Private Client Letter

Publisher: Private Client Bank AG, Zurich | T +41 44 253 73 00 | info@privateclientbank.ch | privateclientbank.ch 1 January 2020 | Q1/20

Strategic Confidence

There is certainly no shortage of potential triggers for the next financial crisis. However, fear and anticipation of the big crash are not good advisors. Rather, an appropriate dose of confidence is called for. And confidence means being invested.

"The Big One." People talk about it with awe: the devastating earthquake that everyone is somehow waiting for. Like many other things, the phrase originated in California, where the violent earthquakes of 1857 and 1906 had such disastrous effects. Since then, no seismic event over 7.0 on the Richter scale has been measured in the region. For Los Angeles and Southern California, which likewise straddle the infamous San Andreas Fault, the reprieve has been even longer, some 300 years. However, California is not the only region situated above an explosive geological fault. Residents of cities such as Tokyo, Mexico City, New York, Mumbai, Shanghai, Istanbul and Jakarta are also well acquainted with the fear of a "Big One". Everyone knows that sooner or later, it will come. And no one knows whether it will be tomorrow, or in five, ten or fifty years. Even the latest technology does not deliver reliable predictions; these forces are hidden too deep in the earth, the system is too complex.

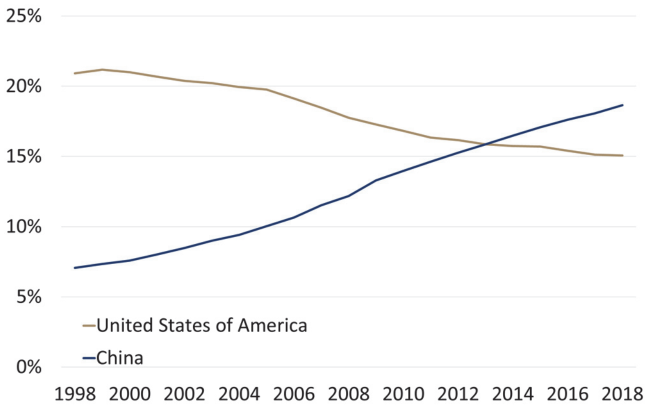
In economic history, too, there have been notable "Big Ones". Two events particularly stand out, triggered by the financial market crises in 1929 and 2007. Shock waves from the great crisis of 2007 are still tangible, and it is not entirely clear whether we are currently experiencing aftershocks of the last, or foreshocks of the next crisis. In discussions, at any rate, there is a recurring question about the next "Big One". This is particularly true in the current season, when investors are in a jubilant mood over their impressive returns in virtually all asset classes (with the notable exception of cash) in 2019, and are asking themselves how much longer this can go on.
There is certainly no shortage of fault lines that could trigger serious economic crises. One obvious candidate is the policy of cheap money and the role of central banks, which we discussed in detail last summer ("La La Land"). Another contender is the euro; although it has not been making headlines recently, its fundamental design flaws persist. At the same time, the rapid pace of technological progress, perceived or real inequalities and, not least, political or real shocks from the climate sphere all have the potential to shake the earth.

The trade conflict is a symptom

There has been a lot of talk recently about the so-called "trade war" between the USA and China, which concerns financial market participants and the media equally. Loud proclamations of punitive tariffs, trade policy measures and countermeasures alternate with equally loudly trumpeted agreements and "deals" that are in turn joyfully acknowledged by the equity markets with price gains. In the process, the expectation is always expressed (and presumably also stoked) that this issue will ultimately be resolved with a sweeping deal.

SHARE OF THE GLOBAL ECONOMY 1998–2018

China has overtaken the USA



Source: World Bank. Gross domestic product, adjusted for purchasing power.

