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MANENTIA WEALTH
CONSULTING GROUP

Quarterly Market Overview 1Q 2021

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MWC Group

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This Time is Different

“At the beginning of the 2020s we entered a new era, which we describe as ‘state-sponsored capitalism’. A new kind of policy paradigm is emerging, which not only puts greater emphasis on fiscal stimulus but explicitly calls for the fusion of fiscal and monetary policy. In the longer term, these policies will manage to reflate Western economies, and when they do, we expect real assets such as equities, gold, and real estate to outperform, in that order.”

Bank Julius Baer research, Market Outlook 2021, 7th January, 2021

The title of this commentary is the oft quoted claim made by the proponents (or holders) in defence of assets that are undergoing steep price increases, often substantiated by transient or ephemeral arguments at best. We ask if it really IS different this time.

Asset Price Bubbles

Under the efficient market hypothesis, bubbles burst before they even have a chance to emerge. Hence, an asset's market price should correctly reflect its underlying fundamental value. However, historically, bubbles have emerged as investors are willing to hold assets even when their prices exceeded their fundamental value. They are hoping to sell these assets at an even higher price to some other investor (greater fool) in the future. In a setting in which a single investor alone cannot bring down a bubble, it can be individually rational to ride the bubble. In other words, the uncertainty of not knowing when other investors will start trading against the bubble makes each individual rational investor anxious about whether he can afford to be out of (or short) the market until the bubble finally bursts. Consequently, each investor is reluctant to lean against the bubble and might even prefer to ride it. Thus, price corrections only occur with delay, and often abruptly.

A second important message of this line of research is that small, fundamentally unimportant news can trigger large price swings. Such information can serve as a synchronization device that triggers the attack on a bubble. This explains why most large asset price movements are not associated with important news announcements. It also suggests that communication by central bankers and regulators is a very important policy tool.

The bubble-riding hypothesis also provides a different view on risk measures. Even though risk seems to be tamed while the bubble is inflating, risk and imbalances are building up underneath the surface and volatility suddenly spikes when the bubble bursts. This is in contrast to the efficient market view, under which contemporaneous risk measures appropriately capture current risk exposure.

So what?

We have witnessed a political shift likely to have profound consequences for investors. Through the blunt public health policy tool of lockdown, governments have dug a very deep economic hole. Their economic response to the crisis has been to announce monumental fiscal spending, with its virtuousness defined by the headline number, rather than its economic or social efficacy.

There is currently no political appetite for either public spending retrenchment or tax rises, so the responsibility for funding these unsustainable double digit fiscal deficits will fall to central banks.

Inevitably this will lead to monetary debasement, with the silent “tax” of inflation eventually balancing the books. The recent Democratic “sweep” has cemented the near-term debasement of the US dollar and its trusted role as the world’s reserve currency. The same can be said of many other major currencies such as the EUR, GBP, JPY, RMB, etc.

What does this mean for equity investors?

The loss of integrity of the US dollar will ease global monetary conditions which will serve to underpin reflation. We are already witnessing a powerful recovery across industrial commodities as the global industrial complex begins to re-stock, with most commodity producers being unable to meet increased demand following a decade of little to no appetite for (read: access to) capital to expand existing production or develop new projects to increase output. We contrast this against current easy access to capital for profitless, disruptive new technology businesses whose valuations are based on expectations that interest rates will remain ultra-low well into the future. It is therefore possible - but by no means certain – that we will see alternative market leadership under a different macro regime.

The announcement of vaccines was a catalyst for reflation. As always, the market looks beyond current conditions and is pricing in a “U-shaped” economic recovery. Ironically therefore, the more destructive the recession (recall that ‘bad news can be good news’ from a previous commentary), the greater the expectation of stimulus and debasement, and hence by this logic the inevitability of eventual inflation and the decline of fiat money.

Weighing up the evidence for a bubble

Despite clear signs of speculative excess in a few specific markets, we do not think that we are currently in the late stages of a bubble in risky assets generally. We give three reasons for our view, and the changes that would convince us that risky asset valuations have become unsustainable.

