Private Client Letter

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Less Quiet Waters

Fears of inflationary spikes and setbacks in economic growth are rife. Signals from China, in particular, are giving cause for concern. However, the general conditions for the markets have not fundamentally changed.

It is one of the best known episodes from Homer's monumental heroic epic: Odysseus, on his intrepid adventure, comes to a dangerous strait, dominated by a six-headed sea monster on one side and a deadly whirlpool that engulfs entire ships on the other. In such a situation, it becomes difficult to emerge unscathed, as Odysseus and his companions also learn to their sorrow. The ship must be steered skilfully in order to get through the narrows at all.

In the economy, there are also phenomena that are particularly feared. First and foremost are the spectres of recession and inflation, which have recently come to the fore again. Especially when the two appear together, things get tight. This very image of stagflation was recently conjured up in the Anglo-Saxon press. The reason for this is disappointing growth figures and rising inflation rates in the world's major economies. After the recovery phase that has now lasted many months, are we really facing troubled times?

All eyes on China

The first thing to note is that, according to consensus forecasts, growth expectations for 2021 have indeed been scaled back somewhat in recent months for both the USA and China. Nevertheless, the US economy is still expected to grow by over 6 per cent and the Chinese economy by over 8 per cent in the current year. For 2022, as well, the forecasts for the two largest economies as well as for Europe, Japan and a number of important emerging markets include attractive growth rates. At any rate, there is still no sign of recession in these figures.

The situation is rather less clear when it comes to some of the other indicators used by analysts for their assessments. For example, the Caixin Purchasing Managers' Index in China fell below 50 points for the first time since June 2020, signalling negative business developments. The Chinese stock market, for many a good indicator of the future course of the economy, has also lost considerable ground since the beginning of the year – in stark contrast to the US equity markets, as the chart on the next page highlights.

In general terms, this time the uncertainty seems to be spreading more from China than from the USA. For some time now, there have been signs of increased state intervention in the Chinese economy: IPOs worth billions are called off at the last minute (Ant Group), harsh regulations for tech firms imposed (Alibaba, Tencent), IPOs abroad hindered (Didi), profits in certain industries prohibited

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(TAL Education Group, Gaotu Techedu), transactions with cryptocurrencies banned (Bitcoin) or the possibilities for online gaming drastically limited. As a result, not only the broad market, but especially shares of leading technology groups have plummeted by double-digit amounts since the beginning of 2021.

EQUITY MARKETS CHINA AND USA SINCE THE BEGINNING OF

No longer in synch

Source: Bloomberg. 1.1.2020 = 100, performance in local currency.

However, one of the biggest economic problems in China lies elsewhere: the high level of debt. As of the end of 2020, private companies outside the financial sector had a debt level of more than 220 percent of gross domestic product. In recent weeks, this problem has become concrete and visible to all. While the state was still providing capital to the floundering financial conglomerate Huarong in August, it has now been struggling for weeks to rescue the real estate developer Evergrande, which is said to have obligations of over USD 300 billion. It is not yet clear whether this is the tip of an iceberg and the beginning of a major real estate crisis. If that were to be the case, the hope remains that the risk of contagion for the rest of the world would be limited, since the global interconnections with the Chinese financial sector are not yet far advanced. In any case, the Chinese government faces a dilemma: how can financial discipline be enforced without risking the wrath of bruised homeowners?

Inflation – likely to be temporary for now

At the beginning of the corona crisis, we addressed in this space under the title «Low on Reserves» the question of whether, in view of uncertain supply chains in the economy, a shift in thinking towards building up larger storage capacities, more redundancies in production or even increased geographic diversification of suppliers could begin. We hoped that this process could proceed in a relatively orderly fashion and without major frictions, if the economy's respiratory standstill caused by Covid-19 did not last too long. Today, we believe we can state that this process is underway. Despite recurring uncertainties caused by the pandemic – also affecting growth expectations – the economy as a whole has proved remarkably resilient. It may be that certain price increases have to do with such a shift. However, we believe it is unlikely that this will lead to a lasting inflationary trend – after all, the costs of restructuring will decrease again at some point.

In any case, it should be noted that consumer prices in virtually all countries have risen more sharply in recent months than in many years. In addition to the adjustments to a more uncertain environment just mentioned, another statistical effect is currently in play: since prices fell significantly in many places during the first phase of the pandemic, the countermovement appears more dramatic than it really is due to the base effect. At any rate, the financial markets are not yet indicating any lasting threat of inflation – not in bond yields, not in inflation-linked bonds and certainly not in expectations of central bank interest rate hikes. The enormous increase in money supply is very likely responsible for higher asset prices, but they are not (yet?) visible in the velocity of the circulation of money or in consumer prices.

