Courtville Partners – Investment Outlook, April 2021

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

- Capulets vs Montagues; York vs Lancaster; Spurs vs Arsenal… And Monetarists vs Keynesians: the inflation feud goes on.
- Bonds have already begun to crumble; but the normalisation of bond yields has barely started. We are a long way from wanting to own more government paper.
- We would not be surprised to see a sizeable correction in equity markets before long, but cannot predict its timing.
- Investors with a genuinely long-term perspective should remain overweight equities at the expense of bonds.
- The Greens are the coming power in Germany. This could mark a sea change for German (and therefore European) fiscal policy.
- Are semi-conductors the new oil? In important ways, yes.

It's not hard to know where to start. After all, it's not every quarter that the yield on the 10-year US treasury bond almost doubles (from 0.9% to 1.7%). To put this in perspective, the last time we saw a comparable move in the world's fixed income benchmark the process took more than two years (the yield went from 1.5% in mid-2016 to 3.2% in October 2018). But if you thought this market tremor might make the Federal Reserve twitchy, you would be wrong. After chairing the Fed's mid-March meeting, Jerome Powell professed himself to be feet-on-the-desk relaxed. Let's not forget, though, that central banking is largely about mind-games. What Chairman Powell says and what he thinks are not necessarily the same thing. How should independent-minded investors interpret the pronounced rise in government bond yields, both in the US and elsewhere?

Both theory and observed practice teach us that sustained higher government bond yields are generally the result of one or two factors: expectations of stronger economic growth or expectations of higher inflation (or at any given moment a mixture of both). The Fed's laid-back stance reflects its belief that 1Q21's spike was a logical response to the vaccine-powered boom that is unfolding across much of the US. And in truth policymakers have bucketloads of supporting evidence. Macroeconomic data in the US have been almost uniformly strong since the turn of the year; and the economy is expected to grow at a lung-busting 6% this year (and some forecasters predict nearer 10%). To take one example at random, American Airlines announced last week that its summer bookings are back to 90% of pre-pandemic levels and as a result it will shortly pull most of its remaining aircraft out of desert storage. By contrast the UK government threatens to fine its citizens £5,000 if they even go to the airport.

Stronger economic growth should be a fillip to companies' profits, *ceteris paribus* – and thus a source of encouragement for stock market investors. And that is pretty much what has been happening. The MSCI World equity index rose another 4.4% in the first quarter; and, within this, the US market did slightly better, climbing 5.8%. Global bond prices (the inverse of yields) were the other side of this coin, retreating 4.6%. So far, so Goldilocks ("not too hot, not too cold"). But are equity investors guilty of complacency? Everywhere one looks governments continue to splurge newly created money on a scale unprecedented in recorded history. The US is still the most egregious example. Having kicked off the new year with a stimulus package equivalent to 9% of GDP, the Biden administration has now unveiled a pharaonic programme of infrastructure works worth $2trn (or 10% of GDP). The money-printing that underpins the Federal Government's spending is mind-blowing: 20% of all the US dollars in circulation were created in the last 12 months. Will all this deficit-funded spending stoke inflation, especially now that the economy is recovering fast? Eventually it will, we think. Let's examine why.

Among economists, the rivalry between Keynesians and monetarists is as entrenched as that between, say, Arsenal and Spurs supporters. Little quarter is given on either side. Among today's Western governments, the followers of J.M. Keynes are very much to the fore, whether out of conviction or expediency. The same is true of central banks, most of which have been stripped of their policy-making independence. The Federal Reserve is a bastion of Keynesian belief; and Chief Priest is Vice-Chairman Richard Clarida, who has written extensively on the subject. Throughout 2020 the minutes of the Fed's rate-setting Open Markets Committee contained no mention of money aggregates (i.e. measures of money in circulation), even though the 19% growth in M2 (cash, bank deposits and "near-money") was the fastest for more than a decade. Talk about elephants in (committee) rooms. Yet Keynesians simply don't believe that the money supply – or, rather, changes in the money supply – are particularly relevant to macroeconomic management. Monetarists do – and hold that excessive growth in the amount of money in an economy sooner or later generates inflation. Well, the Keynesian creed is now going to be given a thorough test.

In fact, inflation in various forms is already here, right under our noses. For example, global stock markets have gone up 77% since their 1Q20 lows; the broad-based S&P GSCI Index of commodities has more than doubled since last April; and shipping costs had soared even before Ever Given's botched three-point turn in the Suez Canal – the bellwether Baltic Dry shipping index has risen fivefold since last May. Meanwhile, anecdotes of upward price pressures in supply chains are legion, even aiming off for an element of lockdown-related dislocation. The question now is whether – and to what extent – asset and commodity inflation will filter through to consumer prices. Already in the US the PCE price index is up an annualised 2.5% over the last six months, i.e. well above the Fed's 2% target. Powell, Clarida and their colleagues may be publicly committed to ultra-loose monetary policy "for several years"; but they also understand very well that, in the face of gathering inflationary pressures, waiting too long to tighten monetary policy will be at the cost of even higher interest rates further down the track.

The US political and monetary authorities are far from being the only fans of Keynesian economics. On this side of the Atlantic, Germany's Greens are the coming political power in the land and therefore the Continent. Assuming the CDU/CSU alliance struggles to repair the damage from the EU's vaccine omnishambles in time for September's general election, the Greens become racing certainties to join any subsequent coalition government. What might that mean in policy terms, both for Germany and the EU? We take as read the party's environmental agenda. Less well publicised outside Germany is its ambition to override Germany's constitutional ban on deficit-spending, aka *schwarze Null* [see Investment Outlook, January 2020] and allocate at least €50bn p.a. to public investment. This feels like the thin end of the fiscal wedge. Moreover, the Greens are an explicitly Euro-federalist party and, among other things, espouse making the EU's Recovery Fund permanent. As we have argued before, such fiscal largesse would give a massive boost to German consumption, which ought in turn to be good for German equities. One to keep an eye on, then.

