Responsive Stewardship
Investment Portfolio Management

How to invest in this climate

What have any past inflation crises taught us about investing?

White Paper

Produced by Aisa Group on behalf of OpesFidelio

An Overview
"The world of 2022 and 2023 and what the past has taught us."

Investment performances to July 2023 have been poor in nearly all markets, both equity and bond based.

The exceptions have been:

- High tech firms linked to the advent of AI technology and the consequential requirements from software and hardware firms.
- Armament and associated companies linked to the heightened state of alert between countries as a result of world turmoil largely based around 4 countries.
- Energy companies (including both conventional, nuclear and new age) linked to both the rush to net zero emissions (clean energy) combined with damage to current energy supplies in certain geographical regions such as gas in Europe.
- Bio-tech discoveries linked to worldwide pandemic.

Whilst some people have been able to take advantage of these areas by solely investing in them, they are increasing risk exposure and all of these areas have been extremely volatile in the last 2 years. There is no guarantee they will continue to grow, nor even maintain the gains they have already achieved as some reach saturation and exhibit bubble-like tendencies.

Inflation, leading to higher interest rates, leads to higher debt costs and higher supply costs. This impacts on fixed interest borrowing as well, and impacts on government borrowing costs, company costs and has a massive impact on all the asset classes in 2022 and 2023. Last year saw a reduction in value of fixed interest and government issued debt of double digits; almost unheard of and making low risk investment strategies perform more like equity-based strategies, which was poor!

Learning from the past
We can review the UK and US markets for experience in what has happened before at times of high inflation, low growth which often goes alongside rising unemployment eventually. In the UK there was the Barber Boom – 1972-74 (1973-75 recession), and the Lawson Boom – 1985-88 (cause of recession of 1990-92.

Commodity prices (Food, Raw agricultural materials, metals) rose initially, interest rates rose, eventually unemployment rose, companies went bust in record numbers, house prices crashed, and this was followed by recession.

At the point of recession, house price negative equity was high, commodity prices dropped substantially as demand dropped and equities which had initially stagnated started to rise again through the recession (in anticipation of future growth from lows).

Where are we in this cycle in 2023?
Some of the points above are clearly in evidence, but negative equity, rising unemployment and a full-blown recession has been avoided at this time. Although stagflation (explained later) in many western economies, and China, appear the current position. Investment planning currently has to be balanced between the idea of whether western countries will or will not go into recession. What is different this time is the huge amount of borrowing and printing of money that has been going on for the last 13 or so years. The borrowing from the US government is being used to encourage liquid capital markets to invest in the US through advanced technologies or similar.

This continuing borrowing of money, and large liquid capital in markets will have to stop at some point but is unlikely to do so whilst 2024 sees the election of a new President.

When the borrowing does stop, and of that we can be sure, then the piper will have to be repaid. To see the extent to which US GDP borrowing has accelerated click here: U.S. Debt to GDP Ratio 1989-2023 | MacroTrends

Top 10 performers in IA sectors in the previous 3 recessions

A full list is provided in this document with graphs of performances. Past performance should not be used solely as a guide to future performance and there is no saying that everything will happen the same with the same outcomes. Despite this, the white paper is about providing the facts which can then be considered alongside other factors.

The timing of investments is commented on, and it must be remembered that when considering data, we do not know exactly where we are in a cycle until after we have already got there. Recessions are only recessions using past data!

What is fair to write is that the conclusion of this white paper is to consider certain sectors for investment albeit some of these may already be in an investment bubble (A bubble is explained within the Explanations and Research section).

The White paper conclusion discusses the various sectors worth consideration and those that do not. However, like all investing the past may not be a guide to the future and investors should seek professional advice before making final decisions.

Explanations and Research

This paper is based on key factors currently affecting most economies but not all. It has an immediate relationship with investments. It also discusses historic data from previous inflation bubbles and their outcomes.

