Private Client Letter

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Riding the Roller Coaster

Rampant inflation is forcing central banks to change course on monetary policy. In the past, interest-rate reversals were always accompanied by lengthy phases of heightened uncertainty. Caution and steady nerves are needed.

If you toss a waterproof, weighted explosive device containing dynamite into waters full of fish, and then detonate it, stunned fish will begin to float to the surface, which can then be collected by fishermen without much effort. At the same time, organisms and the underwater environment are destroyed without it being visible from above. This is why this type of fishing, which was still common in Europe in the post-war period, is rightly frowned upon and banned in most countries of the world, although it is still fairly common in developing countries in Southeast Asia, Africa and the Caribbean.

The obviously crude method of dynamite fishing recently inspired the well-known market analyst Charles Gave, co-founder of the research boutique Gavekal, to compare it with the effects of interest-rate increases by central banks: it is first the little fish who go «belly-up» at the water's surface; only later do the bigger fish appear. As examples for the latter, he named the crash of the Franklin National Bank in 1974, the defaults by Mexico in 1982 and Russia in 1998, as well as the collapse of Lehman Brothers in 2007. All of these events were preceded by lengthy cycles of increasing interest rates by the US Federal Reserve, which had begun a few years earlier.

Today it is already clear that 2022 will go down in history as the year of a great interest-rate reversal. The Fed has already raised benchmark US rates three times: from 0.25% to 0.50% in March, to 1% at the beginning of May, right up to 1.75% in mid-June. June was generally a month for hiking interest rates: the central banks of Australia, Brazil, Canada, Chile, the Czech Republic, Great Britain, Hungary, India, Norway, Poland, Saudi Arabia, and – last but not least – Switzerland have all lifted interest rates in the last four weeks, in some cases markedly. In the case of the Swiss National Bank, it is noteworthy that the 50-basis-point step (to minus 0.25%) was not only sizeable, it also took place before the European Central Bank (ECB) adjusted rates. There is much to suggest that interest rates will continue to be raised – given the surge in inflation rates, the central banks have few other options for the time being. This probably also applies to the most conspicuous absentee from the interest-rate turnaround so far, the ECB.

Driving by sight

In mid-February, even before Russia's invasion of Ukraine, «The Economist» printed a dramatic cover illustration: a roller coaster soaring high into a vivid blue sky before plunging down into a sea

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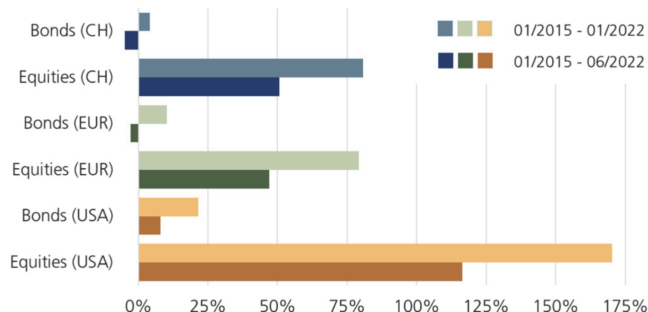
of clouds. The title asked: What would happen if the markets crashed? And further, if big losses do materialise, would the financial system safely absorb them or would it actually amplify them?

Indeed, the financial markets have been wracked by uncertainty since autumn 2021. And since the beginning of 2022, price charts have increasingly resembled a wild roller coaster in a clearly downward trend, coupled with sharply deteriorating visibility. In the meantime, the effects of price corrections are manifest in the longer-term performance of liquid assets. Since a period of seven years is often considered "long term" in financial circles, our chart shows the 7-year returns on major equity and bond indices between 2015 and 2021, and the impact of losses since the beginning of 2022. What particularly stands out is that investors with bonds in Swiss francs (cumulative –5%) and euros (–2.8%) are now also losing money in the long term – and that in nominal terms, i.e. before inflation.

CUMULATIVE LONG-TERM PERFORMANCE SINCE JANUARY 2015

RATE REVERSAL'S BROAD IMPACT



Source: Bloomberg US Government 10 Year Term Index TR, Germany Govt. 7-10 Year TR und Swiss Bond Index SBI Domestic Govt. 7-10 TR. SMI, Euro Stoxx 50, S&P 500. Cumulative performance in local currency.

