Investing in times of boom and bust – the 2017 challenge

R[E]volution 2017,
Leonteq conference, 19 January 2017, Zurich, Switzerland

By Thorsten Polleit
polleit@polleit-riechert.com

Ladies and gentlemen,

Thank you very much for your invitation. It is a great pleasure to be here.

In my talk I would like to touch upon issues I consider to be quite important for you as professional investors.

As you will see, I will mostly take the perspective of an investor rather than of an economist. Why is that?

It is because I act as an advisor to an investment fund, which I co-founded in 2012.

I am therefore quite keen to point out where macroeconomic considerations are useful, and where they are irrelevant for the seasoned investor.

Without further ado, let me start on a positive note.

Chart 1

As you can see on the chart, the major economies of the world are expanding. Real output in the US, the Eurozone, Japan, and the UK has well surpassed pre-crises levels.

Perhaps even more import, leading indicators suggest that economic growth rates should remain positive in the coming quarters.

Chart 2

The Chinese economy is showing signs of improvement as well – as suggested by, for instance, the "Li Qe Quiang" business cycle index, which has been going up since around the beginning of last year.

The outlook for higher economic activity in China seems to help commodity prices to bottom out, as China is by far the world's most significant consumer of raw materials.

All in all, the world economy seems to be up and running again. Growth rates are not stellar, but certainly in positive territory.

Chart 3

I venture to assume you want me to say: Watch out!

The presidency of Donald John Trump will most likely bring far-reaching changes – not only for the US but the entire world, with effects we are just beginning to understand.

You are quite right in this respect – and this is what *I* want to say.

President Trump made it pretty clear that he is not an "internationalist" like his predecessors Bill Clinton, George W. Bush, Barack Obama, or his competitor in the presidential election, Hillary Clinton.

Mr. does not wish to crusade, does want to harness America's exceptionalism to bring about a new world order by political and military means.

"There is no global anthem. No global currency. No certificate of global citizenship. We pledge allegiance to one flag and that flag is the American flag."

From Mr Trump's words I deduce that the future US foreign policy might be much less interventionist and militarily aggressive than it has been in the past.

Chart 4

Americans voted for Mr. Trump to "make America great again". They long for more and better jobs and higher income.

One way Mr. Trump can live up to these campaign promises is to redirect imports in and exports out of the US.

There is an idea that is making its round within the Beltway, namely making imports no longer tax deductible and scraping taxes on US exports. The effect would be that 1) foreign firms get an economic incentive to move production to the US.

And 2) US exports would become more competitive, allowing US producers to gain world market share.

The US trade balance, which has been in deficit chronically, would consequently tip as imports decline and exports rise.

There would be less US$ debt for financing the trade deficit and more dollar demand from abroad to finance investments in the US. This should be US$ positive.

In the *short-term*, redirecting foreign trade flows this way could surely benefit the US, while putting quite some pain of adjustment on countries exporting to the US, particularly on China and Germany.

In the *long-term*, however, the effects would be negative because world production would no longer take place in locations economically best suited for the task.

Output would remain below potential, and production prices would certainly go up.

Chart 5

A more powerful and economically reasonable tool is Mr. Trump's plan to cut taxes.

According to the Tax Policy Center, Mr Trump is about to hand back 9.5 trillion US dollar (that is nearly half of the US GDP in 2016) to the people over the next decade.

It would clearly have a positive and substantial effect on corporate earnings and the return on investment, thereby boosting production and job creation in the US.

It would also make the US more attractive for international enterprises, giving them an economic incentive to move production to the US.

Moreover, lower corporate US taxes could trigger a worldwide reduction in taxes, which should give a positive impulse to other economies around the globe.

Just think in this context of the UK: It is already toying with the idea of cutting corporate taxes as a response to Brexit.

Two-thirds of the tax cuts delivered by Mr Trump would benefit individual income tax payers, giving them more money for consuming, saving, and investing.

What does Mr.Trump's tax plan mean for the US budget deficit?

The budget shortfall is estimated to add 2.8 percentage points to the US fiscal deficit in 2017, rising to around 4 percentage points per year in the years after that.

These numbers, however, do not account for the positive impact the tax cuts will have on growth; and they account for possible spending cuts in the budget.

The so-called "Laffer curve" effect may well come to the rescue. The Laffer curve essentially says that if taxation is too high, a tax reduction increases (rather than decreases) tax revenues.

Lowering taxes can, therefore, be regarded as more of a chance than a risk: money in the hands of firms and consumers will be spent more wisely and productively than through the government.

Also, Mr Trump has campaigned on the promise to "dry the swamp" in Washington, or in more diplomatic terms: to roll back big government. If he lives up to his promise, extensive budget cuts would be a means for reigning in the budget deficit.