Key factors discussed include:

- Inflation
- Stagflation
- Economic Bubbles
- Market reaction in previous stagflation / recessionary times

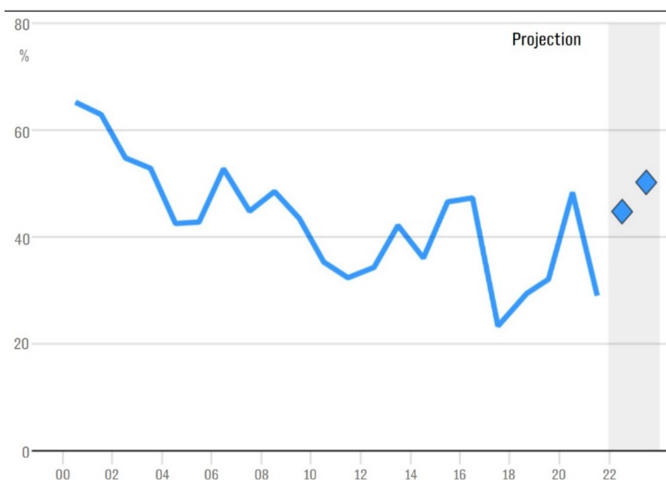
Inflation

inflation is an increase in the general price level of goods and services in an economy. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation corresponds to a reduction in the purchasing power of money.

Most western economies seek to keep inflation low and then hope to achieve growth in excess of the inflation. It is controlled by money supply, supply and demand, currency exchange and interest rates.

These areas can stoke inflation or reduce inflation. For example, interest rates which have become the focus in 2023 in most countries, can be raised to reduce desire to borrow and spend. As borrowing becomes more expensive so people, and companies, have less money to spend and look to become more efficient, reduce borrowing or reduce spending.

More firms suffer dept-service stress



For individual, and companies, that are well financed or have little or no borrowing or fixed interest debt then there can be less of an impact on them than individuals or companies that do not have these properties. For example, companies that are well financed can "weather the storm", whilst for companies with large borrowings or limited profit can go bankrupt.

Bank of England released research confirming what has been obvious for some time: higher interest rates are causing corporate distress. The table on the left shows projected corporate distress

This is also true of the average individual, a wage earner or particularly retiree who watch debts and costs increase whilst their income cannot keep up.

There is some good news. The factors that drove inflation have been reversed. Supply-side pressures owing to the pandemic and war have gone and monetary policy has tightened. Thus inflation will decelerate and boost spending power as real incomes rise.

Summary

For those with large borrowing or limited margin on spending power then inflation can have a disproportionate effect on them. For many "new world" companies that do not turn a profit, they rely on their investors to keep them operating. For firms with low debts, or fixed debts, and have been in profit they are more likely to survive high inflation although this is not guaranteed.

Stagflation

Whilst inflation can lead to interest rate increases it should lead to reduced spending power, thus limiting purchases. Firms therefore raise prices to a point until they cannot raise them anymore as people stop spending. In fact, the basic rule of economics says that prices shouldn't go up when people have less money to spend, or their jobs are at risk.

One of the assessments for inflation is flights – many countries have seen escalating airline prices and, despite this, demand has increased and is back to pre-covid levels. However, this is happening at the same time as people have less money.

Different reasons are given as to why this is happening in 2022 and 2023 but most of them point to a "two tier economy", release of savings after Covid combined with western government borrowing increasing over the last 10 years at rates not seen for over 60 years, government printing cash again not seen for almost 100 years, government propping up firms and individuals at any sign of crisis.

What is meant by a "two tier economy" in this context is that people with savings or money are able to continue their lifestyles, whilst others without savings or lower earnings are being disproportionally impacted. The spending of the first group keeps inflation and interest rates higher for longer until they too are impacted.

