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Taking the (not so) long view

by Robert White, CFA

The latest elevated CPI print of +7.5% has spooked investors this year, triggering volatility in both bond and equity markets. In trying times, it sometimes helps to take the long view. In a recent paper the Bank of England has taken this advice to the extreme, looking back 800 years to the 14th century to calculate the average global GDP-weighted inflation rate of just +1.51%[1]. Unfortunately, 800 years is not a particularly sensible investment horizon for most people, but there are plenty of other more relevant periods for us to examine when considering the importance of current economic events.

We "only" need to go as far back as 1982 to find a period where inflation in the US has been at the levels we see today, and of course back then the US economy was in a very different place. First off, unemployment was +10.7% by the end of that year with manufacturing, construction and auto industries hit particularly hard. Today unemployment appears under control at +4.0%, and much of the job uncertainty has been in leisure and hospitality sectors due to Covid-19.

Inflation was also coming down from a much higher point in 1980 when it peaked at +14.8%. Price stability was in fact not explicitly part of the Fed's mandate until the Reform Act of 1977, and Volker's appointment as Fed Chairman in August 1979 signalled a change of course for monetary policy. Under Volker, the Federal Reserve raised interest rates as high as +20% in 1981, and by 1982 they were on their way down as the worst of the inflation prints were already in the past. Today we are in a much easier environment with interest rates at +0.25%, and we are just at the start of a hiking cycle. While no one expects rates to reach the highs of the early 1980s, there is uncertainty ahead as to just how far the Fed will go.

What about markets? The early 1980s were famous for "Volker's Bear" as the steep increase in rates resulted in a long-term bear market decline from November 1980 to February 1982. Today equities have bounced strongly from their most recent bear market in 2020, but we have seen some volatility this year as the S&P 500 was down +5.2% in January. Such periods can feel painful for investors, for a number of reasons.

The first reason comes down to human psychology. Prospect theory is a field of behavioural economics which scientifically describes how individuals assess their losses and gains asymmetrically; the pain we experience from a loss is greater than the pleasure we derive from an equivalent gain. This doesn't seem to make sense if we behave completely rationally, however it can be understood anecdotally as many of us can relate to the pain of having something we value taken away from us. The truth of this fact is not merely anecdotal; Kahneman and Tversky formalised this principle scientifically, and the former won a Nobel prize for his work[2].

Secondly, the decline in January has come in a period of relative calm for markets, and so has felt particularly sharp. Over the last decade, the S&P 500 has averaged +15.4% return per annum with a standard deviation of +13.2%. Again, we can look further back at history to compare these numbers. Since 1927, the average return has been lower than the last decade at +9.7%, while the standard deviation (a common measure of risk) has been higher at +18.7%.

While investors cannot control their natural behavioural instincts, nor the overall direction of markets, we should focus on what we can control. The best way to deal with market volatility is to hold investments over the long term and to diversify risk optimally across a range of asset classes, regions, styles and companies. This is what we do on a daily basis for our clients, making the journey as smooth as possible through these tough periods.

1 https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2020/eight-centuries-of-global-real-interest-rates-r-g-and-the-suprasecular-decline-1311-2018
2 Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. Econometrica, 47, 263-291
All other sources taken from Bloomberg Finance, L.P.

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