



Holland Macro Views

Rejoicing as law and order is restored

“The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function. One should, for example, be able to see that things are hopeless yet be determined to make them otherwise.” Scott Fitzgerald

We consider the above quote an important one for today’s investors and market watchers. Many are fearful as to what the future holds, worried that high interest rates, inflation and cost of living challenges will erode the value of their investments. They are hoping for a brighter future than they see today. We want things to improve too. However, we also think seeing investors once again fearing the Fed and politicians fearing bond markets is a healthy sign of restored law and order.

It was overdue, needed and we are enjoying it.

Dodge City

Imagine yourself watching an old western movie. Dodge City has been an unruly place for years ruled by gangsters, thieves and speculators. The saloon does a brisk trade as does the house of the rising sun. The church is boarded up and the local sheriff is in the pocket of the thieves. When a new sheriff rolls into town cleaning it up you, the audience, cheer as he restores law and order. But what did the town’s population think? It may depend on who you ask. The old farmers and church goers of course welcomed the restoration of old values. But much of the town by then was made up of ne’er-do-wells. They liked drinking, gambling and other night-time activities. More than a few farmers’ sons’ heads had been turned away from ploughing and harvesting towards speculation and the easy life. Before we leave this story let’s assume that pre-law and order being restored Dodge City was 80% speculators and 20% old timers. The speculators had grown rich for years. The old timers by contrast had been side-lined, bullied and ignored. Which are you? Bear in mind only 1 in 5 readers can be traditionalists.

The consequence of the 2008 crisis

Investing markets post-2008 (or maybe before) could be seen through this Dodge City lens. Many investors (speculators) wanted the easy life. Lots of growth and nice low interest rates to enable cheap leverage.

The bailout of the financial system in 2008 had a number of consequences:

- The most obvious was lasting low interest rates
- Less obvious was the bail-out backstop. Central banks would be perceived to again bail out businesses or markets in trouble. This ‘Fed Put’ as it became known presumed central banks were too fearful of the consequences to do otherwise.
- Some weak companies survived that should otherwise have failed due to super low interest rates. Additionally, markets awash with capital funded projects that otherwise they would/should have not.

- Another consequence was the changing behaviour of many who relied or interact with markets. This included company managers, CIOs and politicians.
 - The latter group, politicians, found that with borrowing costs so cheap they could spend like never before, with seemingly no ill consequences.
 - As a result, bail-outs and generosity became popular policy when once it was frugality and sound finance

As Dorothy once said “*We are not in Kansas anymore.*”

Restoring law and order

Whilst we hope (and believe in) a brighter future, we are actually enjoying the reset to sound finance that is taking place. The restoring of old school law and order to markets and economics. Up to now too much investor chat during this market correction has been around the rotation between growth and value. This suggests it is some sort of fashion show with trends coming and going on a whim. More recent events point towards something bigger and more important taking place.

The FED and its determination

When Jay Powell was being openly criticised by President Trump only a few years ago it was easy to see him/the Fed as a shadow of its former self. The ‘Fed put’ as many describe it seemingly acted as a backstop for speculators. Under this idea the Fed would occasionally step in and raise interest rates, but importantly back off the minute markets fell too much. This gave many a speculator comfort. Whilst the Fed’s hands were tied post-2008 during a period when the financial system was fragile, today’s situation is very different. This is due to the strength of the financial system and strengthened corporate/consumer balance sheets. To think about this in Dodge City terms, there was a time when law and order would be hard to restore and a time when it was easier.

To see still strong consumer spending and good employment in the face of Fed rate hikes surprises many. It shouldn’t. This is a strong central bank doing what it should do, i.e., taking the punch bowl away when the party gets too rowdy. If the party stays rowdy, they do more, not less. The surprise for many investors is either because they have never seen this before, i.e. a central bank properly flexing its muscles or because they are still too drunk to see clearly what is happening!

For the last few years, we have all invested during a super-low interest rate environment. At the same time our sons and daughters maybe studied Economics at school. Their teachers having to rip up macro-economic text books as seemingly the laws of economics had changed for good. Well now those laws are being restored.

