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Courtville Partners – Investment Outlook, July 2021

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

- The biggest risk to asset prices is a sustained rise in the rate of inflation – and has been brought into sharper focus by the recent pronounced jump in consumer price indices.
- The consensus among investors is that the spike in inflation is transitory (to use the Fed's preferred adjective). This strikes us as complacent.
- We remain cautious about US equities. Valuations are extraordinarily high; and new risks are emerging – specifically the G7's global taxation proposals and rising regulatory pressure on Big Tech.
- Our model portfolio takes an avowedly long-term approach, but is positioned to hedge against the risks as we see them.

We gave Keynes decent air-time in our last Investment Outlook. Would the man himself have condoned the sheer scale of fiscal stimulus underway in most developed economies? It is impossible to know; but at the most basic level his economic theories provide the intellectual underpinning (or fig-leaf if you prefer) for the unprecedented money-printing experiment of the current era. If only to be even-handed, we should now tip our hats to Friedrich von Hayek, whose life's work as an economist makes him the intellectual antithesis of Keynes.

In his 1972 book "A Tiger By The Tail", Hayek famously likened attempts to control inflation to trying to catch a tiger by the tail: both are impossible tasks that are almost bound to end in disaster. The remainder of that decade went a long way towards illustrating Hayek's point, even as he collected his Nobel Prize. It was not therefore a coincidence that at the end of the 1970s self-proclaimed disciples of Hayek emerged to build neo-liberal macroeconomic regimes in the US and the UK. Paul Volcker took the reins at the Federal Reserve in 1979 and set about putting the tiger back in its cage. Being wise, he did not do this by trying to catch the big cat's tail, but rather by controlling growth in the supply of money in the US economy. Now that 30% of all US dollars in circulation have been printed in the last 16 months, it is worth contemplating – if only for a moment – what advice Volcker would have for Jerome Powell, the present Chairman of the Federal Reserve.

Our longstanding hunch that resurgent inflation would rise up the list of investors' concerns has received plenty of endorsement over the last quarter. To the extent that investors and market pundits can be said to have conversations, inflation is now arguably the main topic. We have pointed before to astonishing price increases in many sectors of the world's economy – from shipping to housing to commodities to stock markets. But now the plain-vanilla consumer price indices are getting in on the act. For example, the US CPI hit an annualised rate of 5.0% in May. That is the highest level in 13 years. Within the overall index, there were some truly eye-popping year-on-year bounces: energy +29% (within which gasoline +56%), utilities +13% and second-hand cars and trucks +30%. Stripped of the "shelter" element (a government-computed estimate of rents), inflation is running well above 6% p.a.

The Federal Reserve's response remains phlegmatic: "Inflation has risen, largely reflecting transitory factors". No one could argue with the first half of that sentence. Mr Powell also dropped hints that interest rates *might* just go up before the end of 2023 (rather than not before 2024) and that the Fed's purchases of bonds (aka quantitative easing) *might* be reduced at some point. Both US break-evens and long-dated treasuries rallied, as did the US dollar, while gold and other

commodity prices fell, all of which suggests that on balance investors believe Mr Powell is alert to the inflation danger. This is their prerogative, of course. We are not persuaded – and would caution that the Fed's forecasting track record beyond a quarter or two is fairly dismal. For sure, some of the alarming year-on-year price spikes owe to the base effects of depressed economic activity in Spring 2020. But, with the US economy now running almost flat out, we think the Fed's view – which is also the consensus – that these inflationary pressures are "transitory" may prove to be complacent.

Instead, we interpret the aggregate market reaction to the Fed's mid-June statement as further evidence of investors' collective addiction to the ultra-loose monetary policies that have been in place for well over a decade. There is no escaping the fact that combined asset purchases by the Fed and the ECB are still adding almost $3trn p.a. to the money supply of the US/Eurozone. (For reference, the entire UK economy is valued at $3.1trn.) The former Governor of the Bank of England, Mervyn King, is one of many to remark on the "deafening silence" of central banks on the subject of money supply growth – and he could have said the same about sky-high asset prices. In their defence, this generation of central bankers has risen to the top without having to deal with a proper inflation scare. Such a thing will be beyond their range of professional experience. And they can't ring Paul Volcker for tips – he died 18 months ago.

It is hard to avoid the conclusion that markets – by which one *always* means investors, institutional and retail – nowadays look to central bankers principally for reassurance that money will continue to be printed in vast quantities and that real interest rates will be kept negative. It is as if central bankers set the prices of both bonds and equities. Indeed, a legitimate question is whether there could be *any* circumstances in which the West's central banks (above all the Fed) could raise interest rates without precipitating sharp falls in stock and bond markets. We suspect the answer is no, there aren't any such circumstances. On the other hand, the obvious risk of *not* hiking interest rates in response to strong inflationary pressures is the misallocation of resources on a scale to dwarf even late 1980s Japan (from which that country has not recovered properly even now).

Mervyn King is worth quoting at greater length since he hits several nails on the head: "The large monetary and fiscal stimulus injected in the advanced economies is out of all proportion to the magnitude of any plausible gap between aggregate demand and potential supply… A combination of political pressure to assist in financing budget deficits, unwise central bank promises not to tighten policy too soon and an expansion of central bank mandates into political areas such as climate change, all threaten a slow response to signs of higher inflation." What a stark contrast these two sentences make to the Fed's coded and syntactically tortured pronouncements.

