Edition No. 33

Competition is back

bergsicht

CHAPTER 1

Stacking chips – acquiring bargaining power

Truths can get so inconvenient that we would rather quietly ignore them than kick against the pricks of prevailing opinion. After all, who would willingly expose themselves to the suspicion of viewing certain developments in the USA since Trump took office in anything other than what we might delicately call a negative light? In this edition of *bergsicht*, we shall be attempting to chart the topography of the global economic landscape as objectively as possible – terrain that is riddled with slippery slopes and narrow paths.

And why have we chosen to explore this topic? Because stock indices – the ultimate barometers of economic (and thus social) buoyancy – have been rocketing skywards in the USA for some months now, leaving the rest of the world in the dust. This is crying out for an explanation, especially as many of the more alarmist commentators had predicted the new US administration's supposedly disastrous policies would have dire consequences. These would-be Cassandras – Krugman, Stiglitz and company – have since fallen noticeably silent; truths can get so inconvenient that you prefer to hold your peace.

Now, one might be tempted to argue that stock prices are a purely psychological phenomenon, and that it would thus be problematic to describe the performance of an index as a "truth"; such a view would be mistaken, however – each and every index value created millisecond by millisecond is underpinned by prices upon which buyers and sellers have agreed. This is a matter of *fact*. Neither of the two parties wishes to lose out, and their meeting of minds is an objective event. In terms of informational content, prices are thus worth a thousand times more than the results of any survey or – *nomen est omen* – "opinion" poll. For now, let's couch our conclusions in Twitterspeak: the markets think Trump is a good thing. Period.

Facts can even be polemical. If status as a "peacemaker" were to be measured by the number of military interventions authorised by a US president during his period of office, Donald Trump's predecessor Barack Obama could not come out any worse. Compounding four already ongoing theatres of war, hostilities were begun on three new fronts during the incumbency of the 2009 Nobel Peace Prize-winner – in Syria, Libya and Yemen; contrary to his campaign promises of the time, not a single conflict was genuinely halted. It is a fact that Trump has, as yet, never ordered in the troops as such; should things continue in a similar vein, it won't just be Obama who has earned a Nobel Peace prize – now just imagine that...

This said, it is a fact that the USA is prosecuting a *trade war* under its president, Donald Trump – which doesn't sound especially like the work of a peacemaker, so

perhaps no Nobel Prize for him after all? The asseverations and explanations rolled out to justify the imposition of higher tariffs on China and other major trading partners have indeed been scraped out of the waste bin of economic ignorance; in today's highly specialised world of division of labour, any attempt to shore up a policy with mercantilist arguments is on a hiding to nothing. As we set out at some length in the edition of *bergsicht* from the middle of this year (no. 32, *A tale of two hegemons*), every modern product, from a mobile phone to a jumbo jet, contains a host of components with origins of immeasurably diverse complexity. Viewed objectively, statements of provenance are a fiction, or at best an approximation to the actual circumstances. All and any barriers (whether tariff or non-tariff!) that make the free exchange of goods more expensive will simultaneously reduce prosperity for all concerned. The current US government – including even a president whose IQ has not gone unchallenged – undoubtedly understands this fact of economic life.

There is something else going on here, however, and this should have been spotted by now. All this mercantilist drum-banging is but a fig-leaf for a strategy that, from a game-theory perspective, is an entirely rational and plausible attempt to find a way out of a structural trap into which the USA has slowly been drifting over the last 25 years. This trap, which might be termed the "*paralysis of power*", arises when the arsenal of instruments available to a government is heavily tilted towards non-cooperative undertakings – i.e. military operations – while the toolkit for normal, cooperative global interaction has either gone missing or was never present in the first place. In the absence of such resources, the player has no "currency" – no "chips" – to lay down as their stake in cooperative endeavours. No one would dispute that the USA has an arsenal of non-cooperative options at its disposal, ranging from operational military assets on land, sea and air through satellites and cyber-capabilities to the ultimate sanction of being able to destroy the entire world several times over in a nuclear holocaust. The (smaller-calibre?) shots in its locker of non-cooperative options include the American legal system, whose long arm is capable of reaching far beyond its borders, the various levels of sanctions it can deploy, and the territorial clearing requirements for transactions denominated in USD, the global currency *par excellence*.

