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Courtville Partners – Investment Outlook, October 2020

Summary of the key points in this quarter's Investment Outlook

- We are increasingly persuaded that the world is entering a new investment era in which Keynesian policies will predominate
- If we're right, this implies a big increase in state-managed demand and – in due course – higher inflation.
- Chairman Powell's recent speech at Jackson Hole marks a sea change in Fed policy – and underwrites further US dollar weakness, which itself would be reflationary for the global economy.
- Investors should stick with *real* assets (mainly equities) and avoid *nominal* assets (particularly government bonds).

The investment world is fond of aphorisms. It's not hard to see why: just as in other compartments of our lives, pithy phrases *seem* to reduce vast complexity to piercing simplicity. Sometimes an aphorism will end up metaphorically etched into the walls of the marketplace. Think of Sir John Templeton's immortal quip – "The four most dangerous words in investing: this time it's different". Although we can't track down the original source, one particular saying has long struck us as profoundly wise. To paraphrase: investors should try above all to understand what kind of age they are living in. We both began our City careers in the early 1980s. This was the moment in economic history when runaway inflation was finally tamed by the US Federal Reserve under its chairman Paul Volcker. After peaking at 20% in mid-1980, US interest rates – and with them bond yields – descended almost without interruption until they hit zero in the aftermath of the Great Financial Crisis of 2008. They've remained there ever since. As young twenty-somethings, did the partners of Courtville understand what kind of age they were living in? Not really. (If we had, we might have applied for transfers to the bank's fixed income division: government bonds have handsomely outperformed stock markets over the last 40-odd years.) In fairness to our youthful selves, sea changes are hard to spot at the time – but not always.

We've argued for a while that the global economy may be leaving behind four decades of inflation suppression and shifting towards a new era of rising prices. And now Jerome Powell, the fourth Federal Reserve Chairman since Volcker, has in effect endorsed the Courtville view (not that he would put it this way). In his August speech at Jackson Hole, Powell took the wraps off a radically different framework for the Fed's monetary policy. He summed up the new approach as "average inflation targeting" – an anodyne phrase that camouflages a substantial upward lurch in the central bank's inflation target. Inflation has consistently undershot the Fed's 2% target since 2008; but a policy of "let bygones be bygones" has meant that never-achieved-inflation has been written off, so to speak. From now on the Fed promises to catch up any under-achievement by letting inflation run higher than the 2% target. Mr Powell has not clarified how far back his catch-up promise will extend nor how long the Fed will allow inflation to stay above 2% (which by the way rests on the heroic assumption that a central bank can rein in above-target inflation whenever it chooses). What we do know is that US monetary policy – i.e. the setting of the price of money for the global economy – will be not only looser, but looser for longer. Put more simply, the Fed is going to do whatever it takes to generate more inflation. It is likely to be some time (maybe years) before inflation really takes off. Much higher unemployment may well keep wage inflation in check over the next couple of years. Nevertheless, markets are discounting mechanisms; and the inflation genie is already sticking its head out of the bottle.

As an aside, we can't help noticing that "whatever it takes" has become the catch-phrase of today's central bankers. The European Central Bank's Mario Draghi started it in July 2012 when he promised to do whatever it takes to save the euro. The weakness of this approach is that it does tend to offer hostages to fortune.

As you would expect when the world's money-pricing policy changes, profound implications follow for the values of almost all assets. In the broadest terms, investors should favour more than ever *real* assets over *nominal* assets. Among real assets, we still recommend heavy weightings to equities (with discrimination by geography and sector), precious metals (above all gold), cash (in the short term) and inflation-linked bonds (the shorter the duration, the better). Conversely, investors should try to avoid assets where values depend on government promises. Government bonds are the most egregious example, especially long-dated ones.

One corollary of looser US monetary policy and (in due course) higher inflation is that the US dollar seems set to maintain its downward trajectory. After all, Mr Powell has made it clear that the Fed won't so much as *consider* raising interest rates for the foreseeable future. The dollar index is down 9% from its mid-March peak, which counts as a huge move for any currency, let alone the world's reserve currency. Even so, the dollar is still overvalued on a trade-weighted real effective exchange rate basis. Bear in mind also that a win for Biden would add downward dollar pressure courtesy of stiffer regulation and higher taxes. For most of this year we've had a hunch that the US dollar's long-lived hegemony is over; and our degree of conviction continues to grow.

There is much more to investment life than monetary policy, of course. The other macroeconomic elephant in investors' rooms is the tsunami of government spending, which is the direct the consequence of western governments' own decisions to shut down their economies in March. It has become fashionable to say that – in the West at least – we have entered a new Keynesian era of state-managed demand. Well, yes, we have. In retrospect, however, this "new" era arguably kicked off in the late noughties when governments encouraged their central banks to create colossal amounts of money to save the banking system and offset the demand shock to economies. (Unfortunately, most of those central banks then forgot to turn off the taps.) But now, a dozen years on from the GFC, pandemic fall-out has taken money-creation to levels unknown in peacetime. What does this mean for investors?

