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EQUILIBRIUM

"This time it's different"

Mike Deverell
Investment Manager
Equilibrium Investment Management

Executive summary

- **It has been an unusual time in the global economy. The normal relationship between interest rates, economic growth and inflation seems, at first glance, to have broken down.**
- **Interest rates rose more than expected to curb growth and inflation, yet the economy outperformed predictions, though inflation remains high.**
- **We have also seen some unusual movements in asset classes. For example, higher rates would normally have a negative impact on tech stocks, but in fact, they've done well in 2023, mainly due to hopes around artificial intelligence.**
- **These unusual times are perhaps because of the massive stimulus from governments and central banks during the pandemic, which is still having an effect today.**
- **Whilst this may be the primary cause of inflation, which should fade over time, wages are now rising more than prices in the UK. We are keeping an eye on this as it might lead to more persistent inflation if it continues.**
- **As a result, we've put more inflation-linked securities in the portfolio. Over time, inflation erodes the purchasing power of our money, but investing can help our money grow in real terms over the long term.**

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"This time is different" are the four most dangerous words in investing, according to legendary investor Sir John Templeton[1]. It's a quote we've used many times but make no apologies for repeating ourselves as we think it's just as relevant today as it has ever been.

I first came across this quote in the early stages of my financial career, during what later became known as the "dot com" or tech bubble of the late 1990s.

Back then, people were constantly talking about "new paradigms" and how old-fashioned fundamentals such as earnings growth and stock valuations didn't matter anymore in the internet age.

As often happens when investors get so excited about a new "fad", it ended spectacularly in the early 2000s when the tech bubble burst. It turns out that, after all, companies do still need to make money if their stocks are to be worth anything in the long run!

I saw a lot of investors lose a lot of money during that period. As a result, this has always been one of my favourite investment-related quotes and something that often comes to mind when meeting fund managers or reading research.

But is it different though?

Right now, things do feel a bit different in some ways. Like the boy scouts, we always like to "be prepared". As a result, we have a go-to list of asset classes which breaks down what is likely to do well or poorly in different economic environments.

We use this "grid" to help guide our investment decisions.

The grid looks at inflation, economic growth and interest rates. It then considers which of these factors are high (and/or rising) or low (and/or falling) and what types of assets have done well in that environment in the past.

It is highly simplistic because markets are forward-looking, so trying to anticipate where these factors will go in the future can be a useful tool.

The three economic factors influence each other. For example, we often experience high inflation because the economy is doing well. Interest rates are increased to slow the economy and stop it from running too "hot". This, in turn, is expected to bring inflation under control. Eventually, interest rates are cut to stimulate the economy, and so the cycle continues.

However, so far in 2023, it feels like things have gone "off-grid"! This is both in investment and economic terms.

For example, whilst interest rates have been rising more than expected this year, the economy has done better than anticipated. It is still growing, although just barely, and we are still concerned that we could see a recession. Inflation has decreased slightly, but slower than hoped, especially here in the UK.

This creates quite an unusual economic mix, which has led to some unusual outcomes for some of the asset classes we invest in.

For example, when the economy slows, we'd normally expect government bonds to do well.

However, as rates continue to rise such bonds have in fact struggled.

A sluggish economy and rising rates wouldn't normally be the best environment for stocks like technology. These stocks are "cyclical" and sensitive to economic growth and interest rates.

Such stocks did poorly in 2022, but so far in 2023, tech has boomed as investors become increasingly excited about the new paradigm that is artificial intelligence (AI).

AI could really be revolutionary, just like the internet was. But it doesn't mean we should ignore valuations and profits, and we're a bit concerned that investors have become over-excited again.

Is it really different?

Perhaps the missing ingredient in our economic recipe is liquidity.

Liquidity is essentially the amount of money sloshing around the financial system. More money in the system can fuel inflation. Interest rate hikes are designed to drain liquidity by reducing demand for borrowing and making saving more attractive.

In the pandemic, when we were much more worried about deflation, central banks and the government pumped huge amounts of money into the economy through quantitative easing and things like the furlough scheme here in the UK.

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Much of that liquidity is still in the financial system in one way, shape or form. For example, we have often talked about the savings that some people built up during the pandemic when they couldn't go out and spend. This has perhaps helped keep spending levels higher now, even with higher prices.

It is easy to say in hindsight that there was too much stimulus in the pandemic and that is what continues to cause problems now. However, what if they hadn't done it? How many people would have lost their jobs (or lost their lives)? What if vaccines hadn't been developed so speedily, allowing us to get back to normal relatively quickly? Erring on the side of too much stimulus rather than too little still feels like the right thing to have done.

What is different now compared to any other time in my career (or indeed, all of our lives) is that we're dealing with the aftermath of a global pandemic. This hasn't ripped up the economic rules, it is just that it was such a huge issue, with such a huge response, that the effects are still being felt.

One thing that may have changed

We've always felt that the inflation we've seen was a temporary factor that was a result of all this stimulus.

This is still our base assumption, but clearly, it has not been as temporary as we'd hoped!

At what point does it stop being temporary and start being something more permanent?

We've always said, watch the wages. If wage growth is consistently above inflation, then we are in danger of the classic wage-price spiral that many clients will remember from the 1970s, which can lead to more persistent inflation.

Until now, whilst wages have been going up, they have been going up less than prices.

Here in the UK, that has now changed. Wages are up 7.8% over the past 12 months. CPI (Consumer Prices Index) inflation in July was 6.8%. (Source: ONS)

This means that wages are increasing in real terms for the first time in a good while. This is only a one-off figure and comes after two years of negative real wage growth.

The global trend still indicates falling inflation, which, if correct, we believe would bode well for some types of equity, notably smaller companies.

However, we will carefully watch wage growth and remain vigilant for further signs that inflation might persist. In the meantime, we have re-added more inflation protection into the portfolio, by buying inflation-linked bonds.

Whilst the economic rules haven't been broken, each specific scenario we encounter differs from others. In one sense, it's ALWAYS different.

But some things don't change. Inflation has always been one of the biggest issues facing our finances as it eats away at the purchasing power of our money. Over the long term, the best way to beat it has been to invest.

(1) As always with famous quotes, this isn't quite what he actually said. The actual quote from "16 rules for Investment Success" (1993) is as follows: "The investor who says, 'This time is different,' when in fact it's virtually a repeat of an earlier situation, has uttered among the four most costly words in the annals of investing."

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