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Leaders in Wealth Management

Chartered Financial Planners

Booms and Busts Report

I produce these economics and markets reports every two months. We produce, more frequently, more in-depth reports, for clients.

It was all over the 'News'. Stocks are crashing. Is this a Recession beginning? There's too much debt. Even, I told you so, from some quarters.

Me? Zzzzzzzz

Since early 2016, and more so, from November 2016, stocks, globally, have soared. A week of falls means nothing. Can it turn into something? Of course. But what we have seen over the last couple of weeks is absolutely nothing untoward. I even saw 'the largest Dow Jones points fall ever!!!' bandied around.

Talk about misleading. Look, if the Dow is at 5,000 and it falls 1,000 points then that is a big deal. But it was c 25,000. That 1,000 point fall is merely the froth coming off, until it gets going again.

The 'dreadful' falls in stock markets are displayed, below, in the charts of the last few years.

Blue is the US.

Green is Global Developed markets, excluding North America.

Red is Emerging Markets.

Dare I say 'Calm Down!'

(Of course, never in the history of shouting 'Calm Down' has anyone actually every done that very thing...)

What else has been happening?

Global inflation has been rising. And is still rising.
Global economic growth has been solid and, indeed, getting stronger.
Globally, government borrowing rates have soared.

If you read quickly and moved on swiftly, you might not have registered the last point.

Government borrowing rates have soared.

The Bond markets are 5 times the size of the equity markets.

A Bond is jargon for a loan. A Government Bond is a loan to the Government. Also, you have Corporate Bonds.

Governments borrow overnight, for a year, 2 years, 10 years, 30 years etc. As you know, govt borrowing has soared over the last 10 years and, indeed, started soaring in the 1970s as borrowing rates started falling. Borrowing costs less so let's borrow more. Rinse and repeat. Again and again.

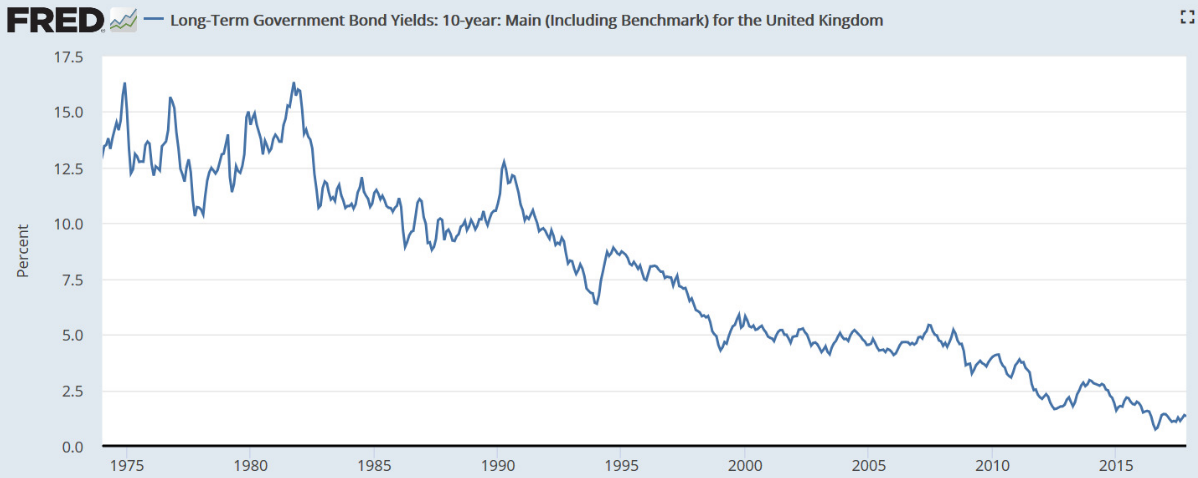
Remember when the Base Rate was well into double digits in the 1970s and peaked at 17% in 1979?

It's been falling ever since. Well, until recently. It's been no higher than 0.5% since 2009!

The Base Rate, as you know, is decided upon by the Bank of England Monetary Policy Committee (though I suspect it's really the Governor who decides... just like the old days before the MPC was created.)

Yet, that's not even the reality. The MPC decides the Base Rate, which is really the overnight borrowing rate.

