Private Client Letter

Publisher: Private Client Bank AG, Zurich | T +41 44 253 73 00 | info@privateclientbank.ch | privateclientbank.ch 1 October 2019 | Q4/19

Genie in a bottle

The smartphone is becoming a wallet. This opens the door to digital forms of money that seemed inconceivable until now. If the result were to be robust, global, secure currencies, then consumers and investors could benefit.

"Reinvent money." This is the ambitious mission of the Libra Association, founded just a few months ago in Geneva. Its aim is to establish a new digital currency that is accessible by smartphone, electronically transferable, and available around the world. The global reaction proves that this is an idea to be taken seriously. While US Treasury Secretary Steven Mnuchin raised Libra to "a national security issue", his French counterpart Bruno Le Maire stated flatly that it should not be authorised in Europe. Others, such as the heads of the American, German, British, and Swiss central banks, took a more liberal stance, identifying opportunities. In any case, it seems that the Libra project has already gained more prominence since its recent launch than bitcoin has in its more than ten years of close scrutiny in financial circles.

One obvious reason for this great attention arises from the instigators of the currency project. The most prominent founding member is the US social media company Facebook, whose over 2.4 billion active users and popular messaging system WhatsApp place it among the world's ten most valuable firms. The company has come under fire recently, particularly due to its treatment of user data.

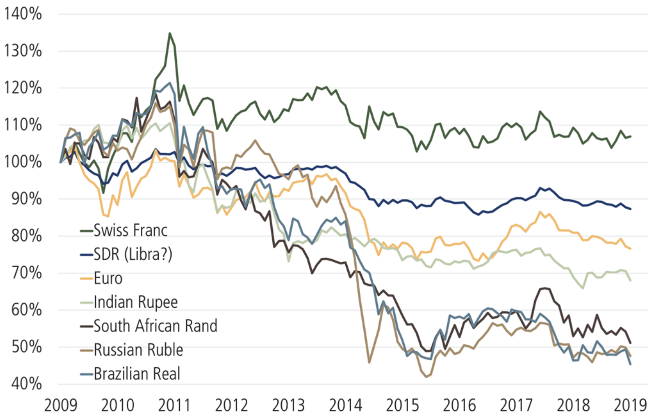
While Facebook is the figurehead of the new currency, it would be mistaken to reduce Libra to this aspect alone. Global heavyweights such as Visa, Mastercard, and PayPal are also on board, bringing their vast experience in electronic payments. Ride-sharing companies Uber and Lyft, internet marketplace ebay, tourism promoter Booking Holdings, and online music service Spotify are likewise involved. In the future, members of these services will be able to pay in Libra. A total of 28 companies and organizations around the world stand behind the project. Their stated objective is to significantly increase the number of members.

A stable currency basket for all

Aside from the prominent founding members, the project is also capturing interest because it is anchored in the existing currency system. Libra – unlike bitcoin – will be based on a basket of relatively stable, sovereign currencies, backed mainly by bank deposits and government securities. The exact composition of the currency basket has yet to be confirmed. Its main components will most likely be US dollars and euros, along with Japanese yen and pound sterling. The Swiss franc has not been mentioned yet, probably because the market for francs is very tight. And the Chinese yuan is out of the question (for now) given its lack of convertibility: the yuan is not freely traded. The goal is to minimise the volatility of the digital currency against today's major currencies with diversification in a basket – which is succeeding, as shown in the chart below.

CURRENCY DEVELOPMENT 2009–2019

Francs, dollars, Libra?



Source: Bloomberg Indexed development of currencies relative to US dollar. SDR stands for "Special Drawing Rights", the currency basket maintained by the IMF. One SDR contains 42% USD, 31% EUR, 8% JPY, 8% GBP, and (since 2016) 11% Chinese yuan.

The idea of a basket of key currencies is not new: the IMF had already launched one in 1969, which is still used today under the name "Special Drawing Rights (SDR)" to provide liquidity to member states. Since the Libra is likely to be similarly constituted, we use the chart above to depict the development of the SDR currency basket compared to the US dollar, euro, Swiss franc, and the currencies of the largest emerging markets, excluding China.

