2021: What's up Ahead?

BY MARK PAGE, MANAGING PARTNER

In 1972, a columnist writing in a Texas newspaper recounted an anecdote in which a wife caught her husband cosying-up to an attractive barmaid. The husband responded, “Look here, honey, are you going to believe what I tell you about this, or are you going to believe your own lying eyes?”

That husband today is the Fed, which alongside other central banks must carefully balance the need to build confidence in a broad-based recovery, against the risk of creating an environment where truth goes to die. In the meantime, nobody likes fighting the Fed, certainly not in the context of the current malfunctioning capital switching mechanism, a possibility not recognised by neo-classical economics. This malfunctioning capital switch supports a dual conclusion: (i) the rally in risk assets is likely to become more volatile as 2021 progresses, (ii) strong asset markets are, paradoxically, a bad omen for future productivity growth and economic stability.

Our lives and economies changed in 2020, and this includes an accelerating democratisation of financial markets as governments ask higher-earning families to take more responsibility for their own financial security. Multiple drivers include a reduction in defined benefit pension schemes, falling job security, and taxation shifts, a secular socioeconomic shift which affords ongoing support to the post-March-2020 bull market.

A second driver comes in the form of a redoubling of intense monetary action as central banks took control of yield curves and credit spreads. Running out of room for manoeuvre, they increasingly sought to influence our minds through harnessing behavioural tools, to in effect encourage investors to set aside personal experiences in favour of the central banks' presumed superiority, organised dogmas, and near-limitless power.

There is nothing more attractive to investors than running with the Fed, which is exactly what most are doing!

The third driver comes in the form of an unprecedented fiscal stimulus, set to intensify now that the Democrats have won control of the U.S. Senate. The trouble is investment demand (capital to fund new production) has not been able to keep pace with rising capital flows, something which classical economics never envisaged.

<u>As a consequence, by late-March 2020 it had become clear that a vast wave of excess capital would be diverted into speculative assets.</u>

It is hard to overemphasise the importance of this development. Stalled productivity forced G-8 natural rates of interest (r*) down to zero, a level where they remain trapped today. A rekindling of trend productivity – and consequently trend GDP growth – is dependent upon new ideas turning into hard investment in productive assets, and not being diverted into Gunfight at the O.K. Corral type financial speculation.

A risk which is perversely magnified as the Fed and other central banks enter the psychological sphere. Mary Daly, president of the Federal Reserve Bank of San Francisco recently commented:

"So, what could get in our [the Fed's] way? History points to one important thing: doubts that our tools are powerful enough to achieve our goals."

Managing doubt is of course an important role in smoothing the path to a post-pandemic recovery but destroy too much doubt and central banks risk disabling the scepticism which underpins efficient and disciplined markets and a sober assessment amongst businesses and households of the risks associated with additional debt.

Go too far down this road and a risk looms large: a central bank supported environment where truth goes to die.

Which takes us to the fourth and arguably most potent driver of today's bull market, human behaviour, in which notions of greed, hope and redemption are deeply engrained. In 2020, such behavioural phenomena contributed to many great narrative-driven investment opportunities including FAANGs, IPOs, Travel, Aerospace, Gold, and US Treasuries amongst many others.

Which in turn set the scene for a profitable and yet deeply disturbing 2020.

At the dawn of 2021, the hope is that a powerful economic recovery will lay firm foundations for future long-term growth as the Covid-19 pandemic recedes, and toxic politics and epidemiology are swept away by recovery and regeneration.

Alas, while a powerful short-term economic bounce is assured, longer-term optimism may well be dashed by the inherently capricious nature of human behaviour; by the many investment fads, fashions, and manias which took root in 2020. Further long-term headwinds come in the form of monetary congestion, and the fact that US and European productivity growth were stalling well in advance of the pandemic.

We offer all of this not as a reason to be fearful as we head into 2021, rather as a reminder that left-of-field market moves require left-of-field investment ideas to capture them. And just as importantly, to avoid the latter-day Greek Sirens who lure the unsuspecting to shipwreck on their rocky shores. Think of the dangerously outdated dogmas surrounding 'value', 'recovery', 'cyclical', 'growth', etc.

If there's an underlying sense of tension in our words, foreboding even, then that's a fair reflection of our current thinking. Going forward, we foresee additional waves of rich opportunities tempered by difficult to manage risks. We doubt that markets will remain one-way bets, but equally doubt that cash will afford much protection.

We'll explore these themes in detail as the year progresses, but for now a reminder that investors should only climb aboard for journeys tailored to their specific needs and circumstances. To then enjoy the ride at their own pace and within their own personal risk tolerances.

The ultimate goal remains unchanged: to capture the long-term benefits of a well-constructed portfolio allowed to work its magic over time.

Best Wishes for a Happy and Prosperous 2021!

Team Eriswell

For any enquiries or comments you may have, please contact us at info@eriswell.com. We look forward to hearing from you.

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