PRIVATE CLIENT LETTER

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# No Free Lunch

The financial markets weathered the turbulence of the crisis year 2020 well. The reckoning for the great corona bailout, however, is far from settled. Nonetheless, those who can deal with uncertainty can be confident.

"Risk, Uncertainty and Profit" – this is the title of a book published in 1921 (!) by Frank Knight, the founder of the Chicago School of economics. Risk, according to Knight, can be objectively calculated with the aid of statistics, as in, say, games of chance or insurance. If something takes place repeatedly, it is relatively easy to estimate the consequences and insure against them. The case is different with uncertainty, which concerns extreme events that are unique or very rare. Recording such events statistically is either impossible or not meaningful, so they are difficult to hedge against.

But there are organisations and offices that address uncertainty. One of them is Germany's Federal Office of Civil Protection and Disaster Assistance, which publishes an annual risk analysis for the German Bundestag. The January 2013 report described a (then) hypothetical coronavirus pandemic in such detail that it now reads as a prophetic forecast for 2020. Small catch: it was described as a "conditionally probable" event that occurs every hundred to thousand years. By this logic, something is "highly improbable" only when it happens every ten thousand years (or less often).

So the coronavirus did not hit us unexpectedly at all, indeed it was not even deemed improbable. Nevertheless, we were taken unawares and unprepared, which should not be surprising for such a rare event. Attempting to cope with such phenomena with statistical risk measures is mathematically sound, but in reality it seems at best helpless. It creates the illusion of control where none can exist. Probabilities are in any case irrelevant if you are the one who is struck. A world that seeks to calculate and control everything deals poorly with uncertainty.

2020 was undoubtedly a year of uncertainty. Politics and society switched to "visual flight" and are still in troubleshooting mode today. For weeks, chaos reigned on the financial markets; given the high level of uncertainty, investors were desperately searching for the "right" prices for bonds, shares, commodities and other goods. It was a glimpse into the abyss, a reminder that things can always turn out differently than the forecasts that are published with fanfare every year. It was also a reminder that dealing mindfully with uncertainty is an essential component of an entrepreneurial investor's toolbox.

### Stock market boom despite recession

A glance at the readings on key equity indices at the end of 2020 almost suggests that we have a "normal" year behind us. In general, the financial markets have weathered the great shock astonishingly well, at least so far. For the second half of the year, we might even call it a stock market boom.

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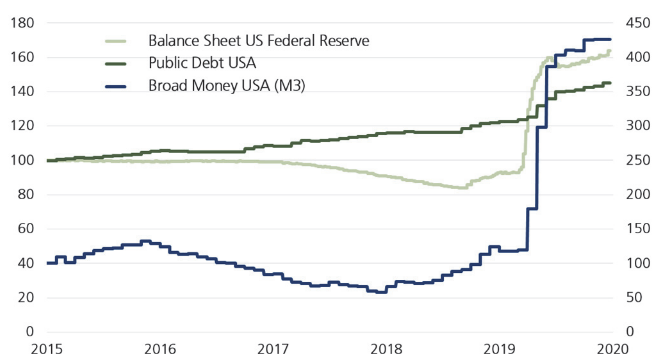
At the same time, the real economy is in the grip of one of the most severe recessions since World War II, with many industries fighting for survival. Great uncertainty on the one hand, rising share prices on the other – is this not a paradox?

LIQUIDITY INDICATORS USA 2015-2020, INDEXED

## Flowing at full force




Source: Bloomberg, PCB chart. The left scale shows the central bank balance sheet and government debt indexed to 2015. The right scale indicates the broad money supply (cash, savings and time deposits).

First of all, the price increases of recent weeks reflect hopes for an imminent normalisation thanks to effective vaccines against the coronavirus. Strong catch-up growth is anticipated. However, we believe the effect of the enormous money creation by the central banks, combined with unprecedented fiscal measures, is of greater importance. All indicators are pointing sharply northward: government debt, central bank balance sheets, monetary aggregates. Our chart shows figures for the USA to represent the global trend. When it became clear to financial market participants in the spring that governments and central banks would once again flood the economy with liquidity at full force, the mood swung abruptly. Basically, this is nothing new, but it has reached a previously unknown scale in the course of the corona crisis.

