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To debt or not to debt?

As a reminder, cash and debt are two sides of the same coin. Although counterintuitive, when interest rates go up fixed interest funds decline in value because they are priced on the predicted rate of interest going forward. If that changes in the wrong direction (e.g. interest rates go up), as we have discovered dramatically over the last 18 months, the other unpleasant side of the coin is that fixed interest funds fall in value.

If you hold cash on deposit the bank is allowed to lend it out, which is fine so long as we all have confidence in the bank. The same is true of governments. If we put cash into National Savings, Premium Bonds or government gilts, the Bank of England has the ultimate authority to print as much money as it likes and therefore, if we have confidence in our banks and currency, all is well and good. However, as the Turkish are finding out, and as Britain found out in September last year, when the world turns against your currency, cash becomes very volatile and extremely risky. Not only was this true when Northern Rock went bust in the great financial crisis of 2008/9 but in the last year, the collapse of Credit Suisse, (one of the worlds, largest and so-called most respected banks), let alone the smaller banks in America, reminds us that there is no such thing as a safe bank or indeed safe debt; which for most people means what is referred to as fixed interest investments. This does not mean we foresee an imminent threat to the UK banking system; we do not. Rather this is a reminder that there is no such thing as an ***absolute*** guarantee.

Part of the current problem for developed economies is that (with the benefit of hindsight) too much money was created during the Covid-period and not withdrawn quickly enough. Neither were interest rates nudged upwards quickly enough to head off the inflationary effects we are now all suffering. Indeed "fixed interest funds" have in the last 12 months been as volatile as equity investing, and yet traditionally we are all taught that these are a lower risk, less volatile investment asset.

Rising interest rates, far from giving us comfort that we can put cash in the bank and expect reasonable returns, is actually giving everybody significant worries because interest rates are still behind inflation. If interest rates go up even more then fixed interest investment values will come down and will perform less well against inflation - both in the short-term and definitely in the long-term.

In addition, the higher interest rates rise, the more stress there is on certain parts of the market, particularly for mortgage borrowers. The knock-on effect in the property market (because banks have possibly lent too much) is that if house prices fall then the security for the banks becomes even more challenged which could lead to more defaults. The Bank of England now has the very challenging dilemma of trying to control inflation without causing too much stress in the market.

Inflation is wonderful for devaluing debt. When the price of everything goes up as companies are forced to pay higher wages this translates into higher prices. So too the price of raw materials goes up which again translates into higher prices. What ultimately keeps pace with inflation, as you all may know, is equity investing. On the other hand, where inflation remains significantly above mortgage rates, which is true even now, the real cost and value of debt falls much to the benefit of home-owning middle England. As wages rise even a mortgage that seemed monumental at the time, as in the 1970s, can become affordable relatively quickly.

The dilemma in the short term is to know whether it is best to be in cash and wait for markets to settle down or indeed to be in the market and be patient and wait for the inevitable recovery which has always, in the end, materialised. Lower energy costs and the phenomenal amount of money going into infrastructure, technology and artificial intelligence all speak as to why your portfolio will perform very well, in spite of the pain of short-term debt.

A recent study shows that if you had invested £1,000 in equities over 25 years you could have received a return of £6,703. However, if left untouched and if you missed 40 critical days within that 25-year period, the return would shrink to £1,540!

Political naivety around the world is always and everywhere an investor's nightmare. We have just lived through another debt ceiling crisis in America, and in the back of our minds we know this must unravel at some point. In the UK we had the spectacularly illiterate events of Truss and 'Kamikaze' in the autumn, and somewhat amusingly Rachel Reeves and the Labour Party suddenly realise that the idea of creating £38 billion out of nowhere is not going to be a happy prospect for markets if Labour win the next election, potentially leading to the same sort of tailspin we got into last year.

Until recently, (well, 2008 when queues extended around the block from branches of Northern Rock), it took some time for a bank-run to unravel: at least a weekend or longer. But, as we saw in September and through the Autumn and Spring of this year, in both America and in Switzerland bank-runs evolved instantaneously and without friction as accounts online moved money fast without having to stand in a queue to draw physical cash to move from one place to another.

The next enormous dilemma for cash and debt is the speed at which technology in the form of artificial intelligence has influenced our way of life, materialism and our internal value structures; especially around climate change, health-risk, ageing populations and armed conflicts to name but a few of the immediate events we are all grappling with at the moment.

The conclusion, therefore, that we have come to at KMG is to remain circumspect, pragmatic and cautious about debt; to invest only in those things we think are reasonably flexible, liquid and accessible while at the same time concentrating on equity investment which, however volatile, has survived inflation, political collapse, wars, climate catastrophes and ultimately produces the bedrock around which we can all remain reasonably financially secure - as some of us remember only too well from the 1970s and 80s!

The KMG Team

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