Private Client Letter

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Waiting for Godot

Waiting for the big recession makes no sense. It cannot be predicted with any accuracy. Moreover, economic conditions may actually be better than sentiment – for one, due to the burgeoning technological revolution.

"And if he doesn't come?" asks the tramp Estragon in the classic play *Waiting for Godot*. "We'll come back tomorrow," answers Vladimir. "And then the day after tomorrow." First performed almost exactly seventy years ago, Samuel Beckett's play is a milestone in the theatre of the absurd and examines the drama of waiting in vain. Everything revolves around Godot, but no one knows exactly what he is or what he means. And by the end of the play he has yet to appear.

"Where's the Recession We Were Promised?" asked a Wall Street Journal headline a few days ago. Although the comparison is imperfect, it somehow resembles an echo from Godot. For over a year we have been waiting for energy shortages, rising unemployment and the big recession. Now, we had already pointed out in our "Letter" last autumn that forecast catastrophes rarely turn out to be as disastrous as announced by media and politicians. Nonetheless, the absence to date of the major upheavals expected by almost all forecasters is surprising: with the exception of the (probably home-grown) weak developments in Germany and the UK, the trend is passable to good in all major economies, unemployment is modest, energy prices are low. In the highly sensitive financial markets, too, the crisis that was widely predicted for 2023 has so far largely failed to materialise, despite inexorably rising interest rates and a few unsettling bank failures in the spring.

Admittedly, the signs have not been good for some time. The challenges associated with geopolitics, climate change, energy supply, debt, demographics and price stability are obviously enormous. And yet, could economic conditions actually be rosier than sentiment? Are we waiting for a crisis that will never come?

Gutenberg moment

One of the great sages of our time, US politician and recent centenarian Henry Kissinger, wrote a remarkable article in February 2023 with two notable co-authors – the former head of Google, Eric Schmidt, and MIT professor Daniel Huttenlocher – in which the emergence of generative artificial intelligence in the style of ChatGPT is described as the greatest transformation in the human cognitive process since the first Bible was printed by Johannes Gutenberg in 1455. This new technology calls for a new concept of processing human thought; in the view of the three authors, the era of "homo technicus" is dawning.

The quoted article is just one of many and we should take the message seriously – although of course it is possible that we are in the opening stages of a new "hype" with all the related

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exaggerations. While we would not want to make this claim, we cannot help observing that the stock markets seem to share the view of Kissinger & Co. For example, the introduction of ChatGPT in autumn 2022 set off a boom in technology shares that has been lifting the entire market ever since. According to an analysis by The Economist, over 70% of the price gains by the US S&P 500 index since November can be attributed to the performance of just 14 companies largely active in the field of artificial intelligence – as is well known, the index comprises a further 486 companies. Shares in chipmaker Nvidia particularly stand out, having risen by more than 180% in 2023 to date, and now fifth largest in the index behind Apple, Microsoft, Alphabet and Amazon. Nvidia is showing signs of a bubble, especially since the price-earnings ratio based on past earnings is now over 200.

APPLE, MICROSOFT, ALPHABET VERSUS S&P 500

TECHNOLOGY DRIVING THE MARKET

Source: Bloomberg, 01.01.2018 – 27.06.2023. Price developments are indexed to 1 January 2018.

The three largest US technology companies – Apple, Microsoft and Alphabet – do not yet seem overpriced, with price-earnings ratios of 25 to 35, and earnings have so far kept up quite well with prices. Our chart shows the latest price increases against the backdrop of the longer-term development. What stands out are the price rises on the back of low interest rates and later the pandemic in 2020/21, and the strong valuation correction in 2021/22 triggered by the interest rate increase. Technology shares were particularly affected by these events.

Anything seems possible

Pandemic, war and interest rate shocks have disrupted the normal order of things around the world. For many years, variables in economic models could be extrapolated relatively easily on the basis of past trends and, if necessary, adjusted upwards or downwards – tomorrow's weather could be derived from today's without much risk. Even then, forecasts were only partially reliable; in times of multiple external shocks and increasingly erratic interventionism by politicians and governments, they begin to resemble the theatre of the absurd. Against this backdrop, the McKinsey Global Institute took a sensible course in a May 2023 study, sketching out scenarios in order to gain a feeling for how growth and prosperity could develop up to 2030. Before we pursue this briefly, two things should be stated in advance. First: anything seems possible; and second: half of the scenarios call for a short, flat recession in the near future, while the others foresee none at all.

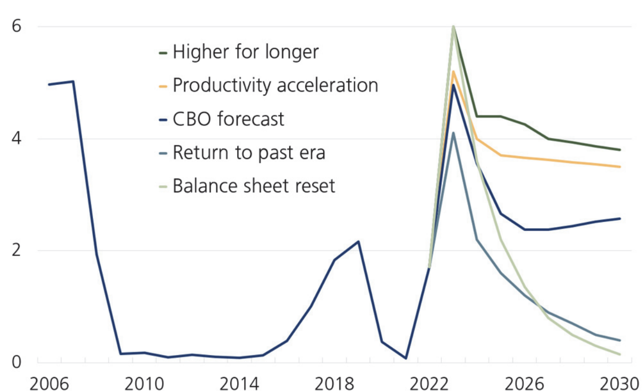
Altogether, the McKinsey Global Institute has outlined four scenarios: (1) "Higher for longer", with heightened inflation rates similar to those after the oil shock of the 1970s; (2) "Productivity acceleration", with a growth surge like that after World War II; (3) "Return to past era", with sluggish growth and high debt as in the years from 2000 to 2019; and (4) "Balance sheet reset", with painful losses as in Japan in the 1990s. The consequences for each of the key asset classes – liquidity, bonds, equity and real estate – are listed in the form of average annual returns in real terms, i.e. after inflation.