Chart 6

In this context, let us take a brief look at the relation between the US budget deficit and changes in employment, which you can see in this chart.

The two lines are positively related: If the employment rate goes up, the deficit shrinks and vice versa – since higher employment lowers spending on social security and increases tax revenues.

If Mr. Trump's plan works out and results in higher growth, an additional 1.2 million jobs may be created per year (translating into an additional employment growth of 1 percentage point), helping to reduce the budget deficit.

That said, concerns about a ballooning US budget deficit and a spike in inflation as a consequence of Mr Trump's envisaged tax cuts might be overblown.

Finally, we should factor in that Mr Trump and his team are very much pro-business – as suggested by their explicit endorsement of the work of Ayn Rand, the novelist and libertarian heroine who celebrated laissez-faire capitalism.

Cutting taxes and doing away with red tape might not be popular with certain political pundits. However, I lean towards thinking that Mr. Trump's approach offers a real chance to promote growth in the US, which would also benefit other parts of the world.

Chart 7

When we talk about investing in times of boom and bust, there is no way of getting around a somewhat delicate issue: fiat money.

Fiat money is the big gorilla in the room; so big that most people would not even see it. Please allow me to explain.

Chart 8

The US dollar, the euro, the Chinese renminbi, the Japanese yen and the British pound are all fiat monies. Fiat money has three characteristics:

1) It is produced by state-sponsored central banks which have the production monopoly

2) Fiat money is created through bank lending, which means money creation out of thin air.

3) Fiat money is intrinsically valueless, representing colourful pieces of paper, and bits and bytes on computer hard drives.

By all means, fiat money (you may also call it irredeemable, or unbacked paper money) is far from being a natural or harmless institution.

The American economist Milton Friedman put it succinctly. He said: "(…) a world monetary system has emerged that has no historical precedent: a system in which every major currency in the world is … on an irredeemable paper money standard (…). The ultimate consequences of this development are shrouded in uncertainty."

Fiat money causes quite a few economic and ethical problems:

1) It is inflationary. The relentless increase in its quantity (made possible by central banks) erodes the purchasing power of money. Take the euro, for example. Since its introduction in January 1999, the euro has lost 27% of its purchasing power in terms of consumer goods.
2) Fiat money benefits a few at the expense of many others. The first receivers of the new money are the beneficiaries. They can exchange their new money against good and services at unchanged prices. The losers are the late receivers of the new money. They can only purchase vendible items at already elevated prices.
3) What is more, fiat money causes boom and bust. It sets into motion economic expansion and speculative frenzies that will, and must, eventually collapse.
4) Fiat money also raises the level of indebtedness. The reason being that fiat money is created through credit expansion, and typically the increase in debt outpaces income gains.
5) Another result of fiat money is that governments become bigger and bigger. This happens because fiat money provides them with financial means well beyond regular tax incomes.

Chart 9

Let us now take a look at the inflationary impact of fiat money. On this chart you see the growth of money supply and consumer price inflation in the OECD since January 1980.

The two time series trend on the same wavelenght: Higher money growth is accompanied by higher inflation and vice versa.

Since around the end of 2014, money supply growth has gained momentum and, with a time lag, consumer price inflation has also started to pick up.

As it is very likely that central banks will keep churning out new fiat money, we should expect that consumer price inflation will be increasing going forward.

Chart 10

In this context let us take a look at what market participants are thinking about future inflation.

This chart shows you inflation expectations in the US, the Eurozone, and the UK – illustrated by the 5 year/5 year inflation swap rates.

(These rates tell you what consumer price inflation is expected to be in 5 years for the coming 5 years.)

Inflation expectations have started to pick up since the beginning of July 2016: Financial markets expect consumer price inflation to remain in line with central banks' inflation promises.

Chart 11

For you as an investor, however, it is important to note that inflation (which is a symptom of an increase in the money supply) can take various forms.

It may emerge in the form of rising consumer prices, but it may also manifest itself in the form of higher asset prices.

On this chart, you see the real estate prices in the US, the Eurozone, the UK, Japan, and China. With the exception of Japan, prices have gone up quite substantially since the 1990s.

Asset price inflation, here exemplified by real estate price inflation, has well outpaced the inflation of consumer prices, resulting in a devaluation of currencies which has most likely exceeded investors' expectations.

Chart 12

I already mentioned that fiat money causes boom and bust. Japan provides a prime example.

From the early 1970s to December 1989 (when the Nikkei 225 hit close to 39.000 points), the Japanese stock market rose by a spectacular 14% per year on average, with land prices increasing by 7.4% and consumer prices by 5.4% per year.

The boom, fuelled by excessive credit and money growth, turned into a bust as from December 1989, though.

Chart 13

Until December 2016, Japanese stock prices fell by 59%, land prices by 63%, only consumer prices went up by 6.5% in total.