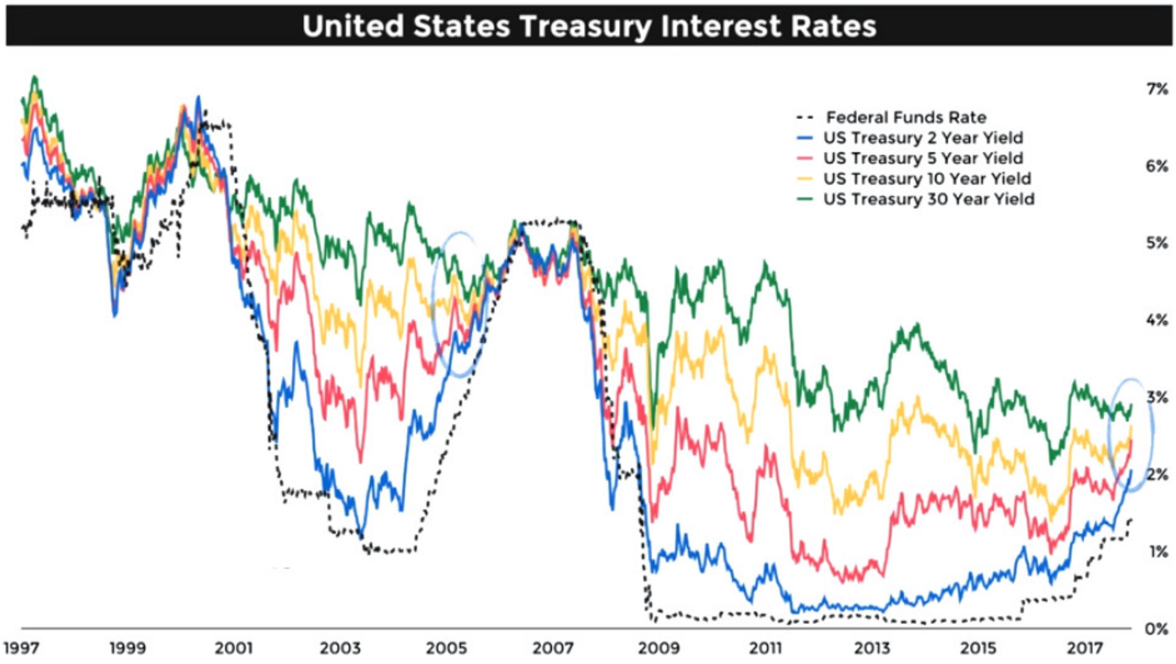
When the government borrows, it can borrow for almost any length of time. The chart, below, shows the fluctuating **10 year rate since 1974.**



You note how the 10 year rate also peaked in the 70s and has fallen since, not in a straight line.

As longer term rates fall so do the short term rates and these push the MPC to reducing the Base Rate. Of course, if longer term rates rise, incessantly, this will push the MPC to raise the Base Rate...

See the last 20 years of various US rates:



Right across the spectrum, be it the Federal Funds Rate (FFR, like the UK Base) right up to the 30 year rate, the trend has been down, from 1997 (before not shown) to recent years.

However, as you can see, in recent years, rates have risen, materially.

The shorter term rates - 2 and 5 year - have been rising since 2013. The 2 year borrowing rate is now higher than anytime since 10 years ago!

They have raised the shortest term rate - the FFR - since the end of 2015. Like the Base Rate, the FFR is decided on by committee, not the markets.

Notably, the 10 and the 30 year rates bottomed mid 2016 and have been rising since.

The shorter term rates rising suggested inflation may be coming back, after years of, on the face of it, hiding away.

The longer term rates rising suggest inflation is expected to be higher in the long term future.

Already in the US, 30 year mortgages (they fix long term across the pond) have risen from c 3.3% to c 4.3%. **A 30% rise in mortgage costs...**

The first question that springs to my mind is **'if mortgage rates rise, materially, for years, how can that be a long term tailwind to house prices?'**

Answer: They can't.

Chart: US 30yr mortgage rate -

In the UK, as shorter term rates have risen, so have shorter term fixed mortgage rates. (We don't really do 25 year fixed rate mortgages. Well, a tiny proportion. I would say, if rates are going to be materially higher 5-10 years from now, wouldn't it be smart to fix for 25 years?)

The main question is, are rates going to rise, incessantly, for years?

