Pythia's Investment Letter

April 2021 – Valère Consulting SA

Terra Incognita

We are amidst turbulent times: 2020, a year full of extremes, is not yet long behind us. The Corona pandemic caused the biggest recession since the Second World War, though the financial markets have shrugged off the event at an unprecedented pace and meanwhile, at the end of the first quarter of 2021, some of them have even reached new highs.

An Attempt at Interpretation

Since the financial crisis in 2008, central banks have been supporting the economy with plenty of cheap money. The magnitude of this endeavour can be seen in their bloated balance sheets and low to negative interest-rate policies. Only the U.S. Federal Reserve has attempted to slowly raise key interest rates since 2018, however had to abandon the endeavour about a year ago due to the economic situation. However, since the onset of the Corona pandemic, monetary policy has now been joined by fiscal policy, i.e., in addition to cheap money printed by the central banks, government spending has increased immensely as a result of the pandemic relief packages; as a result, there is no longer any talk of austerity policy (especially in Europe). Moreover, spending against the economic consequences of the pandemic is, in some cases, more than twice as high as that during the financial crisis.

As a rule, financial markets anticipate developments in the real economy by about six months and, thus, it seems hardly surprising that most financial experts and economists are quite optimistic about 2021 and 2022, not least thanks to the impressive performance delivered by vaccine manufacturers and the somewhat less gloomy economic figures of Q4 2020. Besides, it is also likely that China will continue to manoeuvre its way out of the crisis in the best possible way thanks to its rigorous containment of the virus and its still heavily production-based economy.

Thus, vaccination is clearly the solution to normalize the economy, but what about the long-term consequences for the economic climate? What can we expect from the development of interest rates, inflation, debt, and politics, and how will the financial markets conceivably react?

After the Crisis is Before the Crisis

In economic contexts, too, it makes sense to look into the past in order to dare and predict the future.

For around 20 years now, we have been going through various crises that have kept the financial markets on their toes. In 2007/2008, the technology crisis at the beginning of the millennium was followed by the subprime credit crisis, which led to the biggest financial crisis since the 1930s, followed in 2011 by the euro and the EU sovereign-debt crises (as a consequence of the financial crisis) and now by the Corona crisis.

The godmother of our Investment Letters is Pythia, High Priestess and Oracle of Delphi.
When Croesus, the King of the Lydians, who was famous for his wealth, asked the Oracle for advice before a military campaign, Pythia is said to have answered: “If you cross the Halys River, a great empire will be destroyed.” He did cross the border river though – and thus caused his own empire to be destroyed. A false interpretation had caused a catastrophe, while the correct interpretation would have averted the disaster.

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The global economy is currently on course for recovery, supported by broad-based packages of measures from politicians and central banks. Market participants worry about rising interest rates due to higher inflation expectations, especially in the U.S.A. Although nominal interest rates are rising (10-year U.S. Treasury at 1.65%), real interest rates are still in the negative zone and below pre-Pandemic levels, in the U.S., too. Interest rates above 2% should not really cause headaches either, in particular not compared to historical events, given that most countries are not really likely to be interested in sustained higher interest rates due to the high debt ratios resulting from servicing their interest payments. Inflation may be somewhat higher this year and next year (Corona catch-up effect), but we believe this is merely a temporary increase in price.

In the years to come, governments will have little opportunity to reduce their debt, as spending will remain high and can only be financed to a limited extent by raising taxes. Recently, U.S. President Joe Biden announced a USD 2.2 trillion infrastructure programme which, coupled with the USD 1.9 trillion economic stimulus plan, is music to the ears of the economy and the stock markets. In Europe, the economic support packages are also ready to go, thanks to the EUR 750 billion and EU Corona Recovery Fund plus the ECB's bond purchases. As part of its Pandemic Emergency Purchase Programme (PEPP), the European Central Bank is buying bonds to the average tune of 17 billion a week, which involves a total of EUR 1.85 trillion until March 2022. Thus, virtually everything is being done to deal with the Corona crisis and revive the economy. So why should we be concerned?

The Power of Central Banks

The high national debt and the exorbitant amounts of money that central banks are pumping into the system cannot remain without negative consequences in the long term. The days when central banks used to act as entities independent from the state have, at the latest, been history since the financial crisis. The distortions of the interest-rate structure due to the artificially low interest rates are causing a misallocation of resources and hinder structural changes.

Although there is no significant price increase in consumers' shopping baskets, the prices of property, equities, and other securities, continue to rise despite global crises. This so-called asset-price inflation is, thus, positively fuelled by the policy of cheap money. Besides, investment trends in private equity and venture capital have intensified and new "creations" such as Spacs (Special Purpose Acquisition Companies) have been added. Financial markets are not only shaped by large institutional investors such as hedge funds and ETFs but also by a not insignificant number of private investors active on online platforms, even capable of so-called "swarm actions" via social media, as in the case of the GameStop share.

Cheap money is here to stay along with central banks policy and will scour the market for positive returns like somebody dying of thirst, searching for water in the desert. Consequently, in some section of the market, further exaggerations will continue to occur (e.g. The current Bitcoin "Bubble").

Therefore, the consequences for the long-term economic environment will continue to depend on how governments and their central banks keep a grip on finances and the money glut. The task of monetary authorities and central bankers is, among other things, to maintain the purchasing power of money and, thus, its recoverability. Since we live in a paper-money system without a deposit of collateral (as was the case before the abolition of the gold standard in the early 1970s), trust in the system is of considerable importance.

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For investors, the focus will be on the behaviour of politicians with regard to measures in geopolitics and Corona policy plus the development of the national budgets and debt ratios.

Some economists were of the opinion that after the Financial Crisis, there would be no second major crisis to overcome as otherwise, the System could collapse.

However, we are most certainly in an extraordinary and unprecedented situation ("terra incognita"). Apparently though, the System is more resilient than suspected, despite high debt levels and an ultra-expansive monetary policy. Trust in the System plays an important role but of course, this should not be overtaxed by either politicians or monetary authorities.

Safety First

As a result, the economic environment remains challenging. We are privileged to be able to tailor the asset allocation in the portfolios for our clients according to their individual preferences, which is a great advantage in the currently rather volatile environment. The positioning of our investment policy remains defensive, which allows us to focus on the quality of our investments. Equities are still our preferred asset class, which may come as a surprise from a traditional point of view: highly liquid with a focus on first-class companies with sound balance sheets and sustainable business models. At current levels, we also consider gold to be attractive (USD 1,700/oz). In addition to its high market liquidity, it shows a positive correlation to market uncertainties.

Our assessments and analyses have us conclude that extraordinary market events may occur again at any time: we are prepared to meet that challenge.

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