Our generation remembers very well the oil shock of 1973/4 – the result of OPEC's embargo on those countries that supported Israel in the Yom Kippur War. Oil prices eventually rose 400%, triggering years of stagflation. (The doubling of oil prices over the last 12 months is small beer by comparison.) Might there be an echo of that conflict and its economic consequences in China's sabre-rattling towards Taiwan? To cut to the chase, are semiconductors the new oil? Are they both examples of extended, concentrated and therefore vulnerable supply of indispensable components of production? If so, then Taiwan is the new Saudi Arabia. The developed world's hydrocarbonintensity has plunged since the 1970s, of course. But dependence on oil has arguably been replaced by near-total reliance on semiconductors – ubiquitous and essential components of almost all manufactured goods of any value, even before "the internet of things" really gets going. Almost four-fifths of global semiconductor output comes from just three companies – TSMC and UMC (both Taiwanese) and Samsung (Korean). The old model of integrated chip design and manufacture, as once championed by Intel, Texas Instruments et al., has been replaced almost entirely by so-called "fabless" (i.e. fabrication-less) chip designers that outsource production to mega-foundries, mostly in Asia. Amazon and Apple, among others, now want to design their own chips (and outsource production to Asian foundries), which seems likely to reinforce the new unintegrated industry structure.

This coincidence of demand-side chip-intensity and supply-side fab-concentration brings consequences. First, semiconductor supply-chains are longer – and thus more vulnerable – now that design, fabrication and testing are divided across geographies. Second, the strongly deflationary influence of tumbling chip prices is expiring as Moore's Law breaks down. (Since 1960 the price of computing power has fallen from roughly $10 million per megabyte to 0.5 cents.) Third, "byte-dollars" are replacing petrodollars as Taiwan and South Korea accumulate – and then invest – their vast trade surpluses. Fourth, the historic stand-off between China and Taiwan casts a shadow over worldwide manufacturing (though logic suggests that China has much to lose by taking military action against its neighbour). Fifth, the West's embrace of non-hydrocarbon energy will only increase its dependence on Asian semiconductor suppliers.

Western car manufacturers know all about the vulnerability of semiconductor supply-chains. Having cancelled orders in the first half of 2020 as car demand plunged, they then struggled to restore supplies once demand recovered, which led to assembly lines being shut down. Was this a foretaste of more serious disruptions in the future? It seems perfectly possible.

What about markets? Bonds have already begun to crumble. But the normalisation of bond yields has only just begun; and we are still a long way from wanting to own more government paper. Stock markets, despite their solid 1Q21 performance, feel tired. Valuations are still quite stretched almost everywhere, especially in the wake of the post-Covid rally in "value" stocks; and typical top-of-the-market phenomena are cropping up (e.g. the mania for SPACs or the Archegos Capital blow-up). Our hunch is that investors are still hooked on a diet of never-ending quantitative easing and permanently low interest rates, both of which by definition are illusions. As Charles Gave, founding partner of Gavekal, put it recently: "Markets have come to believe that central bankers can control the prices of all financial assets. A new generation is set to learn a basic truth: central banks can create money, but they cannot create wealth."

In sum, we would not be surprised to see a sizeable correction in equity markets before long. But, as we never tire of saying, we cannot predict its timing. More importantly, we continue to believe that investors with a genuinely long-term perspective should remain overweight equities at the expense of bonds. And this will become more pertinent still if we are right that higher inflation is coming. We don't expect the US dollar's recent mini-rally to last. Its causes seem clear enough: rapid vaccine roll-out and gathering economic momentum in the US, all in contrast to serial failure in the EU. But we think that Biden's left-wing fiscal and regulatory policies will drag the dollar down again before long. Besides, the backdrop for the US currency will be a yawning current account deficit for many years yet. As we have argued before, prospective dollar weakness is one reason why we now favour non-US equities following more than a decade of US outperformance. There are other reasons too; and they include the secular upswing in commodity prices, the partial reversal of the economic globalisation and the superior yields on offer outside the US.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	15	15.8
International Equities	49	46.5
Fixed Income	11	20.6
Alternatives	13	10.1
Commercial Property	1	0.3
Cash	11	6.7
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**15**	**1**	
UK	VUKE LN	8	1	0.09
UK	VMID LN	7	0	0.10
International Equities		**49**	**0**	
US	VUSA LN	12	0	0.07
	XDPG LN	11	0	0.09
Euro	VERX LN	5	0	0.12
Japan	VJPN LN	5	-1	0.19
Asia	VAPX LN	6	0	0.22
China	IASH LN	5	0	0.40
Emerging Markets	VFEM LN	5	1	0.25
Fixed Income		**11**	**0**	
Government Bonds				
Index Linked Gilts	INXG LN	4	0	0.25
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	4	0	0.20
Alternatives		**13**	**0**	
Gold	PHAU LN	6	1	0.39
Infrastructure	INFR LN	4	0	0.65
Water	IH20 LN	3	-1	0.65
Commercial Property		**1**	**1**	
Global	IWDP LN	0	1	0.59
Cash	GBP	**11**	**-2**	
Total		**100**		**0.20%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2021	1.7%	1.7%	0.0%
Since inception(1/1/2015)	67.7%	58.9%	8.8%
CAGR	8.5%	7.4%	1.1%

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