CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

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Steady as She Goes

Another Federal Reserve (Fed) meeting comes and goes, again without the market descending into chaos. This time it was the annual Jackson Hole meeting in Wyoming (although mostly a remote event) which takes place at the end of the summer each year. Fed Chair, Jerome Powell, continues to navigate a fine line between maintaining an accommodative stance on monetary policy, whilst preparing markets for both a reduction in asset purchases and eventual raising of interest rates. In this month's note we take a moment to discuss what these events mean and why it matters so much.

Central Banks around much of the Western world have been on asset purchase programmes (also known as quantitative easing, or QE) for much of the last decade. They do this as means of stimulating the economy, alongside more traditional accommodative measures such as keeping borrowing costs (interest rates) low. In essence, QE reduces the supply of longer-term safe assets (mostly government bonds) available to private investors, pushing down the yields on those assets directly. This action, in turn, leads investors to buy more risky assets, such as bonds issued by companies. This puts downward pressure on the yields of those assets too. Government and corporate bond yields remain at historically low levels. In a low yield environment investors are then forced into assets where returns look more attractive, particularly in *real* (inflation adjusted) terms, and so equities become a favoured asset. For investors in bonds, equities and other financial or real assets, this has broadly led to sustained asset price growth over the last decade.

Looking forward, however, investors may well become increasingly worried about what will happen when the taps (of QE) get turned off. Do we, in essence, have the reverse effect where bond prices start to fall (yields rise) and valuations of stocks come under pressure? This is a very rational concern to have – and one that we wish to do what we can to protect investors from. A *taper tantrum*, where bond yields spike, is explicitly what the Fed is guiding cautiously to avoid, but they (the Fed) may become trapped – particularly if it coincides with interest rates needing to rise in order to combat inflation. For now, it appears unlikely that this will be a 2021 problem. However, the longer-term inflation narrative (whether it is transitory or not) is still in the balance. Investors, if they have not already, should prepare for a new regime – and that means having low sensitivity to bonds (through reduced allocations and short in duration), and genuinely diversified exposures in equities, to include some value stocks. Real assets such as property, infrastructure investments and commodities may also offer investors some protection in the event of a sustained higher inflationary regime.

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