THE 60/40 IS DEAD!
LONG LIVE INFLATION...?

wealtra

INTRODUCTION

In 1981, the US Fed Funds rate rose to just under 20%, with commodities having been in an explosive bull market, bonds being devastated and equities rising, albeit with significant volatility, but failing to maintain real values with inflation.

I recall, as a young independent financial advisor in the late 1980's and early 1990's in the UK selling 5-year Guaranteed Income Bonds issued by life insurance companies, yielding 10.5% p.a. net of the basic rate of tax in the UK. The Bank of England base rate had hit 14.375% at the end of 1981, and after a brief respite was back at 14.875% at the end of 1989.

Commensurate with the fluctuations in interest rates, was of course the cyclical fluctuations and secular trends in inflation. Looking at a longer-term table of US inflation as represented by the Consumer Price Index, one sees some interesting numbers standing out. In 1918, at the end of World War I, US CPI hit a high of 20.7% in November, the month the war ended. Whilst most peoples' recollection of lower rates was the Great Depression of the early 1930's, US CPI in fact collapsed to -15.8% in June 1921, and remained barely positive until 1931 and 1932 when the average inflation for both those years was -9% and -9.9% respectively.

Since those days, a standout is World War II where, considering the tumultuous historical period, and a spike to 10.9% inflation in 1942, inflation then dropped back to as low as 1.7% in 1944. The next most relevant period was of course the 1970's inflation sparked by the abandonment of the gold standard, Vietnam, the Middle East and oil prices. Inflation rose from a low of (an average of) 3.2% in 1972, to a Paul Volker target of 14.8% in March 1980, averaging 13.5% in 1980, the result of which the Fed Funds rates were tightened aggressively into 1981.

Since those heady days of 1981, interest rates and inflation have trended down, with a brief, Quantitative Easing braked -1.4% in June 2009. We have seen the Fed Funds Rate barely above 0.0%, for much of 2010 to 2016, but noticeably we have seen an enormous move higher in the rate to 5.33% recently, and what might at worst be an initial spike in inflation from what, without Central Bank intervention, would have been significantly negative levels.

So, What's The Point of the Story?

Well, the point is really best described by Isaac Newton, and not simply what goes up must come down, because of course financial markets are much more complex than an apple falling off a tree.

The most relevant of his three laws would be a paraphrase as follows:

"A body remains at rest, or in motion at a constant speed in a straight line, except insofar as it is acted upon by a force."

If one takes a look at a chart of the 10 Year US Treasury (please do so at your leisure), one can see that since 1980, the 10 Year Treasury has been pressured by a multitude of different forces, and these forces concluded in a very clear straight line (within a defined channel) of lower yields and higher prices….. until March 2020.

In March 2020, something very dramatic happened – firstly, the yield on the 10-year bottomed at just under 0.40%, and secondly, just over a year later, the yield appreciated above 2.30%, marking the top of the trend channel that had been in place since 1981, or more specifically since 1987 when the clearly defined channel commenced. Yields are of course now closer to 4.6%.

So, after nearly 40 years of declining yields (and inflation) and rising bond values, a very significant yellow flag has been raised. A different force may be at work, and this poses a significant challenge for wealth managers as they consider the Strategic Asset Allocation of their clients' portfolios.

After all, if a different force is at work, then it is quite likely that the comfortable era of the last 40 years may be over, and the collective affect of these new forces is, as Newton put it, to direct markets "at a constant speed in a straight line" in precisely the opposite direction to which investors through habit and rear view mirror analysis may be looking.

The 60/40 Portfolio

The essential principal of the 60/40 allocation is to provide for the potential growth offered by stocks (60% of the portfolio) whilst also providing the stability and income of bonds (40%), which further provide a buffer to the volatility of the stock portfolio. This is the core allocation principal that underpins the Strategic Asset Allocation (SAA) of most private client portfolios, and indeed with some variations, the institutional portfolios of life insurance companies and pensions funds, with variations for different liability durations and risks.

The basis of the 60/40 Portfolio has further extended itself into the realm of private markets, especially Private Equity, Credit, Debt and Real Estate, asset classes that have benefited immensely from cheap cost of funds, and disinflation. These asset classes, highly risky in their own right, have that risk leveraged with financing which if the costs remain high and continue higher, could see immense damage unfold.

The 60/40 Portfolio has worked very well in the last 40 years – a big pat on the back in hindsight, but pats on backs and hindsight are usually somewhat rear-view facing investment methodologies. This successful asset allocation strategy has been predicated on a bull market in both bonds and equities supported by disinflation and falling

interest rates – the critical question for portfolio managers, and even more so their clients, is the question of what will happen if at least one of these variables breaks down, and of course the most important variable is the cost of credit and its accessibility, i.e. inflation, interest rates and by default bonds.

If this dynamic has changed, if this force has changed and the direction of travel is changing, then a rethink of the SAA must take place, with the threat or primary concern being rising inflation. I still remember the days when we spoke to clients about real returns, and protecting the real value of assets against inflation, whereas for the last 20 years or so this pitch has been dumbed down to "how much money can you make me!"

A look at investment research from institutional desks is flagging inflation, and further "waves" of inflation as the new threat or risk that needs to be managed. With the current geopolitical risks and rampant Government deficits globally, this threat seems to have a growing probability of coming to fruition, and yet the debate in the private wealth management sector is limp at best.

Conclusions

The fear for most private wealth managers, is that to stray from the herd can be catastrophic. The comfort zone is to stay put, and potentially lead the flock to the wolves. Some will survive, but history has shown that at significant secular changes in trend, there has been an enormous transfer of wealth to those who are flexible and adaptable, from those who are set in their ways and fail to act.

The challenge for wealth managers and their more sophisticated clients and family offices is do they stay with the herd or do they do more of their own independent analysis, evaluate the risk and evidence more comprehensively, and assess the research of those asset managers who have demonstrated the necessary adaptability and flexibility, and see how they are positioning themselves.

The big question is, as Clint Eastwood put it, "Do you feel lucky…Punk". As one asset manager put it, "What if you are wrong!" to which the retort is clearly "What if YOU are wrong!". The question nevertheless needs to be asked, the answer may be radical SAA shifts for some, less radical adjustments for others, or staying with the herd, no doubt for most, but as a wealth manager, one should have a fiduciary duty to discuss the risks with one's clients and allow them to make informed decisions based on the evolving environment.

It is a potential problem that is well past its time for a more open debate, and perhaps for some, some action to be taken.

Whichever way one turns, may the force be with you!