To return to cooperative options in the game, what chips could the USA have laid down to defend itself against China's flagrant breaches of World Trade Organization (WTO) regulations? Weapons are no good here – not even the ultimate threat of military might is any use. Filing a complaint under WTO rules? Sanctions? There have been any number of complaints made to the WTO, and the USA has often been both plaintiff (on 117 occasions since 1995) and defendant (136 times) in such disputes. The game of raising a WTO claim is certainly worth the candle, and the odds are not insuperable for success – indeed, the USA has emerged the victor on numerous occasions – but these disagreements have always been over relatively minor matters. The situation with China is altogether different; it concerns *matters of principle*. As people wanted to keep the giant newcomer at the table at almost any price at the outset, they initially turned a blind eye to the abounding and blatant incompatibilities that should really have prevented China from joining the WTO. Later, as the colossus gained ever more clout, they didn't wish to queer their pitch with its immense market potential. China's cementing of an increasingly strong position as a holder of US Treasuries has further encouraged such reticence, as did America's wider political calculation to accommodate China with a view to maintaining its own supremacy.

The upshot has been a globalisation that is rightly described as one-sided; the Chinese have routinely manipulated their currency, blocked access to their market in a wide variety of ways, flooded the West with products at fire-sale prices and played fast and loose with Western intellectual property rights on their domestic market; and now, as owners of property, they are increasingly beginning to take advantage of the benefits of a capitalist legal system in the free West. The sums involved are anything but chickenfeed; some estimates put the annual cost to western firms of inadequate patent protection alone at several hundred billion USD.

Ultimately, Trump is a sideshow – a *reconfiguration of the global trade regime* was long overdue. But you can't do this without skin in the game, and the instruments of non-cooperation are rightly best left in their toolbox – as the crafty old real-estate mogul knows only too well. His big lever in this new round of play – which, while still cooperative, is becoming increasingly aggressive – is billions of dollars' worth of tariffs. Our prediction is that the Chinese will not walk from the table. They have to play out their hand as a crash on their stock exchange would sting, and Xi Jinping can't afford to lose face domestically over the long term – the Chinese regime must deliver serial successes if it is to survive.

Our conclusion is that for us – and for the world with us – *competition is back*. The old hegemon, for years an acquiescent and inactive residual within the global trade system, is beginning to stir. The USA's acquisition of negotiating leverage – its stacking-up of chips – is an outward sign of the "new" ways in which major powers are interacting with one another. The fiction of monolithic global unity – a carefully cultivated pretence that was never truthful to begin with – has had its day. But this newfound overtness in the pursuit of self-interest will take some getting used to.

CHAPTER 2

Independence as an asset

So is *bergsicht* outing itself as a member of the Trump fan club? Have we even – heaven forfend – turned populist? No – it would be a cold day in hell. In this, our 33rd edition, we cleave as ever to the maxim we stated at

the get-go: "We take nothing at face value, and we would put nothing past anyone." In particular, this commitment to scepticism has remained unwavering towards politics and politicians, whatever the colour of their campaign rosettes. In the case of America (and its seemingly so unprepossessing president in particular), however, we think that prejudice, *zeitgeist*-driven misapprehensions and unadorned hatred have skewed vision in many quarters, preventing dispassionate analysis of events. There's hardly a newspaper in Europe – not even the otherwise top-quality *NZZ* or the previously cool-headed *Economist* – that can essay an article, even a headline, about America, without indulging in a little Trump-bashing. We shall resist any such temptation. As it is only fair to apply the scepticism we profess to our own powers of discernment, we shall generally refrain from making judgement calls about whether certain eventualities are turning out the way they are *because* of Trump or *despite* Trump; the causalities are often much less clear-cut than journalists in particular would have us believe. A lot of things are just happenstance – they are not necessarily engendered by anyone; equally, the true roots of a given state of affairs may lie in decisions that were made way back in time.

