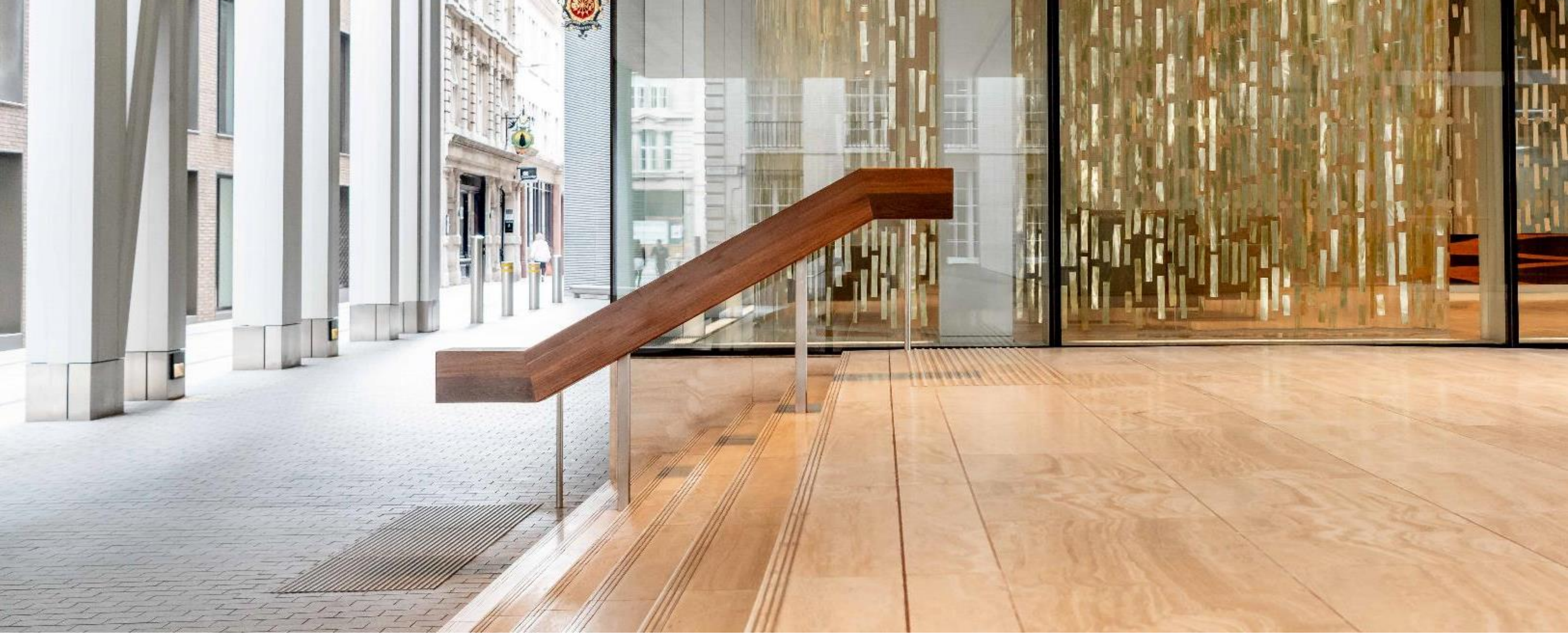

Financial instability: an asset allocator's perspective

23 JUNE 2023

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The views expressed are the personal views of the author

Agenda

1

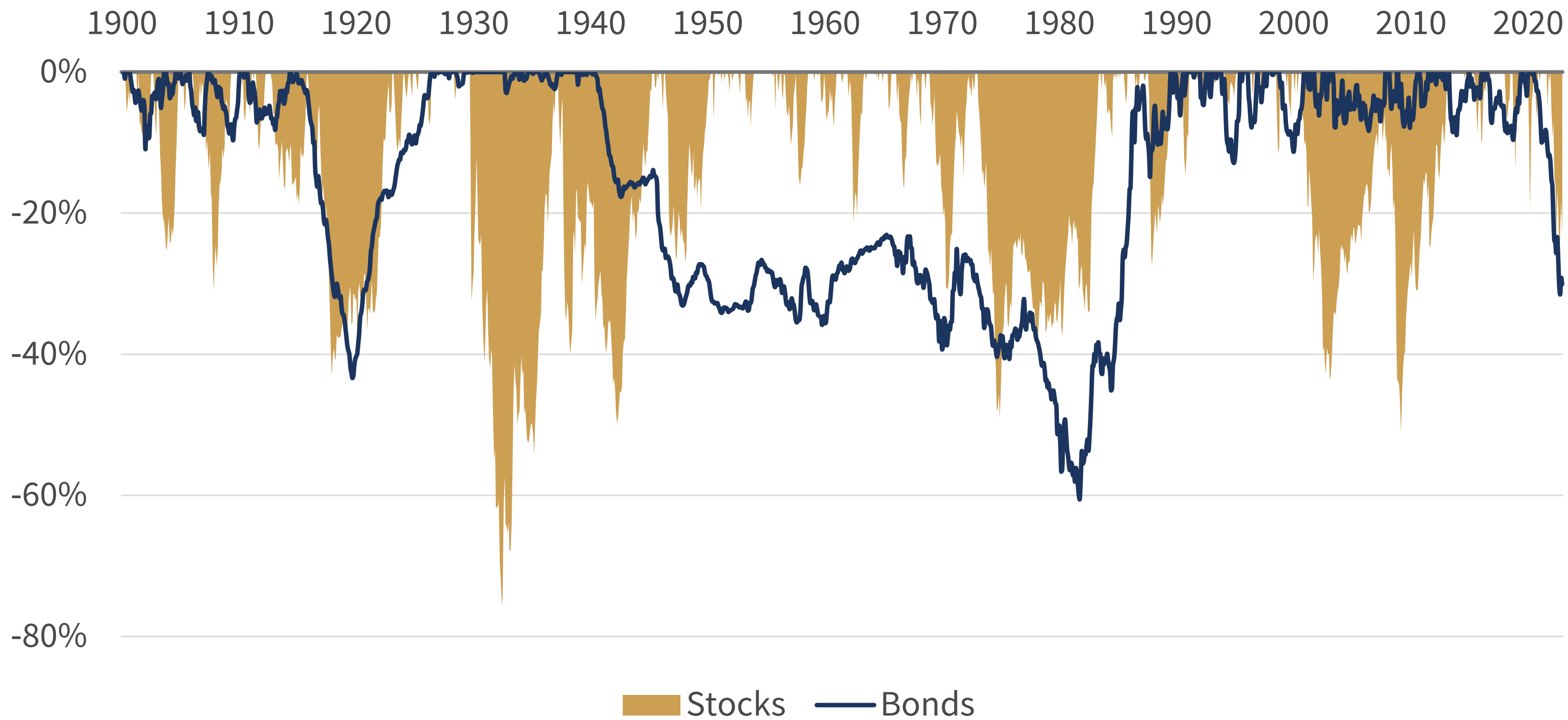
Are markets becoming more unstable?