First, we are wary of inferring from extreme price movements in a handful of specific securities that risky assets generally are highly overvalued.

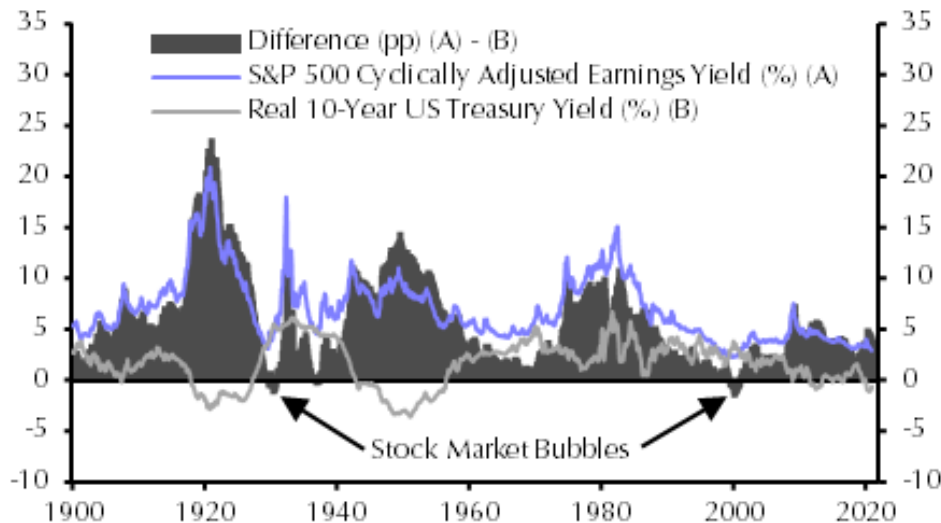
- The recent surge in the price of bitcoin is often cited as an example of excess, but it is worth reflecting on its last boom-bust cycle. From early 2015 to late 2017, its price rose roughly 125-fold, before collapsing by more than 80% in the next year. Ownership of bitcoin was, and still is, highly concentrated (a third of all bitcoins are apparently owned by just 1,000 addresses). And it was largely held outside the mainstream financial system, not on the balance sheets of systemically important institutions. What happened to it then was mainly driven by a small and atypical community of investors, rather than developments in the global financial system. Not surprisingly, there was no tangible impact on risky assets generally.
- Since 2017, bitcoin has moved a little closer to the mainstream. It has become easier for investors to access, helped by the launch of a few funds tracking its price. But daily trading volumes across major bitcoin exchanges are still a tiny fraction of a percentage point of those of US equities. And as far as we can tell, it still represents only a minute share of institutional investors’ portfolios, if it appears at all.
- Admittedly, the prices of a small number of conventional assets have also rocketed in recent months, in some cases to hard-to-justify levels. But there are also plenty of previous examples of investors generating surges and slumps in the prices of small groups of stocks or bonds, which have signified little about the state of markets generally. The past decade has seen huge rallies and collapses in the prices of assets like biotech and solar energy stocks, for example. This time around it may well be the case that the prices of some individual assets are now unsustainable. But we

ought to judge risky asset prices overall on their own merits, rather than generalising from a few extreme examples.

Second, we think that the sustainable levels of risk-free rates are lower now than in the past, meaning that the sustainable valuations of risky assets generally today may be much higher than their long-run averages.

- The valuation of the benchmark US equity index, for example, does not seem particularly stretched now relative to the low level of bond yields – in stark contrast to before the 1929 and dotcom crashes. (See Chart 1) And we expect that real yields in the US could either stay close to current levels or may even fall further for another few years, based on the FED’s ‘flexible form of average inflation targeting’, which would allow the central banks to overshoot the inflation targets of 2% over the medium term compensating for the prolonged periods of low inflation over the past decade.