Having made these preliminary remarks (which, given the tide of mainstream opinion, were presumably necessary), let's first turn our attention to an area of divergence between the USA and the rest of the world that is only minimally susceptible to political influence (and thus to the Donald Trump effect): American monetary policy. To put it more plainly, there is "something" going on here, something even quite significant, *despite* Trump. In defiance of all his loudly broadcast displeasure, *interest rates are steadily being ratcheted up*. This phenomenon is worthy of note and – to touch on the topic of causality for a moment despite our earlier caveat – it may well be reinforcing the standing of the USA as a country, the American economy, and the USD both as a target currency for global transactions and as a store of value far more than many of the explicitly political actions of the current administration.

In the wake of quantitative easing (QE, the large-scale monetary policy response to the financial and banking crisis), most leading economists had assumed that the Federal Reserve would never revert to a more rigorous monetary policy – or that, if it did, it would do so too late. Some "dismal scientists" of a particularly Keynesian bent even advised against any tightening of the reins, as they claimed this would endanger the "tender green shoots" of recovery. Since March 2017, however (i.e. while still under the aegis of Governor Janet Yellen), the Fed has instigated a series of interest rate hikes that has been systematic (i.e. introduced at regular intervals) and thus predictable for market participants; we have progressed from the 0.75% of the time to a current target range of between 2 and 2.25%. And Ms Yellen's successor, Jerome Powell, who was appointed by Donald Trump, has not wavered from this policy since assuming office in February 2018.

Such perseverance is remarkable, not least as Donald Trump subscribes to the decidedly simplistic economic view that "low interest rates are good for growth, high ones bad" (to continue the Twitterese). This was also the mantra of the Greenspan era on Wall Street, and it no doubt left its mark on the New York real estate magnate. Powell and the Fed, on the other hand, seem to be aware of the abyss that would open up beneath their feet if even the slightest expectation of inflation were to enter the system – long-term interest rates would rise overnight and a crash on the bond market would be a foregone conclusion. This would presumably be compounded by a slump on the stock markets, and a newly minted financial and banking crisis would be lurking on the horizon. By taking tiny, cautious, baby steps towards a level of 3%, the Fed has so far succeeded in allaying any such inflation expectations and/or nipping in the bud any threat of their emergence. The crazy part here is that, given the current situation of full employment, too much tightening would also give rise to just such expectations of inflation as, in those circumstances, the Fed would stand accused of panicked over-reaction. In short, the margin for error in monetary policy is vanishingly small.

To date, their manoeuvring has paid off handsomely. Working from the prices paid [*sic!*] for inflation-protected bonds, we have subjected inflation premiums to close scrutiny. We found no anomalies in any part of the maturity spectrum – from 12 months to 30 years – and no differences between monthly measurements. To put it another way, inflation expectations have remained unchanged over recent months – against a backdrop of full employment, *nota bene*, and an economy that is humming; and, whatever the mantras of Greenspan/Wall Street/the Twitter-crazed real estate mogul-cum-president, economic activity, too, has been unaffected by the interest rate hikes.

This success has been twofold in nature. For a start, this balancing act (maintaining a booming economy while normalising monetary policy) seems to be working; there has been barely any reaction on the stock markets – at most, a positive nod – to recently mooted interest rate hikes (which incidentally knocks a hole in the models of a host of stock market gurus, many of whom are also wedded to the mantra "low interest rates good, high ones bad"). Secondly, and far more significantly, America's most important institution is *proving its political independence*, and herein lies the true dividend. Both the Fed and its governor are fully conscious of the interest costs that might accrue to the national budget – and thus to the taxpayer – were the Treasury obliged to finance itself at substantially higher rates. So what orders of magnitude are we talking about? Given the current debt level of almost USD 22 trillion, we are already now looking at no less than 500 billion *per annum* or 6.8% of the annual national budget. Were interest rates to remain the same(!) and the public debt to increase by around USD 1 trillion *p.a.*, debt-servicing would soon be the costliest item on the nation's books, up above Medicare/Medicaid and defence. Would this be even remotely feasible politically? It is awfully tempting to cling to a policy of ultra-low

interest rates, as we suspect the ECB of doing, but the Fed is set on following the roadmap it has defined for itself. The question is: is this a path it has chosen freely, or has the *return of competition* exerted its anticipatory effect, i.e. the notion that the USD will soon have to be defended against the incursions of another, aspiring currency and that the American economy and the American state's future financing options are no longer a given?