Testing times?

- 1994: Tequila crisis, Orange County (US interest rates)
- 1997: Asia crisis
- 1998: Russia default; LTCM
- 2000: Tech bubble
- 2008: commodities “supercycle”; Global Financial Crisis
- 2011-15: US credit downgrade; Greece/peripheral EU debt crisis; Taper Tantrum
- 2020: COVID suppression
- 2022/3: Ukraine; interest rate normalisation?

Market declines: US stocks and bonds (%, net of CPI)

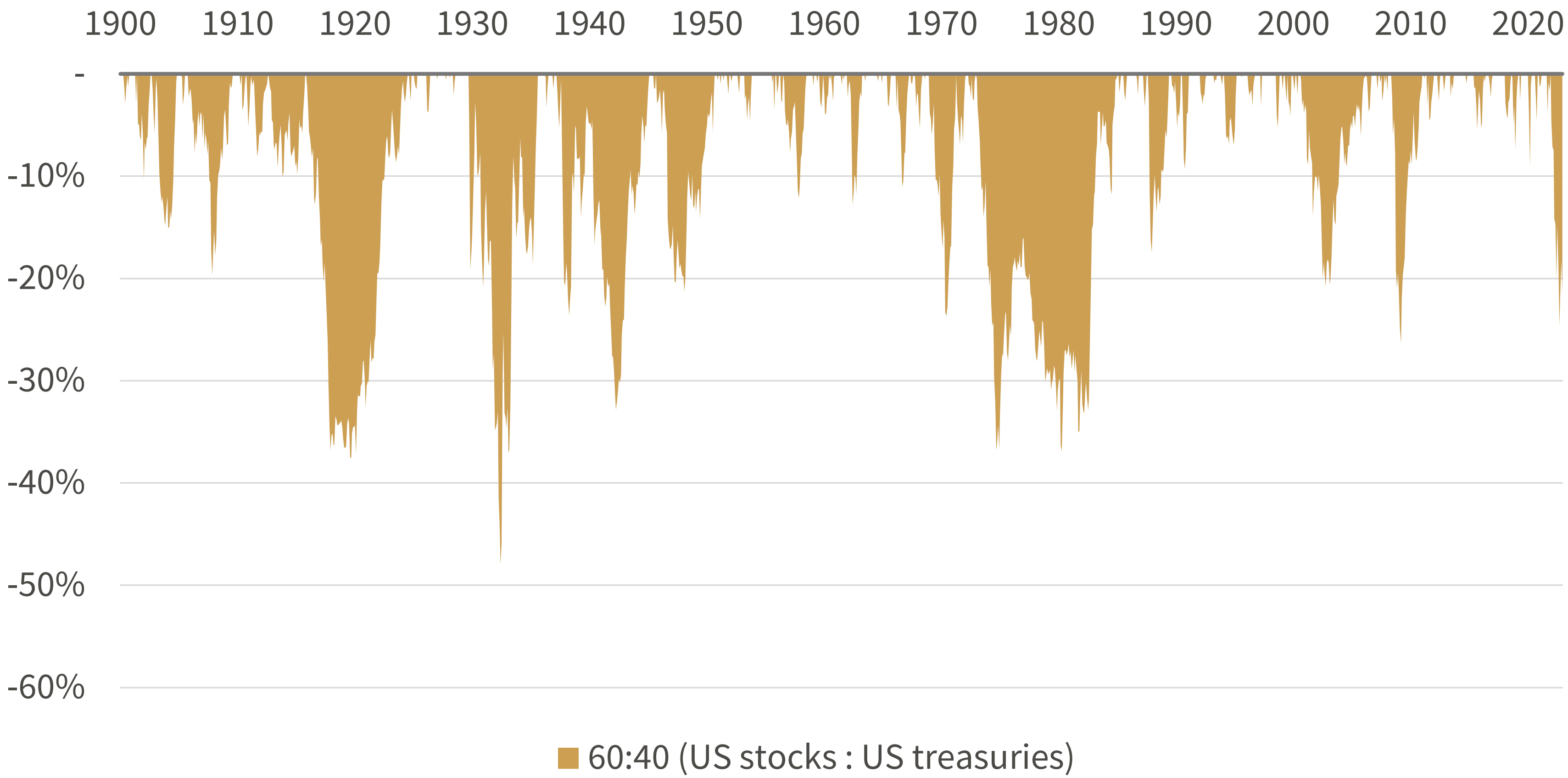
'Real' (inflation-adjusted) peak-to-trough drawdowns, Jan 1900 - Dec 2022



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream

Market declines: US 60:40 portfolio (%, net of CPI)

