# Investment Views

## March 2021

**Hoist with their own petard**

Global Central Banks are now captive to a problem of their own making. Encouraged by a decade of supressed base rates, bond yields and plentiful QE liquidity, the world is now shouldering a simply epic pile of debt. According to the Institute of International Finance, Governments, companies and households added $24 trillion of debt last year, pushing the total to $281trn or c. 355% of global GDP. They forecast another $10trn before the year is out.

This has rendered monetary policy impotent. If the economy struggles, cutting rates further or injecting additional sums into the financial system will do little to stimulate growth; the cost and availability of money is not an issue for the credit worthy. Going forward, the vestigial purpose of monetary policy is to sustain past excesses, making interest due on existing liabilities affordable. Indeed, it is interesting to note that US government debt interest payments have remained below 2% of GDP since the early 2000s, even as debt-to-GDP has more than doubled to 125%.

On the flip side, if the economy recovers and inflation reappears, the ability of Central Banks to control an overheating economy is limited. Activity is now hyper-sensitive to interest rates, with even a modest rate hike likely to crowd out any nascent recovery. Mindful of this, most Central Banks have endorsed the idea of running economies hot before they seek to dial back growth.

The latter point is particularly relevant, as inflation is set to increase as we head into the summer. As we noted last month, March and April will see US CPI rise as current prices compare to covid-depressed readings a year ago. These soft comparisons will be compounded by pervasive inflation across the commodity complex. For the 12 months to end February, the WisdomTree Agriculture ETF (a basket of cotton, corn, coffee, soyabean, wheat and sugar) was up 24% with a basket of industrial metals (aluminium, copper, nickel and zinc) showing a 42% gain. West Texas crude oil was 37% higher. These moves are starting to show up in the data, with disrupted supply chains aggravating the situation; in both the UK and US, January manufacturing input cost inflation rose at the fastest rate since 2018, with the EU equivalent hitting a decade high.

Whilst inflation is by no means rampant, bond markets have woken up to the threat of a sustained rise in prices as covid lockdowns ease. Over the last month, sovereign bonds have sold off sharply, pushing yields higher; the notable exception was in China, where the yield on the 10 year CGB stayed around 3.3%. In the UK, the benchmark gilt yield has risen to 0.8% from a 0.1% low, with the equivalent US treasury adding 1% to touch 1.5%. In Australia, the move was even more dramatic, with the 10 year AGB yield more than trebling to 1.9%. The sell-off in European and Japanese issues was more muted.

Interestingly, the move in Aussie yields forced the Reserve Bank of Australia to act. On 1st March they doubled their QE bond purchases in an effort to halt the rise in borrowing costs; the 10 year yield duly fell back to 1.7%. The ECB was also spurred into action. With the 10 year German bund yielding -0.3% (up from -0.6%) and the spread on peripheral state bonds still tight, the need was less urgent but they still wheeled out various Bank Governors to state that the ECB "can and must react against" any unwarranted rise in bond yields that threatens the Euro economy. If you add in the fact that the Bank of Japan is already targeting a 0% yield on local government debt, three of the major monetary authorities are actively manipulating their local bond markets; so called 'yield curve control'.

So far the Bank of England (BoE) and the US Federal Reserve have demurred, noting that the rise in yields simply reflects the post-covid recovery. Whilst this is true, as both the recovery and inflation continue to build, bond investors are set to demand higher yields; current levels broadly equate to local inflation. This leaves us wondering how high yields can go before economies stumble and asset markets riot, forcing the BoE and Fed to intervene.

In the US, two prior episodes serve to inform. In 2013, the Fed tried to moderate QE support, triggering a bond market "taper tantrum". The 10 year treasury yield rose about 1.4% before the then Chairman, Ben Bernanke, was forced to backtrack. The Fed was also forced into a similarly embarrassing pivot in early 2019, after hawkish talk and a rate hike in the final quarter of 2018 drove the treasury yield 1.2% higher, triggering a 20% fall in the S&P500. US debt-to-GDP was about 100% during both periods; it is now 125% and rising (source: St Louis Fed).