The route the Fed has elected to take through this economic landscape is narrow and steep – the USA is almost as heavily indebted as Italy. In the absence of an *inflation-free economic boom over the next couple of years*, the threat of severe economic and political hardship looms ever-present. For the moment, the markets – as evidenced by the prices they are paying day in, day out – are keeping faith with just such a miracle.

CHAPTER 3

Banking at the heart of the boom?

A further miracle that will have to come to pass (to some extent, as an unexpected consequence of Donald Trump's trade policy) is an increase in America's savings rate. This is a necessary precondition if the current US administration is to achieve its goal of increasing domestic production – as well as an ineluctable consequence of China's goal of raising domestic consumption; if the Chinese are themselves consuming more within their own borders, this consumption has to be financed, and the result will be fewer Chinese trade surpluses with the USA that can (and must) be repatriated to the USA via the capital account of the balance of payments. The People's Bank of China will acquire fewer Treasuries – and American savers will have to step up to take its place.

This has nothing at all to do with mercantilism, it is simply a by-product of immutable economic identities. It is undoubtedly a propitious omen for the advent of this second miracle that American banks have begun to pay their depositors interest again – offering zero or rock-bottom rates (even if they turn out to be positive in real terms) is no way to induce savers to part with their hard-earned cash. Strait is the gate and narrow is the way that leads to any such hallowed outcome, as the Americans are not in the habit of saving. Since the financial crisis of 2008/09, indebtedness in most segments of the US private sector has returned to pre-crisis levels – or even markedly overshot them (viz. corporate loans, auto financing, and consumer credit). Mortgages are more or less back where they were in 2007. An *inflation-free economic boom over the next couple of years* is also a prerequisite for the "exercise" to succeed in respect of any increase in the savings rate; significantly higher interest costs would be a millstone round the neck of America's national finances and seriously impinge upon both private and corporate spending – which would probably be enough to trigger the next financial crisis.

The "sweet poison" of debt has permeated every level of economy and society in America, and is now almost taken for granted as part of the furniture. While it proved possible to ward off immediate insolvency with a flood of liquidity in the immediate aftermath of the financial and banking crisis, ultra-low interest rates have only encouraged America to pile on more debt ever since. We thus predict no *volte-face* in this situation any time soon – people don't pick up the saving habit that quickly, as it means cutting down on consumption. Nonetheless, interest rate hikes – albeit tentative – and changes to trade policy bespeak a new phase in the way money is treated in both corporate and private America. It is difficult to say to what extent the state sector will partake in this change of heart, though. We remain sceptical. Politics is politics, and spending money you haven't earned is far too agreeable for anyone, whether blue or red, to want to give it up.

A further circumstance militating in favour of increased saving among private individuals is that *US banks* – unlike those in Europe – have emerged relatively unscathed from the financial and banking crisis; savers can *trust* their banks again. The reason for this is undoubtedly the far-reaching "Troubled Asset Relief Program" (TARP) that was rapidly deployed by the incumbent administration (headed by Bush *fils*) to recapitalise financial institutions that had hit the skids. Legally authorised expenditure of up to USD 700 billion was not maxed out. Total disbursements amounted to about USD 430 billion, and there was even a modest, post-disinvestment profit of about USD 15 billion, once the Treasury had sold off the last tranches of TARP at the end of 2014. This stands in striking contrast to Europe; the Old World was dilatory in cleaning up its act – regulating all the more rigidly the while – and the banks were to make it back into the black only much later, if at all. There is a good deal of evidence to suggest that "zombie banks" with low-risk (but economically ineffective) balance sheet business were kept alive in Europe even as banks in the USA were wiped out, merged left, right and centre or – in some isolated cases – even created from scratch amidst the massive upswing in the fintech sector.

