PORTFOLIO MONTHLY REPORT – September 2021

Situation

Central banks are hoping that inflation is only temporary but it is becoming clear that countries around the world are experiencing higher inflation than for many years. The highest since 1993 in Germany. Not only is it a problem for consumers but it is also a huge problem for governments.

The most important thing for a government is to stay in power and the way to do that is to spend money. Centuries ago governments raised money to spend by taxation and that of course still continues. However they also discovered that they could issue bonds or IOUs and investors would give them money, hence we end up with Gilts in the UK, Treasuries in the USA and Bunds in Germany. Clearly to find investors the IOUs have to pay some interest and over the last decade interest rates have consistently dropped lower and lower, but that has recently changed.This year has seen interest rates on government bonds rise. Not enough to cover inflation but they are rising and that impacts the economy.

Ten year US government bonds are now yielding 1.5% while in the UK they have in the last month moved over 1%. They are also higher in Germany but still amazingly negative. Central banks try to keep them low by buying bonds and this so called QE shows no sign of stopping or even "tapering". They are scared that if the central banks stop buying other investors will not step in to buy bonds without demanding higher interest given the current inflation rates. Higher rates would mean governments having to pay more interest on their debt and we know that has grown substantially in the last few years. So they have got themselves trapped.

One of the features of the bond market is that as interest rates rise so the capital value of a bond falls. Looking at the FT today I can see a German Bund maturing in August 2027 with an interest coupon of 0.5%pa trading at 106. That means in 2027 I get back 100 for my 106 cost today plus 0.5% interest pa. The return to maturity is already negative but if the ECB increased rates to say 1% the bond's value would fall very quickly. Insurance companies, banks and pension funds would see significant capital losses and that is why that bond is probably held by the ECB. They will hold to maturity and suffer the loss, not today but tomorrow. (The ECB now employs 3,500 people while the Bundesbank has 10,400)

There is little chance that the ECB or the other main central banks will raise rates or even cut back on bond buying, although discussed in the financial Press. So the current policy continues and Newton's first law comes to mind ...

... that if a body is moving at a constant speed in a straight line, it will keep moving in a straight line at constant speed unless it is acted upon by a force.

What that force might be is unclear, but the above chart shows inflation is becoming a significant force.

Best wishes

Tim 7 October 2021