Is the Fed partly to blame for the inflation genie getting out of the bottle? Maybe. But at least now they are acting as they should. Might a recession result? Arguably it is now quite likely as central banks want to see a cooling in employment markets to ensure inflation does not become embedded.

Today’s Fed is being portrayed as some sort of Attila the Hun figure from an ancient past. Its actions harking back to old times; aggressive and unpredictable. We see its actions very differently. They are just fulfilling their mandate, including righting any policy wrongs they or others made during the pandemic. Importantly that does not make the Fed set on destroying the economy by imposing the wrong long term interest rate. This is a cycle, nothing more. Savers (*Farmers and Church goers if you will*) will enjoy higher interest rates on their savings. Speculators with too much debt will suffer. The speculators we note make much more noise!

[Gimme, Gimme Gimme](#)

After the 2008 bailout came the handouts. A combination of factors we think drove this:

- The first was with Government having intervened in economies once, there was an acceptance that they could (and should) do so again when events required it
- This occurred under the pretext of ‘well you used money to save the banks, so now why won’t you give it to us’
- These forces drove a temptation for Government action to help voters directly
- The fact that it came with seemingly no consequence or economic cost whatsoever (in terms of higher government borrowing rates) was very appealing to those in office
- What started as unfunded deficits morphed into cheques in the mail –and voters loved it
- We should be mindful that during this period whoever rose to political leadership positions were those who listened to voters and heard what they wanted i.e. direct help. They have not been those who prescribed tough love. *(Even if they were born farmers over time they had succumbed to the music from the saloon).*

Thus the fire was laid and Covid lit the touch paper. Once super-rare government intervention became commonplace. Business bail outs and furlough schemes came thick and fast. Politicians convinced themselves that a once in a lifetime event (Covid) justified such unprecedented actions. This belief was folly. For another ‘once in a lifetime event’ soon followed, Russia’s Ukraine invasion. European populations clamoured for their leaders to do something, so they acted fast, in a myriad of ways. But these actions have consequences and the consequences have consequences. As the war, real and of words/sanctions, escalated global inflation and cost of living spiralled ever higher. The political solution was not to reverse course on sanctions, or adapt policy in some way. Instead to use the new tool that voters loved. The one they had learnt came with little consequence. They would give more money away. This time for heating bills.

As investors rather than elected officials it is not for us to say any or all of these actions were definitively wrong or right. What we can now say with certainty is that collectively and over time they have consequences. Arguably those consequences just became very visible in the UK.

[This green and pleasant land!](#)

If the Fed is restoring law and order on one side of the Atlantic the bond vigilantes have been doing so on the other. Whatever came before in higher global rates or systemic cracks in UK pension fund derivative use, the Liz Truss mini budget brought events to a tipping point. Up until then markets had tolerated fiscal deficits, furlough costs and heating bill subsidies, but finally the damn broke.

Last week as the fourth UK Chancellor in as many months reversed almost all Government fiscal policies, he spoke directly to bond investors. He did so grovelingly, using the words ‘stability’ and ‘confidence’ over and over again. For a G7 country to be brought to this point is humiliating. It is also an important moment that investors should pay attention to. It did not just occur as an isolated incident, but as a consequence of much that had gone before. All leaders around the world should watch Jeremy Hunt’s presentation to Parliament while the new Prime Minister sat powerless and neutered next to him. These are quite possibly the new rules of the game. Any global politician thinking giveaways, bailouts and unfunded promises is still the way of the world may get a rude awakening. The other faction who will have watched UK events closely are past-bond vigilantes. Asleep for two decades they have now awoken. If they smell weakness elsewhere in the world expect them to pounce (Italy..?). Like the Fed, the bond market was once one of the global policemen politicians respected and feared.