Look at the next chart of 10 year US govt borrowing rates, since the 1920s:

This is, arguably, the most important chart in finance.

You can see, from the mid 20s to the early 60s, the 10 year rate stayed low, as inflation was low.

From then on, inflation and borrowing rates soared. They peaked in the late 70s, as many of you will remember.

As discussed, gradually, US and global inflation and interest rates fell. Indeed, look at the blue line. Nothing goes in a straight line. As the rate fell, from the 1980s, whenever it rallied, it never once rose above that blue line.

Until now.

Does this mean we will now have an era of rising rates, following an era of falling rates?

THAT is the question everyone in finance is (should be!) asking. Nobody knows. However, the signs are that it is more probable that at any time in decades.

What we can say is inflation and interest rates are rising now. And, likely, they will continue to do so this year. Indeed, they will likely continue to do so until we have the next recession, whenever that will be. 2019? 2020? Who knows?

I waited until the announcement from the Bank of England, today, to send this Report out. I didn't expect a rate rise although it has been abundantly obviously needed for ages. Not just one but several, like the US Federal Reserve has been doing.

What was notable was the total change in tone. This is what the MPC meeting said:

"The Committee judges that… monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November report,"

Rates will rise in the UK, folks. This has been inevitable since the Pound Sterling started really strengthening (October 2016) and UK Govt borrowing rates had soared. In the Summer of 2016, the Govt was borrowing, over 10 years, at a 0.5% rate. Now, it is over 1.5%. A **trebling** in c 18 months. This was the market telling the Bank of England that inflation is here and you need to raise the Base Rate. The Bank has finally got the message.

As to the future, if, in the next recession, rates and inflation fall but to a higher level than the lows of 2016, then, yes, we will be in an **era** of rising inflation and interest rates.

The recent hiccup in stock prices was likely caused by interest rates rising more steeply than stock markets expected However, it's likely just a hiccup for now, as I say. There is nothing to suggest stocks will immediately crash. Also, there is nothing to suggest interest rates will now fall again.

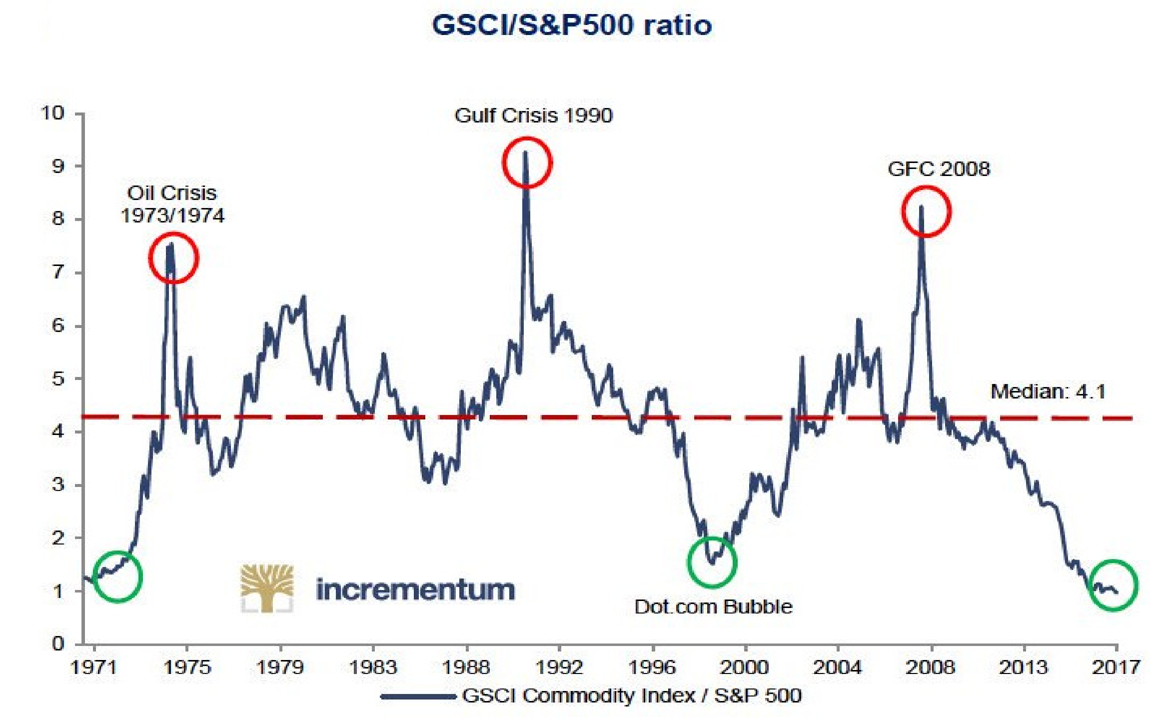
Now, I've been writing for 2 years about rising rates and inflation. And clients are invested according to inflation etc conditions.

