McInroy & Wood

"All, with one consent, praise new-born gawds,
though they are made and moulded of things past
and give to dust, that is a little gilt,
more laud than gilt o'er-dusted!"

-(Troilus and Cresidda)

Extraordinary thing fashion, how it changes. In little more than 100 years St. Pancras station, Gilbert Scott's neo-Gothic celebration of Victorian expansionism, has come to look like a rusty old hulk, a monument of tasteless extravagance. The female nude, which one might have thought would possess a changeless appeal, looked to Rubens plump and round, to Ingres like a Greek goddess, and to Picasso like a series of circles and triangles. It is not that the architect or artist sets out to stylize or to create a fashion. He simply adds an expressive dimension of his own to the cultural heritage of his day. But when that extra dimension is later shared, a new idiom, a new fashion is born, only to fade again into obscurity as the life-blood of aesthetic discovery quickens elsewhere.

There is something of the artist in a successful investor. He shares with others the humdrum world of screens and data-banks, which make up his professional milieu. But unlike his fellows he can break out of it all and see something beyond. He is able to add a dimension of his own which is what makes him a master, not a slave, of investment fashion. As a rule he is ahead of his time.

Perhaps that explains the reaction to a piece about bonds we wrote 5 years ago in March 1989 ("I do expect return of three times the value of this bond") which was met by some of our friends with that mixture of polite amusement and blank incredulity they might otherwise reserve for an oriental herbalist whom they wholly mistrust, but fear to ignore in case they miss something.

Actually they did miss something. Despite all the fireworks in world equity markets over recent years, bonds in some markets have done considerably better. In the UK for example, the average annual real return from Government bonds over the four years ending December 1993 was 12.4%, whereas from equities it was 8.7% (gross income reinvested in both cases).

What brings this to the fore is the collapsing state of world bond markets in 1994. By the end of last year world bond buying had become a fashion which had sucked in lots of speculative investors. Sadly for them, bond prices have been falling ever since, especially in the US and the UK, and their weakness has pushed UK equity prices down to a more or less equal extent. Have the prospects for an orderly and relatively inflation-free economic recovery changed overnight, or is it just that the see-saw of investment fashion has taken a lurch and tipped off the more excitable investors sitting on the edge?

Back in 1989, bond-buying was less fashionable. Not so many years before that, one the of the Edinburgh financial community's wisest old owls confessed to us that he didn't know how to buy a US Treasury bond: the idea of buying into the largest and most liquid securities market in the world hadn't entered his head. Today, by contrast, the price of the 'benchmark' US Treasury bond appears on the front page of the FT. Our Edinburgh friend in the early 1980's had been brainwashed, like others, by decades of boom and bust and a rising spiral of inflation. A bond for him was nothing but a passport to penury.

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But of course a borrower cannot go on short-changing his creditors for ever and, in the end, spendthrift governments in the USA, the UK, and France, among others, were brought face to face with the reality that unless bond investors – a Government's creditors – were assured of a satisfactory real return, deficits

could not be financed short of crippling the whole economy. The age of disinflation and the political will to go with it arrived with that realisation and the decade of the 1980's threw up some marvellous years for bond investors, even if the Lawson boom in the UK took some of the gingerbread, so to speak, off the gilt.

What happens next to bond prices affects everyone and is not just a matter of piecing together a bizarre financial jigsaw. Because they regulate the cost of long-term capital, bond prices affect every long-term investment decision in the economy, whether that means building a factory, buying a home, or saving for a pension. More than that, the health of a country's long-term bond market tells of the credit-worthiness of government itself. Stable or rising bond prices imply a coherent fiscal programme. Falling prices are the mark of failing policies.

If that was all there was to it, the collapse of recent weeks would indicate failure on a grand scale. Failure, that is, of governments in the USA, the UK, even Germany, to convince investors that the result of their policies will be to keep inflation low and provide bond investors with the sort of real return they thought they were going to get only last January.

But of course that is not the whole story. What puts day-to-day prices up or down is not a nice calculation of relative return, but supply and demand. In this case it is not just the supply of new bonds which matters, but of the other things like shares and property that compete for bond buyers' attention. Over the last 15 months or so buyers have been buries under a mountain of new equity share offerings, first in the US dollar interest rates have been rising, and governments everywhere continue to issue record amounts of new bonds. Oversupplied with new paper speculative bond-holders have turned sellers, and fled.

The reversal of speculative investment flows explains part of the weakness, but two longer-term factors are at work. Firstly, there are simply not enough long-term savings available in the major economies to fund the current spending requirements of governments as well as support the investment needs of the private sector.

Secondly, it has become impossible to keep track of, still less control, the flow of funds across the work's trading centres. Foreign exchange transactions, for example, exceed by a factor of about 100 the underlying trade in goods and services; trading volume in so-called financial 'derivatives' – options, futures and the like – is vastly greater than in the real markets to which they relate; and this palace of mirror markets has been built up over a time when the huge fall in American and European interest rates has turned savers into speculators, conveyed by financial products promoters in increasingly bizarre vehicles to some very strange places indeed.

Little is left of January's euphoria among bond markets, and all that remains of last winter's fashion is a shabby remnant. Yet equity prices in most markets are also looking stretched and with the yield on cash at rock bottom, there doesn't seem much to attract the global money managers one way or the other.

Paradoxically it is in this rather barren-looking neutral territory that the seeds of the next investment opportunity are taking root. Policy makers in every major economy, with the possible exception of Japan, are constrained as never before, on the one hand by the need to maintain social programmes, but on the other hand by the power and mobility of international capital which holds each of them hostage to the threat of withdrawal. Between these constraints lie the twin requirements of continuing economic recovery and a relatively high real return on long-term capital. Those requirements are now being met; they are likely to be met for some time to come.

Long-term investors should welcome this prospect, for they may be entering one of those rare periods of investment history when all savings mediums – cash, bonds, and shares, - will provide a satisfactory real return. In relatively stable conditions, the return from most investments will not soar or plunge as the pendulum of investment fashion lurches dizzyingly from one extreme to another, and we may have

reached an equilibrium level somewhere round the 4% real annual return currently available from UK index-linked gilts.

If one accepts that bonds, equities, and cash each have their attractions in today's conditions, one must also accept that a balanced portfolio will be less subject to extravagant swings in investment sentiment. That may sound boring, but at least investors can be confident, unlike the builder of St Pancras, that what looks attractive to them today won't look like a faded glory to others tomorrow. The time to watch out will be if a balanced portfolio ever becomes, itself, an investment fashion.

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