Despite the turbulent times, system-threatening shock waves have so far failed to materialise in 2022. Banks, at least, appear safer than before the great financial crisis from 2007 onwards, thanks in part to increased regulation and higher capital requirements. Now, the danger is more likely to come from the realm of shadow banks, i.e. those outside the regulated financial system – for example in automated high-frequency trading via funds or unregulated digital channels. According to «The Economist», the volume of shares traded in the USA today is 3.8 times higher than it was 10 years ago. Cheap money has certainly persuaded many investors to take on more risk than their profiles can actually bear. And increasingly innovative ways of using debt to leverage capital have been found that have yet to pass the test of a major financial crisis. To stay with our image of a roller coaster, we could be dealing with a steadily accelerating car, travelling on worn out rails.

The euro zone is a big fish

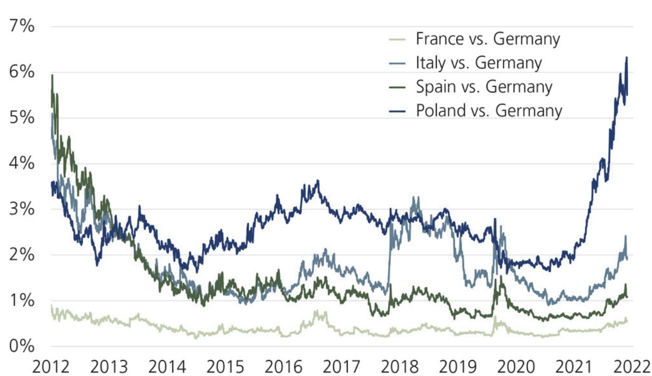
In recent weeks, annual returns on a wide range of asset classes have been deep in the red. The major equity indices were down between 15% (SMI) and 30% (Nasdaq) at the end of June, and 10-year US government bonds shed around 10%, as did the index for Swiss real estate shares. Almost everywhere, we saw that there is what we call in the trade «nowhere to hide». There were exceptions, notably in commodities and energy, as well as anything close to cash. At least there have been no major movements in the key currencies so far. On balance, despite the uncomfortable situation, financial market stability has yet to be challenged – unlike in 2007 or 2020, for example. A real panic, also referred to as «capitulation», has not yet occurred in 2022. Or in other words, the big fish have not yet risen to the surface.

Aside from the risks outlined above in the areas of shadow banking, high-frequency trading and excessive debt in the financial system, an old acquaintance has also reappeared on the list of problems in turbulent times: the euro zone. Almost exactly ten years ago, on 26 July 2012, then President of the European Central Bank (and current Prime Minister of Italy) Mario Draghi uttered his famous words in support of the euro: «Within our mandate, the ECB is ready to do whatever it takes to preserve the euro.» These words are still in effect today, and the markets trust that the ECB can and will do it. Our chart backs this up: the yield premiums for French, Spanish and Italian 10-year

government bonds over their German counterparts fell significantly in 2012 and have remained largely under control since then. What is unclear is whether a trend reversal is now emerging. One indication could be the considerable rise in risk premiums for Polish government bonds – after all, Poland is one of the five most populous countries in the EU, albeit not a euro member.

YIELD PREMIUMS ON 10-YEAR GOVERNMENT BONDS 2012-2022

PRESSURE RISING IN EUROPE



Source: Bloomberg, data for 26.07.2012–23.06.2022.

It is clear that rampant inflation is also fundamentally changing the situation in Europe. For the first time in many years, there is an urgent need for interest rates to be raised. This creates difficulties for highly indebted governments and revives questions about the monetary union, which is laden with major design flaws. It is not for nothing that the ECB Council had an emergency meeting on 15 June and intends to combat «fragmentation». In plain language, this means the ECB buying more government bonds from highly indebted member states to protect them from disaster. Although it would still be very risky to bet on a breakup of the euro, the financial world is once again keeping a wary eye on Europe. This goes so far that Gavekal refers to the euro zone as the whale that might rise to the surface when dynamite fishing. That may be an exaggeration. Nonetheless, some factors suggest that the euro is at least on the way to becoming an increasingly soft currency.

