What could possibly go wrong?

In recent years, the pound has fallen, credit spreads have tightened, bond yields have collapsed and stocks have soared. It has been a perfect storm for UK investors that has flattered returns. Now imagine a scenario where the pound recovers, bond yields rise, credit conditions deteriorate and stocks fall. After eight years of relatively plain-sailing, it's not only possible, but probable.

Whichever line of reasoning you chose to follow, all roads return to the bond market. Bond yields are low as central bank policy that has outstayed its welcome. It was introduced as an emergency measure at the depths of the banking crisis, yet continues in a world of essentially full employment. Just as many were puzzled when asset prices soared in 2009, while the economy remained gloomy, so many will be shocked as they collapse, when the economy has recovered.

Low yields have bid up asset prices, not only because of the fall in the discount rate, but also by appearing to boost profit margins as the cost of debt falls. Companies that generate strong cashflow have been some of the biggest beneficiaries. While they appear to be fairly valued on a free cashflow yield basis, they are in bubbly territory when viewed via old fashioned metrics such as price to sales or price to book. In addition, many have raised debt in order to buy back their own shares; something that has become fashionable in a low rate world. If bond yields were to rise, the cost of servicing their debt would rise which would damage those artificially, and elevated, margins. As the discount rate rises, these companies will feel the pain twice over.

What could cause bond yields to rise? The obvious answer would be inflation; something most investors believed in five years ago, but few do today. The popular narrative is that global trade has kept a lid on the price of goods and the free movement of people has held down wages. Yet with unemployment flirting with historic lows, the pressure on wages will likely rise.

The other driver of inflation is energy. You could say that economic growth is directly related to the amount of energy that society consumes, whereas the price of energy reflects inflation. With the boom in US production, oil has become cheaper and many believe that will potentially last into the distant future. Yet much of US shale's financing comes courtesy of cheap credit, and so once again, there is a virtuous circle that has its roots in cheap credit. If that's not enough, then consider that the long-term levels of investment in conventional oil exploration have collapsed, and at some point, that will turn around and bite us. With global oil demand soon to pass 100 million barrels per day, can we afford to be so complacent?

There's perhaps over-confidence in the potential for renewable energy. Despite good intent, it is an expensive and unreliable source. An efficient and prosperous economy needs a continuous supply of cheap energy. Renewables are neither continuous, nor cheap. In fact, for every 1% increase in the share of renewables in EU countries, there has been a 4.5% increase in the cost of electricity to the consumer. And if everyone drives an electric car, some estimates suggest, electricity production would need to rise by 50% from current levels. It's hard to imagine achieving this without hydrocarbons.

When, and not if, inflation rises, the price of bonds will fall. This is a process that is likely to drag on for several years, or possibly decades, until the system readjusts, and debts return to more agreeable levels. While this is happening, real returns will likely fall, for the simple reason that they are mean reverting, and in recent years, have been too high. This is what happened to gilts from 1946 until 1981, where real returns were negative, resulting in the loss of the majority of the initial purchasing power.

A well-constructed portfolio is diversified, and that means not everything within it is the same. If you genuinely want to be diversified, then acknowledge that bonds, property and stocks will be highly correlated. To diversify, you need to look further afield and find value. One area that will benefit is energy, as aforementioned, along with gold and commodities, will proved successful during the 1970s.

One reason for confidence is that commodities haven't felt the love during this recent credit cycle and so there is no meaningful premium to erode, nor speculative money dashing for the exit.

In the UK, long-term interest rates (10-year yield less expected inflation) are -2%. That is minus two percent if you missed it. Yet there are countries, some of which are out of favour, with attractive real interest rates. That means you can earn a government-backed return that will become attractive when the tide goes out. These countries, with high real yields, include Russia 3.7%, India 4.4% and Pakistan 5.3%. They may be perceived to be risky, but at least you are being compensated for that risk. The alternative is a hope strategy. That means you hope that bond yields remain low, credit remains tight, the pound remains weak and US oil keeps on flowing. And all while the wind blows and the sun shines. I like hope strategies. It's just unfortunate that they never last.

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