*I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. **Because the bond market can intimidate everybody.**" Clinton political adviser James Carville*

We remind younger readers that the Clinton administration was in office between 1993-2001. The lowest yield the 10y US treasuries traded at during that time was 5%. Today, post a parabolic rise they yield 4%. In the old days, (before the gangsters arrived in town) bond markets ensured that governments who borrowed from them kept sound books. We welcome this return to old values. Whether Liz Truss and her polices were unlucky in their timing or foolish makes no difference. They were the straw that broke the camel's back. There will be no going back.

The old lady shows her teeth

As the UK Government U-turned in dramatic fashion the BoE showed some mettle. Clearly loosening fiscal policy whilst a central bank tightens monetary policy is far from ideal. At the same time for UK pension funds' to experience the explosion of what Lord Wolfson in his 2017 letter to the BoE described as "a time bomb" put the bank in a difficult situation. Yet another quasi-bailout followed with the B of E intervening in the gilt market. Then last week she said:

"we have announced we will be out by the end of this week. My message to the pension funds is you've got three days left" BOE spokesman on LDI intervention

This was also music to our ears. It was again a proper restoring of law and orderly markets. A central bank stepping in to ensure functioning markets, but quickly then stepping back. It was not underwriting others losses.

Unlike 2008 almost all important institutions are now strong enough to whether the consequences of their own mistakes in capital allocation. Any that might fail are not significant enough in size to cause unmanageable contagion. That is the key difference between 2008 and now and why central banks can be stronger in market defying actions if they deem it necessary. As politicians used their access to low-cost borrowing to let debt burdens rise it is now countries that may be asked questions by bond markets in the coming months and years rather than companies. Each one will be expected to react as the UK has done. Not all will comply. (In the appendix we show the UK Yield curve as of October 20th. Also overlaid is the same curve one week and one month before. The moves were unprecedented as many have observed)

Reason of optimism

Much of this actually makes us more optimistic 5y+ out than when interest rates were zero. The global economy needs a sensible interest rate and needs strong and respected financial institutions. If this stops some speculation that we have come to expect as normal, so be it. If it means some house prices are no longer viable at giveaway interest rates, so be it. Of course there will be consequences, there always are when cycles change.

Are you scared of high interest rates, why?

There is fear that the speed of rising interest rates will tip economies into some sort of Armageddon. Why would it? Markets and the Fed are now on a discovery mission to find the true neutral interest rate above and below which investment or employment is eased or expanded. Coming from a base of 0% this level was unlikely to be 1%, but nor will it likely be 8%. The speed of movement is only to try and stop any wage inflation spiral before it starts. This is a good thing.

We also observe, who really benefitted from 0% interest rates anyway? Savers didn't, nor credit card borrowers paying 20% APRs. Strong companies like Berkshire Hathaway and Exor could borrow at 1%, but did they need help? Some consumers were lucky enough to secure mortgages at 1-2% rates but any house-buyer assuming this was a long-term rate was a fool. Indeed, banks' lending at low rates had to stress test whether a borrower could afford the loan at 3% higher rates. Maybe the right neutral rate should have been 2-3% a few years back. Now it needs be higher to tackle inflation. As we stated earlier the borrowers shout louder than the savers!

Do interest rates of 1% or 4% make you think that differently about investing in Microsoft, Amazon or Ryan Air. If you were reaching for yield, by just comparing stock PE's with super low yielding bonds, maybe it does. But that shows the error of your investment approach nothing more. Absolute return focused investors do/did not think like that. As a result few have won popularity contests in recent years!

[The fear of lasting high inflation](#)

Whilst we are all right to have concerns over the possibility that inflation will be lasting in nature, it also falls upon us as investors to assess whether such an outcome is actually likely. Whilst this is a difficult question, if we were to conclude with any decent probability that inflation would not stay high, then our investment optimism might be markedly improved. Whilst we lean towards this view, in truth we think investors are wise to select companies that can prosper in all environments. (See our comments on Sustainable Competitive Advantage in *Holland Macro Views: Raining Gold + Unpeeling Amazon*.)