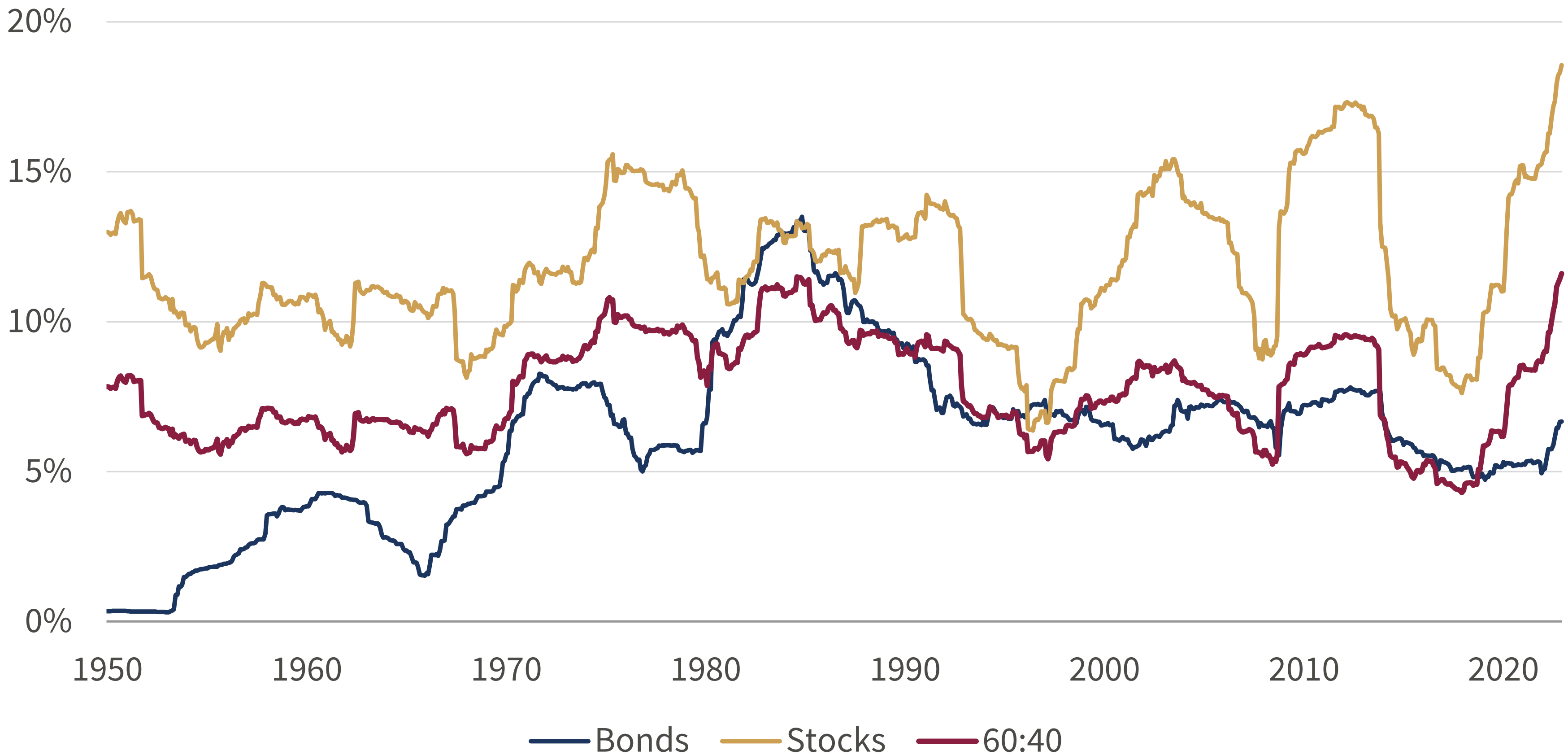
'Real' (inflation-adjusted) peak-to-trough drawdowns, Jan 1900 - Dec 2022



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream

Rolling 10-year volatility: US stocks and bonds

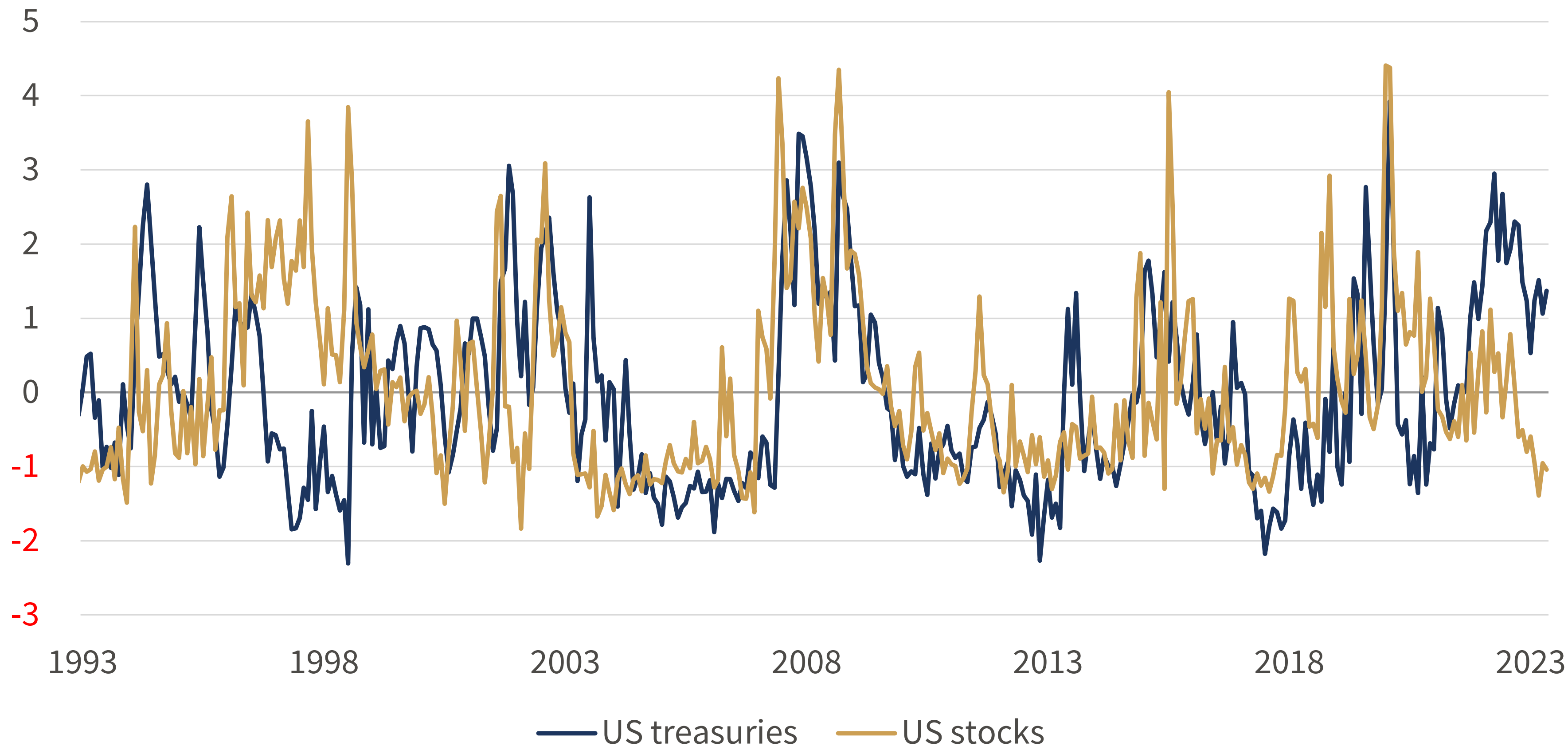
Annualised standard deviation of monthly returns, 1950 - 2022



