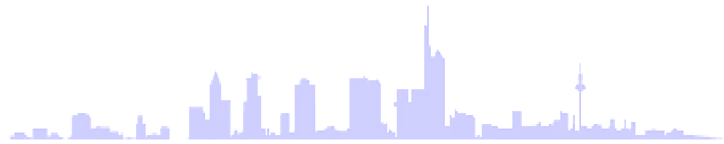


PORTFOLIO MONTHLY REPORT – May 2022

Situation

This year has started as one of the worst ever in the investment world. The USA stock market, the global leader, was down by 14% (S&P 500) in the first five months while the technology Nasdaq index was down by 24%. Popular shares such as Amazon down 27%, Facebook down 44% and Netflix down 68%. These darlings of the market, the so called FANGS, have not done well. Asia is lower by 10% and the German DAX also down 10%. The London FT100 on the other hand was actually up a few percentage points. We avoided these falls.

The common reason given for this reaction is the conflict in Ukraine, however there were problems looming well before February this year when that started. Last year in my newsletters I mentioned the growing threat of inflation and that has turned out to be a major fact today. Central banks last year were not concerned about inflation and took no action, indeed the US Federal reserve thought it was „transitory“. They were wrong, as were the ECB and the Bank of England. In May the German inflation rate was 7.9%, the highest since 1973/4. It's a similar situation throughout Europe, in the UK and the USA. The central bankers target is 2%.

The textbook reaction is central bankers should raise interest rates to quell demand and the USA has raised rates to 1%. The expectation in the markets is for them to rise to 1.75% by year end. They have made a similar move in the UK, but the ECB sits on rates at 0%. It is argued that inflation today is caused by lack of supply due to the Ukraine conflict, particularly higher oil prices and this will all pass. The risk is that this argument is only partly true and that ultra low interest rates for years and huge amounts of quantitative easing (QE) have flooded the economies with money that is now chasing goods and services. Of course the response to CV19 was an even larger amount of QE and money injected into the economies. Once money is created it has to go somewhere. If inflation is the result, higher interest rates follow which is not what stock markets like to see.

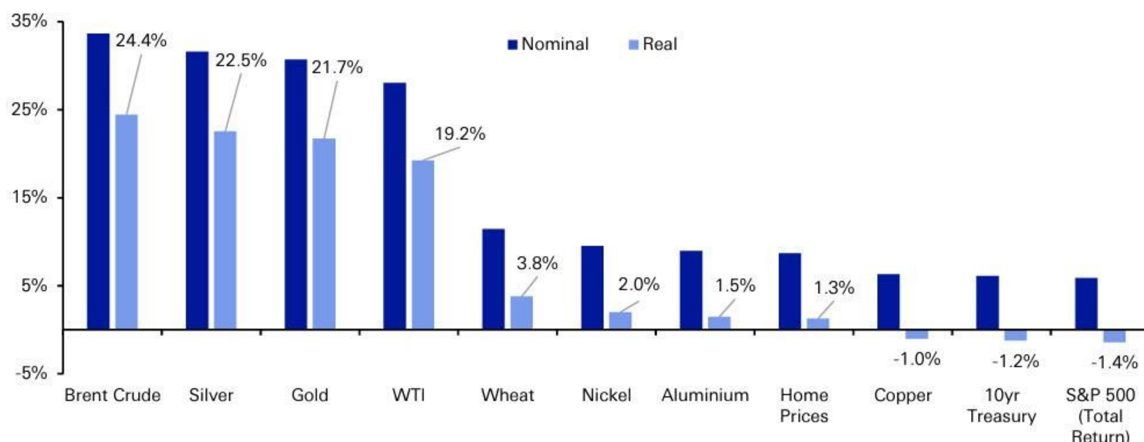
The classic model portfolio is called the 60/40 model which means 60% is invested in the stock markets and 40% in bonds. The latter usually does well if the former are volatile and therefore such a portfolio can weather any problems with lower volatility. That has not been the case this year because bonds have also fallen in value. With inflation rising who wants to hold a long dated fixed interest bond?

For example, in the UK the Government 2061 bond pay interest of 0.5%pa and was priced at 70. On maturity in 2061 it pays out at 100. The interest each year and the capital gain mean the yield to redemption is approx 0.7%. But that is not attractive when inflation is at 7 or 8%. Who buys such things? Most likely the central bank who stuffs it in the cupboard for the next several decades. The ECB and Fed do the same. For anyone else to buy it the yield must rise ie. the price must fall say to 40 so the capital gain plus interest over the period make an attractive yield to maturity. So bonds fall in price.

Inflation is difficult to control once it starts to rise. In the 1970s, it was in double figures before the Fed raised rates to 20%, which quashed it and the economy at the same time. The UK experienced similar in the Thatcher years as rates rose to bring down inflation. Turkey recently had inflation around 18% and in place of raising rates it lowered them Inflation in Turkey is now over 50%, but at these levels it is hard to measure and could be higher. So a real problem looms and what are the central banks going to do?

It is very unlikely they will raise rates above the current rates of inflation. Much more likely is a modest rise and an end to QE. That may reduce demand and money in the system but it does not improve the supply side problems. Central banks can create money from thin air but they cannot create oil or wheat. So inflation will continue and I have seen an interview with the former governor of the bank of Canada who expects central banks to wait until the base effects of high rates now, to reduce the annual rate next summer. So higher inflation will last into 2023. Also politics come into play. The EU has recently decided to ban Russian oil by the end of 2022. The EU will have to buy oil on the international market with the world largest supplier, Russia excluded. That is inflationary.

The term being used more and more now is Stagflation, that is stagnant growth with inflation and this was the situation in the 1970s. If that is something we are moving towards it would be good to know what did well in that period and here is the answer.



This is the annualised return during the 1970s. Clearly the US stock market as measured by the S&P 500 had a poor time as did bonds, such as the 10 year Treasury.

Commodities did well and therefore it makes sense to have in a portfolio some fund managers who are investing in these winning areas. I mentioned this in my June 2021 report. See timunderwood.com

Best wishes

Tim 3 June 2022