However, this fabulous deal is almost certain to remain pending, regardless of the outcome of the US presidential election on 3 November 2020. The trade spat is actually a symptom of a phenomenon that goes much deeper: after many years of continuous economic growth in China, the world's two largest economies are grinding towards each other like tectonic plates. As our chart illustrates, China overtook the USA as the world's largest economy a few years ago. There are inexorable forces at work that will certainly not disappear in the foreseeable future. Moreover, for years, the message from the ranks of the Democratic Party has actually been quite similar, in terms of content, to that of the current US administration. So while the style of American policy on China might change somewhat in the event of a Democratic victory (which does not appear particularly likely at the moment), the content probably would not.

Despite all these geopolitical developments, which are naturally to be taken seriously, we do not expect the next economic "Big One" to break along the USA-China fault line. For that to occur, political reason and, especially, all checks and balances would have to fail completely. This may not be impossible, but it is improbable. Further, the many smaller and larger quakes on the trade front and others ensure that tensions are regularly discharged and a new equilibrium can be created over a (very) long period. Finally, global economic crises do not seem to have arisen from geopolitical conflicts in the past, at least not directly. In short, we will have to continue to endure a great deal of noise and certainly some setbacks in the USA-China relationship. It is conceivable, for example, that the two powers will attempt to restrict the use of their rival's technologies within their own sphere of influence. All this may provoke substantially higher volatility on the financial markets. Nonetheless, a sudden, violent quake with economic devastation and catastrophic consequences for the financial markets cannot really be expected from this quarter.

Increasingly limited room for manoeuvre

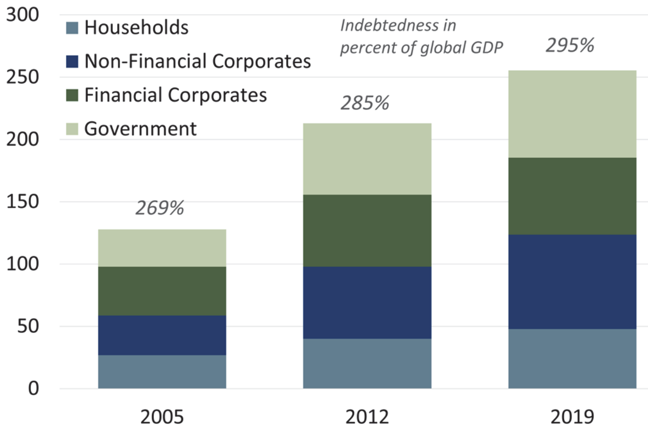
We are far more concerned by another development that has been observed for some time: the relentless increase in debt at all levels and in all regions of the world over many years. Debt per se is no bad thing, provided it is offset by solid assets or healthy growth. At the same time, it is true that the higher the debt, the less room to manoeuvre when something goes wrong. The chart on the next page depicts the absolute figures as well as the ratio of total debt to global economic output. The sharp growth in sovereign debt is most evident in the industrialised economies, while in contrast, the increase in corporate debt appears in the emerging markets. For some time there has been talk of

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

"zombie nations" and "zombie companies". These typically report earnings that are lower than their current interest costs. Their existence hinges on supplies of new, very cheap debt. Estimates indicate that more than one in ten companies worldwide now exist solely thanks to ultra-low interest rates. At the same time, it does not require a vivid imagination to picture what will happen when interest rates finally begin to rise again.

GLOBAL INDEBTEDNESS 2005–2019

WHERE IS THE LIMIT?



Source: IIF, IMF. The left scale depicts debt in absolute figures (USD trillions). The italicised numbers indicate relative debt as a percentage of global economic output.

The most severe economic crises of the past were often triggered by the excessive indebtedness of households, companies and governments. So there is indeed a potentially catastrophic financial earthquake lurking on the debt–interest–inflation fault line, although we cannot predict whether it will be triggered tomorrow or only in five, ten or more years.