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream

Implied volatility: US stocks and bonds

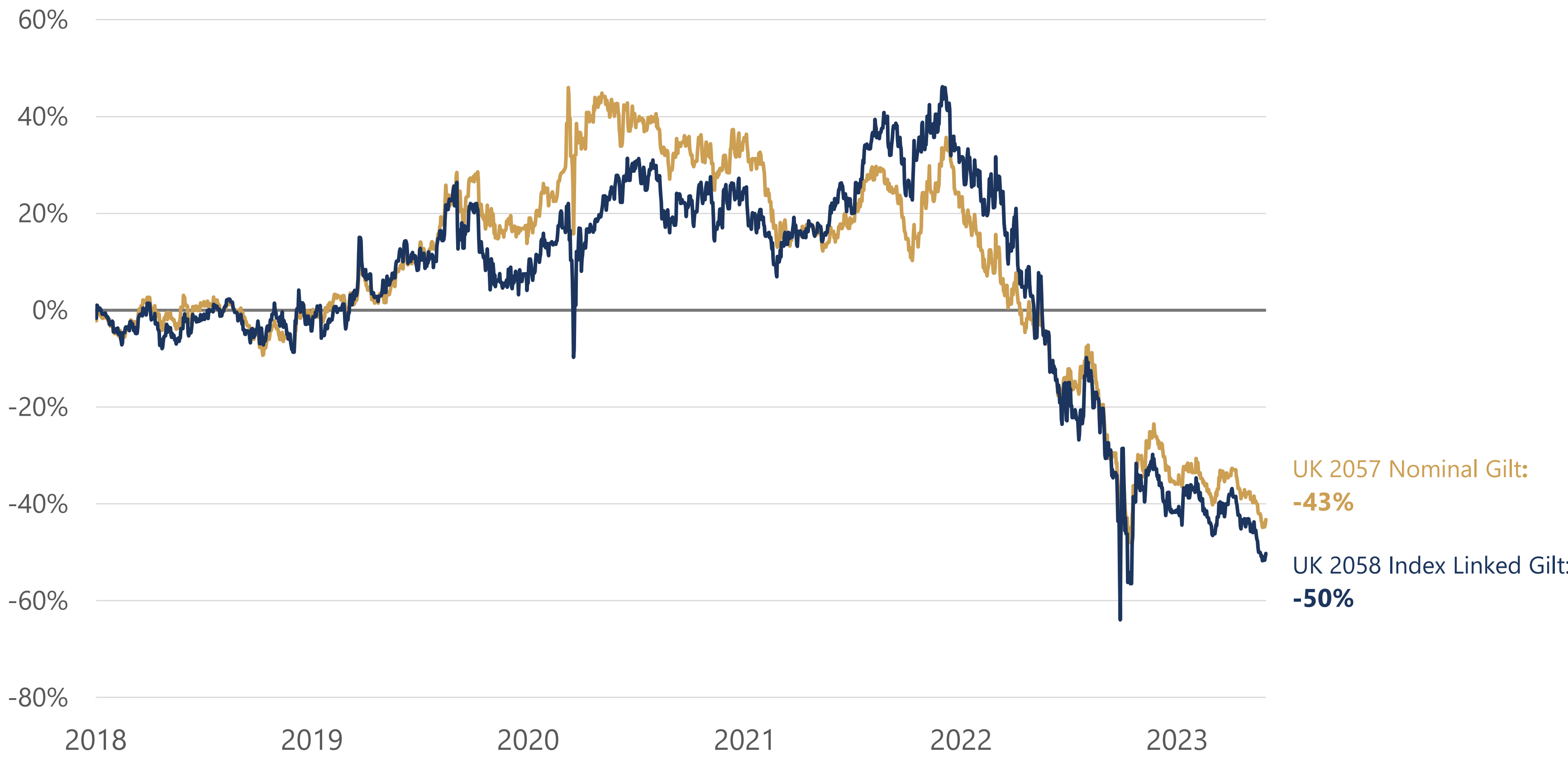
One-month options, normalised (3-year z-scores)



Source: Rothschild & Co, Bloomberg, Refinitiv Datastream

Memo: mistaken assumptions – inflation-linked bonds

Cumulative total returns: Jan 2018 to May 2023



Source: Rothschild & Co, Bloomberg

Are markets more unstable?

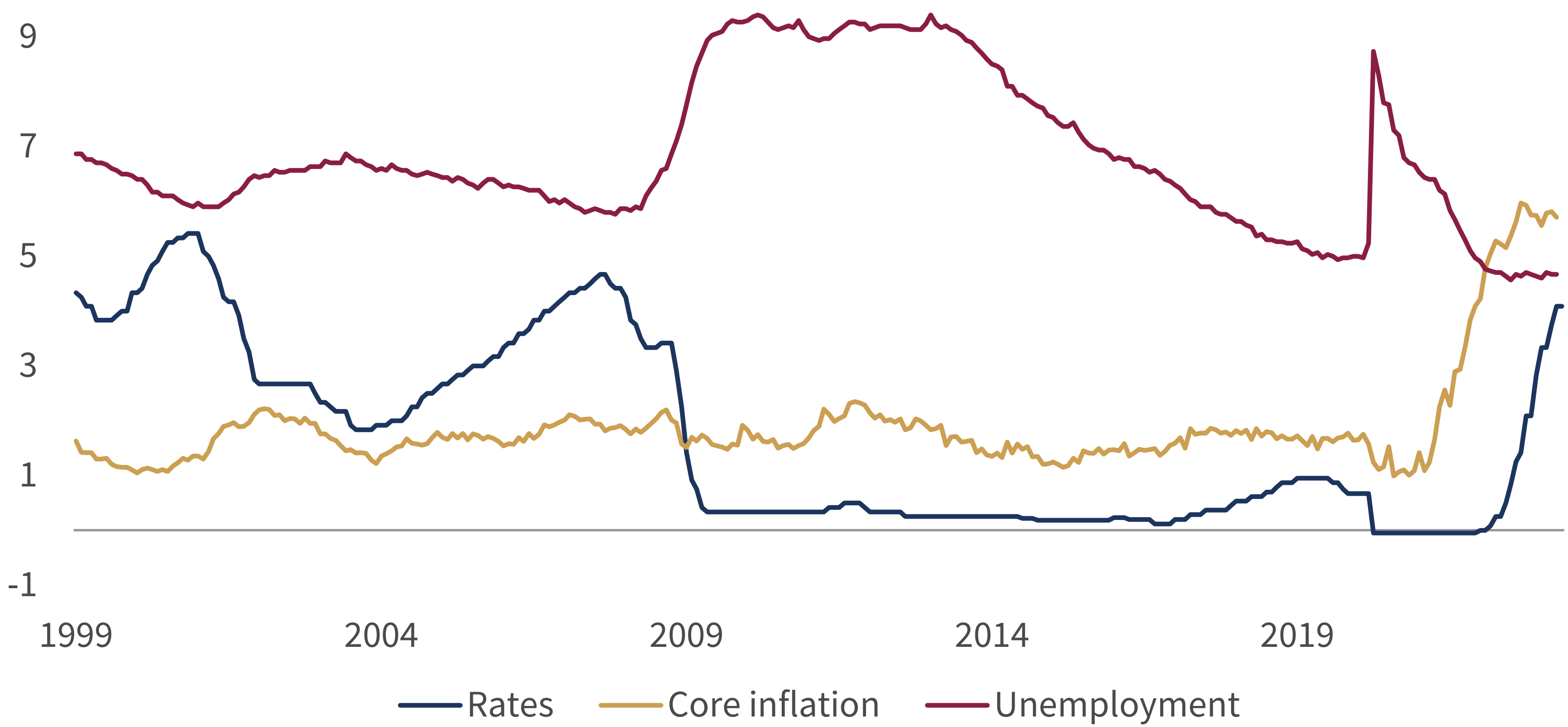
- A succession of "crises"… but is this new? 1907, 1929, 1987; 1971, 1992…
- How do we measure instability anyway? Volatility – ex post, traded – or its absence?
- Eg: Gold standard – paradise lost or volatility repressed?
- Eg: Financial repression – paradise found or volatility repressed?
- If not more volatile – certainly bigger, more complex