When thinking about the threat of inflation and thus lasting high interest rates we observe a few reflections that make us a little more optimistic than some:

- Almost all agree that the current inflation problems are “*rooted in the supply of good, energy and services*” as Lord Wolfson recently observed. He went on: “*Restrictions on the production of raw materials during Covid, along with the disruption of international freight routes, reduced supply which inevitably pushed up prices. These problems that might have been short lived, were compounded by the war in Ukraine and the exceptional increases in the cost of energy*”. **We agree with every word.**
- And those same supply constraints are now easing as factories reopen, port/shipping congestion reduces and container rates fall. Leaders are now also tackling this supply side issue We note some demand destruction accelerates this process further (#Semis/TSMC).
- Inflation surely only becomes ingrained if there is a spiral of wage and costs inflation that feed off each other. Whilst such a scenario is possible, it is far from certain. Indeed it is the threat of wage inflation that has arguably tipped central banks over the edge into aggressive tightening. Again we should welcome this concerted action.

[Vive la difference](#)

The other observation we would make is how different the global economy is today from that of the inflationary 1970's or 80's. Whilst there is some protectionism and nationalism creeping in of late the global economy is still dynamic and interlinked with products sourced from low cost producers. Additionally the powerful consumer facing business that dominate today are deflationary in their thinking. Costco, Walmart, Amazon, Alibaba and IKEA all get up each day trying to offer the customer a better (i.e. lower price) deal. We should think of this as a 'cost minus' culture. Capital invested in the likes of fibre or streaming also bring lower prices (Netflix/Spotify).

Having to raise prices in December “*really hurt us in our hearts*” **IKEA CEO**

The dominant businesses of the past were inflationary by comparison (Sears/Marks and Spencer/Telco's). These were 'cost plus' businesses run for margin not high volume at low prices. They had strong market positions not due to scale economics that they shared with customers, but due to a stranglehold on certain locations or customer relationships. Technology and the success of consumer-centric business models has been great for the customer, but it has also kept inflation under control.

Where inflation might be lasting is in old economy sectors that have gone through depressed capital cycles. The energy and materials sectors are easy to see examples. Airlines another. Underinvestment has been chronic due to a variety of factors. As such the future balance of supply and demand likely results in higher prices. However, even here we wonder if there is not a case for optimism Sectors like Airlines or Paper are small parts of GDP and inflation. Energy and materials are much bigger. But have the 2022 energy price leaps (that have driven inflation higher) not just been many years increases compressed into a short period? Does anyone think these commodities will be higher still in future years? Oil and mining could still be good investments due to constrained past investment in capacity while year on year commodity prices fall from 2022 levels. This would help inflation fall, not keep it rising.

Much is made of the low-cost production abilities of China and surrounding countries being a deflationary force. But this was only true because Next, IKEA, Primark ++ passed these low prices onto customers. Would a 1970's retailer have done the same, or just been happy to see their margins rise as a result of the savings? The changing relationship with China is seen to be inflationary. As we hear many a company talk of sourcing from Vietnam or Turkey we are less sure. China's cheap workforce also did not help Spotify charge less for access to music, or Schwab charge almost nothing for looking after our savings. These deflationary forces were partly a function of technological changes (i.e. the internet and fibre/3G speeds). **More importantly they were driven by the free market/competitive culture that built them. That business culture still exists today and is a far cry from the protectionist/unionised national industries that dominated the landscape in 1970 or 1980.**

In Closing

We all made a few (or a lot) of mistakes when interest rates were so low. As the environment changes we have to live with them and adapt. Seeing a part of your savings fall in value hurts. Seeing your mortgage cost rise does too. Pain aversion and recency bias tells investors to worry and react to such changes. We feel differently. Not only do we think investors need to be wired to be greedy when others are fearful. We also think they should welcome recent market events for what they are. A restoration of order.

"You pay a high price for a cheery consensus." Warren Buffett

With kind regards

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Appendix

UK Interest rate curve – Credibility restoration

- Middle line (Green) - As of 20th October 2022:--Day Prime Minister resigns
- Above line (Yellow) - One week before
- Bottom line (Dotted Green) - One month before
- As we press send (on 25/10) this curve is lower still due to UKs restored credibility under a new Prime Minister



Source: Bloomberg

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