According to a study carried out by EY (formerly Ernst & Young), the balance sheet total of the ten largest US banks has almost doubled since 2007, increasing from around USD 7 trillion to around USD 15 trillion, during which time the European banks (which were in a far stronger position in 2007) have marked time with a balance sheet total of circa USD 14 trillion. A comparison of profit numbers is even more compelling: in 2007, the ten largest US banks generated profits in the order of USD 40 billion while their European counterparts generated some USD 60 billion; nowadays, the profits of the ten largest US banks stand at over USD 110 billion while those of their European peers are just north of a paltry USD 24 billion. Thanks to their fat profits, the equity ratio of US banks is substantially higher (7.5%) than that of European banks (a scant 5.7%).

An inflation-free economic boom over the next couple of years, the prerequisite we have posited for avoiding severe economic and political hardship, is contingent on a healthy banking system. While the time gained through QE has been spent learning important lessons in the USA, this window of opportunity has largely been neglected in Europe. The genesis of the “decoupling” of the stock markets described in our introduction might thus be located in the clean-up of the banking system that was begun much earlier, under Bush II, before being continued and completed by the Obama administration. Our conclusions would then be that competition is back. Policy matters. It all depends on how government chooses to set the conditions within which the economy operates.

CHAPTER 4

Sell in May? Get away!

Now let’s take a closer look at the so-called “decoupling” of stock markets. Logically, the indices reached peak convergence during the financial crisis of 2008/09 – when half the world is suddenly trying to ditch its shares in a panic, they are bound to try to jump through the same hoops, and the same applies during the subsequent rebound, when the investors that have been scattered to the four winds all return to the fold. However, extraordinary events of this kind must be filtered out if we wish to identify longer-term correlations and trends. We addressed this topic back in August 2014, establishing (in *bergsicht* no. 8: *The significance of change*) that the correlations between major indices had been unambiguously receding since the end of the financial crisis, which had decidedly not been the case in the period following the bursting of the dotcom bubble in 2002/03. These empirical results appear to validate our thesis that *the world is drifting apart*, a phenomenon we believe we identified following the nationalist realignment of Japanese economic policy and Russia’s cold annexation of the Crimean Peninsula. At the time, we spoke of the formation of “tectonic plates” where once the world had appeared a uniform, blue planet.

We think this view has been forcefully underscored this year. While the munificent liquidity supply afforded the global economy by the central banks is still being trumpeted as the principal driver of the general stock market rally by the majority of the financial rags (i.e. the bank publications, all of which are pumping out the same line), more has begun to stir beneath the surface and greater differentiation is occurring than fans of glib explanations might be happy to countenance. The days of convergence under the banner of ultra-low interest rate policies combined with a liquidity glut (and of the open-ended perpetuation of the same) are long gone – it is precisely where this liquidity is being withdrawn (i.e. the USA) that the stock markets are performing best. By contrast, share prices are faltering where ultra-low interest rate policies have been retained and the banking system and/or the bond market is being propped up with central bank money (i.e. Europe).

The graph on the next page charts the performance of various stock market indices year-to-date. It shows us that “decoupling” has essentially been under way since May 2018, to the detriment of two “tectonic plates”, the emerging markets and Europe (although for both, the spotlight falls on one major national market apiece: China and Germany). In the case of China, the *Shanghai Composite Index* sank to its lowest point for four years in mid-September 2018, and it has languished at –20% since the beginning of the year. The People’s Republic has been trying to apply counter-pressure in its own inimitable way, with the China Securities Regulatory Commission (its counterpart to the SEC) instructing brokers and fund managers to refrain from publishing any further downbeat forecasts. Negative opinions expressed via Chinese news portals are being censored – and a discreet veil has of course been drawn over the fact that it is the depreciation of the CNY instigated by the government as a countermove to American trade policy that has been enhancing the appeal of the Chinese stock market; nerves seem to be fraying in Shanghai and Beijing.