2

Cyclical threats

G3 policy rates, core inflation, unemployment (I): %

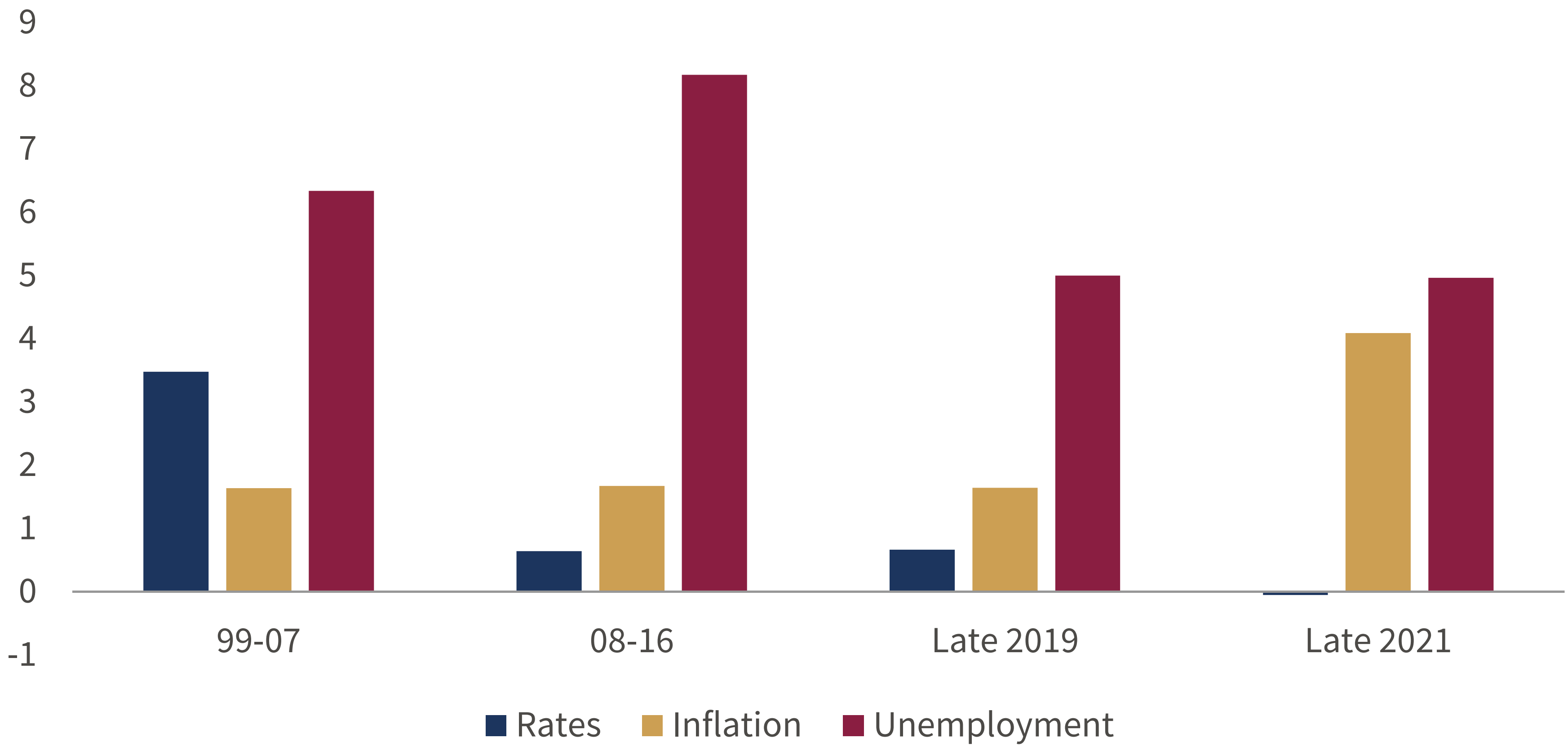
G3: unweighted average of the US, EZ and UK



Source: Rothschild & Co, Refinitiv Datastream

G3 policy rates, core inflation, unemployment (II): %

G3: unweighted average of the US, EZ and UK



Source: Rothschild & Co, Refinitiv Datastream

Threat 1: recent monetary policy

History may not be kind:

- End-2021: historic lows in interest rates *and* unemployment
- Subsequent rise in core (demand-led) inflation

How did policy become so pro-cyclical (ie potentially destabilising)?