More cautious in the second half

In the summer of 2020, we addressed the major bear markets of the last forty years under the title «Anchoring in Real Assets». The period between crash and recovery ranged from around four months (2020) to nearly five years (2000). Despite all confidence and conviction about the long-term superiority of investments in equities and real assets, we may now be facing a prolonged phase of heightened uncertainty. A roller coaster ride with limited visibility is not for the faint of heart – and certainly not for investors who, due to obligations or other circumstances, have a short time horizon. Such investors should use phases of market recovery to adjust their risk profiles. But let us harbour no illusions: in such times, there are no safe and simple solutions.

In June 2020, Fed Chairman Jerome Powell, who still holds the office today, was quoted as follows: «We're not even thinking about thinking about raising rates». Who would have thought back then that just two years later we would be living in a drastically changed, mirror world? Today, too, no one can know what the world will look like in terms of the economic, geostrategic, monetary, climatic and other challenges we will face two years from now. Should bigger fishes go «belly-up» in the meantime, many people think that central banks will again attempt to intervene with cash injections. Despite the interest-rate trend reversal, this could nonetheless take some time and it is not guaranteed that cheap money would again have a calming effect.

Similar to fishing with dynamite, central bank policy is not fine mechanics and can only work with crude means – even more so in times of great change. In this light, we prefer to act somewhat more cautiously in the portfolios and not to stock up to the strategic equity allocation again for now. At the same time, we remain convinced that quality shares belong in every long-term-oriented portfolio, roller coaster or not.

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IA, 30.06.2022

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Is it Volcker Time?

Those who consciously experienced the 1970s and 80s remember well the turning point in history that was heralded in 1979 with the appointment of Paul Volcker as Chairman of the US Federal Reserve. The USA had hit bottom: an ignominious retreat from the ill-fated Vietnam War, an expulsion from Tehran in embarrassing circumstances, weak growth as a result of overly active monetary and fiscal policies, and annual inflation that intermittently peaked just below 15% in early 1980. The country began to straighten up under the new president Ronald Reagan; needful structural reforms were addressed and the fatalistic mentality of the 1970s was banished from people's minds. However, it took nearly ten years to force the poison of overly loose monetary policy out of the financial system. Above all, though, it needed a Fed Chairman who, regardless of accusations from virtually all sides and with admirable strength of purpose, pushed through his new monetary policy based on monetarist principles. High interest rates – the benchmark rate was at times 20% – initially strangled the economy, only to put it on a healthier footing after years of bitter disillusionment. For the economy, «Volcker time» meant blood, sweat and tears.

This is the last chance to save the US dollar as a global currency.

Given the overheating of the US economy following the pandemic and the decades-long practice of accommodating the financial markets with cheap and even cheaper money («don't worry, the Fed will fix it»), the question is now whether current Fed Chairman Powell will follow in Volcker's footsteps and continue to implement his restrictive monetary policy. Political augurs and financial analysts, and presumably also a substantial share of market participants, do not believe this will be the case. They assume that Powell would capitulate at the first real opposition from Washington or Wall Street and quickly cut interest rates again. They would say he does not have Volcker's character, is not a real expert, and on top of all that, the Fed is dependent upon the financial markets because of its high bond holdings. Nor can Powell rely on any political force because both parties have long succumbed to the sweet poison of low interest rates.

After careful consideration, I have come to a different conclusion: Chairman Powell and the Fed will continue and prevail with their new monetary policy, even in the medium and long term. For this is the last chance to save the US dollar as a global currency and to preserve the unique attractiveness of the American capital market (and thus the American economy). Otherwise, the dollar is fated to become a «me-too currency» à la euro or Brazilian real – with incalculable consequences for the financing of the US government and economy.

Events in the USA are being shaped by three predominant forces: Washington, Wall Street and a group of «sages» in the Treasury department, IRS, a few banks, industrial companies, the military and security authorities. This «invisible backbone» is overlooked by most observers, but it has survived every administration and generally preserved order, albeit often at the last minute. Washington's current weakness and the foreseeable stalemate after the upcoming midterm elections suggest that such a time is at hand, especially since the USA also needs to find a path to a more powerful geopolitical position vis-à-vis China and Russia. The «invisible backbone» will strengthen Powell's position, no matter how loudly Wall Street howls.

One more thing: if I am right, the ECB will have to prepare itself for the worst. The collapse of the euro system could be the price for the resurgence of the US dollar as a global currency.

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