However, there will come a point where this growth slows dramatically due to rise in inflation and interest rates. Companies and individuals with large borrowing will start to struggle, perhaps become bankrupt, which will lead to efficiency drives. Efficiency drives lead to cuts in expenses, and this often leads to cuts in staff which means unemployment goes up.

Stagflation is an economic cycle characterized by slow growth and a higher unemployment rate accompanied by inflation. Economic policymakers find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another.

Policy solutions for slow growth tend to worsen inflation, and vice versa. That makes stagflation hard to fight for governments and already you can see some governments taking different measures.

Theories about Stagflation:

- **Supply side shocks** – Such an unexpected event, such as a disruption in the oil supply or a shortage of essential parts. During the COVID-19 pandemic there was a disruption of the flow of semiconductors that slowed the production of everything from laptops to cars and appliances all the way thorough 2022 and early 2023.
- **Oil and energy costs increase** – this considers that stagflation is caused when a sudden increase in the cost of oil reduces an economy's productive capacity.
- **Economic Policy** – This suggests that the confluence of stagnation and inflation is the result of poorly made economic policy. Harsh regulation of markets, goods, and labour in an otherwise inflationary environment are cited as the possible cause of stagflation.

Are we in stagflation yet in the western world. The absence of a slowdown in spending overall, and relatively low unemployment in the UK would suggest that stagflation has not happened yet. However, many other European economies show clear signs of stagflation although inflation does appear to have peaked. The concern is the methods used by some government to control inflation which has included state legislated control of private company prices, or more government borrowing to subsidise. They could just be delaying the inevitable with these short term polices. In the US they are borrowing money and subsidising targeted business in order to promote growth; with the US debt ration being at over 130% this is a risky strategy (U.S. Debt to GDP Ratio 1989-2023 | MacroTrends) and could yet lead to a recession (some economists predict this) which could lead to stagflation. The jury is out on the various deployed methods of different governments around the world as to which will be the most successful and we may not know for a couple of years.

In the UK, we know what is needed to boost investment and improve growth potential: sound macroeconomic policy on the level, predictability and simplicity of tax; sufficient finance for companies, including small and medium-sized ones; a skilled labour force; supportive and functioning infrastructure; a lack of bureaucracy or risk-averse regulation; and future expected demand.

Economic Bubbles
A “bubble,” is where the price for something is no longer based on intrinsic worth nor fundamental valuations, thus leading to speculation which drives prices higher exceeding any rational valuation normally used; due to it not being based on intrinsic value the bubble is driven by speculative demand and grows larger.

Bubbles often start with a new idea, such as recently, Artificial Intelligence (AI) and “all the things it can do for us”. Prices may rise slowly until momentum gains from more and more participants (more people thinking they need to be in on this one) which leads to boom phase. The asset in question, AI, attracts widespread media coverage. An increasing number of people see this and talk about the future, with a fear of missing out spurring further speculation, and more investors risking their money. As Euphoria sets in, a bit like the recent cryptocurrencies examples, people who have no idea about investing, and even some who do, throw caution to the wind encouraged by each other, stories of rapid wealth and easy money. Valuations reach extreme levels as new valuation measures and metrics are touted linked to the theory it will be “different this time”.

It is at this point that clever investors recognise the warning signs that, not only is there a bubble, but it is likely to burst soon. This is the time to sell and take any profits, even though it is impossible to time this perfectly, but it only takes a relatively minor event to prick a bubble. If the assets have not been sold and investors hold on they start to see the asset price reduce, sometimes constantly, sometime rapidly. At this point asset prices have reversed and can go down as rapidly as they went up. Investors, faced with plunging values of their holdings, now want to liquidate at any price before it gets worse in their mind. This is the panic stage and anyone who invested in the later stages of the bubble stand to lose a lot of their investment money. If they have been operating on borrowing or margin calls, they may lose all their money.

