Jackknifing

A cautionary tale . . .

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A lucrative autumn job for a teenager was spud-picking and for me this included a free trailer-load of rejects which could be used as animal feed, another project to divert me from study. In the same way that pigs seem incapable of knowing when to stop eating, I failed to appreciate the dangers of overloading a trailer.

Driving down a long, steep and everlasting bend, the weight of the trailer started to push the car, but I delayed braking. By the time I did, the trailer was swinging violently and I made a bad situation worse. After a 180-degree spin, my car stopped dead, straddling the road. With the trailer on its side, I was completely mesmerised by thousands of potatoes slowly rolling down the hill in the peaceful evening light. Wasting no time, I jumped out of the car, heaved the trailer back onto its wheels and headed off...but waited anxiously all evening for a knock at the door. It never came and I said nothing, but I did learn that applying brakes too late does not prevent the inevitable.

On the 27th August, the Fed Chairman Jerome Powell announced an important policy shift towards 'average inflation targeting'. This means that the US central bank will allow inflation to run higher than its 2% target before increasing rates, their objective being to avoid a Japanese-style deflationary spiral. The fear of inflation which persisted up to the 1980s has long since passed, but it may show signs of life next year when a collapsing oil price falls out of the data and one must wonder if this new policy will provide much-needed oxygen for inflation, with widespread consequences.

A successful investment should achieve a return greater than inflation and this is not difficult when the latter is almost non-existent. Summing up the past thirty years in this environment, equities have been re-rated onto higher multiples whilst fixed interest stocks benefited from a falling interest rate environment. Success becomes more elusive when these factors reverse and this is the risk associated with the Fed's new policy, should inflation find a new lease of life. In the midst of a global pandemic, deflation is a natural concern, explaining why this policy change has not attracted the attention one might expect. Yet, the virus period will eventually end and there is little harmony, either domestically or internationally, putting pressure on governments to be radical in their attempts to retain power.

Inflation can be either 'cost-push' or 'demand-pull' and in the case of the former, this could be due to the implementation of green taxes to curtail climate change, import tariffs from trade wars, a falling exchange rate or rising wage costs, as described in the book, 'The Great Demographic Reversal' published in September. Demand-pull inflation could arise due to a lack of supply (companies folding due to COVID), rising house prices, tax cuts or even increased government spending, which could move to a new level if central banks revert to Modern Monetary Theory (MMT). Otherwise referred to as the 'magic money tree', this is perhaps a last resort, if everything else fails and unemployment becomes the scourge of society.

MMT is a back-door method of greater state control which, given the precarious position of airlines, hospitality, sports and leisure, may be inevitable, but it is a leap beyond quantitative easing. To enact such a policy, a change in central banks remits may be required, where the goal becomes full employment, creating unlimited amounts of new money. It could be highly inflationary, especially if a country did this in isolation. Pushing rates higher to control inflation would subsequently undermine the policy itself. Inflation control would need to be directed at those who have benefited the most (the asset rich) whilst protecting zombie households and businesses. Given the levels of inequality across society, however, the definition of 'asset rich' may have a much lower threshold than we expect. It was recently reported that the median salary for a working-age American man was just $36,000, less, in real terms, than four decades ago and less than the UK equivalent. Subsequently, it's not unreasonable to assume that the tax burden won't fall here. What about an income of $50,000 however? Or a wealth tax - a policy becoming popular in Europe?

The global reaction to the virus has changed considerably, with both wealth-destroying and wealth-creating consequences, but there are other headwinds to consider. Twelve months ago, governments were declaring climate emergencies, while advances in technology were destroying jobs, but are these trends moving faster than changing demographics? Trade wars are escalating, societies are becoming polarised and these challenges must be addressed before they become that jackknifing trailer, where a delayed reaction spells disaster. To do this, however, countries need leadership and vision, qualities which are in short supply. Investors and savers face potential headwinds that previous generations might struggle to imagine and the option of putting your capital at risk or earning a zero (or negative) return is not morally fair.

The global economy has reached a point where there is no room to manoeuvre without radical change and MMT remains an option, as indeed does the reengineering of inflation to erode debt. Whatever direction this takes, the backdrop will be equally challenging for savers, investors, house buyers, retirees and those considering careers. Discussing and sharing these challenges with an investment manager will help to identify a more resilient solution, as there are always opportunities to create wealth.

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