Over long stretches of world history, such a policy would have long since led to currency collapse, inflation and interest rate hikes. What is different today? In a recent position paper entitled "A World of Distortion", Konrad Hummler, Nick Huber and Chris Prevost explore this question. They conclude that special factors have been at work for quite some time, making the (so far) unpunished central bank financing of states possible in the first place. For our purposes, three of these factors in particular seem relevant: first, the deflationary effects of the technology surge that has been going on for years have been woefully underestimated; second, the banking system has become dysfunctional, so that lending activity is steadily dwindling and money is circulating more slowly in the economy; and finally, third, China has not allowed its own currency to appreciate for years, so that the US dollar maintains a quasi-monopoly as the world's undisputed reserve currency. Under these conditions, the US Federal Reserve can take any action it pleases without the threat of inflation or currency turbulence. On the contrary, the higher the debt climbs, the more the state and central bank are trapped in a monetary policy that must become ever looser. This, in turn, boosts the financial markets.

Should the effect of one or more of these special factors weaken, the authors identify a threat of greater turbulence. The more distorted the world, the greater the correction that will be required when the trend reverses. In any case, the great reckoning for the corona bailout has not yet been settled. And if economics teaches us anything, it is that very little in this world is free of charge: "There is no such thing as a free lunch." It would be astonishing if, of all things, one of the greatest monetary policy experiments in history were to be an exception.

### Zero risk is not free of charge

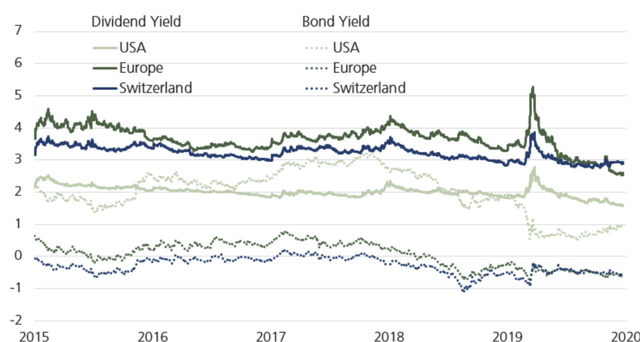
To describe the situation, the authors of the position paper use the image of the ocean after a seaquake. First the water retreats, only later does the tsunami build up. However, in our view the quake has not yet occurred, despite (or perhaps even because of?) the recent surge in liquidity. It is a classic case of uncertainty: a very rare event with potentially disastrous consequences that cannot be precisely foretold, even when it is about to

occur. For most people it comes surprisingly, but not unexpectedly.

One question that comes up often in discussions with our clients is to what extent financial investment valuations can predict that a tsunami – specifically, a major stock market crash – is imminent. It is true that US stocks, in particular, are now at historically high valuations. Indeed, certain prominent companies such as Tesla or Airbnb seem downright expensive, and expectations are sky-high. However, the valuation of investments always depends on the general interest rate level as well, since this is used to discount future earnings. And interest rates fell sharply again in 2020, especially in the USA. Finally, the recurring returns on an investment should not be overlooked. As our chart shows, the figures continue to speak clearly in favour of equities, at least compared to bonds, and that was by no means always the case.

DIVIDEND AND BOND YIELDS, 2015-2020, IN PERCENT

Equities, despite everything




Source: Bloomberg, PCB chart. Dividend yields for the S&P 500 (USA), Euro Stoxx 50 (Europe) and SPI (Switzerland). Bond yields for 10-year government bonds: USA, Germany and Switzerland.

For those who fear a crash, there are alternatives. Not the sole, but the best-known, option is to hold liquidity. However, this is only really safe if the cash is held in a solid currency and, if possible, at the central bank of the country in question. After all, in a severe crisis, assets in commercial bank accounts become a risk. At the same time, holding well-protected cash is not free of charge. For example, the interest rate at the highly secure Swiss National Bank is currently negative, at –0.75% p.a. Here too, there is no such thing as a free lunch. But that's not all. There are said to be investors who have been waiting more than ten years for the right moment to invest. During this time, certain equity indices have more than tripled in value. This definitely makes supposed zero-risk quite expensive.

