Private Client Letter

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Anchoring in Real Assets

Financial markets are recovering rapidly from the corona shock; the state of the real economy, on the other hand, is still far from normal. In times of great uncertainty, it is worth taking a look at the long-term trends. These speak for real assets.

"We're not even thinking about thinking…": unbidden, the somewhat Dadaist aphorism "Never think that you have thought" comes to mind – "for the thinking of thoughts is thoughtless thinking." However, the absolute negation of thinking was heard in the US Federal Reserve's press conference on 10 June 2020: "We're not even thinking about thinking about raising rates". With these words, Jerome Powell, as President of the Fed one of the world's most powerful men, intends to emphasise that all measures are being undertaken to prevent adverse developments in the financial markets. Since the beginning of the crisis, the Fed's balance sheet has grown from around USD 4 trillion to more than USD 7 trillion at the beginning of June 2020 – a 75% increase in just a few weeks. The plan seems to be working, at least in the short term, as implemented by leading central banks and governments around the world. This policy of cheap money is thus a main factor for the surprisingly fast market recovery in recent weeks and months despite the rampant pandemic. It is particularly apparent in share prices, but bond markets have also gone through a similar process. Their recovery from the liquidity disruptions in March 2020, which in some cases were serious, may be less headline-grabbing for the media, but perhaps even more relevant.

So while the financial markets are reflecting the huge surge in liquidity and are rapidly approaching pre-crisis levels, it is still not clear whether the worst is now over for the real economy. In some sectors, there is talk of short-term sales slumps of 60–70% or even more, while other sectors have benefited hugely from the digital transition of the economy. Rising unemployment figures, dividend cuts, and earnings revisions are warning signals that might cause some major disappointment in half-year results. Nevertheless, despite all the justified scepticism regarding the strong recovery on the financial markets, there is also reason for (cautious) confidence in overall developments, at least in the medium term.

From fear to worry

First of all, there is the general impression that people are learning to live with the hitherto unknown virus. In a book published in 2005 by the Progress Foundation entitled "Fear of Danger or Danger from Fear?", the Luxembourg-Swiss economist Guy Kirsch describes fear as a diffuse feeling of being threatened by an intangible danger. However, once the danger becomes more concretely tangible and describable, the general state of fear diminishes and becomes a specific worry of an identified danger that is considered controllable. It seems that the transformation from diffuse fear to specific worries about the coronavirus is in full swing. This is evident not only in the adaptability of people and companies in the crisis, which until recently was considered hardly possible, but also in a glance at the streets of Zurich, which are now full again. It would be astonishing if, in a second wave (if it arrives), the economy were to come to such a screeching halt as it did in March and April 2020. And even if this happened, everyone would know that it would be a temporary rather than a lasting situation. All this is constantly being reflected in the prices on the financial markets. As we know, it is the future that is traded there, not the past.

NUMBER OF DAYS BETWEEN COLLAPSE AND RECOVERY, S&P500

FASTER THAN EVER

Source: Bloomberg, PCB chart.

It is a fact that over the last 40 years, the American stock market has "processed" no crisis more rapidly than the corona-related slump of spring 2020. As our chart shows, the decline was steeper and the subsequent rise even faster than ever before. At the same time, institutions such as the IMF and the World Bank are outdoing each other with gloomy economic forecasts. The expected "leaning L" or at best "U" in the real economy contrasts with the "V" currently seen on the stock markets. *The Economist* had already described this development as "a dangerous gap" on its front page at the beginning of May. And indeed, equities are now no longer cheap by historical standards. Besides the usual indicators such as the price-earnings ratio, analysts often cite the relationship between market capitalisation of companies and gross domestic product (GDP). They emphasise that the market value of companies in the USA is currently just under 150% of GDP, which is a historic high. However, this is not entirely new, as this so-called "Buffett indicator" has been registering high values for years. So it is likely that not only the virus plays a role here, but also factors such as low interest rates or productivity gains in the economy due to digitalisation, which are difficult to measure.

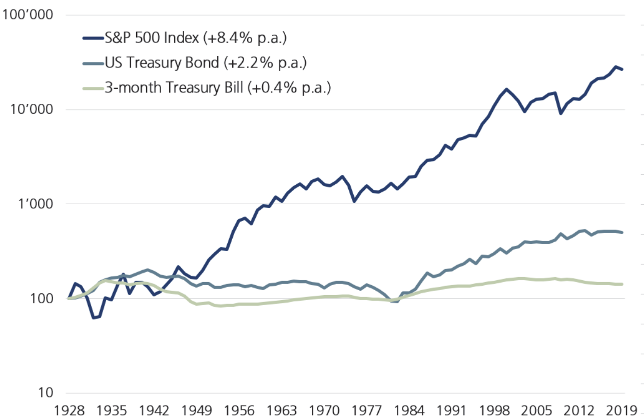
When we first looked at the potential consequences of a corona pandemic in early February 2020, we assumed that epidemics generally subside after a certain time and that market reactions are temporary. There is no doubt that the scale and consequences of Covid-19 exceed anything we could have imagined at that time. It is equally true, however, that normality will return in the not too distant future. Pandemics are neither financial crises nor wars. Infrastructure, factories, knowledge, supply chains, and networks have not been permanently destroyed. We therefore continue to believe that we are facing a temporary rather than a permanent phenomenon.