In the past, persistent inflation arose primarily when wages began to rise due to shortages in the labour market, setting off a wage-price spiral. So far, it seems that there is enough cheap labour available in the globalised world – whether physical, automated or virtual. This, too, tends to suggest that inflation will not rise uncontrollably, at least in the short term. In China, at any rate, which

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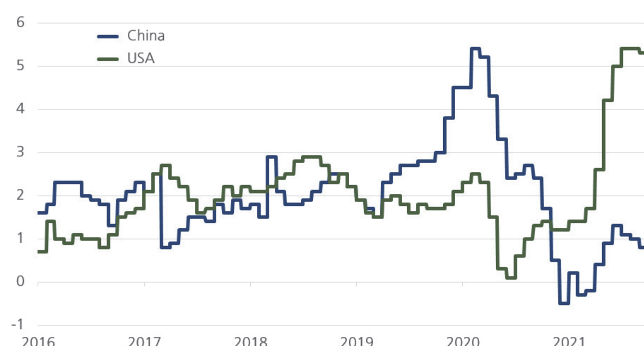
as we know was the first country to be hit by the pandemic, the surge in inflation was temporary, as our chart shows.

INFLATION CHINA AND USA SINCE THE BEGINNING OF 2016

HIGHER WAVES



Source: Bloomberg. Nominal inflation rates (consumer prices).

So in the short term, the signs are pointing more toward easing. Looking to the longer term, however, it should not be forgotten that forces have been at work for some time that could put an end to the era of controlled, low inflation. First, there is the huge expansion of the money supply mentioned above, which would have to be painfully scaled back (if at all possible) if a maelstrom of inflation were to break loose. And second, demographic conditions are beginning to change fundamentally with the retirement of the baby boomers from the labour market, as Charles Goodhart and Manoj Pradhan describe in their remarkable book «The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival». In a few years, the world could indeed look completely different, with major challenges for financing the mountains of debt that have also grown enormously in the Western industrialised countries. It seems that while the monster is not directly in front of us, we certainly cannot ignore it.

No perfect storm for the time being

So are we, like once Odysseus, heading for an (economic) strait between Scylla and Charybdis? No, according to our analysis, the signs are not currently pointing to stagflation: investors would be well advised not to disproportionately gear their portfolios to such a scenario. First, developments in China and the USA have so far not been synchronised. Second, the central banks – whether we like it or not – still seem determined to flood the economy with cheap money when signs of weakness arise. Third, the money glut has not yet had a measurable impact on inflation rates for consumer prices. So, interest rates are likely to remain historically low and inflation moderate for the foreseeable future.

In contrast, cheap money and the recent recovery have led to higher prices and valuations for shares, real estate and private market investments. This also explains why markets have been reacting more nervously to rumours and news lately. In particular, many market participants fear a reduction of central bank liquidity programmes («tapering»). This goes so far that bad news is sometimes received positively because it suggests a later tapering. In any case, it seems to us that corrections in the markets are fundamentally necessary, healthy and most likely temporary, because nothing fundamental has changed in the general framework so far. It would take more than that, such as a transformation of China into an importing nation, a loss of market confidence in the central banks or a debt and real-estate crisis of global proportions.

For many months, at least on the financial markets, the sailing was relatively calm and blessed with attractive returns. It may be that less quiet waters are ahead. However, that is no reason to give up hope and lose sight of the course. And staying the course still means being invested.

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IA, 30.09.2021

Tally-ho!
Blithely hunting the rich

Switzerland has just voted again. It often does, and the issues are not always of overriding importance. A few years ago, for example, voters were presented with a petition for a referendum on horned cows. The right of initiative granted by the constitution naturally knows no limits in terms of content, and so every now and then, nonsense dictated by the zeitgeist makes its way to the ballot box. But for the most part, the people's common sense has prevailed so far, or let's say, at least no worse than some supposedly knowledgeable parliaments in foreign countries near and far.

At this year's central bank meeting in Jackson Hole, three American economists presented a paper that – to put it briefly – blames the rich for the sustained low interest rates.

A week ago, a special tax for higher-income citizens was up for debate. A seductive political move, the so-called 99 per cent initiative, since the vast majority of the electorate was among the potential beneficiaries, while a raid on the incomes of those «who can afford it» was envisaged. The good news: the popular initiative from the far left was resoundingly rejected, namely with 65 per cent of the votes. Moreover, not a single canton voted in favour of the project. That is reassuring. Somehow the causal link between income, growth and prosperity seems to be well anchored in Switzerland.

The bad news: the next, comparable initiative is already in the wings. Now it will no longer be about income taxation, but about large fortunes. Everything that amounts to more than 100 million per person is to be «socialised», in other words: expropriated. This proposal will also be rejected. That is not the problem.

What is more troubling is that only 30 years after the collapse of the Soviet Union, which was based on socialisation, expropriation and forced labour, anyone would even think of reaching into the mothballs of the Communist past. But somehow hunting the rich is in the zeitgeist. The French economics professor Thomas Piketty began it, and it is now being blithely continued, for example by three American economists who were permitted to present a paper at this year's central bank meeting in Jackson Hole that – to put it briefly – blames the rich for the sustained low interest rates. Because the richer save more than the poorer. How surprising, one might remark. But the fact that the rich have become so rich because, among other things, the central banks let asset prices skyrocket to unreasonable heights by lowering interest rates, is not mentioned. What is cause, what is effect, who is really «to blame»?

This academic paper will not have any direct impact either. But it is another beacon on the way to a rather uncomfortable world in which performance and risk-taking are little appreciated and alleged equality is held up as the ideal. In Switzerland, at least the people still have the last word and can resist the zeitgeist. In Anglo-Saxon countries, there has always been an inhibition against snatching property, in the UK even under the reddest of red Labour governments. In all other cases, I would not be so sure.

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