- **Stock market bubbles** involve equities—shares of stocks that rise rapidly in price, often out of proportion to their companies' fundamental value (their earnings, assets, etc.). These bubbles can include the overall stock market, exchange-traded funds (ETFs), or equities in a particular field or market sector.
- **Asset Market bubbles** involve industries or sections of the economy outside of equities. Cryptocurrencies and real estate are a classic example.
- **Commodity bubbles** involve an increase in the price of traded commodities.
- **Credit bubbles** involve a sudden surge in consumer or business loans, debt instruments, and other forms of credit linked to slack lending criteria or low rates. Specific examples of assets include corporate bonds or government bonds or mortgages.

Why are bubbles relevant in this discussion white paper? There have been a series of bubbles over the last 10 years based on the low interest rates that have been available. Combined wit governments printing of money this has led to large scale asset price increases (the rich get richer) in many areas linked to lending or speculation or simply availability of money.

2022 and 2023 have started to see some of these bubbles burst, whilst creating others due to further new technology or plans for net zero of huge government lending programmes. All of these have destabilised the normal operating of markets or they have amplified returns, such as those seen in real estate over the last 15 years.

With the return to higher interest rates sensible investors are now planning for the next cycle. It is also fair to write that as a long period has passed that many people under the age of 35 have never experienced anything other than what has been happening and therefore, they see it as the norm. However, this also makes them unprepared for a recession or high interest rates, or asset price deflation, nor stagflation.

Market reaction in previous stagflation / recessionary times

These have Previous market reactions:
Barber Boom – 1972-74 (1973-75 recession)
Best performers: Commodities (Food, Raw agricultural materials, metals) sharp increase at initial crisis point, followed by big drop in 1975 recession.

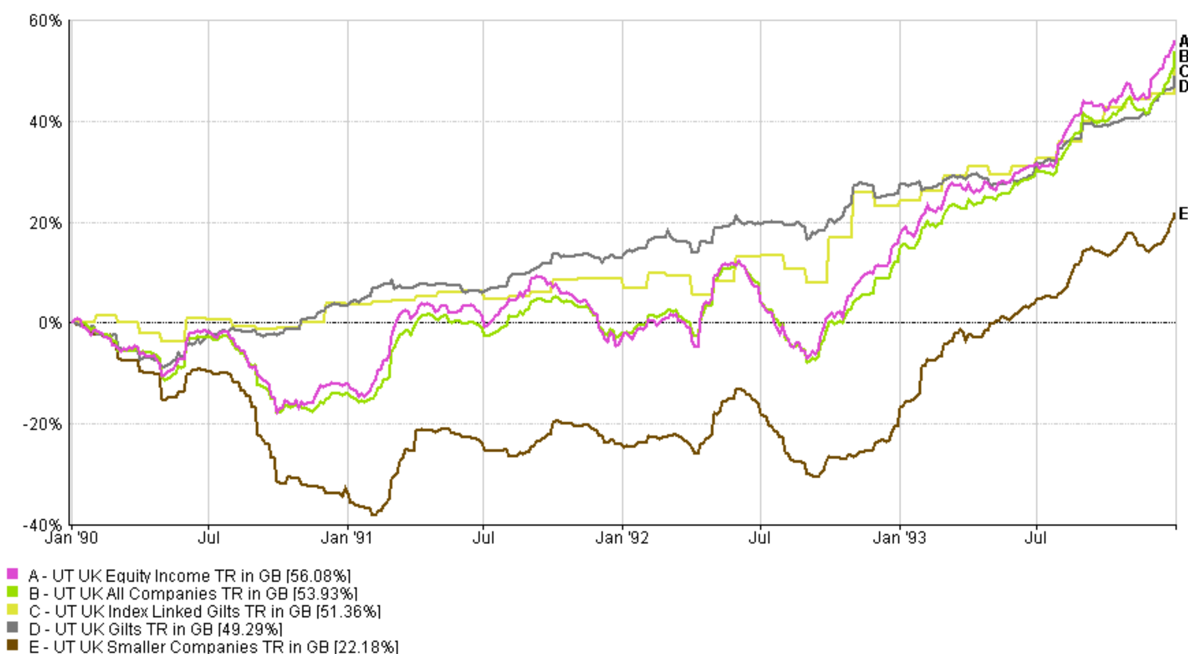
Lawson Boom – 1985-88 (cause of recession of 1990-92): House price crash of 20-30% between 1988-93. 40% of Londoners who bought homes in the 80s had negative equity at this point, caused by rising inflation triggering 15% interest rates ***(similar to current situation).***

