Pythia's Investment Letter

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Established myth of the infallible central banks

Central banks have been the champions of rising stock markets for almost 10 years now. Whenever the market show signs of stress - whether due to political or economic factors - they take immediate action. Tweets are the new prophecies, politicians the oracle and Donald Trump the high priest vouching that up to election day the economy stays on track.

«Don't fight the central banks» has been the credo of market participants around the globe for years. In practice, this means: take as much risk as you like - the central bank will be there to save you. Pythia is taking up this credo today and is taking it with:

«Established myth of the infallible central banks»?

Central banks have clearly defined mandates and limited room to manoeuvre. The latter are of a political or legal nature. In the USA, all former US central bank governors have recently raised their voices in an article questioning the current independence of the FED.

In Germany, the Constitutional Court's decision on the admissibility of the ECB's QE program (purchase of government bonds), which has been in place since 2015, is still pending.

Trust in the central banks is not absolute. As a result of a massive breach of confidence in monetary policy, we are currently witnessing the faltering of the banking sectors in Japan and Europe. Consequently, share prices have reached historic (!) all-time lows.

Another venue we have to thank the central banks for is the $16 trillion of negative yielding bonds (mainly government debt).

The policy of cheap money is reaching its limits, its credibility and effectiveness is being increasingly questioned. Do the massive price rises of the Republic of Austria bond of +50% in one month, or the jump of the German Federal bond of +20% in a few months, constitute proof of confidence or a sign of a bubble?

Is there an upcoming paradigm shift?

The depreciation of the Yuan by the Chinese Central Bank pushing it through the 7 CNY/USD barrier is the decisive factor for the financial markets. It will have an enormous impact on the stability and confidence of the markets. A fully blown currency war is in the making. The markets will have to adapt to this in the coming months as more severe swings in asset prices must be expected and coped with.

Pythia says, «it's easier to start a war than it is to end it».

The next "flavour of the month" crisis management tool might well be ‘helicopter money’, or MMT (academic for Modern-Monetary-Theory). The flood of money from the QE programs has failed its purpose and a new beast is born. Pythia says:

«the seeds for the next war are planted in the last peace treaty».

We remain sceptical. As we did before the financial crisis of 2008/2009 and at the occasion of the last adjustment at the end of 2018, it pays to be prepared.

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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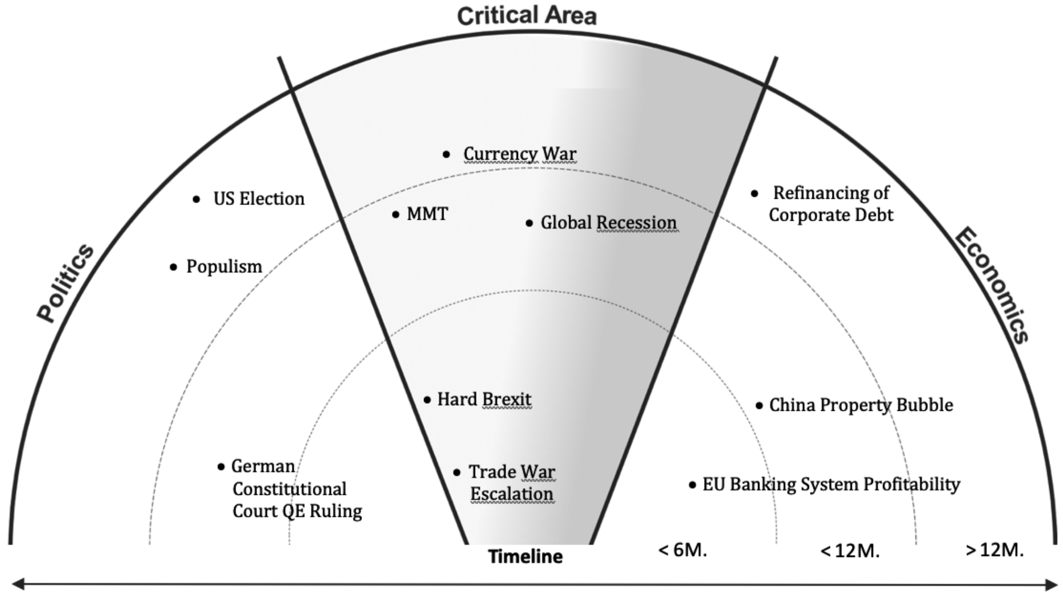
Opportunities and risks on our radar



Risk-Assessment | **Opportunities & Portfolio actions**

EU banking system

The EuroStoxx Bank Index is trading at a critical historical low (-85% since May 2007). The economic figures continue to deteriorate, the necessary reforms have failed to materialise and interest rates have not bottomed out yet. In 2012, the banking system narrowly escaped collapse.

- no investments in bank shares
- buying volatility (VIX index)

Corporate Debt

…has doubled in the US since last recession (75% of GDP). BBB- debt is now larger than the overall corporate bond market in 2008. A recession will result in significant credit rating downgrades and massive selling waves triggered by US pension funds. The latter are already heavily exposed and very fragile.
Highly indebted corporates: *GE, AT&T, Lafarge-Holcim, BAT, Bayer, Verizon*

- purchase put options on US High-yield-Bonds
- selling high-yield bonds or ETF's on corporate bonds
- on equity investments, focus on strong balance sheets & high cash flows

Helicopter Money / MMT (modern-monetary-theory)

At the outbreak of the next crisis, central banks are expected to resort to this instrument, which has long been discussed in academic circles (including the FED), and finance massive government fiscal pacts to lift the economy out of recession - and all this without really understanding the full implications of their actions!

- Increase in equity exposure
- Focus on Gold & Gold Miners
- Attractive emerging markets

BREXIT

Expected hard-brexit led to a sharp depreciation of the pound and corrections in equities, which are mainly dependent on the British domestic market. Financial markets expectations are reflecting mainly negative outcomes on the topic.

Before 31.10. we begin to buy stocks that should particularly benefit from:

- government infrastructure spending
- tax cuts