The question of price stability and, linked to it, the question about future interest rate developments, is particularly tricky. It is decisive in order to calculate real returns for the various asset classes. As our chart on the next page shows, expectations for the nominal leading rates in the USA differ widely in the four scenarios. However, we also observe the following: all the scenarios assume that interest rates – and thus, implicitly, inflation – will soon have passed their peak. Some analysts would already call this assumption bold.

In their summary, the authors of the McKinsey study acknowledge that three of the four scenarios are quite or very pessimistic. Even a return to pre-pandemic conditions, for example, would be only temporarily reassuring, since the problems existing then – high debt, economic distortions and asset price inflation – would only be exacerbated.

NOMINAL CENTRAL BANK INTEREST RATES IN THE USA TO 2030

Many scenarios



Source: McKinsey Global Institute, “The future of wealth and growth hangs in the balance”, May 2023. The CBO forecast is based on official data from the US Congressional Budget Office.

With regard to our comments on a possible “Gutenberg moment”, we are basically less pessimistic than many voices today. It may even be that the estimated inflation and interest rate figures in the positive “Productivity acceleration” scenario are too high. Indeed, in contrast to the post-WWII landscape, a growth surge based on artificial intelligence would stem from machines and not (scarce) labour. This could mean low inflation and high growth – the best of all worlds. Given the rapid pace of innovation, this is not unthinkable. We say this with circumspection, since the new technologies are not a panacea and, like all revolutions, carry the risk of frictions, uncertainty and bubble formation.

Entrepreneurial investing

Critics will complain that the McKinsey authors are non-committal and therefore offer nothing concrete. However, in view of the great uncertainties, we believe this is an honest and fair approach. And for investors, one important insight remains: none of the asset classes examined promises positive real returns in all scenarios – sometimes one works, sometimes another. And in the worst case, let it be said, losses or at best zero returns can be expected everywhere. The asset manager's only sensible response is, unsurprisingly, to emphasise the importance of smart diversification. Betting the farm on one card is perilous – regardless of whether it is the end of the world or paradise.

The question remains about the promised recession. First the short answer: unlike Godot, it is bound to come at some point. Could investors use this to their advantage? Yes, but only if they could accurately predict occurrence, depth and duration of recessions; if they also knew exactly how asset classes and instruments would be affected; and finally, if they could implement this in portfolios in a timely way at a reasonable cost. We are convinced that all this is only possible in exceptional cases. That is why we focus on companies that should also weather recessions well. As a rule, we remain invested even in difficult times if we are convinced of a company's business model. Entrepreneurs do not shy away when the times are more challenging – this is the essence of entrepreneurial investing.

Really bad recessions are rare. They are part of the fitness programme for companies and they strengthen the economy's immune system. Long-term investors should remain calm and take the excitement for what it often is: media entertainment or, sometimes, theatre for attention, votes and money.

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Rapid and brutal

Since the inglorious demise of one of the two major Swiss banks, the once proud Credit Suisse, the global financial community has been enriched by an important experience: the modern, globally effective bank run. It contrasts hugely with the almost tranquil images of long queues in front of venerable bank buildings in London as creditors tried to save what was left of their assets in cash. The modern bank run takes place invisibly in the electronic-virtual sphere. It has neither open-counter hours nor banknote logistics, and makes no material distinction between account balances – which are indeed at risk – and privileged deposit holdings. The modern bank run is radical and takes place within a very brief timespan thanks to social media and other means of communication. A few days are enough to empty a bank and render its continued existence unthinkable.

The problem of the radicality and speed of the modern bank run remains. Rumours would presumably be enough to shake even solid banks to their foundations. The global financial system remains latently unstable post-Credit Suisse.

It hit the undoubtedly right institution. At the latest since the bad news about the Greensill conglomerate, it was clear that the many previous promises of business-political rectification were smoke and mirrors. Credit Suisse's risk premiums could hardly be controlled any longer, and it was foreseeable that even minor shocks in the banking system would have serious repercussions for the embattled bank.

But everyone, first and foremost the recently appointed new Credit Suisse management, but also the supervisory authority Finma and the Swiss National Bank as lender of last resort, had completely underestimated the speed of a modern bank run. Foreign banks and authorities were equally shocked, especially in the USA, where the banking crisis of 2023 had originated. In view of the impending CS catastrophe, there were fears of a global financial crisis with multiple victims among banks that certainly deserved to survive. There was probably no alternative to this unique CS rescue, involving the far healthier UBS and under the strict orders of Swiss Finance Minister Keller-Sutter.

However, the problem of the radicality and speed of the modern bank run remains. For rumours would presumably be enough to shake even solid banks to their foundations. Two or three unfavourable comments on business conduct and the balance sheet, a few minor personal scandals, high management salaries... The global financial system remains latently unstable post-CS; new crises can hit anyone and everyone. This represents a challenge to central bankers and regulators – what is needed is a new architecture adapted to the dramatically lower information and transaction costs.

At the moment, all I see is the following: either we find ways to geographically or materially contain a banking problem (“containment”), or we must delineate a sharper separation between central bank money and the commercial money created by the banks. Payment transactions and ordinary savings would then have to be reserved for secure “full money banks”, all the rest for a banking community beyond state guarantees and too-big-to-fail ideas (“segregation”).

At least one thing is certain: until that happens, the financial system and thus the banks will remain at risk.

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