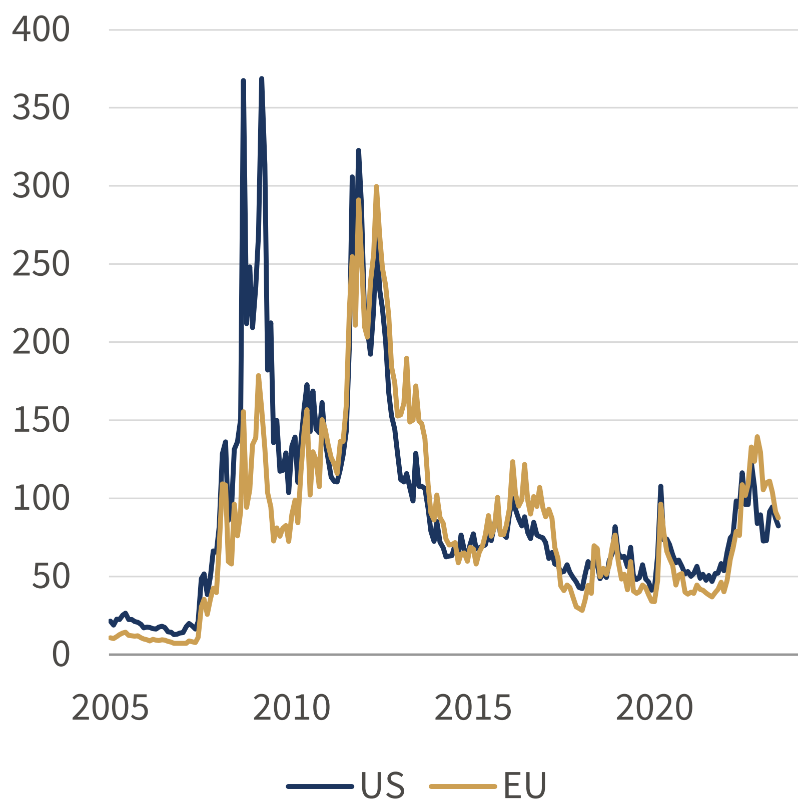
- Groupthink, mission creep, technique, pandemic-related distractions…
- … and general epistemological overconfidence (discuss)

Threat 2: banks and money – the butterfly's wings

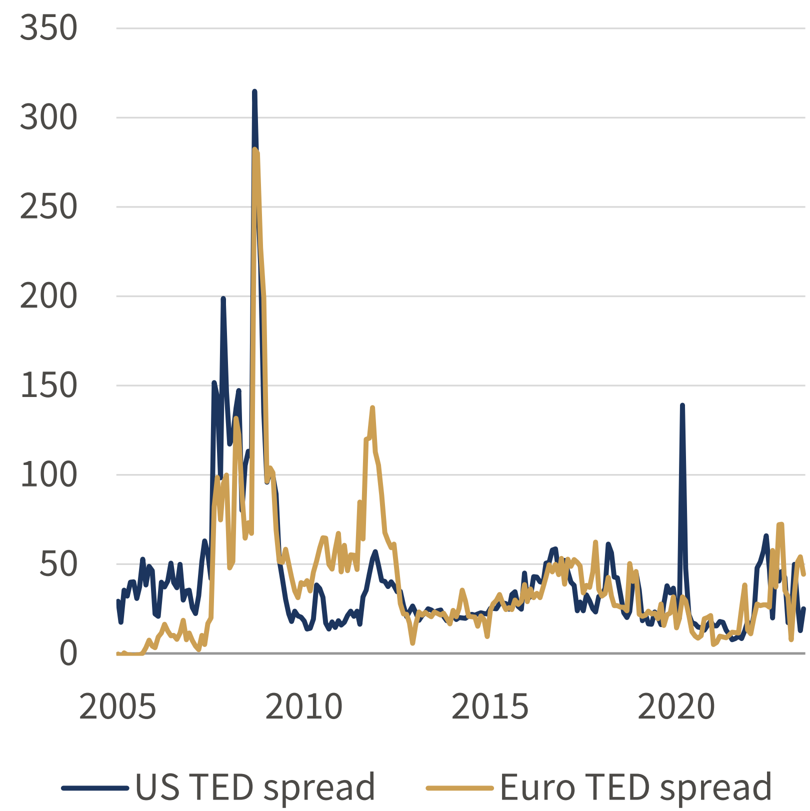
- 2023 context: idiosyncratic risk; more capital; better assets; faster/practised intervention. There are usually more butterflies than tornadoes
- Nonetheless… expectations, the crowded cinema
- All businesses are vulnerable: what's special about finance?
- If banks are too big to fail, are they too big to take risk? Can we separate money from credit? Digital (not crypto…) currency?

Banking stress contained (so far)

Major banks' credit default swaps (5-year senior CDS, bps)



Liquidity stress (interbank spreads, bps)