Investors should heed the Japanese experience and should interpret it as a mild version of what may happen if and when the fiat money frenzy blows up in all our faces.

Chart 14

Fiat money makes economies run into too much debt. On this chart, you see the US Federal Funds Rate and total US debt in percent of GDP from 1960 to the end of 2016.

The message is straightforward: interest rates down, debt-to-GDP ratio up. Why is this? In a fiat money regime, debt expansion outpaces the credit-financed income gains.

To prevent the debt pyramid from coming crashing down, central banks keep pushing interest rates to ever lower levels.

And as the economy is getting used to very low interest rates, it becomes difficult, even impossible, to bring interest rates back up.

Chart 15

Central banks, with their policies of relentlessly expanding the quantity of fiat money through credit expansion, caused the economic and financial debacle in 2008/2009 in the first place.

The response to the crisis was even lower interest rates and more fiat money, and so the continuation of the latest economic recovery rests on keeping interest rates at relatively low levels.

The power of central banks is not unlimited, but investors should expect them to remain quite powerful for quite some time.

Chart 16

Nevertheless, however, central banks' manoeuvring room has significantly decreased. To demonstrate this, let us have a look at this chart.

It shows the S&P 500 stock market index (black line) and the shape of the US yield curve (that is 10-year Treasury yield minus 2-year rates in percentage points).

The shaded areas represent periods in which the yield curve was negative; that is when long-term rates fell below short-term rates. When the yield curve became negative, the stock market nosedived. Why?

Banks lend long-term and finance themselves with shorter maturities. If the yield curve starts flattening out, lending becomes less profitable for banks. They become hesitant to refinance maturing credit and increase their loan book.

By hiking rates, the Fed pricked the stock market bubble in 2000/2001 (which the Fed had helped inflationing through easy monetary policy), and it also pricked the

credit bubble in 2008/2009 (which the Fed had helped fuelling through a very easy monetary policy).

This is not to say that the shape of the yield curve would be the only significant factor in determining the direction of the stock market.

But a positively shaped yield curve appears to be a necessary condition for preventing another bust, and this goal ranks high on central bank's priority list.

Chart 17

Also, keeping interest rates low is at least equally important.

By cutting interest rates, central banks have succeeded in dispelling default concerns in credit markets.

They have, for instance, managed to lower CDS spreads for bank debentures markedly since around the end of 2012.

As a result, investors returned to credit markets, providing funds at very low interest rates even to borrowers of low credit quality.

(I am inclined to think that the credit market is the most distorted financial market segment of all.)

Low interest rates and, at the same time, a steep yield curve are indispensable for keeping the fiat money system going.

This is why central banks already effectively control the entire yield curve, from the short to the long end.

Chart 18

This is not a new policy. It is the same policy that was put into place during World War II.

As from 1942, the Fed kept interest rates at 3/8 of a percentage point and long-term yields at around 2.5%.

The Fed monetized government debt, increased the quantity of money, and drove up inflation. Interest rates became negative in real terms.

This helped to lower the US government's debt level from 120% of GDP in 1946 down to around 70% in the early 1950s.

History does not repeat itself, but it does rhyme, as Mark Twain is often reputed to have said.

Currently, it is expected that the Fed will raise the federal funds rate to around 1.5% by the end of this year, with 10-year Treasury yields remaining at around 2.5 to 3.0%.

I think that financial markets are correct in forecasting the Fed to raise interest rates only very moderately in 2017.

Chart 19

In Europe, the major flashpoint is the Eurozone banking system. It is the largest in the world with a balance sheet total of around 32 trillion Euro or 311% of the GDP.

By way of comparison, the US banking system’s balance sheet total amounts to just around 16 trillion US dollar or 86% of the GDP.

Many Eurozone banks are suffering from low profitability, non-performing loans, and a rather thin equity base.

The ECB has successfully fended off a *liquidity crisis*. If, however, a *solvency crisis* reared its ugly head, things could get pretty ugly.

One way to deleverage and shrink the Eurozone banking system is to opt for a "bail-in", which means wiping out bank liabilities.

A case in point is the Italian bank Monte dei Paschi di Siena. A debt-for-equity swap is now in store for the bank’s bondholders.

Tier 1 securities will receive bank stocks that represent 75 percent of the nominal value of the bonds. Tier 2 bonds will be converted at 100 percent of the nominal value and will be later converted into senior bank bonds.

This illustrates nicely that a bank bail-in is fairly problematic, as you could compare it to open-heart surgery.

When, and if, investors realize that a bail-in on a grand scale is forced upon them, credit markets would most certainly collapse.

Chart 20

Politically speaking, there is a superior solution, and that is inflation. It was brought into the open by ECB President Mario Draghi in July 2012 when he said: ”[T]he ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”

Since Mr Draghi spoke these words, ECB interest rates were cut to zero, and the ECB deposit rate was even pushed into negative territory as from June 2014.