Chart 1: Relative Valuations: US Equities & Treasuries



All Chart Sources: Refinitiv, NYSE, FINRA, Federal Reserve, Shiller, FRASER, Capital Economics

- What if we are wrong and (real) interest rates do increase markedly? In short the effect on risky assets might depend a lot on why rates were rising – whether primarily in response to even stronger economic growth that we are anticipating, or more worryingly because central banks’ “reaction functions” turn out to be far more hawkish with regards to inflation than currently seem to be the case. The effects of interest rate changes on equity valuations is covered in more detail in the separately attached article.

Third, we cannot yet see the kind of leverage or financial imbalances that have accompanied systemic bubbles (i.e. those affecting more than just a few individual securities) in the past.

- Systemic bubbles historically have been associated with high and rising leverage, for a few reasons. In the financial system, access to leverage increases the buying power of the most optimistic investors, making it easier for them to [bid up risky asset prices to extreme levels](#). Leverage also makes prices less stable once they have risen. Investors who are highly leveraged are far more

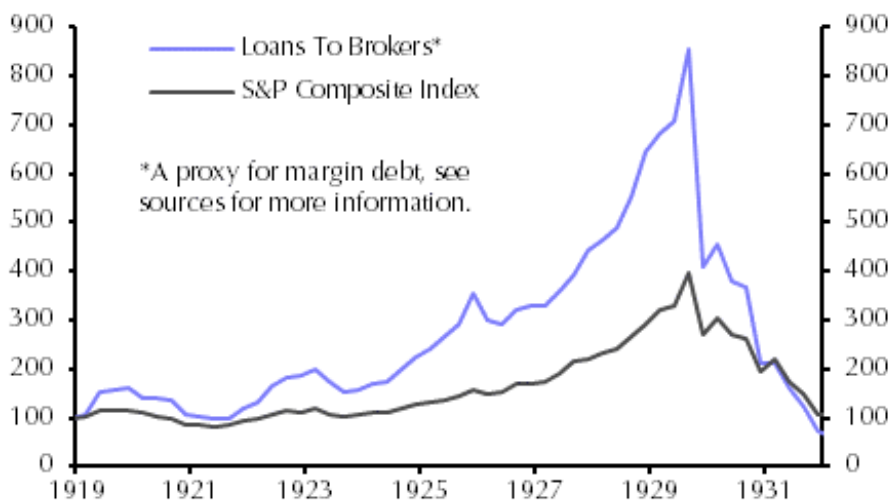
likely to become [forced sellers](#) (since it takes only a small loss to wipe out all the equity of a highly-levered investor). Forced selling can compound tiny initial price falls, generating the so-called loss/margin spiral effects that are virtually always features of broad-based collapses in risky asset prices. Meanwhile, outside the financial system, rising leverage in the private sector can temporarily boost spending to unsustainable levels, inflating the earnings relative to which the prices of risky assets are compared.

- No single metric captures the whole picture here, so it makes sense to look at a range of things. The amount of margin debt relative to the size of the market is a crude measure, but nonetheless a starting point. It has increased a bit recently, but not yet in the way that it did prior to the dot com collapse and global financial crisis, and certainly not like it did before the 1929 crash. (See Charts 2 & 3)

Chart 2: Ratio Of NYSE Margin Debt To Size Of US Stock Market (%)



Chart 3: Loans To Brokers & US Equity Prices, 1919-32 (Indexed To 100 At Start Of Period)