Source: Rothschild & Co, Bloomberg

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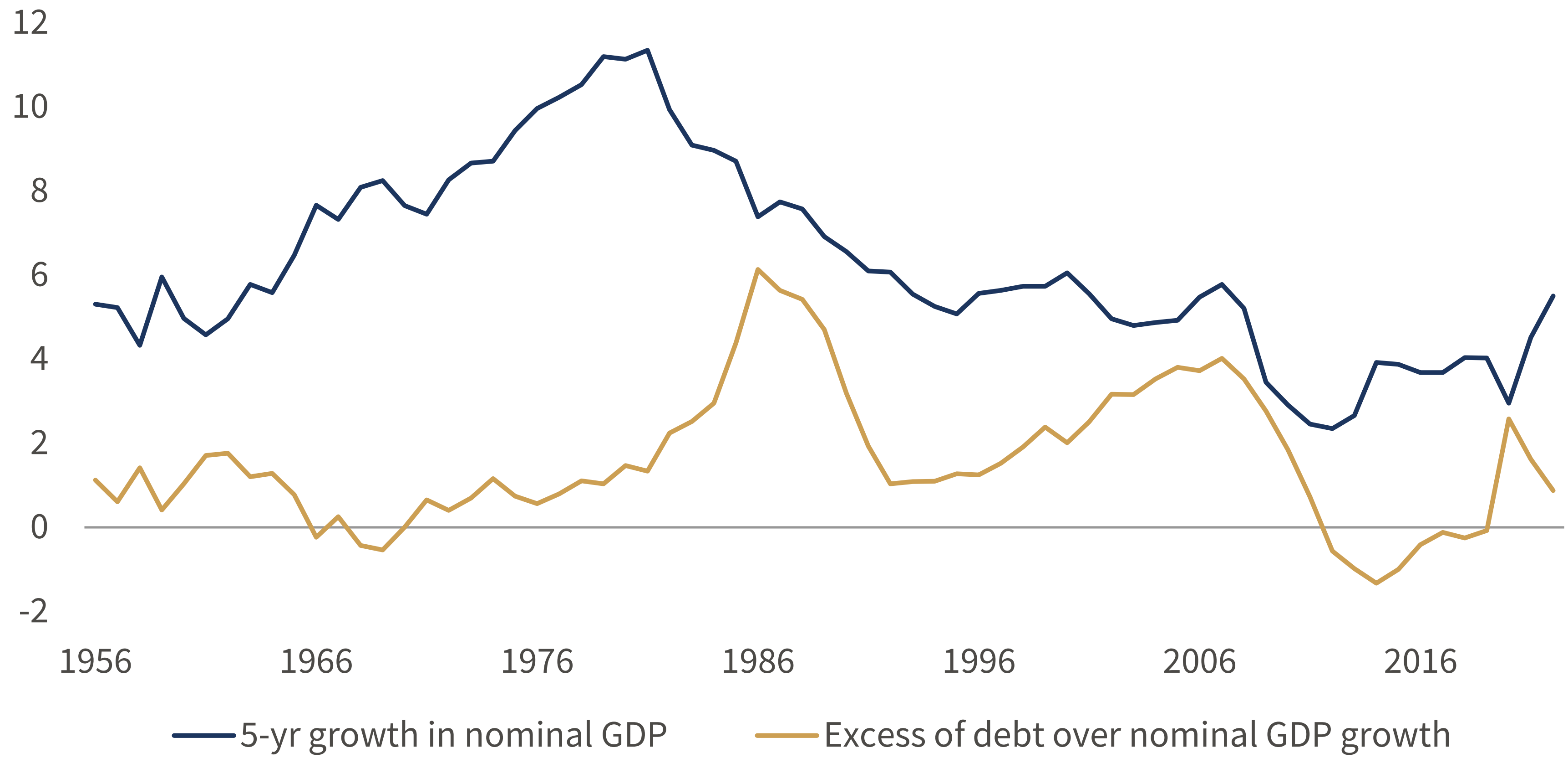
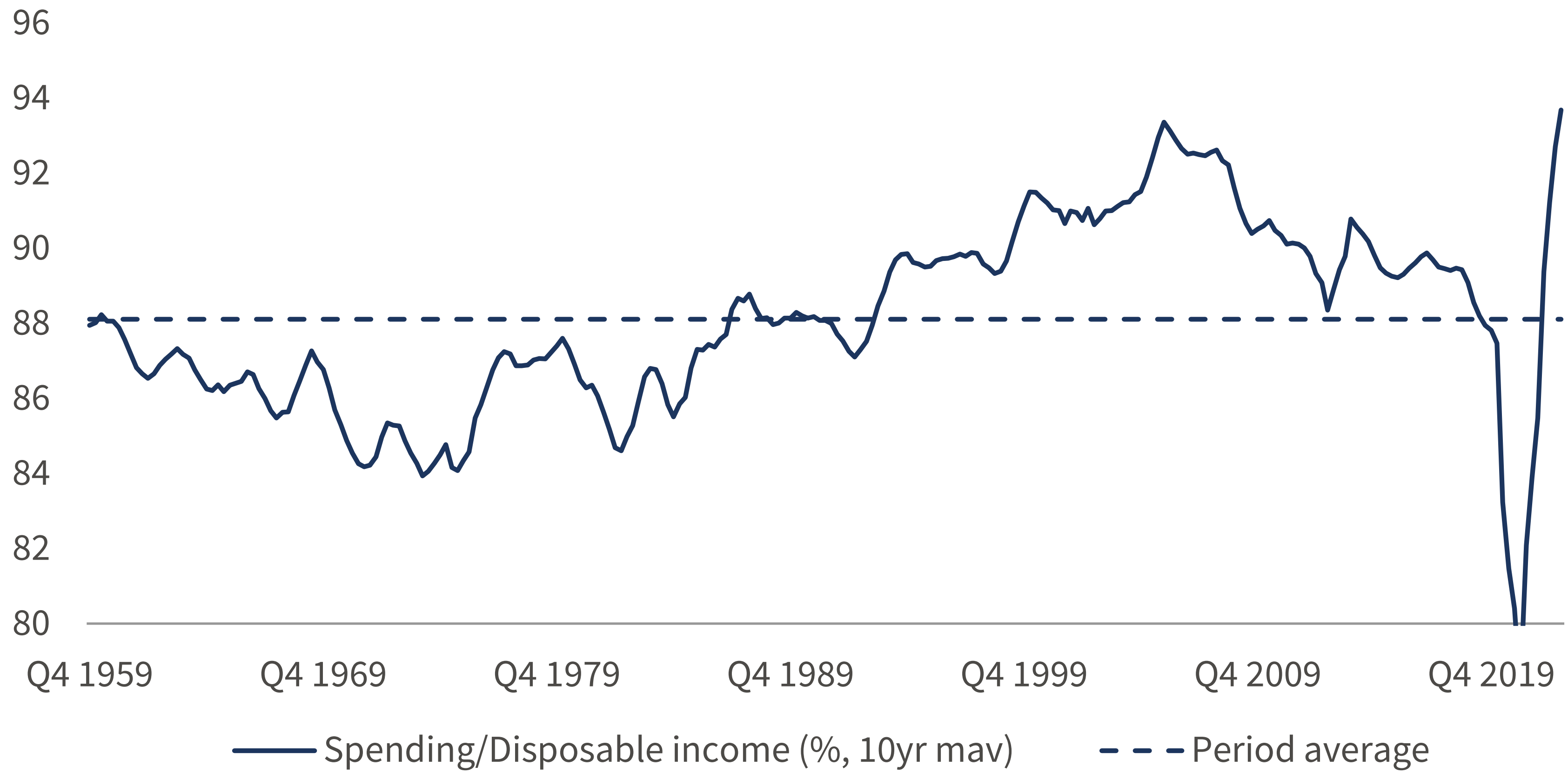
Structural threats

US nominal GDP and debt (%, 5yr mav). Not what we imagine?