Are **YOU** invested to meet inflation? What about your company's pension scheme?

Are you invested heavily in commodities? Oil and gas, agricultural produce, metals etc i.e. things you grow or dig out of the earth or sea. They will normally soar in price during periods of inflation.

There's a second reason for investing in commodities. They are cheap. They are stupid cheap. Certainly, versus major stock markets.

Look at this very long term chart of the **Commodities Index vs The US S&P 500 Index:**



Source: Dr. Torsten Dennin, Incrementum AG

Commodities (and their associated mining etc companies) are the cheapest in relation to the S&P 500 Index for nearly 50 years!

No doubt you have seen the more than doubling in the oil price, over the last couple of years. I read, just this week, BP's annual profits doubled, year on year. Yes, we are fully invested in global energy companies.

Also, are you (too) heavily invested in Government Bonds? They lose money in inflation / rising rates.

Finally, if you look back at your portfolios at the peak of Dotcom (early 2000) and the trough (March 2003) and also the peak of the housing / banking bubble (late 2007) and the trough (March 2009), you will probably notice that your portfolios fell 25-40% during those recessions. As I said above, I am not calling for a recession this year. Will you be ready though for the next one? Will you and your adviser/manager take the action needed to avoid the inevitable slump?

Not one of my clients lost in 2008.

It might be an idea, earlier than later, to have the needed discussion of strategy with your current managers.

What will they do and under what circumstances? If the answer is 'we invest strategically so we retain the same level of exposure to stocks, property, bonds etc whatever the markets do' then expect 25-40% losses in the next recession. They might add 'we will move from more to less volatile stocks'. I can assure you this will only marginally help in a stocks recession. The markets will throw the baby out with the bath water.

In the ongoing growth/inflation phase of the cycle are you sufficiently exposed to inflationary assets?

Are you too heavily exposed to Govt Bonds?

Clients of JD WM are suitably invested for the economic and inflationary conditions.

Lastly, I want to touch on Bitcoin, a subject over which I've had loads of questions through 2017. If you quite recently went in then you took a massive risk, after a 1,000% rise in a year! So far, it has not paid off for you. It may do. Or it may fall to £zero. And that, of course by the way, also goes for early investors.

If you bought at $200, a few years back, then congratulations.

It's currently c $8,250, having touched c $2,000 mid-December 2017.
It was c $1,000 at the beginning of 2017.

Clearly, it is HUGELY volatile.

It seems to me it is acting similarly to DotCom in the late 90s bull market and, potentially, the bust of 2000-2002/03. Many dotcoms went bust. Some went down 90-99% and are now worth hundreds of billions eg Amazon.