The same can in no way be said of the German federal government, which has been busying itself with very different matters, not least itself. Here too, the signals sent out by the financial markets should provide food for thought. With the business of business firing on all four cylinders (*vide* the export champion’s ever-bulging order books, record-low interest rates and the comparatively low external value of the EUR), how come the markets have so little faith in the future of Germany’s economy? What has clipped the wings of the DAX even as the American stock market surges to new heights? We have already mentioned the subdued profits of the European banking sector; it’s no secret that banks that earn too little are unable to take on or manage additional risk. The erstwhile flagships of Deutsche Bank, Commerzbank and Dresdner Bank have either disappeared or are shadows of their former selves, while the middle ground of Germany’s banking landscape is dominated by the various *Landesbanks*, state-run entities under public law. The remainder is highly fragmented, which is of course in part a function of the territorial nature of the savings banks (*Sparkassen*). Can one of the world’s most important economies really be run like this? The question is all the more pressing if one considers that SMEs (who by definition enjoy only limited access to the capital markets) make up the backbone of the German economy. These are companies that are completely reliant on solidly established banks with a certain appetite and capacity for risk. We suspect that it is this structural difference in their respective banking systems that explains the “decoupling” between the USA and Europe (specifically, our near neighbours to the north): while *Germany* may have many banks, it is de facto “*underbanked*”. Having been spoilt by its export successes (which were achieved thanks to the weak EUR?), it has taken its eye

Decoupling of the US market since May

Note: The four indices were indexed at 100 on 31.12.2017.
MSCI World = NDDUWI index, MSCI Emerking Markets = NDUEEGF index,
MSCI World ex USA = M1WOU index, MSCI USA = NDDUUS index.

off the ball, and this is now dragging down the stock market. All this is compounded by the fact that the political scene is lurching towards dysfunctionality.

It is incidentally also worth casting an eye over the performance of the various countries that make up the MSCI Emerging Markets. In a comparison over the last five years (a period in which the MSCI World index made gains of some 39%), the Russian market, for example, may indeed have staged a partial recovery following crashes of 60% and more, but it is still in negative territory (–10% when adjusted for currency effects); hikes in crude oil and natural gas prices will certainly have helped it keep its head above water to some extent. While Indonesia (which our readers will recognise as a favourite of ours of many years' standing) may have conceded some territory in the course of this "decoupling", it has returned a very pleasing performance over this five-year period, as has Brazil. The Icarene fall of the Turkish stock market, which once floated on high, eclipsing all other emerging markets, borders on Greek tragedy. The reasons for this sad course of events are well known to all, so we shall not recount them again here.

We can only conclude that the performance of these share indices is further, specific proof that *competition is back* on a global scale. Policy matters – and both the financing conditions and the quality of a country or region's banks play a decisive role. Will the world continue to drift apart? We think so, for a while at least – and it won't stop until those responsible for crafting "policy" notice that they have recently re-entered the cut-and-thrust of competition.

CHAPTER 5

Our conundrum

Why are we devoting such an exceptional amount of attention to a topic like the financing conditions for economies – why indeed do we suppose we have found in it the key to understanding what is causing the world and its markets to drift apart? In our view, a black hole has opened up in the financial system since the crisis of 2008/09 – an undiscovered domain that is crying out for more extensive and more convincing explication, and that academics and monetary policy makers have been avoiding at all costs. We are talking about the *money multiplier*.

What exactly do we mean by this? Under the classical model for financing an economy, both the central banks and their vicarious representatives, the commercial banks, are allowed to create money by allowing a customer's deposits to be used multiple times over to grant loans to bank customers (the borrower re-deposits the loaned funds in his or her bank account and the merry-go-round starts all over again). An upper limit to the money supply is established through a mechanism known as the "reserve requirement", which sets the minimum balances commercial banks must maintain at the central bank (usually a specific percentage of the loans on their books). In the USA, the reserve requirement is 10%; in Switzerland, it is 2.5%; and in the EU, it is 1%, resulting in a theoretical multiplier of 10 for America, 40 for the Swiss Confederation and 100 for Europe. Given the latter figure, you might imagine Europe to be a banking paradise, but there are of course restrictions designed to curb lending/risk-taking in addition to this reserve requirement, such as capital requirements and indeed self-imposed business

practices. Historically, the multiplier has rarely exceeded a factor of 12.

