Private Client Letter

Publisher: Private Client Bank AG, Zurich | T +41 44 253 73 00 | info@privateclientbank.ch | privateclientbank.ch 30 June 2019 | Q3/19

La La Land

Cheap money is playing the music on the financial markets. Those who have been invested in the US stock market for the last ten years have nearly tripled their assets. The policy of cheap money is likely to continue; however, there are doubts as to its sustainability. Sober investors should be positioned in such a way that they are prepared to act when the wind changes.

"As long as the music is playing, you've got to get up and dance." This quote appeared in the Financial Times of 9 July 2007 from an interview with Charles "Chuck" Prince, chief executive of Citigroup, then the largest banking group in the USA. "We're still dancing," he added with a nod towards the huge amounts of liquidity in the financial markets. This liquidity was not expected to seep away any time soon. "When the music stops, in terms of liquidity, things will be complicated," Prince warned. This is precisely what happened just a few weeks later, and the world was plunged into the gravest financial crisis since World War II. Prince lost his job shortly thereafter and, as reported by Reuters, was grilled by a US congressional panel in 2010 about his now infamous comment. He had simply stated on the record what many others were thinking and acting upon.

In the Prince era, it was mainly the big banks that were responsible for the music. They supplied liquidity to the financial markets. In the meantime, this has fundamentally changed: over the last several years – going by appearances, at least – it is the central banks that have taken up the baton. The markets now literally hang on the lips of the US Federal Reserve Chief, and react immediately to any signal that the economy will be supplied with fresh money. The latest stock price surge since the beginning of this year was also based primarily upon the – hitherto merely expected – reversal of the liquidity supply by the US central bank. In mid-June the European Central Bank followed suit, referring to "additional stimulus". The central banks are the market wizards of today, they make the music. And they are the guardians of a multi-year trend of a generous money supply as well as low, zero, or negative interest rates.

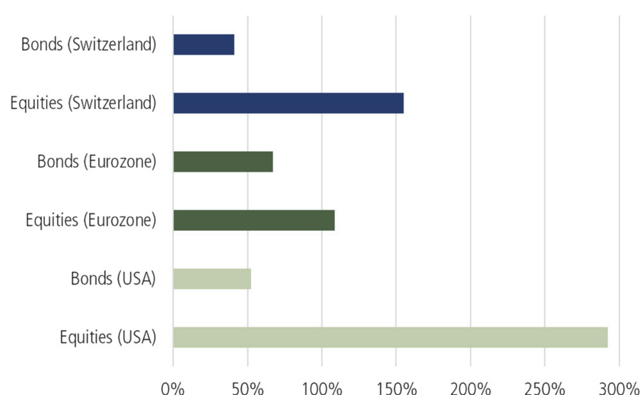
Real…

Interest rates, as the price of money, may well be the most important prices in the market, since ultimately all prices in the economy are tied to them. Over the last ten years, practically all asset classes have benefited from cheap money and the steady decline in interest rates. During this period, the key stock indices in the USA and Eu-

rope turned in a cumulative performance of up to 290% (see chart). Bonds have also profited enormously for years from the trend of falling interest rates. The same is true for real estate, private equity, art, classic cars, and many other investments. It seems as if the bubbling tide of liquidity lifted all boats. On top of that, since inflation is extraordinarily low, it means that the returns are indeed – at least thus far and predominantly – real returns, that actually boost purchasing power.

PERFORMANCE 2009-2019

FINANCIAL MARKETS – A DREAM FACTORY?



Source: Bloomberg. Barclays US Govt. 10 Year Term Index TR, Germany Govt. 7-10 Year TR and Swiss Bond Index SBI Domestic Govt. 7-10 TR. SMI, Euro Stoxx 50, S&P 500. Cumulative performance in local currency.

Low inflation is a significant potential justification of the central banks' policy of cheap money. It is often argued that we are living in a new era. In this view, low inflation (and thus low interest rates) has its origins in the massive cheap labour force in China and other countries, which has shaped the global economy for years. Add to this the notion that aging societies have a shorter investment horizon and individuals (must) save more in order to finance their pensions. The rush of investors into short-term investments makes these less profitable. A third argument to explain low inflation and low interest rates suggests that innovation and technological progress result in lower prices – expensive human workers are replaced by cheaper machines.

If all these arguments were correct and if central banks could indeed trim their policies to these conditions, then we could all lean back and enjoy the party with few worries. But there are nagging doubts.

…or surreal?

Under normal conditions, depositors can expect that their saved money will be able to purchase at least as much in the future as it could have at the time they decided to put it in the bank. Here it is of critical importance that price increases, or inflation, do not entirely consume the interest earned. However, if this happens over the years, interest rates can no longer play their role as a bridge between the present and the future. When real interest rates – i.e. the difference between inflation and the benchmark interest rate set by the central banks – turn negative, this corresponds to a loss of purchasing power. And if this condition persists, it is fair to call it a creeping, imperceptible expropriation of depositors' savings. As the chart on the following page illustrates, this is exactly what is happening. Over the last ten years, there have been hardly any periods in the western industrialized countries, particularly in the USA and Europe, with positive real interest rates. Those with money in the bank are losing, even if the statement still shows the same balance.

