McInroy & Wood

PERSONAL INVESTMENT MANAGERS

" ….. for I perceive
A weak bond holds you; I'll not trust your word."

A Midsummer Night's Dream

Investors may be puzzled by the bizarre behaviour of global markets. Some might conclude that lunatics really have taken over the financial madhouse. Over the past six months investors have been confronted with Brexit, the pound's collapse and a prime minister's resignation. Instead of taking fright, equity and bond prices rose briskly in July. Come November, enter Trump leading America on a march of rebellion - prices higher still. And today, order in the Middle East in virtual meltdown; Western allies numbed by uncertainty as icy blasts from Moscow herald another cold war; European economies struggling against recession - equity markets don't seem to notice any of it.

Examine whichever entrails you like, the ritual signals of market fortune – company profits, earnings trends, dividend yields, asset values, borrowing levels – all show amber or red. Yet markets resolutely defy them.

Reason lurks behind apparent insanity. Successful investing does not rely on the study of absolute values or the discovery of unchanging criteria. If it did, we would all prosper merely from the application of common knowledge. Instead we have to consider each economic context as the unique product of its own history, then look for the relationships that matter within it. The history of the present context is this.

Up until four months ago, bond investors had enjoyed one of the biggest and longest 'bull' cycles ever. It had been initiated by Paul Volcker, chairman of the American Federal Reserve Board, in 1981. He was determined to reverse the cycle of rising inflation over the previous 15 years or so. At the time, the interest rate on 10 year US Treasury bonds had risen to 15%. Volcker succeeded. The wonderful bond cycle of the following 35 years was the result. It has been the bedrock of rising financial asset prices across the globe.

But since July this year, bond prices have fallen sharply from their peaks. Several factors underlie the sell-off. Central banks in America, the UK, Europe and Japan had been manipulating bond prices since the financial crash in 2008. New 'funny money' created in this process – known as quantitative easing – helped revive economic activity. But it had some pretty funny side effects too. One was to push interest rates down to an Alice in Wonderland level at which, by this autumn, buyers of some government bonds had begun to pay the borrower for accepting their cash.

Because America's economy had responded quite well to this monetary stimulus, its central bank recently indicated that it might raise American interest rates (again) soon. Furthermore, in America and Japan, governments have recently announced spending programmes designed to add more stimulus to their economies. Those programmes will have to be funded by more government borrowing, so postponing further any return to fiscal balance. On top of that, insurgent populism across Western democracies is leading investors to question whether governments will be able to resist pressures for yet more spending, if they arise – all this at a time when the supply of credit may become less plentiful and more costly.

This is the background against which bond prices have fallen. The question today is whether the recent shake-out marks the first stage in the reversal of an immense upwards cycle. Both equity and bond investors need to consider a potentially different trend to that which has supported capital markets across the globe for decades.

British, American and Japanese leaders have lately abandoned their timelines for achieving deficit reduction. Fiscal 'austerity', formerly considered a virtue, now intones the resentments of a host of voters across Western countries. Society is polarised. Hardly surprising given that, for example, 95% of American households earn

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less now than they did in 2007; 5% earn more, some of these much more. The voice of the underdogs has prompted both UK and US leaders to embark on new spending programmes. Trump says his will involve spending an extra $1 trillion and tax cuts in addition. Hammond in Britain splashes a mere £20 billion or so. Neither spend is necessarily ill-timed. Indeed it may well be sensible to resort to fiscal stimulus when monetary relaxation has reached the limit of its effectiveness.

For a while this great reflation may work as intended. In America, at least, incomes may grow, possibly even in real terms; there may be enough demand from pension managers, overseas owners of dollar balances and others to fund the extra borrowing. All that should be quite helpful for equities. Big rises in cyclical sectors of the equity markets have begun to discount that possibility. But suppose, despite the spending splurge, Western economies stutter. Reflect for a moment on the tone of recent political discourse.

Popular resentments can readily be inflamed by incendiary rhetoric, and they have been. Pandering to America's tribal populism certainly eased Trump's path to the throne. But native spirits so heated brook no frustration. Liberal democracy does not constrain its members who wish to sever their ties with common decency and respect. But liberty of expression is ever hostage to abuse. Those who choose to cut loose turn quickly, it seems, to new targets for unbridled invective. The very institutions of state upon which their licence depends are not immune to unscrupulous assault. A few weeks ago two of Britain's leading national newspapers thought nothing of traducing the motives of our Supreme Court judges. America's president-elect sought to discredit any election result that rejected him. The authority of our own Parliament is diminished when Labour MPs are sidelined by unelected activists bent on wrenching their party leftwards. If reflation falls short of heightened expectations, populism is likely to vent its frustration yet more vehemently.

Perhaps the new programmes will buy leaders in America and the UK enough time to soften hostilities. Interest rates might continue upwards without any great impact on companies, consumers or the expectations of investors. With luck the stabilising voice of calm and constraints of practicality will cool the heat of clamour. But if not, the institutions and culture that have safeguarded liberal values over centuries will stand unprotected. As guardian of the financial security of future generations, we think the possibility has to be taken seriously.

At the root of this summer's traumas lies a loss of trust. Trust is not the product of sound bites or commercial dexterity. It springs from relationships forged over time in the shared pursuit of worthy ends by worthy means. A local minister is leaving after 38 years' service. His congregations, though fuller than most, represent a fraction of the parish population. Across the community, however, families will weep at his going. They have learned to trust a man whose actions square with the values he professes. Whether they recognise any spiritual dimension or not, these people acknowledge a high calling and recognise the integrity of a life given to it without compromise.

Schmaltzy folk-lore when it comes to the needs of practical politics today – irrelevant to the prospects for financial markets? Trust alone underwrites global markets and much else besides. Lenders must trust that a borrower is willing and able to pay the interest and repay the capital when due. In America, government bonds are guaranteed by the "Full Faith and Credit of the United States". Governments' ability to fund burgeoning deficits hinges on the worth of that assurance. If it ever became suspect, bond prices round the world would collapse. So probably would equity markets. The leaders, therefore, of our political and commercial life need to shape every strategy and each utterance so as to reaffirm those words' enduring worth. Bond markets are the vigilantes that will tell us whether this is being done. Much hangs on their verdict. For unless trust can be returned to the heart of our society, the financial system as we know it cannot survive.

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