**The right dose of confidence, as before**

Exactly one year ago, in this Client Letter we wrote about living with the dangers of major earthquakes. Our conclusion was that fear and simply waiting for a great collapse are not good advisors. Today, one pandemic later, this has not changed. At best, these challenging times have taught us to better deal with the phenomenon of uncertainty. We are convinced that prudent action and entrepreneurial thinking pay off even more in turbulent times. Those who follow a few simple rules when investing need not worry too much, even in times like these. Moderate debt, good liquidity planning, careful diversification, a mindful approach to risk and uncertainty, a bit of courage and the willingness to occasionally go against the herd and the trend – all this is part of the plan. Ultimately, good wealth management is nothing other than solid craftsmanship.

The right dose of confidence is again the thing for 2021. We agree with the majority of forecasters who predict better times in the New Year – ultimately thanks to the ongoing policy of cheap money, which is both a blessing and a curse. More important to us, however, is the strategic view: standing still is fundamentally not a good idea. Especially in uncertain times, it is important to be invested. Not for nothing did Frank Knight emphasise a hundred years ago "risk, uncertainty" and... precisely: "profit". He should know, since the last major pandemic had just swept through the world.

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IA, 31.12.2020

# Uncomfortable thoughts at year's begin

In the outgoing year of corona 2020, there were some owners of second or third properties, whether in Tuscany, Majorca or the Maldives, who had to forego the physical enjoyment of their property in the form of holidays in pleasant surroundings. Instead, they explored the charms of their local region anew, perhaps even for the first time. Nevertheless, the circumstance of "not being allowed to travel" should give pause for thought. Why? Because it highlights how very vulnerable the cross-border exercise of property rights can be.

Corona has opened the floodgates to more intervention. This could become a threat to private property, including real estate.

If this time the highly contagious Covid-19 virus was to blame for the travel restrictions (or the apparently rather helpless authorities imposing such restrictions), another time it could be trade policy or even military reasons that restrict freedom of movement in the world. Corona has shown politicians how they can take away citizens' freedoms, indeed how to literally lock them away. Provided they have sufficient valid reasons to do so and thus suspend the constitution, at least temporarily. Let us be clear: the political system has tasted blood as a result of corona. There is a great danger that in the future we will be restricted in our constitutionally guaranteed individual rights for less serious reasons.

Real estate as an investment is at risk in this context. First of all, in terms of personal use, as corona illustrated. But also as an investment, because it is not possible to relocate a property and the investor is therefore dependent on local conditions, for better or worse. It is to be feared that populist-induced encroachments on the freedom of ownership will also spread in traditional constitutional states. Even in Switzerland, there have been discussions about government-imposed rent reductions for tenants affected by Covid – at the expense of the owners, of course.

In contrast, liquid investments, such as those offered and recommended by Private Client Bank for its clients, have the advantage that one can switch from investment A to investment B at any time. One can even change both the location of the investment and its underlying currency, and at extremely low transaction costs. And because this is so, policymakers avoid attacking property in the liquid capital market. Their only option is to impose heavy taxes on the owner of the capital at his domicile. In other respects, however, the advance effect of the threat of capital outflow has thus far largely protected liquid investments from expropriation attacks.

It is commonly said that crises are opportunities. Yes, that may be true. But only if we take the crisis as an opportunity to think rightly about the situation and its consequences. For example, the current practice of central banks to become very substantial owners of liquid securities should give pause for thought, especially from the point of view of the future permanence of ownership. Capital stockpiled at central banks can flow away less easily than privately held securities. The loss of the advance effect of the threat of capital outflow would then be another devastating side effect of Modern Monetary Theory and practice that has not yet been considered.

My recommendation therefore for 2021: to be as harmless as doves and continue to follow the corona requirements. And to be as wise as serpents – to observe closely just where, just what mischief is brewing. Corona has unfortunately opened the floodgates to more intervention. Be on your guard.

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KH, 31.12.2020

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