In January 2015, the ECB announced it would purchase debt in the amount of 1.14 trillion euro as from March to autumn 2016. In the meantime, the ECB has extended its purchases until December 2017.

Where will all this lead to? To provide an answer to this question, you may want to look at this chart.

It shows you the overnights deposits (that is the dark line) held with euro banks. They amount to around more than 6 trillion euro.

The orange line shows euro banks’ liquidity in form of central bank deposits, amounting to around 1.5 trillion euro. In other words: Euro banks are quite vulnerable to a “bank run”.

To close the gap, the ECB must inject further liquidity. This can be done by purchasing government or corporate debt.

It would allow a transfer of around 50% (or perhaps even more) of Eurozone government debt (which amounts to close to 10 trillion euro) onto the ECB’s balance sheet.

In doing so, a euro government and bank credit event can most likely be prevented.

But the ensuing expansion of the euro money supply, and it may well become substantial, can be expected to push up prices in the years to come. By that, I mean consumer as well as asset prices.

Against this backdrop, I would think that the chances are high that the ECB will keep its interest rate unchanged this year and next year.

Chart 21

What does that it mean for the Euro's external value? The Euro is already a currency in deep trouble.

National political developments in many EU countries suggest a rising probability of the European integration project unravelling.

This year, key elections will be held in Germany, France, and the Netherlands; in countries where citizens' disenchantment with the political establishment and the euro is already rampant.

Growing uncertainty about the fate of the euro can be expected to weigh down on the external value of the euro, especially against the US dollar, for if the EU disintegrates, the euro will lose all of its political and economic support.

I wouldn't be too surprised if the euro, currently standing at 1.07 against the US dollar, would trade lower for the remainder of this year.

Chart 22

It seems that the central banks' motto is "keep it going". They will most likely continue to churn out new credit and fresh money.

This is certainly one of the drivers of the stock markets – as you can see in this chart, which shows the US S&P 500 together with US bank credit in billion USD since the beginning of 1990.

In an environment of ongoing economic expansion, relatively low interest rates, and an ongoing rise in credit and money, prices in asset markets, stock markets, in particular, should benefit.

Chart 23

The risk premium in the US stock market – calculated based on the S&P 500 earnings yield and the short-term US interest rate – has moved to a fairly high level since the outbreak of the 2008/2009 crisis.

The Fed policy of zero interest has not driven up stock valuations in the first place but the risk premium in the stock market.

This would suggest that even if the interest rate would creep up a bit, a further decline in the risk premium could keep up current stock valuations.

The current downside risk for stock prices thus appears to be less pronounced than the careful investor might think.

Chart 24

Ladies and gentlemen, we have been discussing quite a few issues so far. Now, the pressing question is: “What does it mean for you as an investor?”

How can you navigate the challenges, some of which I just described, and take advantages of the opportunities that come with them?

Chart 25

For quite some time now, I have outlined to people the problems of fiat money and what it does to their savings and invested capital.

This made quite a few people asking me for advice: What should I do with my money?

Six years ago, I started to look for an answer. I studied in greater detail what the successful investors have been doing, and tried to find out *timeless principles of sound investing*.

What I found to be one of the most convincing and important principle was coined by investor legend Benjamin Graham: „Investment is most intelligent when it is most business-like."

Businesses create value. And, if successful, they reward their stockholders with a decent return on capital invested.

Most important, I found out that investing in so-called *great businesses* provides a perfect solution for meeting the challenges resulting from the global fiat money regime.

There are great businesses which are inflation-resistant and are well positioned to weather times of boom and bust.

Chart 26

Investing in great businesses allows you to take advantage of the miracle of compounding capital.

On this chart, you see the S&P 500 from 1977 to December 2016. It compounded at a rate of 7.5% per annum on average.

I also put in the stock performance of a great business, a firm that has compounded at close to 12% per annum.What a difference it made!

Buying a great business at a price that is below its value provides the investor with a "margin of safety", thereby lowering investment risk.

Chart 27

Since I had conviction and a desire to put my findings into practice, I teamed up with a very dedicated value investor, Matthias Riechert.

Together, we set up the P&R REAL VALUE fund in 2012, which I support as an advisor. This table shows what we have achieved so far: in 2016, the fund was up 18.5% against 8.9% made by the MSCI World in euro.

I would be happy if you find our approach to investing inspiring. In case you want to learn more, please check www.polleit-riechert.com and let me know what you think.

Ladies and gentlemen,

My speech has to end here.

I would be pleased if I succeeded in providing you with some stimulating and useful guidance when it comes to investing in times of boom and bust – in 2017 *and* beyond!

Thank you very much for your attention!

***