The Time Value of Money and What if the Trend of the Last 40 Years Reverses in 2021? (Part 2 of 2)

Last year (well, last month actually!) I talked about the time value of money - the idea that money in the future is worth less than money in the present.

See part 1 here

I noted how we have been in an odd period, where that gap in value between today's money and tomorrow's money has narrowed relentlessly to the point where sometimes tomorrow's money is considered to be worth more than today's (We are talking about what negative interest rates really mean).

This month I consider what happens when that trend reverses.

Interest rates are far, far lower than their 300-year average right now.

So a borrower - which can be a government, or your high street bank (when you deposit money with the bank, you effectively lend your cash to the bank), will usually have to offer you a return that at least keeps up with inflation, and more typically, slightly more.

For example, according to research published by the Bank of England's John Lewis in 2018, a ten-year UK government bond has typically paid the holder a real interest rate of 2% - 3%. That is the average over the last 300 years or so.

In other words, with inflation at 2%, the ten-year gilt would, on average, yield a bit under 5%.

Things have, however, changed drastically since the financial crisis in 2008.

In the decade running up to the end of 2007, the average real interest rate on the ten-year gilt was just above 3%. In the decade since then, it's been just under 0% (about negative 0.1% to be more precise).

Why is that? Why would you accept such a massive drop in the real return on your money?

The most obvious answer is because you expect things to get even worse.

2008 was a huge deflationary shock and ever since then, much of the global economy has teetered on the brink of deflation.

Markets are all about expectations.

If, as an investor, you expect inflation to turn negative in the future, then you might be happy to buy a gilt yielding 1% at a time when inflation is running at 2%. While 1% might look poor now, you'd rather lock it in because it will look good in a year's time, say.

Rather than all that faffing about with yields, equity investors might prefer to look at it this way;-

You buy the bond at what looks like an expensive price, because market expectations, the general backdrop, and pure momentum, lead you to believe that its price will go even higher.

Of course, all this talk of market expectations does ignore the fact that central banks have been buying bonds at any price offered for this entire period. The market is also underwritten by that promise (although it's worth noting that during periods of active quantitative easing (QE), bond yields have in fact tended to rise, as investors become less risk averse, and have increased equity holdings).

Anyway, that's what's happened in the last decade or more. Investors have bought into the "secular stagnation" theory - the idea that strong economic growth is mostly a thing of the past, and that what we all really need to worry about now is turning into something like 1990s and 2000s Japan.

In short, they have been betting that tomorrow's money will be worth pretty much exactly the same as today's. But what happens if that changes?

Even if inflation rises, interest rates might not.

Let's suppose that inflation and economic growth surprise on the upside. Let's say it turns out that secular stagnation is wrong, and that the "new normal" was just a blip in the course of the "old normal", mostly resulting from the painful healing process that always follows a long drawn-out banking crisis.

What would that mean?

With inflation rising, one thing it would mean is that the gap between the value of today's money and that of tomorrow's would start widening again. And investors would start to demand compensation for that.

A saver might accept a negative real return today if he thinks that inflation will fall tomorrow, but he definitely won't accept it if he thinks inflation is going to rise.

So that's quite a dramatic shift in market psychology.

The assets that typically benefit from rising inflation expectations, commodities and other real assets are the most obvious ones, and are not the same as those which benefit from collapsing inflation expectations.

With rising inflation, the most vulnerable asset has to be anything that pays a fixed income.

The value of a piece of paper that promises to pay a fixed payment of £100 a year will go up if you expect inflation to fall, but it will drop if you expect inflation to rise.

That's what the bond market is facing if inflation rises.

However, the other big question is: will interest rates rise? And this is where it gets trickier. Put simply, governments can't afford for interest rates to rise, so they won't let them - And they have many tools available to allow them to do that.

It creates an interesting scenario, though.

Both interest rates and inflation have been falling in recent decades. We're now moving into a scenario where we may see inflation rising, but interest rates held static.

What happens then?

Even if interest rates remain low, rising inflation will reduce the value of the big promised future cashflows from the likes of Tesla (that we highlighted last month), and increase the value of actual real-life cashflows right now, from the likes of the oil companies, say.

To my mind, that implies that the switch from "growth" to "value" has genuine legs. (Perhaps imprecise terms, but they sum up the point I'm trying to make.)

It also implies that investors who are being denied a real return in one portion of their portfolios, might try to compensate for that by overweighting sectors with a proven defence against inflation - such as commodities - compared to what has been their historical allocations.

But remember, (and the message will be the same in 2021 as it has been for many years), a balanced portfolio and a long term view is designed to iron out those inevitable kinks that appear along the way within parts of your overall portfolio - Making short term decisions on a long term plan often have negative consequences - So always look at the bigger picture and remain committed to the long term plan.