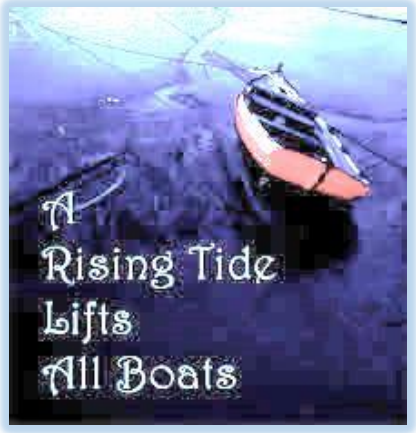

Interesting times.
Bond markets are out of the cage, off the deck, ready to rumble.

This week feels like another one of those big calls that investors have faced over the last year, and in many ways much less obvious. Forget the chatter, it is the bond markets that are now back in charge. While upsetting Californian law makers and the SEC is small fry for Musk and Tesla, the bond markets will just roll over him. They are the gorilla in the room, for all those frothy tech valuations.

Bond holders are just dumping the stuff as fast as they can; like tectonic plates they move slow, but like any earthquake, you get the sudden shift, then the aftershocks, and then it will all settle down. But the landscape will have changed.

What has woken them up? Well inflation and the conviction that the colossal election bribes handed out by Joe Biden will cause inflation to go over 3% and perhaps, as important, possibly stay there. It is the *stay there or persistency risk*, we are looking at. We can all see a short-term inflation spike, from commodities and logistics snarl ups.

Now, everyone (including us) have been focused on excess capacity and deflationary forces. Indeed, as we keep being reminded, over 10 million Americans are out of work, but for some reason the nasty bond markets have decided giving those citizens jobs is not the priority.

So, the naïve equation Powell (at the Fed, who I keep reminding readers, is not an economist by training) is working on, is if you stuff 20% of US GDP in one end, all of course borrowed, out pops nationwide low paid jobs, focused on the low skilled workforce, by the ten million or so. That's the bit which is no longer credible.

It seems more likely all that stuffing is instead creeping into asset price inflation, with virtual currencies attracting a lot of speculative flows and likewise hot stocks, be it SPACS or GameStop. None of these areas provide much of the required nationwide low skilled employment.

A detailed look at the UK employment statistics

So, what is happening? Well, a more detailed look at the labour market in the UK (not the US), provides some clues. My source is the Office for National Statistics, February Labour Market report. Not a bad date, as the year-on-year figures are clean; from the March one onwards, we will have the COVID shocks in the annual comparator.

Who is hit the hardest?

The employment crisis is hitting the young hardest, under 25 employment is dire, of the job losses year on year, 58% were in those below 25. While we have both lower employment (so people exiting the labour market) and also higher unemployment (so not working, but available). Noting that furlough for these purposes remains classified as employed, which is a little moot.

But here is the first paradox, wage inflation is also very apparent, hitting 4.7%, which is recorded as 3.8% above actual inflation, so a pretty high real rate. Now that's not causing deflation at all.

While the furlough impact, doubled to December (from 5% to 10%) of the workforce, and no doubt has now gone up again, with the arts, entertainment and recreation industries (sic) and food service industries, each have over half their workforces on furlough.

So, while the claimant levels has been stabilized quite well, we see relatively low levels of actual employment, but with the secure workforce getting good pay rises, well over inflation, and those in less secure positions, or who are younger or in the wrong sector, hit hard.

Should preserving capacity be the real concern?

The assumption then is that the labour market is clearing, indeed faces inflation, for those in work, but for those who are not, there is a big presumption that the leisure sectors will bounce back hard and take up the slack. You wonder if just more money across the board, is the right way to tackle this specific problem. Oddly if this was in banking or steel, a targeted approach aimed at preserving *capacity* would now follow. Time to rethink that?

This two-speed position is also apparent in other Government statistics, tax gathering is going well, self-assessment returns were *higher* than a year ago, and total tax returns only marginally lower due to reduced VAT income from the leisure sector. The strain on Government finances is on the other side, excessive spending, not reduced tax. There inflation via fiscal drag, is already working its magic.

What the bond market is afraid of

So, the bond market fear is that more of the stimulus will go to the "wrong" places, than the "right" places, creating inflation in areas that are already running hot. Not that it really cares of course. While Central Banks have apparently decided they no longer think about money, just the jobs market. Which is also odd, because they have so little control over it.

Indeed, the heavy political pressure in the US to sharply raise the minimum wage, must work in the opposite way, as must the surge in automation and home working. It is noticeable that when Trump tried to turbocharge labour markets with a tax cut, we had a pre-emptive rate rise from the Federal Reserve. Clearly this time round Yellen has told Powell that if he tries that stunt again, he is out.

So, what do investors do?

We did not expect this rise in rates so soon, but nor do we see it automatically stopping, as Powell has clearly said he won't intervene more to hold rates down, nor will he acquiesce by raising overnight rates. Broadly rising rates, with rising inflation is good for equities, but the end of free money is less good for the out and out speculators, who can gamble on trivial things, without a great deal of care.

It is these periods of cross currents, short sharp movements, that are toughest to navigate. While the first order effects will be in falling bond prices and the badly overvalued tech markets globally deflating; so, all of that stuff with inflated multiples or no sales. But the second order impact will be on equity markets overall and on currencies.

At some point if you can get a nice return in bonds, even better a *real* return for holding them, there is a lot of money heading that way. It is a finely judged switchback, taken at speed, if they raise rates and then find inflation (and employment) actually starts to fall, the Fed can again wreak havoc by going too fast.

While elsewhere boring may in the end be best, especially in well run financials. There is an old market saying that a rising tide lifts all boats, but perhaps not electric ones?

Our own performance

Our own VT Global Total Return Fund, has now had three distinct patches of outperformance, in the last year, as against behemoths in the Absolute Return space.

Which is odd, one such would be fine for us. It is of course partly good timing (for whatever reason), but it may also be that small, focused funds like ours, can simply turn that much faster and make the needed adjustments more quickly, which then generates patches of outperformance.

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