It is extremely important, however, determining as it does whether a central bank's monetary policy has inflationary consequences. The central bank sets the parameters with its monetary base and the commercial banks apply the multiplier to this base amount; if it is too large (and it sometimes has been), excess money will start making its way into an economy with insufficient capacity, and lo and behold – in no time, inflation starts to run rife. According to classical economic theory, this is why the central banks should exercise caution in how they set the monetary base – thanks to the banks' multiplier effect, any excess has the potential to wax into a far greater surfeit in the monetary system, assuming that the banks' multiplier remaining at a relatively constant level.

But this is no longer the case. As the graph below clearly shows, the multiplier for the M2 monetary aggregate (currency in circulation plus sight deposits plus savings deposits) in Switzerland fell from a factor of more than 10 in 2007 to barely 2 by 2012 and later. Lending activity on the part of the banks has been stuck at this extremely modest level ever since. There were analogous developments in Europe and the USA. Many economists and commentators believe that this absence of any meaningful money multiplication on the part of the commercial banks explains why QE has failed to stimulate inflation in any jurisdiction – and why this trend looks set to stay.

This phenomenon throws up several important questions, including:

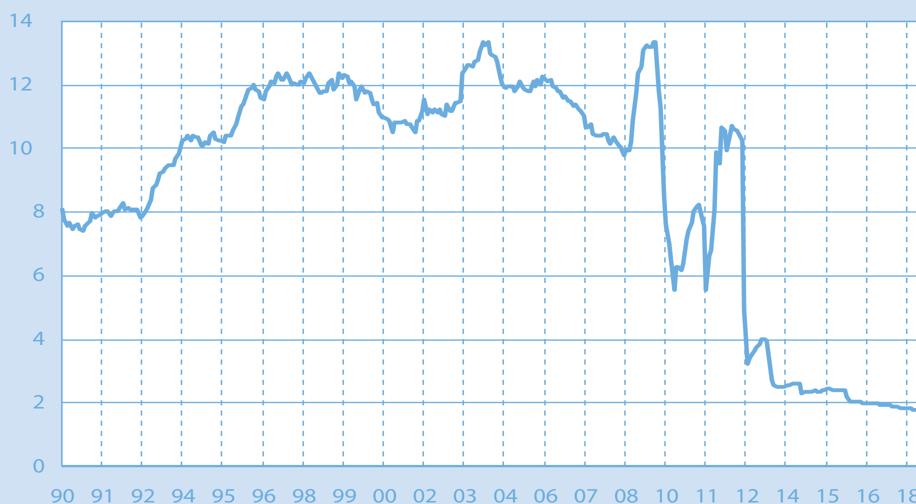
- What lies behind such a conspicuous decline in the banks' money multiplier? Is it due to cyclical/situational developments (financial crisis) or are structural factors (technology) at play here?
- Will the multiplier remain at this level, and if so – why?
- Can a central bank's monetary policy even function over the long term without the commercial banks' multiplier effect?
- How will the economy be financed in such circumstances? How is it working right this minute?
- What happens if the multiplier suddenly shoots up again? Do the central banks have the tools at their disposal to rapidly re-absorb the money that has already been created?

We are not in a position to answer these questions at the moment, and we suspect that there are currently no definitive answers to be found. Let's not forget that QE – the massive expansion of the monetary base – was a last-ditch, Hail Mary manoeuvre (devoid of any grounding in monetary theory) to keep the banks afloat; and where there is no theory, it is difficult to arrive at explanations – and more difficult still to identify any way out of a sticky situation. In 1998, Allan Greenspan introduced the notion of the "conundrum" in the context of monetary policy when he too noticed that a certain phenomenon lacked any theoretical underpinning; *bergsicht* sees a similar monetary policy conundrum here.

Our assumption is, however, that the Fed (whose former Governor, Ben Bernanke, the "inventor" of QE, provides plenty of background material in his book *The Courage to Act*) is furthest along the path towards normalising this anomaly of monetary policy. The markets' faith in this lead is reflected in the "decoupling" that has been taking place on the financial markets since May; sound monetary policy seems to be turning into a decisive competitive advantage.

