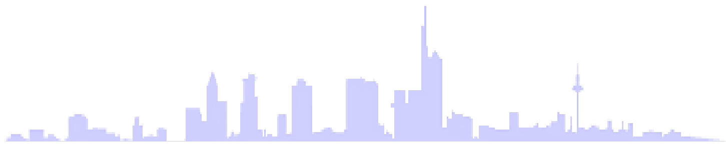

PORTFOLIO MONTHLY REPORT – August 2021

Situation

In July 2021, prices had increased by 5.4 percent compared to July 2020 according to the 12-month percentage of change in the consumer price index, respectively the monthly inflation rate for goods and services in the United States. (Statistia 12 Aug 2021)

Consumer Price Index UK rose 2.1% in July 2021 compared to a year earlier (ONS 18 Aug 2021)

The annual inflation rate in the 19 countries that use the euro currency jumped to a 10-year high of 3%, according to an estimate from the EU's statistics office Eurostat. Inflation in the eurozone had already increased in July to 2.2%, after 1.9% in June. (Euronews 31 Aug 2021)

That inflation is rising is beyond doubt now and above central bank's 2% target. The question is if this is a new rising trend or is it just temporary. This matters because different investments perform differently in an inflationary environment. There is also a timing factor to consider. Short term and long term performance.

Clearly holding cash on deposit only makes sense if the interest rate paid by the bank is higher than the rate of inflation. This is not the case for the US dollar, the UK pound or the Euro. Interest rates have been reduced to effectively zero by these central banks and therefore the "real yield" ie. after inflation is negative. Indeed for the US a rate of 5% inflation will reduce purchasing power by 10% in just two years. In Euroland it would take three years and I think the UK inflation rate is much higher than the quoted number. So holding cash for years makes very little sense because rates are very low and they are not going to rise anytime soon. Governments have built up so much debt, especially recently in response to Covid19 that raising rates would mean their interest payments would seriously impact their spending plans. So cash is not attractive apart perhaps in the short term as markets adjust to a higher inflation environment.

Bonds are generally considered a poor investment with rising inflation as they have a fixed interest coupon for the term of the bond. Amazingly however bond prices have held up quite well this summer after an initial fall at the start of the year. The 10 year German government bond yields -0.35%. (Yes that is a negative return). UK bonds 0.63% and the US bonds 1.3% so all below the rate of inflation.

What should happen is that the bond prices should fall so the yield rises to the point they are positive. But central banks are buying bonds (QE) every month to support prices and keeping yields low. For example the USA buys $120 billion of bonds every month. To put that in context, I read that the war in Afghanistan cost the USA $1 trillion over 20 years. That is the same as just over 8 months of QE. All this cash has to go somewhere and monetary economists claim it will bid up prices and is inflationary.

Equities, being claims on a company's assets and income, tend to grow in value in times of inflation but there can be a period of volatility as the new inflationary environment takes hold. Margins can only be maintained if higher costs of materials and labour can be passed onto customers. Some companies (monopolies) can do this, others cannot.

Tech companies with high valuations based on estimated profits well into the future do poorly while solid dividend paying companies do well, benefiting from a positive cash flow.

Then there are real assets such a property, commodities and gold which over time can hold their value. The risk for property assets is to make sure the debt interest is covered should rates rise by the central bankers in an effort to tame inflation. But central banks have made it clear they are not going to raise rates. (the head of the Fed in the USA is Mr Powell and his term ends in February 2022 so it seems highly unlikely he will raise rates before he is reappointed)

Commodities can do well in times of inflation as a new cycle develops.

Gold should be a good asset as inflation rises because its supply is limited but cash creation is not. For example gold has tended to follow the M2 money supply in the USA.

The effects of the rise in money supply were amplified by the financial crisis of 2008 and more recently by the COVID-19 pandemic. In fact, around 20% of all U.S. dollars in the money supply, ***$3.4 trillion****, were created in 2020 alone. (Bureau Labor Stats)*

	M2 Money	Gold Price	
31 August 2011	$ 9.6 trillion	$ 1,859	Post 08/09 financial crisis and QE
31 August 2021	$ 19.5 trillion	$ 1,814	CV19 crisis and QE

To complicate matters estimates for growth in 2021 and 2022 are being revised lower. It seems expectation for the bounce out of the CV19 crisis are now lower than expected. When there is inflation together with little or no growth it is called Stagflation and was a feature of the 1970s. Something to watch!

Best wishes

Tim 7 Sept 2021