Negative Reaction to Housing market crash	Positive Reaction
All real estate linked investments (REITS, Estate agencies, Development companies e.g. Taylor Wimpey,)	**Gilts** Maintain value when other markets plummet
Banks	**Healthcare & Consumer staples**
Retailers (Big hits to home improvement e.g. B&Q, Screwfix)	**Recovery funds**

Labour markets decline leading to unemployment.

Banks enter financial difficulties as house price drops lead to many banks needing to boost their capital ratios by reducing loan portfolios at the same time, lowering value of loans in secondary market.

Forex trade profits increase – Housing market decline -> Cut interest rates to encourage spending -> devalue of pound -> FX traders' short pound.



i) UK Markets 1990-94

1. https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/1981/commodity-prices-in-the-1970s.pdf
2. https://www.cityindex.com/en-uk/news-and-analysis/how-would-a-housing-market-crash-impact-financial-markets/
3. https://www.onlondon.co.uk/richard-brown-what-type-of-recession-is-heading-londons-way-this-time/
4. https://www.hl.co.uk/news/articles/2-fund-ideas-to-survive-a-recession

Past crises effects on house prices (UK used as benchmark)

1970: Average UK house price £ 4,057.00

Around 1/3 of population living in social housing provided by local authorities – alternative to home ownership.

1980: £ 20,268.00

Introduction of housing act (1980) – “right to buy” for tenants with turbo-charged discounts → councils had less money to keep therefore their ability to build new houses crippled

1983: £ 24,522.00

1985: £ 29,143.00

Under the initiative (from 1980) ~ 500,000 council homes had been sold

1986: £ 33,103.00

Throughout 80s there was deregulation in financial sector → Mortgages are readily available & lenders could charge whatever they wanted

1987: £ 38,662.00

1988: £ 49,319.00

Another housing act – enabling householding associations (HA) to source private money.

HA> councils → people start transferring to HA

1989: £ 58,887.00

Interest rate rose to almost 15 % → economy in recession.

1990: £ 58,162.00

90s subsequent fall & high interest rates led many homeowners to “negative equity” (= occurs when the value of real estate property falls below the outstanding balance on the mortgage used to purchase that property).

1992: £ 55,053.00

easily available mortgages → high demand for houses. Low supply due to low number of new houses. Both factors drove up the house prices.

1993: £ 54,121.00

from this year prices began to rose. Mortgage payments went from 1/5 of first-time buyer pay packet/wage to 1/3 within 10 years.

1994: £ 55,559.00

1995: £ 55,939.00

1996: £ 57,986.00

Association of Residential lending agents and four lenders launched a “but-to-let initiative” making it easier to invest in properties. This, falling interest rates and rising house prices persuaded investors that property market was a good place to invest for next 2 decades. This also added to rising prices.

1997: £ 63,085.00

1998: £ 70,313.00

1999: £ 77,961.00

New type of high-risk mortgage. Borrowers can take on debt equal to 125 % of the value of the property.

2001: £ 96,892.00

2003: £ 130,164.00

2005: £ 145,609.00 – £ 153,236.00

Politicians are concerned over loans that do not verify the borrower's incomes → new rules were made for this as this kind of loans were risky.

2007: £ 185,196.00

US Lehman brothers' filed for bankruptcy and started global financial crash. UK lenders took off risky products from the market and significantly cut their prices → Difficulty to get mortgage → people pushed into private renting.

