

Gradually and then Suddenly

by Richard Parfect

Spotting dangers and threats can be a difficult skill; not least because they often hide in plain sight. The physical act of literally seeing a danger can require a deliberate act of searching it out. For example an object such as a car or aircraft you are on a collision course with is often masked by the fact that the relative angle between you is constant, thereby it appears stationary. If the eye does not detect an angular change then it can be literally blind to it until the final moments before impact when its relative size in your field of view blooms to a large size, at which point evasive action can be too late. It is due to this optical phenomenon that to spot the danger we need to move our head around in our scan to create an angular change for the eye to spot.

Just like in Ernest Hemingway's novel "The Sun Also Rises", the character Mike Campbell was asked how he went bankrupt; "Two Ways" Campbell replies, "Gradually and then suddenly". Essentially the factors had been in place for a long time but their insidious effects only showed themselves in the final moments of his financial demise.

We are now witnessing a similar situation with this current "inflation shock". While Central Banks are hoping (with diminishing credibility) that it is short term and transient, we can point to a number of factors that have been present for many years but are only now revealing themselves. Whether, we are talking about an insufficient (in size and skills) workforce, the supply of which was artificially (and unsustainably) boosted by low cost immigration in the service economy, a demographic retirement bulge in lorry drivers, commodities that have been mis-priced against their hidden costs (e.g. carbon embedded within fossil fuels), a supply chain that was so stretched to maximise "efficiency" that it lacked any level of resilience to cope with shocks (blockages in the Suez canal, chip shortages for car manufacturers, insufficient warehouse space to accommodate "onshoring" of production and storage). All these

factors have been present for many years, and while it may have taken COVID amongst other things to trigger the inflation shock but the foundations had already been laid.

Having been mindful of this risk through the years of Quantitative Easing and the build up of structural risks, we became increasingly concerned about inflation early this year. It is for this reason we had already built up a high level of knowledge and understanding within our Specialist Assets or, "real assets" as some commentators call them. This portion of our portfolio generates income streams, much of which is implicitly or even explicitly linked to inflation, but without having to pay the very high prices of government index-linked bonds. Diversifying across real estate (REITs), infrastructure, specialist financial and asset backed lending trusts and even private equity, has resulted in a portfolio of assets that are not intrinsically linked to headline short term GDP expansion or significant counterparty risks of default.

Our inflation defences are further bolstered by an allocation to physical gold and gold mining companies. The yellow metal has been valued for its wealth preserving qualities for millennia. While gold suffers the flaw of failing to pay an income; this is of little concern for the moment as governments and central banks grapple with how to combat inflation that will not necessarily respond to any future increase in interest rates. Financial Repression; the act of allowing inflation to run without hiking interest rates above it and thereby deflating the real value of government debt, could prove to be that stationary dot on the horizon.



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