Confidence is a good strategy

Billions of people live directly on the unstable fault lines between tectonic plates. Regions such as California, New York and Japan are among the most productive in the world, despite (or because of?) the hourly threat of major earthquakes. Rather than being paralysed by fear or focusing constantly on precautions against a "Big One" that in any case cannot be accurately predicted, these people are obviously motivated by confidence and a relentless drive to create new things. And they have great success.

It is up to investors to decide how close to the economic fault lines they choose to dance by, for example, purchasing debt or bonds issued by governments, companies or banks that are basically bankrupt, in order to squeeze a bit more interest out. Massive investment in illiquid assets also belongs in this category. However, it is also clear that hoarding cash on a large scale and orienting a portfolio one-sidedly towards the next big financial crisis can be costly. The crisis is sure to come, but until it does, a great deal of time may elapse. And time is, of course, the decisive factor in investing. Experience teaches that the greatest long-term risk of all is not to be invested. So while we remain prudent, it seems to us that confidence is the right strategy – even if it is sometimes an effort to be confident despite your own gut feeling. Those whose fear prompts them to flee as far as possible from the tectonic fault lines must know that such a strategy also involves costs. And let us not forget that even the greatest caution is no guarantee against serious injury in a devastating financial earthquake.

It is indisputable: behind us is an impressive upward movement on the financial markets, not least in equities. Questions inevitably arise about when the trend will reverse. Experience proves that fear is very rarely a good advisor. Caution is appropriate, but in most cases, confidence is rewarded. And confidence means being invested.

—

IA, 30.12.2019

The Right Direction

Some call it hysteria, others say climate policy. Either way, this theme has now taken over the European Union, or vice versa. A "Green Deal" calls for our continent to be carbon neutral by 2050, whatever the cost, which is to say: a lot. One thing is already clear: all this can only be financed with borrowed funds. Particularly in business circles, there are quiet hopes that all the fuss will soon blow over.

The polluter pays principle belongs in a market economy. We have always known that we were environmental free-riders. Now we have the tools to change this – and change it we will.

In my view, however, this is not simply a passing fad, because the issue is not the climate per se. This is simply a reasonably measurable symptom. What is actually at stake is a fundamental, much more vital structural change. The CO_2 problematic, that is, the change in the atmosphere around our planet due to human action or inaction, belongs to a class of phenomena that economists call "*externalities*". These arise when the consequences of human action are not or not entirely borne by the producer, but are passed along to an (unspecified) general public. Exhaust from cars or chimneys of industrial plants are typical instruments for causing externalities. The noxious gases are socialised, distributed to residents near and far.

Whether external costs are internalised – that is, borne by the producer – or not, depends upon the *information and transaction costs* associated with their determination. The later Nobel laureate Ronald Coase demonstrated that the existence of information and transaction costs is ultimately responsible for the creation of externalities. The result is the tragedy of the commons, their overexploitation.

Thanks to the extraordinary technological advances of recent years, information and transaction costs have decreased steadily and granularity has deepened to include every combustion engine of even the smallest car. So now, a new equilibrium from an economic point of view must be reached. An equilibrium with significantly *lower external costs*, with much less environmental impact. This has nothing to do with Greta Thunberg, it would have happened in any event. We are still a long way from thoroughly understanding the impact of reducing or even eliminating information and transaction costs on society and the economy. What at first resembles hype and hysteria is just the prelude to a megatrend towards more of the polluter pays principle.

There will be plenty of trials and tribulations (also expensive, stupid ones) along the way. Calls for police-state regulation and collectivisation will drive us to the brink of despair. And future election results will do the same. For now, market economists and liberals will have a difficult time of it. And those who call their wealth their own must be prepared for fiscal raids. Politics is trending green and far left. This will involve heavy costs, and not only in the EU.

Nonetheless, this is the right direction. The polluter pays principle belongs in a market economy. We have always known that we were environmental free-riders. Now we have the tools to change this – and change it we will. What does this mean for investors, for our clients? The most significant changes will take place on the real side – precisely where holders of equities are invested.

—

KH, 20.12.2019