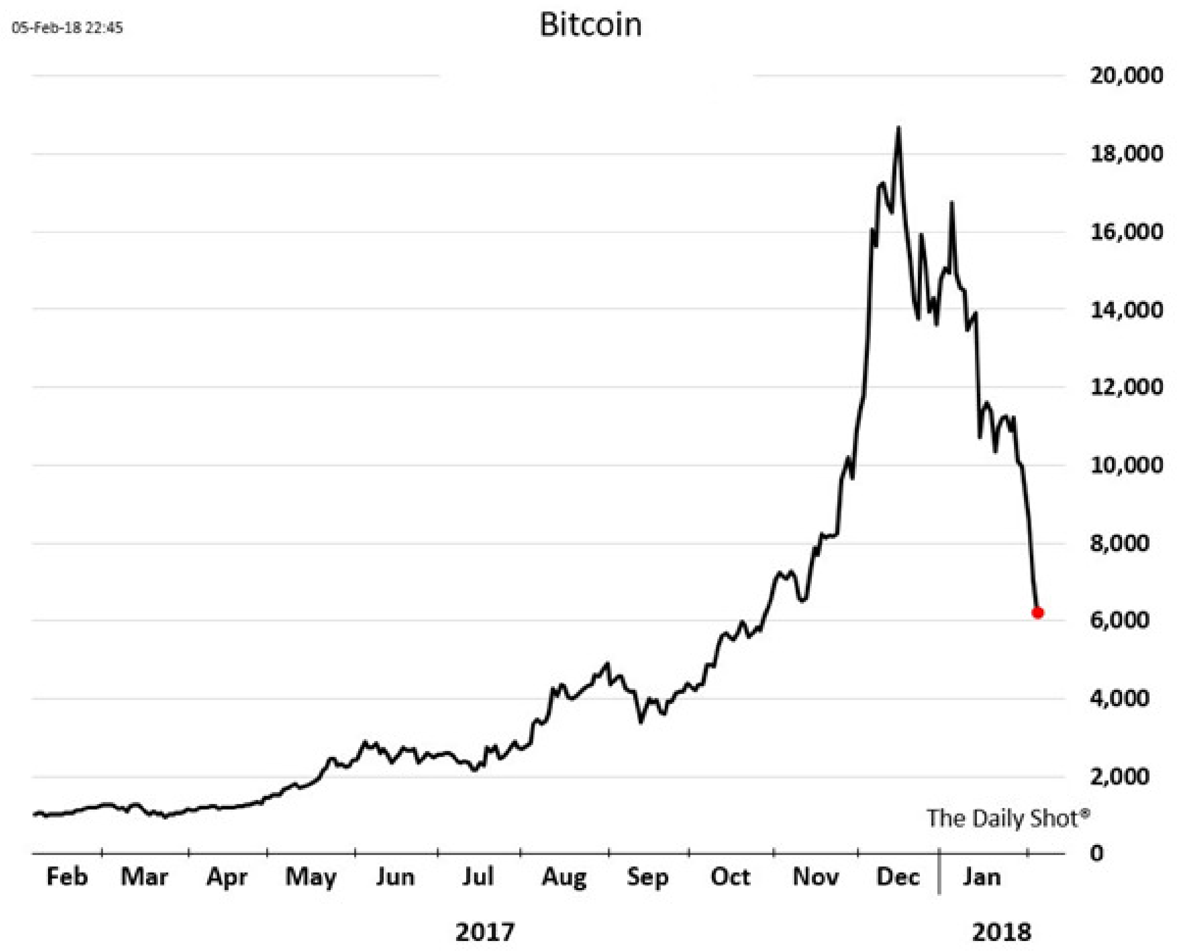
Don't invest / speculate more than you can afford to lose. That is a general rule but particularly relevant here.

If it works you'll be rich. If it fails you won't be bankrupt.

We don't and can't advise on it. If it goes back to $1,000 then, who knows, it might be attractive to the right speculator.

In December I fielded lots of queries about it. I felt sure then it will crash.

Nobody knows if it will be here in the long term. It could be. Some are sure it will be. But then they were also sure it wouldn't go down to $6,000.



What should **YOU** do to secure your wealth and purchasing power?

Don’t put it off till it’s self-evidently too late.

Can you benefit potentially from our advice?
We work for wealthy families and/or high earners.
We work for clients all over the UK and indeed on three continents.

We now have an association with an excellent financial planning firm who can advise interested parties with portfolios materially under £500k. Contact me for details.

Our most important and most often repeated philosophy is (as seen widely on our website): “We advise you based on what we would do, were we in your shoes, given what we know”.

Call me personally to see how we can help.

Please note carefully the following important messages:

I believe most folk do not realise, in big picture, the changes happening right now in our economy and markets (major stock markets, corporate and government bonds and property).

They will.

I think most folk also do not realise, in big picture, the amazing opportunities in our markets.

They will. But will they benefit?

Click ***to forward to a friend*** if you think they could benefit from reading this.

If you have any queries over any of the issues raised do not hesitate to get in touch with me by calling me or emailing me at ***jdavis@jonathandaviswm.com***.

On Twitter, follow me ***@J0nathanDavis*** where I frequently comment and link to important commentaries on markets and economics.

Kind Regards

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Please note that investments can fall as well as rise. And they do!

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