These figures suggest that the central banks are setting their benchmark rates too low. One justification often heard today is that lower interest rates stimulate the economy, and it may be that short-term growth stimulus can be released. However, this means the dose of liquidity must be ever larger in order to have an effect. And now, there are even serious discussions of a "Modern Monetary Theory" (MMT) that believes in extreme injections of liquidity without side effects. This is almost certainly nonsense, because it would mean that the perpetual motion ma-

chine, mankind's dream for over 2,000 years, had been discovered. The central banks have not been so radical thus far. Nonetheless, it would only take excessively low interest rates and an overly generous supply of liquidity for a lengthy period to trigger serious distortions and bubbles on the financial markets.

Under these conditions, it has become extremely difficult to determine the real value of assets. So central bank interest rates act in many cases as a compass, providing a basis for calculating the value of companies or investments. If the interest rate is zero or negative, these calculations become either useless or arbitrary. By that point, if not before, we would find ourselves in the surreal world of La La Land, constructed on masses of liquidity and the hope that the music will keep playing a little longer.

REAL INTEREST RATES 2009-2019

CREEPING EXPROPRIATION

Source: Bank for International Settlements, Bloomberg, own calculations.

Captive wizards

Events of recent weeks have strengthened the impression that the central banks are not only wizards, but also captives, of the financial markets, and perhaps of policy too. Whenever a major downturn hits the markets, the central banks react with more liquidity. Nowadays it seems as if in many places it is primarily the stock market that is steering monetary policy, rather than inflation and the business cycle.

The central banks are also captives because their room to manoeuvre has become extremely limited due to the high and rising levels of sovereign and corporate debt in most countries. No national bank will risk a scenario in which its own government is unable to service its debt due to a hike in interest rates.

In a nutshell: we can assume that the music will play on for some time. Nonetheless there is no guarantee that volatility will not become somewhat wilder in future, since a growing number of market participants are asking how long the alleged perpetual motion machine can continue to function. It will become especially complicated if inflation expectations rise or faith in the magical powers of the central banks ebbs. Neither of these is currently in sight, but either could occur at any time.

Remain sober

If the wind does change, there will be stormy weather. Since the generous liquidity has lifted all boats, such a change would necessitate a revaluation of all assets. Some observers recommend dancing as close to the exit as possible, whatever that may mean. In our view, however, this is an illusion. Rather, risk-aware investors should always be positioned in such a way that a fundamental revaluation would not inevitably correspond to destruction of assets and an incapacity to act.

So what to do? Here there are really only two, albeit not entirely satisfactory answers. Diversify, and aim for real assets. Nominal assets and any kind of debt have drawbacks. Furthermore, it is important to keep adequate liquid assets on hand so as to be able to act when in doubt.

In any case, leaving the party is not an option, since all assets are affected in one way or another. And perhaps we are not really in La La Land after all. But we should not count on that.

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IA, 28.06.2019

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Reassuring self-deception

Feelings of ambivalence emerge when a market upswing lasts and lasts and lasts yet further. This is because one must assume, quite correctly, that the probability of a reversal is increasing daily and hourly, and one naturally does not wish to miss this tipping point. Later, people will say that we should have seen it all coming. And they will reproach their asset managers, insisting that they are hired precisely to catch the tipping point. Is this the case?

Financial crises have very little effect on the real world. Factories are not destroyed nor are merchant fleets scuttled.

Those who have spent a lifetime amid the ups and downs of the financial markets take a measured view of it all. Yes, it is naturally true that a great deal of capital is destroyed during a market downturn. Some companies actually go under, which amounts to a total loss on that particular equity position. And entire economic sectors may come under pressure, such as the traditional technology stocks after 2002 and banks after 2009. Here the recovery is sluggish, if it emerges at all. In contrast, other sectors, such as the modern tech giants in recent years, gain the upper hand.

As painful and alarming as crises on the financial markets can be – the long-term observer has nonetheless yet to witness the apocalypse. In every cycle, even if nerves of steel were required, the upswing would return, and those market participants whose pure fear had prompted them to exit too early, usually missed the onset of rising prices because they were again waiting for a tipping point. Financial crises have very little effect on the real world. Factories are not destroyed nor are merchant fleets scuttled. It is only their valuations that are viewed somewhat differently than before. If there are good reasons to continue to assign these assets a value in future – a solid cash-flow situation is certainly helpful in this respect – then it is only a matter of time before there is a return to sensible prices.

From this viewpoint, it is worthwhile, even during so-called market overheating, to remain invested to the extent that is possible or desired. Adequate diversification is considerably more important than timing, or catching a tipping point. Ensuring adequate diversification is the true responsibility of the asset manager or advisor. After all, none of us knows how the future will look. We can only theorize about the specifics, but we know that the future will unfold one way or another. There will be a need for capital, and those who provide it will be compensated.

But how can one continue to provide capital while simultaneously and with mounting fear staring into the depths of a market downturn? The author has adopted a method of mild self-deception in the form of accumulating price fluctuation reserves. One takes a minor downturn – such as the one at the end of 2018 – and notes the prices according to one's own lower-of-cost-or-market principle. The price gains from that point forward can be considered a cushion. In this way, one's own assets become somewhat more elastic than if one were to use a continual mark-to-market approach. With this technique, one can at least screen out the market's jittery fluctuations. And when the tipping point finally comes (as it doubtless will), one will have lost ten or twenty percent less than all the others and can await with ease and interest the revelation of how the world will look afterwards. The main thing is to be invested in it.

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KH, 30.06.2019