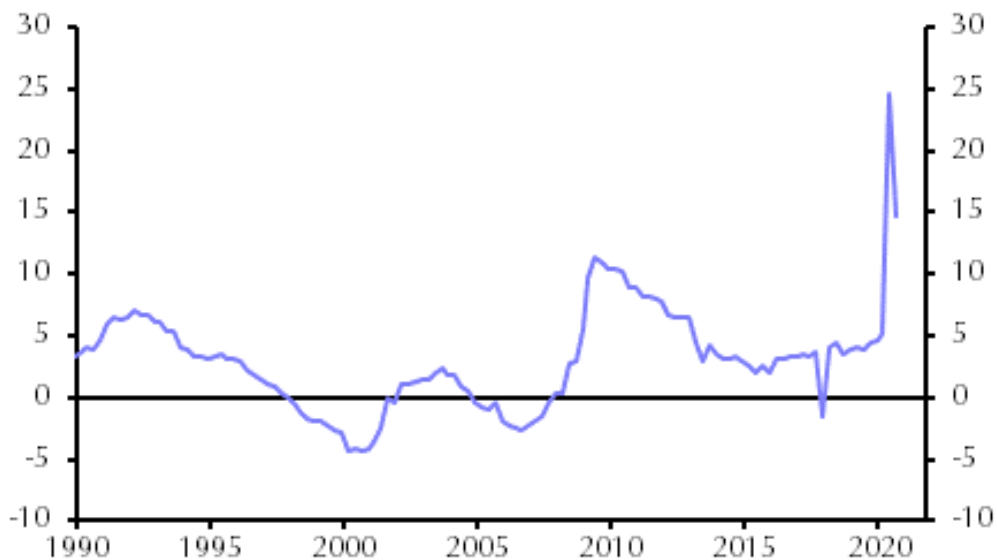
Source For Chart 3, see p494 & p434 [here](#), and p11-12 [here](#).

- The balance sheets of key financial institutions are also worth considering. In general, reforms since the global financial crisis have reduced leverage in key parts of the global financial system considerably. For the largest US financial institutions, measures of leverage (like the ratio of tangible equity to assets and the regulatory standard common equity tier 1 ratio) appear much healthier than on the cusp of either the dotcom crash or the global financial crisis. (See Section 3 of the Fed’s [Financial Stability Report](#) for example.) Despite the impact of the coronavirus crisis on

financial institutions around the world, the overall balance sheets generally appear to be in reasonable shape despite the pandemic.

- In terms of financial risks in the economy more broadly, the situation also looks quite different to during systemic bubbles in the past. In the run-up to the dotcom crash and global financial crisis, for example, the US private sector's financial balance was negative – the private sector as a whole was a net borrower. But the opposite has happened recently during the unique circumstances of this pandemic. (See Chart 4) The enforced reduction in spending plus extraordinary fiscal support has substantially *improved* private sector balance sheets, at least in aggregate.

Chart 4: US Private Sector Financial Balance (Net Lending Or Borrowing, % Of GDP)



None of the evidence above means that another systemic bubble will not inflate in the next few years.

Aside from during the decades of very stringent financial regulation and capital controls just after the Second World War, systemic bubbles have been a recurring feature of capitalist economies. With monetary policy likely to stay loose for some time, and central banks' unprecedented support for risky asset markets in 2020 fresh in investors' minds, it is easy to imagine another one inflating in the next few years.

But neither does this evidence suggest to us that we are *currently* in the late stages of such a bubble.

That will be more of a concern if it starts to become apparent that we are very wrong about the sustainable level of interest rates, or more likely if leverage begins to rise in key parts of the financial system while broader financial imbalances like those shown in Chart 4 become apparent again. For the time being, provided that vaccines enable the gradual relaxation of coronavirus restrictions around the world, we continue to expect that the prices of most risky assets will rise further.

We conclude by attaching an article (with express permission) penned by a rising star in financial journalism, Ms. Lyn Alden Schwartzer*. Lyn's background in engineering and finance together with her analytical skills and easy to read prose allows her to convey complex financial concepts in a manner easy for most to understand or at the very least to get the essence.

The article, entitled: "Equities and Interest Rate Risk" compares the discounted cash flow valuations of three hypothetical companies in the value, growth and hypergrowth categories using different interest rates and seeks to explain how (or why) we see such seemingly outrageous valuations today. As she demonstrates, in a low or falling interest rate environment, equity valuations can increase, sometimes

significantly. **Implicit in that demonstration, but not explicitly stated, is that in a high or rising interest rate environment, the opposite is true.**

Final Words

Despite a seemingly one-sided argument that the stock markets do not appear to be overvalued on certain measures, we are cognisant that future interest rates and rates of inflation will be the factors that determine whether some or all equities are (were, in retrospect) overvalued.