Some analysis by Pictet seems to echo these findings. It shows that, since 1990, the S&P500 has suffered a significant correction every time the difference in yield between 2 and 10 year treasuries (the 2/10 spread) has increased by more than 1%. The latest sell off pushed the spread up by 1.1%.

Our sense is that a sustained move above 1.5% on the 10 year treasury could give asset markets pause for thought. However, the Fed (and the BoE) will try to avoid overt yield curve control until they see structural distress in the financial markets and/or evidence that the rise in yields is impacting real world activity. Mindful of this, we are keeping a close eye on mortgage, employment and bank lending data as well as forward looking activity surveys. Credit spreads are also key. The additional yield that corporates pay to borrow, over and above government bonds, remains at or near record lows. Any material widening of the spread would pose an immediate threat to the post covid recovery.

Of course, the uptick in inflation could be transient, with bond yields sinking back alongside price indices. The structural disinflationary forces of technology adoption and shrinking working populations remain in place. To this, one can add the solvency hangover birthed by the covid pandemic; many companies and individuals will struggle to repay their crisis debts, acting as a drag on activity. If growth and inflation do fall back, we expect the authorities to double down, adding further monetary and fiscal fuel to the fire. Recession and deflation are not politically acceptable options.

So where does that leave us? In the near term, growth and inflation will pick up; whether this continues beyond the summer remains an open question, although the probability of a sustained increase in general prices is rising. Regardless, we do not believe that the Central Banks will countenance a significant rise in nominal yields, even as most major economies embark on an aggressive post-covid fiscal reflation. This suggests that towards the end of this year we will either have higher inflation or an increasingly aggressive set of global policies that seek to engender it. Ceteris paribus, real yields will probably be lower as nominal ones are capped by Central Bank intervention (or fears thereof).

After recent strength, many equity indices look vulnerable, especially as the CPI data ticks higher. However, as we look beyond the summer, if we are right about falling real yields, equity indices could well grind higher, as an earnings recovery continues to make them look relatively attractive when compared to bonds. Despite the debt market sell-off, the equity risk premium that we discussed in our November edition, continues to favour equities over bonds.

## Bitcoin Bonanza?

It is very hard to add anything to the ongoing debate around Bitcoin. It is widely acknowledged that the underlying blockchain technology has many potential, transformative uses. It is also seemingly uncontentious to believe that we will, over the coming years, move away from paper money to a digital means of exchange, probably using distributed ledger/blockchain technology; all the major Central Banks are working on versions thereof.

Whether Bitcoin becomes a widely used medium of exchange, independent of Governments, remains open to debate. Believers see this as its eventual use, a currency that is free from state intervention and that cannot be debased to finance the unrealistic spending promises of populist politicians. Doubters see its growing popularity as the very seeds of its downfall. Governments will not easily cede control of their currencies, given their vital role in macro economic management.

To us, it's a matter of time horizon. Bitcoin could well become more widely adopted, as a credible belief in digital currencies vests in this "first mover". However, a better expression may eventually arrive, either government sanctioned or privately led. The original innovation is seldom the final answer. Just ask the creators of 'Archie', the earliest internet search engine…

As to where the BTC price goes from here, we can build a speculative 'bull' and 'bear' case. At $48,000 per coin, BTC has a market cap of $0.9trn, making it five times more valuable than Ethereum, the second largest crypto asset. With surplus global liquidity looking for a home, the finite supply and growing institutional interest suggest it could rise further. Whilst the normal price chart is disconcerting, the log scale chart (below) is easier to live with. BTC advocates note the near 100x rise from 2015 to the end 2017 peak; it then fell 85%. A simple extrapolation from that rally suggests that the current one, that started at $3,000 in 2018, could have further to run!! This says nothing of the risks, the most obvious being some form of regulatory intervention.

**BTC – January 2015 to current day**


Whilst we are on the subject, it was all but inevitable that Elon Musk emerged as a backer during February. His car maker, Tesla, bought $1.5bn of BTC and will start accepting it as payment for its products. Whilst this headline grabbing move sits well with his self-styled role as "Disruptor-in-Chief", we question the coherence of a "green" electric vehicle maker buying BTC.