First, governments' gargantuan spending programmes plausibly explain why stock markets have been so resilient since late March. We may have expected large-scale fiscal manoeuvres to take the sting out of lockdown; but most of us under-estimated their sheer size. Second, it is reasonable to argue that all this Keynesian largesse might just usher in an investment boom on the scale of the 1950s and 1960s. Imagine, for example, the capital investment needed if the world gets serious about ditching carbon-based energy in favour of renewables. Having stripped their central banks of independence, governments know that their funding costs for all this spending would be anchored at near-zero for the foreseeable future. Stock market returns trumped those of bonds for most of the post-War period, at least until Volcker defanged the inflation serpent. Why not again?

The existential problem facing investors is that the classic 60/40 portfolio (split 60% equities, 40% government bonds) is dead and buried. Since March, US treasury bonds have not provided the diversification they are supposed to. They should have risen as stocks plunged (and *vice-versa*), but they didn't. It is hard not to suspect that investors smell a rat in 10-year yields of 0.7%, as well they might. Their grandparents bought government bonds by the armful during and after the Second World War, expecting them to be the foundation of a comfortable retirement, only to see their *real*

value dashed on the rocks of rampant inflation. The other signal that investors are becoming wise to the uninvestibility of government bonds/IOUs is the price of gold. With little fanfare, the price of gold has outperformed a basket of major currencies by almost 19% over the last 15 months. This is hardly surprising at a time when most governments are determined to debase their currencies. Gold is a store of value that governments cannot debauch (though they *can* forbid their citizens from owning it, as in the US from 1933 to 1974). Better still, the demand/supply outlook for gold looks quite encouraging: the $200bn-worth of gold due to be dug out of the ground this year is dwarfed just by the Federal reserve's $5trn balance sheet expansion. Not much of that newly created money needs to find its way into gold to keep pushing up the price.

As a general rule, investors are doing well if they manage to identify what kind of era they are living in. That said, western governments' new-found devotion to Keynes – and the accompanying inflation risk – are unusually conspicuous at the moment. The next-step challenge is always to discern where capital can be deployed productively and rewarded appropriately. In one sense this task has been made easier by the reckless abandon with which OECD governments are now spending their taxpayers' and lenders' dollars: by their actions, governments rule out their bonds as sensible investments. Leave these strictly *nominal* assets to the central banks, content as they are to buy unlimited bond bundles for returns of zero (or even less than zero). Stay real, to coin a phrase. Invest in equities, gold and infrastructure – and don't own fixed income assets beyond specialised instruments (e.g. inflation-linked paper and Chinese government bonds).

The first three quarters of 2020 have seen some startling disparities in performance between different assets. Among major stock markets, the UK has been unchallenged in its awfulness (down 21% year-to-date), while at the other end of the scale Chinese equities have soared 22%. Bonds have done reasonably well: the Barclays global index is up 6% YTD, within which UK index-linked gilts have returned a decent 8%. Star of the show, though, has been gold (up almost 25% so far this year). We've made some minor changes to our model portfolio (see table below) but we're inclined to stick with our current strategy of being overweight equities (tilted away from the Anglo-Saxon markets in favour of Asia), and very underweight fixed income. The mixture of gold and cash should provide both diversification and downside protection.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	14	16.0
International Equities	49	41.9
Fixed Income	11	24.8
Alternatives	13	9.4
Commercial Property	0	0.5
Cash	13	7.4
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**14**	**-2**	
UK	VUKE LN	7	-1	0.09
UK	VMID LN	7	-1	0.10
International Equities		**49**	**7**	
US	VUSA LN	12	1	0.07
	XDPG LN	11	0	0.09
Euro	VERX LN	5	3	0.12
Japan	VJPN LN	6	1	0.19
Asia	VAPX LN	6	0	0.22
China	IASH LN	5	1	0.40
Emerging Markets	VFEM LN	4	1	0.25
Fixed Income		**11**	**-1**	
Government Bonds				
Index Linked Gilts	INXG LN	4	0	0.25
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	4	-1	0.20
Alternatives		**13**	**2**	
Gold	PHAU LN	5	1	0.39
Infrastructure	INFR LN	4	0	0.65
Water	IH20 LN	4	1	0.65
Commercial Property		**0**	**0**	
Cash	GBP	**13**	**-6**	
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2020 YTD	-0.6%	1.2%	-1.8%
Since inception(1/1/2015)	53.9%	47.9%	6.0%
CAGR	7.7%	6.9%	0.8%

The value of your investments can fall as well as rise, and you may not get back all the money you invested.