whole array of economists' theories. Dhaval Joshi at BCA Research is showing us very clearly that when the average 10 year bond yields in the US, the Euro Area and China reach 2.5%, they find it impossible to stay there. This coincides with the equity markets having fallen sharply each time that they have hit this ceiling. On the flip side however, equity markets have done well when the aggregate bond yields from these markets have declined, particularly below the 2% level. We now calculate this average on a weekly basis. It is now around 1.76%.

This strongly suggests then that risk assets such as equities will be broadly supported at these levels and that there is some headroom before the danger signals begin to flash. Having said this, it also shows that the band is quite tight, which backs up the reasoning for a more volatile market and the need to modestly trade this band in terms of risk on and risk off. What it does mean though is that any short term downward movements in values are likely to be corrections rather than the onset of a bear market for now.

Which is where our other favourite chart comes in.

The chart below clearly shows how bear markets and recessions travel together. It is highly unusual to have a bear market outside a recessionary era. It should be borne in mind though that, as an investor you don't want to wait for the recession to arrive before de-risking your portfolio. Contrary to what would seem to intuitively be the case, recessions don't lead a financial dislocation, but the opposite tends to apply. So if it seems that a recession is within 6 to 9 months away on the horizon, which may well coincide with higher bond yields, we will be actively rearranging our risk assets within our funds to try to protect our investors from the worst that may be coming.

The good news is that there appears to be little or no sign of a recession hitting the US within this timeframe and so we're happy to keep our foot down for now, always aware of course of the need to brake if need be.



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