2007-2008: £ 176,853.00

Credit crunch was felt across the country. Repossessions were kept in check due to low interest rates and also rules forcing lenders to do their best to help people keep their homes. This made it possible for investors with spare cash to invest in property with "cheap credit".

2009: £ 161,148.00

2010: £ 170,365.00

Growing population & low number of new houses build → high demand for housing.

Government announces "affordable rent" → making tenants pay up to 80 % of the market rent (far above social housing rates) would enable to build more new houses. Low-income earners struggled with high rent prices.

2013: £ 172,890

Launch of 2 "help to buy" schemes. One independent budget economist warns that this will push prices up but will have no impact on demand.

2012: £ 168,556

2014: £ 186,770

2015: £ 197,890

George Osborne introduces some tax changes on landlords:

- rax relief cut from 45 % to 20 % by 2017
- no longer automatic relief worth 10 % of the rent for wear and tear
- 3 % surcharge on second homes

2016: £ 211,725

2018 -2019: £ 228,354

Theresa May gets rid of council's cap on borrowing → boost house building capabilities.

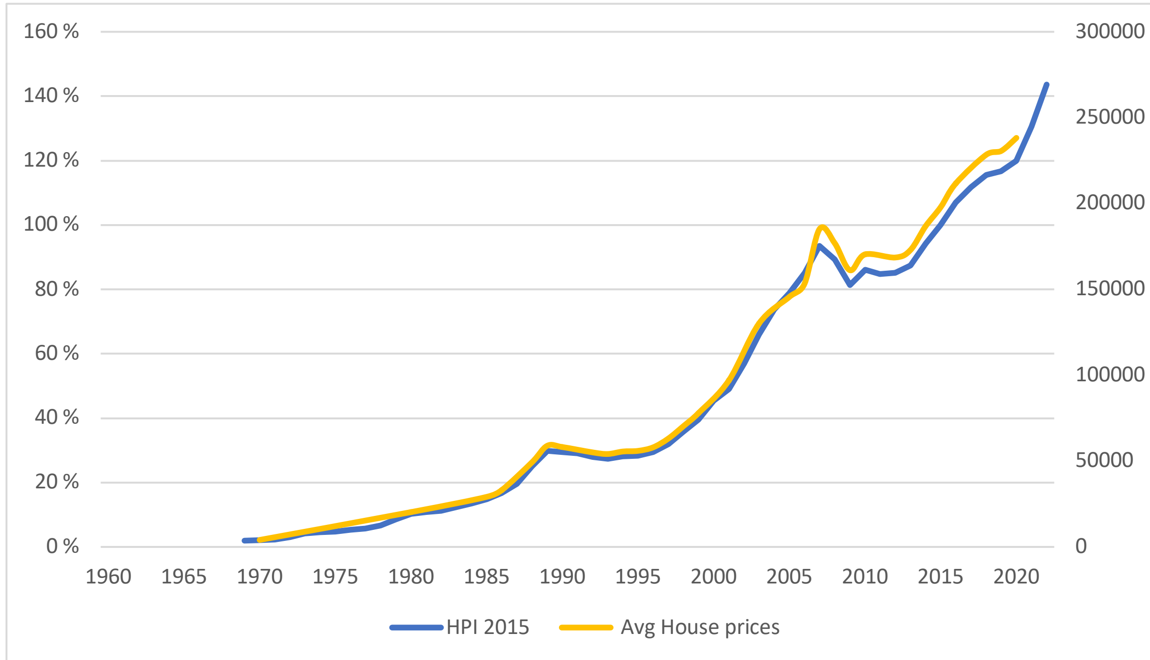
2019: £ 230,612

2020: £ 238,211

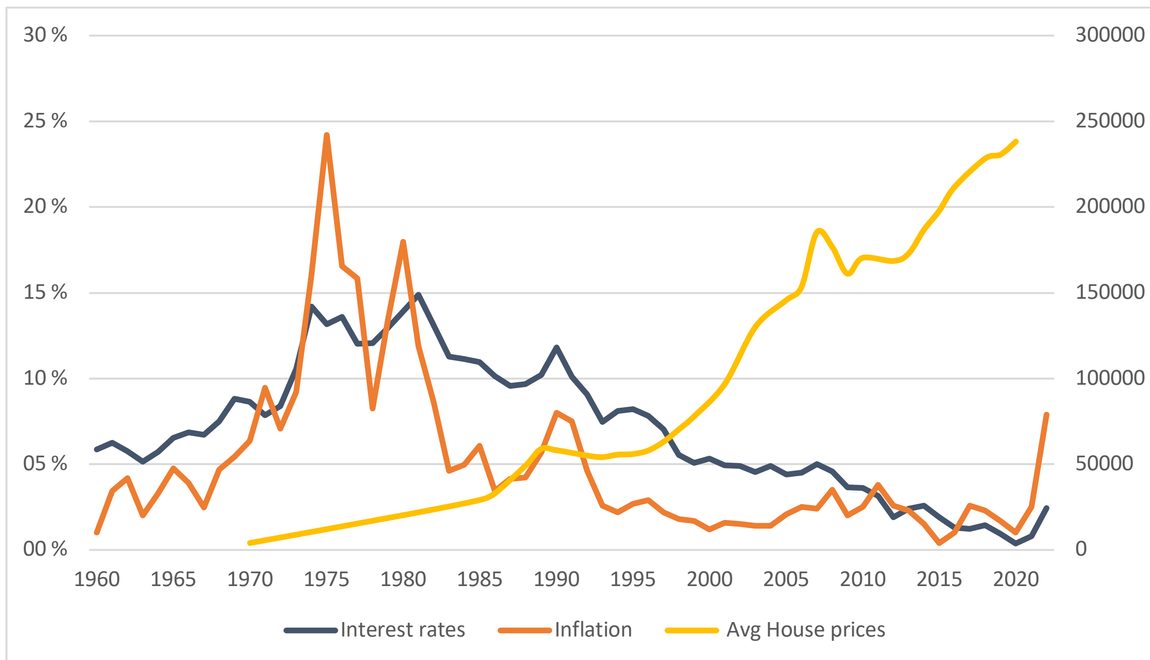
Covid aftereffects.

Visuals:

Using Average house prices and comparing them to HPI 2015 is explained below (1).



Data seems to be valid if compared to OECD HPI index with base in year 2015.