History has repeatedly shown that it always FEELS different every time, but in the end, as events have unfolded, it was just a variation of one theme or another. The only way in which this scribe can envision it being different this time is if Central Banks permanently set interest rates at zero (or if the Central Banks are collectively disbanded or lose their independence) and politicians restart determining interest rate policy (Trump?, Erdogan?) and rack up infinite amounts of debt. MMT anyone?

As we still have not been able to acquire a crystal ball, we are in many ways hostage to an unknown and unknowable future. Perhaps, we will all be guilty of bubble-riding. The question will be when to get off?

*Lyn Alden Schwartz is a popular contributor on Seeking Alpha, founder of Lyn Alden Investment Strategy, and recent addition to the Stock Waves team at ElliottWaveTrader.net. Blending a background in engineering and finance, Lyn provides fundamental market research to tens of thousands of individual investors and financial professionals per month. Her work has been featured or cited on Forbes, Business Insider, CNBC, MarketWatch, Time's Money Magazine, Kiplinger, The Street, US News and World Report, and other financial media.

Economic Data Table March 2021

Stock Markets	Month	Q1 21	YTD	GDP YoY	Interest Rates	Inflation Rate
United States	4.24%	5.77%	5.77%	-2.40%	0.25%	1.70%
Euro Area	7.78%	10.32%	10.32%	-4.90%	-0.54%	1.30%
Germany	8.82%	9.07%	9.07%	-3.70%	-0.54%	1.70%
France	6.38%	9.29%	9.29%	-4.90%	-0.54%	1.10%
Italy	7.88%	10.87%	10.87%	-6.60%	-0.54%	0.80%
Spain	4.32%	6.27%	6.27%	-8.90%	-0.54%	1.30%
Greece	9.17%	6.93%	6.93%	-7.90%	-0.54%	-1.30%
Switzerland	4.99%	3.21%	3.21%	-1.60%	-0.75%	-0.20%
United Kingdom	3.55%	3.92%	3.92%	-7.30%	0.10%	0.40%
Brazil	6.00%	-2.00%	-2.00%	-1.10%	2.75%	5.20%
Russia	5.83%	7.68%	7.68%	-1.80%	4.50%	5.67%
India	0.83%	3.68%	3.68%	0.40%	4.00%	5.03%
China	-5.40%	-3.13%	-3.13%	6.50%	3.85%	-0.20%
Japan	0.73%	6.32%	6.32%	-1.40%	-0.10%	-0.40%
MSCI World Equity Index	2.46%	4.18%	4.18%			

Bond Indices	Monthly	Q1 21	YTD
Barclays Capital U.S. Aggregate Bond Index	-1.42%	-3.93%	-3.93%
Barclays Global Aggregate ex-USD Float-Adjusted Index (Hedged)	-0.09%	-2.44%	-2.44%
J.P. Morgan Government Bond Index Emerging Markets Global Core Index (Local Currency)	-3.28%	-7.78%	-7.78%
Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged) Index	-0.11%	-2.40%	-2.40%

Currencies	Monthly	Q1 21	YTD	Price
EUR/USD	-2.87%	-3.98%	-3.98%	1.17
GBP/USD	-1.10%	0.78%	0.78%	1.38
EUR/GBP	-1.81%	-4.73%	-4.73%	0.85
USD/CHF	3.88%	6.56%	6.56%	0.94
EUR/CHF	0.89%	2.32%	2.32%	1.11
USD/JPY	3.87%	7.26%	7.26%	110.70
GBP/CHF	2.73%	7.41%	7.41%	1.30

Commodities	Monthly	Q1 21	YTD	Price
Gold	-1.53%	-9.99%	-9.99%	1707.01
Oil (WTI Crude, NYMEX)	-4.64%	23.37%	23.37%	59.55



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