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Quarterly Commentary Q1 2022

Jerry Powell, chairman of the Federal Reserve Board, says there are “some grounds for optimism” that a soft landing will be possible – in other words, inflation will be brought down without a recession. He cites, grasping at straws in short supply, 1963, 1984 and 1994 as occasions when interest rates were raised without causing a recession. To put it another way, it is a rarity. Central banks are in a bind. A year ago they were talking about inflation being transitory. The Bank of England was forecasting that UK inflation would peak at 2.2%; they are now forecasting a peak of over 7%. This looked complacent in the face of massive expansion in the money supply with quantitative easing and zero interest rates producing a magic money tree policy, coupled with post-lockdown supply problems. There was not much the central banks could say but platitudes, because their position is impossible. Interest rates were and are ridiculously low in relation to inflation. For 15 years or so, in which inflation has been around 2%, a policy which resulted in interest rates at about that level or less did not seem too bad. Now that inflation is well over 5%, the policy seems almost surreally inadequate and there is no prospect that it can be put right. The Fed in the US is expected to raise rates by 0.5% five times in this year, but even then short-term interest rates will be several percent less than inflation, and unlikely to have much impact on inflation. Other central banks are in much the same position. The result is that the most realistic prospect of getting inflation down is to have a recession.

We expect inflation to remain a problem. Karl Otto Pohl said that inflation is like toothpaste: once it is out of the tube, it is very hard to get back in. Inflation becomes embedded, and not in a nice safe predictable way but unstably. It requires a special mindset for companies to deal with it – a department of the corporate brain which has been redundant for the last two decades. It is also a problem for governments, with very high debt levels. Public and private debt in France is 361% of GDP, 289% in the UK, 205% in Germany. A rise in interest rates is cripplingly expensive for indebted governments, unless it is accompanied by inflationary growth in tax revenues resulting from continuous strong economic growth.

The invasion of Ukraine magnifies the instability. It is hard to see a quick end to the increase in food prices which stems from dependence of the world on Ukrainian crops which are not being sown. In parts of the world the consequence is not just inflation but famine. Meanwhile the dependence of Europe on Russian energy means that since the war in Ukraine began the EU has paid roughly €35 billion to Russia, despite all the sanctions and other measures. Providing finance to Russia on this massive scale does not seem likely to shorten the war. The Bundesbank has recently produced a study about the effect of any shutdown of Russian energy imports and concluded that it would cause a recession in Germany; the report was (according to newspaper coverage) written wholly in an economic context without any consideration of the consequences for Ukraine. The think tank DIW believes that Germany could increase its pipeline imports from Norway and the Netherlands, and could take conservation measures, which together would enable the country to do without gas from Russia. After Fukushima, the Japanese were able to cut their energy consumption by 20%, by turning down thermostats, turning off lights, and taking other conservation measures.

It is not a pretty picture. On the other hand – there always is another hand - there are mitigating factors. Employment is high, and there are savings: the consumer may be able to continue spending at a reasonably robust level. In our narrow investing perspective, there are plenty of companies with essentially sound businesses, strong balance sheets, and low valuations, contrasting with the still high valuations of companies with businesses that have had more pzazz (not necessarily profitable pzazz). The fall in the share price of Netflix in the last few weeks is a reminder of what can happen when the valuation of a company with an exciting business and expectation of everlasting growth rises to a level at which even the mildest disappointment in operating performance results in a stock market disaster. Icarus flies too close to the sun. But we will be on the look-out for opportunities even among the Icari.

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The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not necessarily a guide to future performance

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