To put it in economic context next chart shows Consumer price index (inflation) & Long-term interest rates:



1. Article

Investment Solutions

Utilising the research in this paper we are able to look at what sectors have performed and not performed during a recession.

Top 10 performing IA sectors in the previous 3 recessions		
31/12/2019 to 30/06/2020	**31/03/2008 to 30/06/2009**	**30/06/1990 to 30/09/1991**
IA Technology & Telecoms	IA USD Government Bond	IA UK Gilt
IA USD Government Bond	IA USD Mixed Bond	IA North American Smaller Companies
IA UK Index Linked Gilt	IA Global Emerging Markets Bond Blended	IA £ Corporate Bond
IA USD Corporate Bond	IA EUR Corporate Bond	IA UK All Companies
IA USD Mixed Bond	IA USD High Yield Bond	IA Specialist
IA China/Greater China	IA Global Mixed Bond	IA Standard Money Market
IA UK Gilt	IA UK Gilt	IA North America
IA Global Government Bond	IA Short Term Money Market	IA UK Equity Income
IA Healthcare	IA Targeted Absolute Return	IA £ Strategic Bond
IA EUR Corporate Bond	IA Japanese Smaller Companies	IA Unclassified

However, it is worth highlighting that during these recessions the policy of governments has to be to decrease interest rates. At the moment the policy is exactly the opposite and so it may be that consideration has to be given to the fact that only a few countries, mainly in Europe and China, are effectively in recession. When will other countries follow?