We concede that this amounts to a highly

An abrupt fall in the M2 money multiplier



Note: The money multiplier is the ratio of the M2 monetary aggregate to the monetary base.

optimistic take, especially as far as the state of the USA's economic health is concerned. In the interests of delivering on our promise to be as balanced and objective as possible, some of the *risks* should also be enumerated:

- The markets' faith in a low-inflation future with a booming economy may yet prove to be misplaced; there is already talk of wage increases in some key sectors (Amazon has been mentioned).
- The highly aggressive fiscal policy pursued by the Trump administration has a procyclical effect, i.e. it heats up the economy in a phase of bulging order books, fat profits and insufficient production capacity – and in the absence of real progress on the productivity front.
- Current trade policy has the direct effect of driving up prices for goods that cannot be produced domestically in the foreseeable future; domestic end consumers will have to pick up the tab for the customs tariffs.
- The bond market and global foreign exchange markets seem to be in fairly rude health. Given the lack of theoretical underpinning for recent and current monetary policy, however, there are no models that might support such robustness, and scenarios involving abrupt evaporation of liquidity and dramatic price changes can certainly not be ruled out.

CHAPTER 6

Selecting or diversifying?

Competition between systems, continents and countries is set to be the "new normal" for the way we live our lives on this planet. It will take some time for us to re-acquaint ourselves with this notion, and any (re-)realisation that our own behaviour matters (and – yes – that individual failure can result in disaster) may well only dawn on the back of bitter, first-hand experience. Relying on the accommodating behaviour of others was far too simple a solution, and the Old World in particular still has a few lessons left to learn in this respect.

Let's leave such general observations to one side for now. With interest rates rising in one place in the world but not another, and stock markets booming across the pond but stagnating elsewhere (or even heading rapidly south); with an inflation-free economy being run over there while there is primarily robust state expansion over here, while barely a day passes without a preposterous potentate taking the reins in one emerging country or another and literally bringing it to ruin, we are suddenly faced with the question of how we (as investors) should proceed.

Intellectual modesty would suggest that maximum diversification is the way to go; given both our own ignorance and a complexity in global finance that dwarfs any and every model-based methodology, why bother going to the effort of selecting particular strategic options – especially given that the capital markets nowadays offer wonderful and affordable instruments for just such a scattergun approach? Well, for all their advantages, it is important to note that in any such entirely passive strategy, there will always be winners and losers in competition – Turkey and Venezuela will be in the mix, along with Silicon Valley, and your money is inevitably going to help finance any number of anti-social characters.

As complete diversification is not in human nature, however, we would thus advocate "selective diversification". This may initially sound like a contradiction in terms, but as we know that even the decision to invest in a global index via an exchange-traded fund ultimately rests on one selection criterion or another (usually that of capital weighting), we feel it is eminently possible to focus on a few additional criteria without putting the kibosh on the diversification effect. The actual number of individual elements required for diversification to obtain is not as great as you might imagine; with shares, a basket of seven or eight, maybe even 12 different(!) stocks will get you a considerable way indeed. Other criteria? There is no shortage – some are keen to ensure that their capital causes no harm to the environment, others wish to avoid (unwittingly?) financing the arms industry. Others again may be nursing a grudge against banks and will therefore tend to pass up investments in the financial sector – and why not, as long as their portfolio remains sufficiently diversified overall?

While diversification of all kinds is obviously critical, we believe investors would do well to pay particular attention to those corners of the Earth where financing of the economy in its widest sense is taken seriously – only there will they see their property rights upheld and be assured of heedful treatment, irrespective of business cycles and market gyrations. Once again – and this is the bottom line of this *bergsicht* – the *Anglo-Saxon system* has proven to be *superior* on this score. In our introduction, we mentioned negotiating the "slippery slopes and narrow paths" of objective analysis. While acknowledging that nothing in life is ever certain, we are quietly confident that this closing statement will prove surefooted.

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