CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

May 2021

Thinking About …

The last decade has seen returns come relatively easily to investors. The economic backdrop globally – averaging steady growth, with low inflation – coupled with persistently accommodative monetary policy, has seen most assets fare well both in nominal and real (inflation adjusted) terms. There is a sense, this year, that the tide is starting to change and investors, alongside policy makers, are getting nervous. The latest meeting minutes from the Federal Reserve (Fed) showed their clear concern on the effect the withdrawal of stimulus might have on asset prices, giving a very cautious tone that they are merely *thinking about, thinking about* (tapering asset purchases and raising interest rates) it.

There is general agreement that the monetary policy backdrop in most developed nations has had a considerable effect on inflating asset prices over the last decade. This is mostly due to the near zero interest rate policy forcing investors into other assets (than cash) in order to receive a return. The Fed is well aware of this phenomenon and, if the minutes from their latest meeting in May were anything to go by, are very nervous about the market reaction when they start to withdraw the stimulus that investors have become not only addicted to, but accustomed to, over many years. One of the key roles of central banks is to ensure financial stability and some officials have expressed concern over elevated asset prices and risk of destabilisation. Strong growth and inflationary forces are undoubtedly putting pressure on central banks to start considering the withdrawal of stimulus and an increase in interest rates, and so guidance needs to be careful if they are to avoid a “taper tantrum” and ensuing declines in asset prices.

Whilst the ongoing impact of COVID will be a headline grabber and market mover in the months ahead, we believe the real market driver lurks beneath the surface – that of inflationary forces and central bank policy. If central banks get this wrong (by being too cautious or too aggressive), it can have a dramatic effect on asset prices. So, what can one do to protect themself from an environment that is, in effect, the inverse of what we have experienced in the last decade? The answer: diversify – but diversify effectively. Create a portfolio that protects you against inflationary forces – by including real assets such as commodities, property and infrastructure; reduce exposure to long duration (interest rate sensitive) assets, such as long-dated bonds and high growth stocks; start to look again at those steady businesses that have been left behind in the last 12-months as neither high growth (lockdown winners) nor deep value (re-opening winners), more so the stalwarts that compound year on year; and finally, be more active – in asset allocation and security selection.

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