Therefore, this outlined top 10 performing sectors happen during and afterwards, when coming out of the recession rather than going into the recession.

This would be supported though by the very poor performance seen in these sectors at the time of writing this White Paper. We continue to suffer the after effects of Covid, the reckless printing of money by governments across the globe, and the energy crisis caused partly by Russia and partly by the net zero drive. Supply side inflation from China has exacerbated all this. All of these to a greater or lesser extent have provided the ideal situation for creating a rise in prices which in turn has led to an increase in interest rates to combat inflation.

From a consumer point of view, it is much simpler; with costs going up and the real value of earnings going down the impact is on day-to-day life. As investors, the two major concerns at Aisa about our own portfolios are linked to inflation (interest rates) and China.

In reality, it maybe that the worst is behind us in many of the key areas above but that hardly provides re-assurance to people whose next question is, “I have lost money, and where do I invest to make it back!?”

Timing is not something that anyone can accurately forecast whereas trends are not so tricky. The trend is now to consider that interest rate cycles across the globe continue to rise but are potentially reaching / have reached their peaks. Likewise, inflation has been tamed in many countries (and remember that like for like inflation figures in each country are not possible as each country has their own way of measuring and presenting them).

Has the cost to the consumer fully fed through then? In a word, no!

For most of our clients their biggest asset is their home, and this is where there is always going to be a lag in re-action and prices.

And Bitcoin? Who knows but it goes outside the scope of this White paper as it is not a regulated investment and suffers volatility in excess of all the other assets. Along with the recent collapses of exchanges and current indictments and future talk of regulation, we simply cannot comment on it and would not therefore include it in our recommendations.

This white paper is about providing the facts which can then be considered alongside other factors.

Conclusion

This paper is based on key factors currently affecting most economies but not all. It has an immediate relationship with investment performance in the world. The MSCI World tracker index over 18 months is showing zero growth before charges are applied.

Timing is a consideration, but we do not know exactly where we are in an economic cycle until after we have already got there. Recessions are only recessions using past data!

The main learning point from this White paper is that property may not be a great place to be for the next few years; this may shock anyone who has seen the relentless rise in house prices for the last 30 years. However, the conditions behind that, easy money, easy access to money, low rates have likely gone in the short term. On the other hand, corporate bonds, fixed interest and gilts are normally a great place for recovery after peak rates have occurred. We are NOT giving individual advice to you, and you should seek further personal advice before making any decisions. Past performance is not necessarily a guide to the future!

Investors may consider the following sectors for investment albeit some of these may already be in an investment bubble.

USD Government Bond, USD Mixed Bond, UK Gilt, Corporate Bonds in all currencies all feature consistently throughout all 3 recessions which may surprise some. However, the returns may surprise even more as they can match equities at points.

Then there is also historically a bounce back in equity markets, which appear determined by a particular country individual make up in each recession. The first recession looked at in 1990/91 was led by the US and the UK. In the second in 2008/09 it featured Japan and in the third in 2019/20 it featured Technology & Telecoms which probably does not come as a surprise.

In 2023/24 it appears that this has been led by armament and energy companies due to the particular circumstances of these times. Whilst everyone's focus has been on things such as bitcoin and investment companies (manly in the US0 quietly a traditional engineering company since the beginning of 2022 has risen by over 160%; it's name? Rolls Royce.

Therefore, in each period it appears the White Paper conclusion is that the focus on short term investment hereon in has to be linked to what is normally regarded as lower risk investments linked to corporate and government borrowing, alongside particular current world requirements in equity companies. After all, long term results of equities surpass that of corporate bond and government gilts. Therefore, the strategy adopted should be considered as two different timelines – short term positioning and long-term planning.

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If you require individual advice or wish to make or change an investment please contact your advisor for investment advice.

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