The chart clearly shows that potential customers for the currency basket can be found particularly in emerging markets. For investors in Brazil, South Africa, Russia, or India, diversification into strong currencies has been *de rigueur* for the last few years (and decades) – not to mention Argentina, Venezuela, or Zimbabwe. Since 2009, the Swiss franc has been the only currency to have gained in value against the US dollar; the euro, for example, shed a total of over 20% of its value, a surprising loss.

Money via smartphone

If francs and dollars are so attractive, who needs Libra? The fact is, the well-off already have access to established currencies through their bank accounts at home and abroad, and they can create their own currency baskets (as well as diversified securities portfolios) to suit their needs. For them, a digital currency such as Libra is only attractive as a payment method if it is particularly low in cost and used by many others. They certainly have no need of such an instrument as a way to safeguard their assets. On top of that, the affluent often attach more value to discretion and data privacy, especially when they are based in Western Europe. And here, Facebook in particular does not have the best reputation.

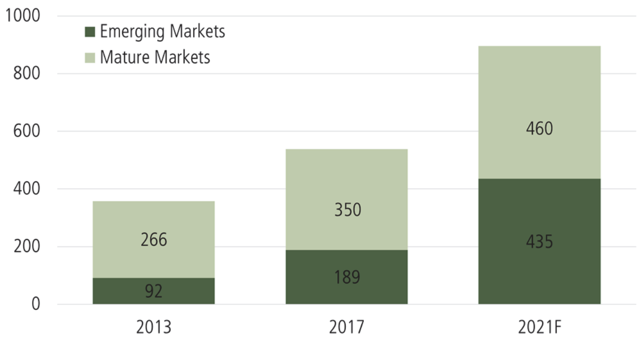
The situation is completely different for people who today have neither easy access to the established currencies, nor – as is often the case in emerging markets – their own bank account. Furthermore, such people are generally less sensitive with regard to the use of their data. And not least important, they now have large numbers of smartphones, and perhaps accounts on Facebook and WhatsApp. This represents an enormous demand reservoir for a stable currency that can be accessed on a smartphone and transmitted as easily as a text message. And around this currency, an array of products and services can be developed to benefit billions of people.

The powerful founder, the base in the existing currency system, billions of potential consumers – these are all excellent conditions for the launch of a project such as Libra. On the technical side, too, the time appears to be ripe, especially since there has been a surge in blockchain technology development in recent years.

The following chart shows the latest figures for global growth in electronic payments. They confirm what observers have been noticing for some time: there is a constant stream of new players in the rapidly growing market. Well-known names such as Revolut, N26, and Transferwise are just a few examples. In China, a majority of payments are now settled via WeChat or AliPay. Growth is particularly strong in the emerging markets: in India, Russia, and China, annual growth rates for electronic payments have climbed well above 30% per year.

ELECTRONIC PAYMENTS, BILLIONS OF TRANSACTIONS

EXPONENTIAL GROWTH



Source: World Payments Report 2019, Capgemini Research Institute.

Many winners

From a wealth management perspective, a new digital currency *à la* Libra is of only limited interest. Compiling a currency basket with assets is a skill every portfolio manager should possess. More exciting for investors would be the moment that the Libra's value pulled away from its anchor in the existing currency system – but only after it had become a popular global digital payment method. And it appears as if the founders have considered such a development. In their White Paper from summer 2019, they highlight parallels with the introduction of new currencies in the past: "to help instil trust in a new currency and gain widespread adoption during its infancy, it was guaranteed that a country's notes could be traded in for real assets, such as gold." This was true for decades with the US dollar, for example, until the abolition of the gold standard with the "Nixon shock" in 1971.

If it were indeed possible to establish Libra or a similar construct as a stable, global, and private currency, there would be many winners: consumers, because they could pay more efficiently; investors, because they would have better diversification options; and issuers, because they could generate profits through managing the reserves or even creating money – not to mention gaining access to billions of consumers. The increased currency competition would be very welcome. But it is precisely this aspect that troubles national governments.