The power of real assets

In times of particularly high uncertainty and nagging concerns about the value of equity investments, it is worthwhile to consider the very long trends. As our chart on the following page shows, US stocks have yielded an average annual return of 8.4%, after adjusting for inflation, over the last 90 years. By contrast, US government bonds have yielded just 2.2% per annum and money market investments a mere 0.4%. Due to the accumulation effect, this results in huge differences in value gains over time, as our chart also indicates. Many investors thus see shares as no more than financial instruments for generating returns. However, this is a very short-sighted view of things. In reality, ownership of a stock is (fragmented) ownership of real means of production: buildings, machinery, knowledge, networks, customer relationships, and much more. Just like (physical) commodities or real estate, shares thus belong to the real asset class – provided that their balance sheets are not themselves full of debt or the like. Companies that have a strong market position are also likely to protect their owners from inflation, as they can quickly adjust the prices of their products to a changing environment. Nominal values such as cash, bank balances, or bonds, on the other hand, represent a promise that the interest and the amount owed will one day be repaid. They fluctuate less, offer lower returns, and are at the same time much more exposed to the risk of devaluation due to inflation. Once a loss due to currency devaluation has occurred, it is almost impossible to recover it.

CUMULATIVE RETURNS IN USD AFTER INFLATION, 1928-2019

IN THE LONG-TERM IT'S EQUITIES



Source: PCB calculations, data from Damodaran, Aswath (Stern School of Business, NYU, http://pages.stern.nyu.edu/~adamodar/).

Ideally, a cleverly compiled equity portfolio reflects the essence of the economy, anchoring investor ownership (in a very fragmented fashion) in the real existing assets that form the backbone of the global economy. Such a portfolio may incur significant losses, either temporarily or in exceptional cases over longer periods, but a total loss of the assets is virtually impossible.

A mountain of debt remains

So while the fear of Covid-19 – with all due caution and respect for the situation of those whose health is directly affected – seems to be ebbing, important questions from an economic point of view remain open. Systemic risks are found particularly in the global mountain of debt that has soared even higher, and in the question of a more resilient organisation of supply chains and warehousing, as described in our last "Letter" under the title "Low on Reserves". Sooner or later, both could lead to inflation.

Particularly in the area of debt, the corona crisis has acted as a catalyst for a trend that has actually been in force for some time. Current IMF projections suggest that global debt will surge this year, exceeding 100% of gross domestic product in many larger countries by the end of 2020. The increase will be particularly large in the USA, where debt is expected to equal some 130% of GDP by the end of the year. Japan remains at the top of the rankings, with government debt that will soon total 300% of an entire year's economic output. It is unimaginable that such a trend can be sustainable. However, experience teaches that mountains of debt can soar very high before they are no longer controllable. Moreover, the direct and indirect financing of sovereign debt by central banks can evidently take on very large proportions before confidence in the value of money falters.

In the short term, a sharp rise in inflation is rather unlikely, as the strong contraction of the economy has a deflationary effect. And without inflation, interest rates are unlikely to rise either. Despite all the scepticism about taboos and bans on thinking, it will probably be the case for quite some time: "We're not even thinking about thinking about raising rates".

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IA, 30.06.2020

THE HOTEL IN THE BEDROOM AND THE OFFICE IN THE LIVING ROOM

There are some ground-breaking changes that are neither sufficiently registered nor thoroughly understood. Around 1920, people were still philosophising about the future of the match industry, and in 1990 there remained serious doubts about the future of personal computers. In the meantime, candlelight has been relegated to the Christmas season. More importantly, computing capacity has increased exponentially since then, and the ability to store data appears to exceed the infinite.

With the corona crisis, there has been an enormous shift. Fewer offices and fewer aircraft will be needed. Already existing capital will be better utilised.

As a result, the so-called "information and transaction costs" have fallen towards zero. This rather technical sounding phrase refers to all the frictional losses that stand in the way between value creation and consumption. That is to say, all the things that must be paid for without adding any element of value. The internet, in the widest sense, has eliminated or at least sharply reduced this type of cost. It has done so with information platforms of all kinds, with auction processes, with newly established forms of business. Fifteen years ago, Airbnb as an independent hotel "company" did not exist, nor did Uber for personal taxi services. We have all profited from the technological changes; for one franc or one dollar, we get considerably more and better goods and services than we did a relatively short time ago.

However, what has also become clear is that the reduction in information and transaction costs has resulted in a significantly more intensive use of existing capital. Airbnb relies on existing living space, Uber on existing vehicles and human capital, car owners and drivers. Few new buildings have been built because of Airbnb, and no surge of car purchases has been set off by Uber. "Utilisation of idle capital" is the technical term in the language of economists, but their mainstream thinkers display difficulty in dealing with the phenomenon. This is because they are fixated on raising gross domestic product. In their eyes, what is "good" is what lifts GDP. However, this is precisely what better utilisation of capital does not do; rather, it goes unnoticed by the experts. From the viewpoint of promoting sustainability, the opposite should actually be the case, but the profession does not think that far.

Now, with the corona crisis, there has been another enormous shift. Suddenly everyone realises that a home office is not such a bad idea, that it works – indeed, for certain activities even better than the chatty surroundings of the workplace. And everyone has experienced that virtual meetings via Skype or Zoom are often more efficient than lengthy physical meetings. And that not all the travel in the past was really necessary. These experiences will change the world. Fewer offices and fewer aircraft will be needed. Already existing capital will be better utilised. Here and there, this will provoke changes in the economy that appear recessionary. But take note: these changes are not cyclical but structural in nature and they contribute to the recovery of the economy, society, and the environment. So it would be wrong to offer too much aid and support to maintain the structure. We must make space for the gale of "creative destruction" (Schumpeter) to do its work. This way, new green shoots can grow.

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KH, 30.06.2020