Creating or "mining" BTC takes vast amounts of computing power. A study by the Cambridge Centre for Alternative Finance sort to quantify this. Their conclusion is startling: they estimate that the total annual electricity load and consumption of the Bitcoin network is 128.84 terawatt-hours. As the table below illustrates, this is slightly higher than Ukraine and Argentina and only just shy of Sweden and Malaysia.

| Argentina | Ukraine | Bitcoin | Sweden | Malaysia |
|---|---|---|---|---|
| 125.03 TWh per year | 128.81 TWh per year | 128.84 TWh per year | 131.80 TWh per year | 147.21 TWh per year |

**Source:**
U.S. Energy Information Administration country data, 2019 est. (or most recent available year)

Whilst some of this electricity is sourced from renewable sources, one questions the ESG coherence of Tesla adding BTC to its balance sheet.

(Note: given the speculative nature of Bitcoin and the views of the UK regulator (the FCA), we are duty bound to note that the above commentary does not constitute investment advice. It is simply our views on this evolving topic. If you'd like to discuss things further, do please get in touch).

# Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

| 6-12 Month view | Overall | Equities | Bonds | Alternatives |
|---|---|---|---|---|
| + | Alternatives<br>Cash | Gold Miners<br>China A Shares<br>Sustainable yield<br>Japan<br>ESG/Impact funds<br>FinTech | Inflation-linked,<br>Emerging Market,<br>China | Gold,<br>Volatility Strategies |
| – | Equities<br>Bonds | European<br>US<br>Technology | UK<br>European<br>Japanese<br>High Yield | |

# Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

| | 28 February 21 | -1 Mth | -3 Mth | -12 Mth |
|---|---|---|---|---|
| CURRENCIES (VS USD) | | | | |
| GBP | 1.3933 | 1.6% | 4.6% | 8.7% |
| CHF | 1.1006 | -2.0% | 0.0% | 6.2% |
| AUD | 0.7706 | 0.8% | 4.9% | 18.3% |
| JPY | 106.5700 | 1.8% | 2.2% | -1.2% |
| EUR | 1.2075 | -0.5% | 1.2% | 9.5% |
| BOND YIELDS (10 yr) | | | | |
| UK | 0.82 | 0.49 | 0.51 | 0.38 |
| US | 1.41 | 0.34 | 0.57 | 0.26 |
| Germany | -0.26 | 0.26 | 0.31 | 0.35 |
| Australia | 1.92 | 0.78 | 1.02 | 1.10 |
| Japan | 0.16 | 0.11 | 0.13 | 0.32 |
| EQUITIES | | | | |
| US. S&P 500 (USD) | 3,811.15 | 2.6% | 5.2% | 29.0% |
| UK. FTSE 100 (GBP) | 6,483.43 | 1.2% | 3.5% | -1.5% |
| FTSE Europe Ex UK (local) | 290.13 | 2.1% | 3.5% | 10.1% |
| Japan. Topix (JPY) | 1,864.49 | 3.1% | 6.2% | 23.4% |
| China. Shanghai Comp (RMB) | 3,509.08 | 0.7% | 3.5% | 21.8% |
| HK. Hang Seng (HKD) | 28,980.21 | 2.5% | 10.0% | 10.9% |
| Australia. All Ords (AUD) | 6,940.63 | 1.0% | 2.9% | 6.6% |
| FTSE Asia Pac ex Japan | 716.45 | 1.5% | 11.7% | 37.2% |
| FTSE World (USD) | 767.28 | 2.4% | 6.0% | 27.7% |
| FTSE World (GBP) | 813.64 | 0.5% | 1.3% | 16.6% |
| COMMODITIES | | | | |
| Oil (WTI) | 61.50 | 18.1% | 34.5% | 32.9% |
| Gold | 1734.04 | -6.1% | -2.4% | 9.4% |

# Disclaimer/Regulation

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