Concerns expressed by politicians and regulators centre around preventing money laundering, protecting data privacy, and ensuring cybersecurity. All these issues should be resolvable. The real fear is that governments will lose their monopoly on money, and thus their control of the money supply – to the extent that they still have any at all. This is why systemic risks are being invoked and prohibitions advocated. The Libra project faces correspondingly strong headwinds. There are already some signs that Visa and Mastercard are reconsidering their involvement because of political pressure.

However, even if this attempt to launch a digital currency is unsuccessful, there are plenty of potential initiators in the wings: giants such as Amazon, Apple, and Alphabet (Google) are sure to be watching the Libra project closely so as to learn from its mistakes. Libra is a focal point for the fast-paced technological developments that are changing the very character of money. While we would not go as far as financial historian Niall Ferguson, who sees Libra as the West's urgent response to the threat of Chinese fintech dominance, we do believe that the genie is out of the bottle. And it's not going back in quietly.

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IA, 30.09.2019

Private Client Bank AG
Alte Boerse
Bleicherweg 5 – P.O. Box
8034 Zurich – Switzerland
T +41 44 253 73 00
F +41 44 253 73 20
info@privateclientbank.ch
privateclientbank.ch

Calm and composed – yes, but…

Who would not be delighted to have an early warning system, preferably for themselves alone, so that they could anticipate the long expected but yet pending stock market downturn with deliberate, risk-mitigating divestments? We know that such a system does not exist, and most of the robo-advisors bursting with artificial intelligence will also fall into the next financial market trap. They may have all the data on previous crises, but none on the one to come, which will be unlike any of its predecessors. It will be the first of its kind, and we cannot even imagine its scope. Never before have interest rates in the world's major currencies been so low or even negative, never before have the central banks had such damp powder; and never before have there been so many robo-advisors stuffed with so-called artificial intelligence. The latter will, in all probability, generate precisely what they attempt as individuals to avoid: a particular hysteria whipped up by robo-emotions.

Financial market agnostics are aware that the trigger of the next crisis cannot be predicted, not even with artificial intelligence. Even in the midst of dramatic price fluctuations, they stand by their chosen strategy.

They say that the beat of a butterfly's wing can trigger a turnaround on the financial markets. In retrospect, we will be able to identify which of the millions and millions of butterflies was the culprit, and people will ultimately use this information to draw futile conclusions about the next crisis. "Agnostic investing" is my name for the position that takes all this into account, calm and composed, in the knowledge that prices will fluctuate, even dramatically, and yet stands by the selected strategy.

Among the guiding principles of agnostic investing, that is, the disbelief in some pseudo-superior financial market savoir, is my dictum: "Those who are unable to accept a 50% nominal loss on their positions overnight should not own shares." Or: "Shares are a fire hazard, but it is only because they are that one can earn an economically sound return with them."

At the same time, there is something about agnosticism – what agnostic would not like to, occasionally and as secretly as possible, question in some way their own detachment from the action? And so still attempt to outsmart the unpredictable markets? This is certainly true for me, and I don't mind admitting it. Lately, for example, I was considerably unsettled when, aware of the yield curve trend in the US dollar, I learned of a liquidity squeeze in the American money market in mid-September. The word was that the US Federal Reserve would have to inject massive amounts of liquidity into the banking system. In contrast to the 2008/09 financial crisis, however, the bank assets offered as security retained their value. Since I take a similarly agnostic to sceptical position on such credit quality euphemisms, I began to experience a vague premonition of a systemic collapse that is beyond our comprehension. Around this time, at the commemorative lecture for the great Swiss theoretical monetarist Karl Brunner (1916–1989), I met a large number of experts. To sum up our discussions: uncertainty and uneasy feelings abound.

No, I am not saying that this will be the fateful beat of a butterfly's wing. Nonetheless, the financial market agnostic Hummler is no longer perfectly calm and composed, and will not be, at least until the dollar yield curve is back to normal.

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KH, 30.09.2019