King's reference to climate change should make us sit up. Western governments have yet to level with their electorates over the costs of "net zero" targets. No member of the UK government, for example, has yet denied the "more than £1 trillion" figure mooted by Philip Hammond when he was Chancellor in 2019. Let's not get hung up on precise numbers. The crucial question is who will pay the bill. Once Covid is over, expect much more focus on the costs – and therefore the financing – of governments' grandiloquent greenery.

Why do we expend so many words on the subject of inflation? Because in our view it is the most important factor influencing US equity and bond prices – and, by extension, global asset prices. Our model portfolio expresses relatively few strong views; but among them is a marked preference for equities in the rest of the world (in effect Greater Asia and Emerging Markets) over the American variety. During 2Q21 this view was again confounded by strong stock market performance in the US (+7.6% versus MSCI All World +6.8%). But we are not changing our stance. We reckon the Fed's control over inflationary forces in the US economy is not nearly as

firm as the press releases claim; and this leads us logically to expect both US asset prices and the US dollar to weaken (though, as usual, we cannot predict the timing).

There are other reasons for our cautious attitude towards Wall Street. Stretched valuations are an obvious example: the US stock market's Shiller cyclically adjusted P/E ratio (which compares current share prices with 10-year average earnings) has only ever been higher in the run-up to the dot.com crash of 2000. But another reason is the US market's reliance on a relatively small number of tech-related mega-capitalisation stocks. These companies' vulnerability to more stringent regulation is hardly new; and we have flagged this risk in the past. Over the last few weeks, however, two developments have raised the risk premia for Alphabet, Amazon, Apple, Facebook and their ilk. First, the G7 agreed in Cornwall to impose a global minimum corporate tax rate of 15%. If implemented, this will compress multinationals' profit margins (the mooted additional tax take of $50-80bn p.a. will have to come from somewhere) – and will presumably weigh on stock market valuations too. Being the obvious target did not prevent Big Tech from publicly welcoming the proposal. In Silicon Valley they know which way the wind is blowing – and may even rate the G7 approach as the least of several potential evils.

Second, the Biden administration seems to have the same companies in its regulatory cross-hairs. Among straws in the antitrust wind is the appointment of the impossibly youthful (and London-born) Lina Khan as chair of the Federal Trade Commission. Ms Khan, a law professor at Columbia, is known as an outspoken critic of both Amazon and Google; and she has argued for the FTC to enforce existing antitrust laws more proactively. Meanwhile, the House Judiciary Committee has been flexing its own competition muscles via a series of bills aimed squarely at platform companies such as Google, Amazon and Facebook. It is perfectly reasonable to argue that the Fed (via interest rates) is a greater near-term threat to Big Tech than the FTC, not least because these tend to be "long-duration" stocks the net present value of which is especially sensitive to changes in the discount rate. In the longer term, however, the outlook is much murkier. And, as one analyst remarked, investors need only look as far as banks to see what stiffer regulation can do to profitability. In sum, given that the five biggest technology companies together account for 17% of the US stock market's capitalisation, these are risks that investors should not ignore.

A brief survey of markets in 2Q21 reveals a continuation of many of the trends seen in the previous quarter. Global equities rose almost 7% and again outstripped bonds by some margin (despite bonds rallying modestly). As already mentioned, US equities defied our caution by rising 7.6%, which was the strongest performance of any major market over the period. US equities are now up almost 14% year-to-date; and global equities are up 11%. Global bonds, by contrast, were down 3% in the first half.

Our model portfolio has risen 6.5% so far this year, which is slightly ahead of its benchmark. Overweight equities and underweight bonds has been the correct call. But our bias towards equities in China, Asia and Emerging Markets has been a drag on performance. Nevertheless, we are happy to stick with our relative geographical bets. Gold, which performed so poorly in 1Q21, recovered in 2Q21 and is now down less than 6% year-to-date. And since we've mentioned gold… The precious metal's capacity to store value, immune to central bank depradations, is thrown into the sharpest possible relief by a couple of killer statistics that caught our eye (hat tip to Gavekal): since 2000, the S&P 500 and 10-year US treasuries have risen 345% and 195%, respectively, in US dollar terms. If, however, an investor had measured the starting and ending values of his investment in these two assets over that period by reference to the gold price, then the value of those holdings would have depreciated by 58% and 65%, respectively. Go figure, as they say over there.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	15	15.8
International Equities	48	46.5
Fixed Income	12	20.6
Alternatives	15	10.1
Commercial Property	2	0.3
Cash	8	6.7
Total	**100**	**100**

UK Equities		**15**	**0**	
UK	VUKE LN	8	0	0.09
UK	VMID LN	7	0	0.10
International Equities		**48**	**-1**	
US	VUSA LN	12	0	0.07
	XDPG LN	10	-1	0.09
Euro	VERX LN	5	0	0.12
Japan	VJPN LN	5	0	0.19
Asia	VAPX LN	6	0	0.22
China	IASH LN	5	0	0.40
Emerging Markets	VFEM LN	5	0	0.25
Fixed Income		**12**	**1**	
Government Bonds				
Inflation Linked	INXG LN	4	0	0.25
Inflation Linked	TIP5 LN	2	2	0.10
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	3	-1	0.20
Alternatives		**15**	**2**	
Gold	PHAU LN	5	-1	0.39
Commodities	BCCU LN	3	3	0.35
Infrastructure	INFR LN	4	0	0.65
Water	IH20 LN	3	0	0.65
Commercial Property		**2**	**1**	
Global	IWDP LN	2	1	0.59
Cash	GBP	**8**	**-3**	
Total		**100**		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2021	6.5%	6.3%	0.2%
Since inception(1/1/2015)	75.5%	66.1%	9.4%
CAGR	7.8%	7.0%	0.8%

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