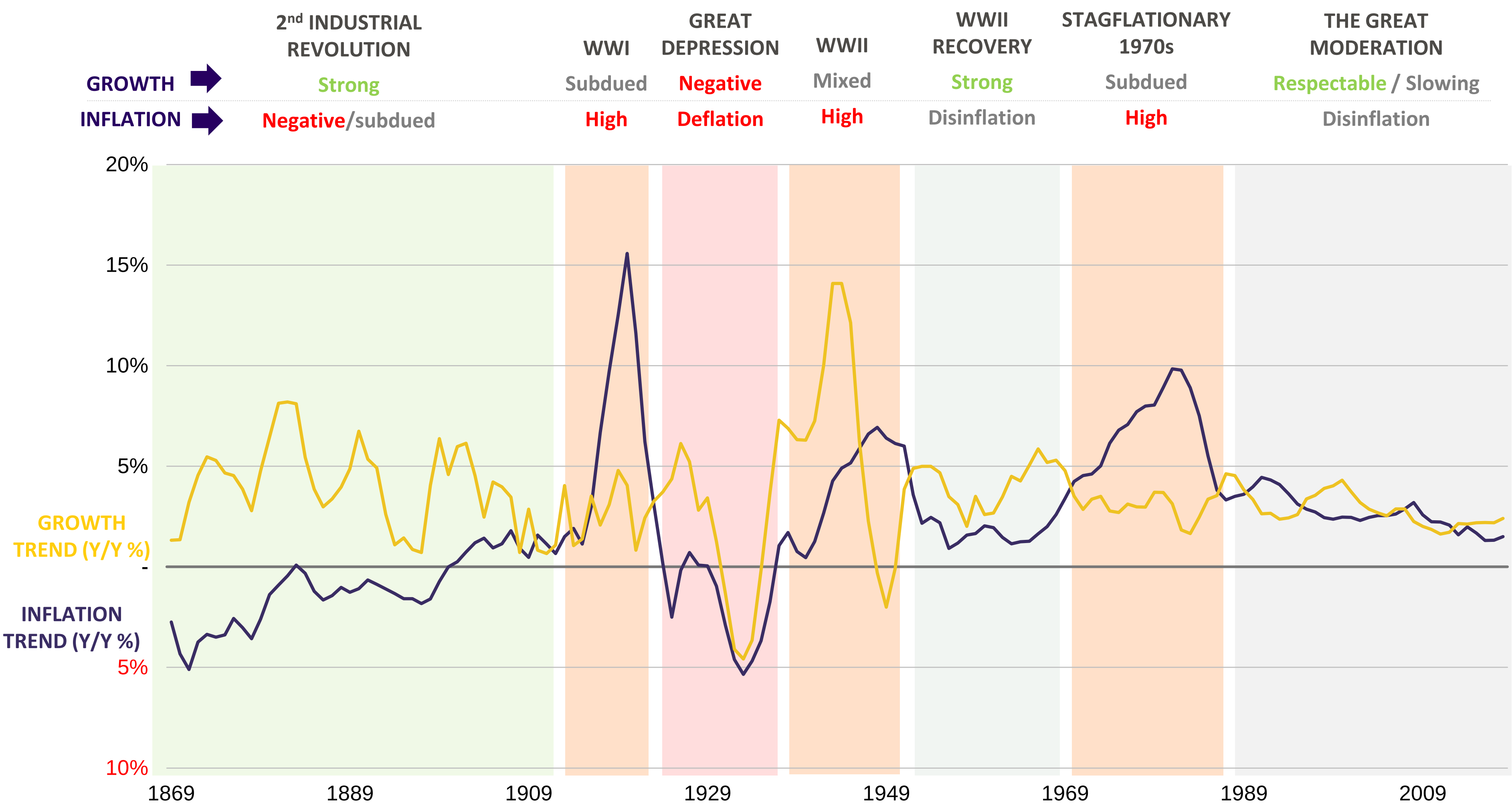
Source: Rothschild & Co, Refinitiv Datastream, US Bureau of Economic Analysis, Federal Reserve

US consumer spending ratio (%, mav). What role for credit?



Source: Rothschild & Co, Refinitiv Datastream, US Bureau of Economic Analysis

US growth and inflation since 1860



Source: Rothschild & Co, BEA

Drivers of growth and financial risk

- US debt growth led nominal GDP most when latter slowed. Is this evidence of full capacity, or of the unimportance of debt? Between 1949 and 2019, credit arguably made no net contribution to consumer spending growth

- Different macro regimes bring different risks: might supply-driven growth (technology, labour, globalisation) mean smaller balance sheets as well as less inflation?

- This is not a case for pro-cyclical monetary policy

Debt: the things people say (I)

- *“The average person on the planet owes $28,000”*

- *“… public debt allows the current generation… to live at the expense of those as yet too young to vote or as yet unborn”*

- *"The pattern of borrowing, spending more than you make, and then having to spend less than you make… is as true for a national economy as it is for an individual.”*

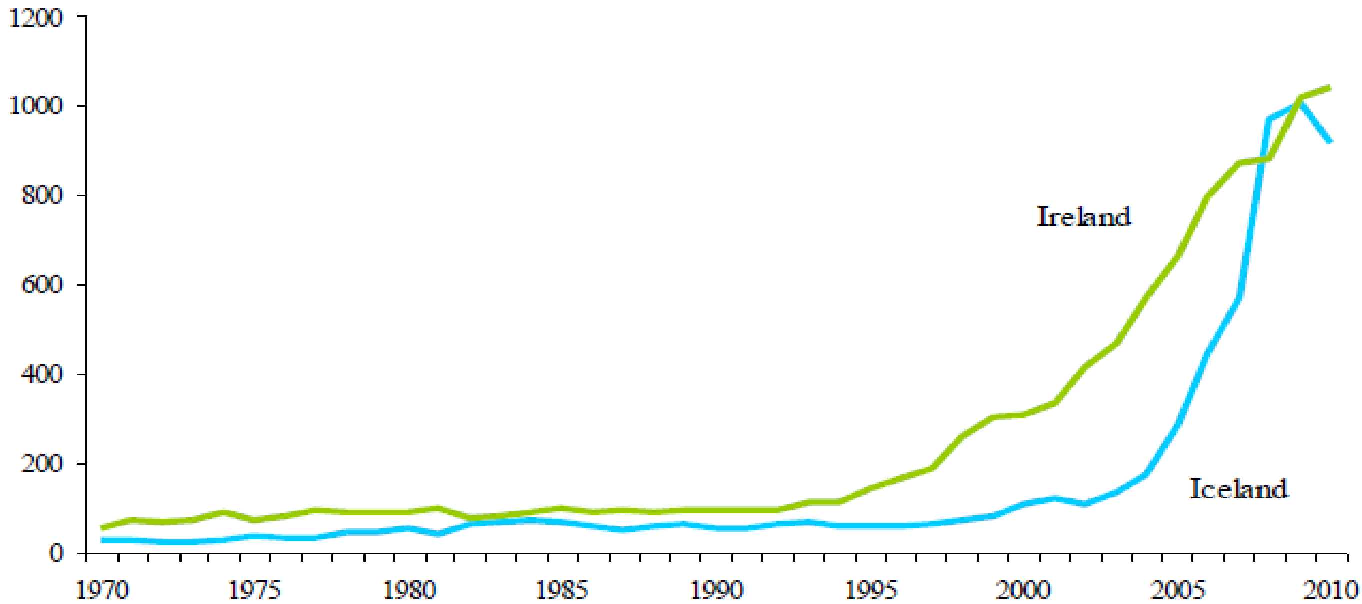
- *“These high levels of public debt are… not the most immediate risk. The near-term priority is to avoid premature withdrawal of fiscal support… Fiscal policy can be a bridge to smart, resilient, sustainable, and inclusive growth.”*

Source: Rothschild & Co, Mckinsey, Niall Ferguson, Ray Dalio, IMF

Debt: the things people say (II)

Reproduced from "A Decade of Debt", Reinhart & Rogoff, CEPR Discussion Paper No 8310, April 2011

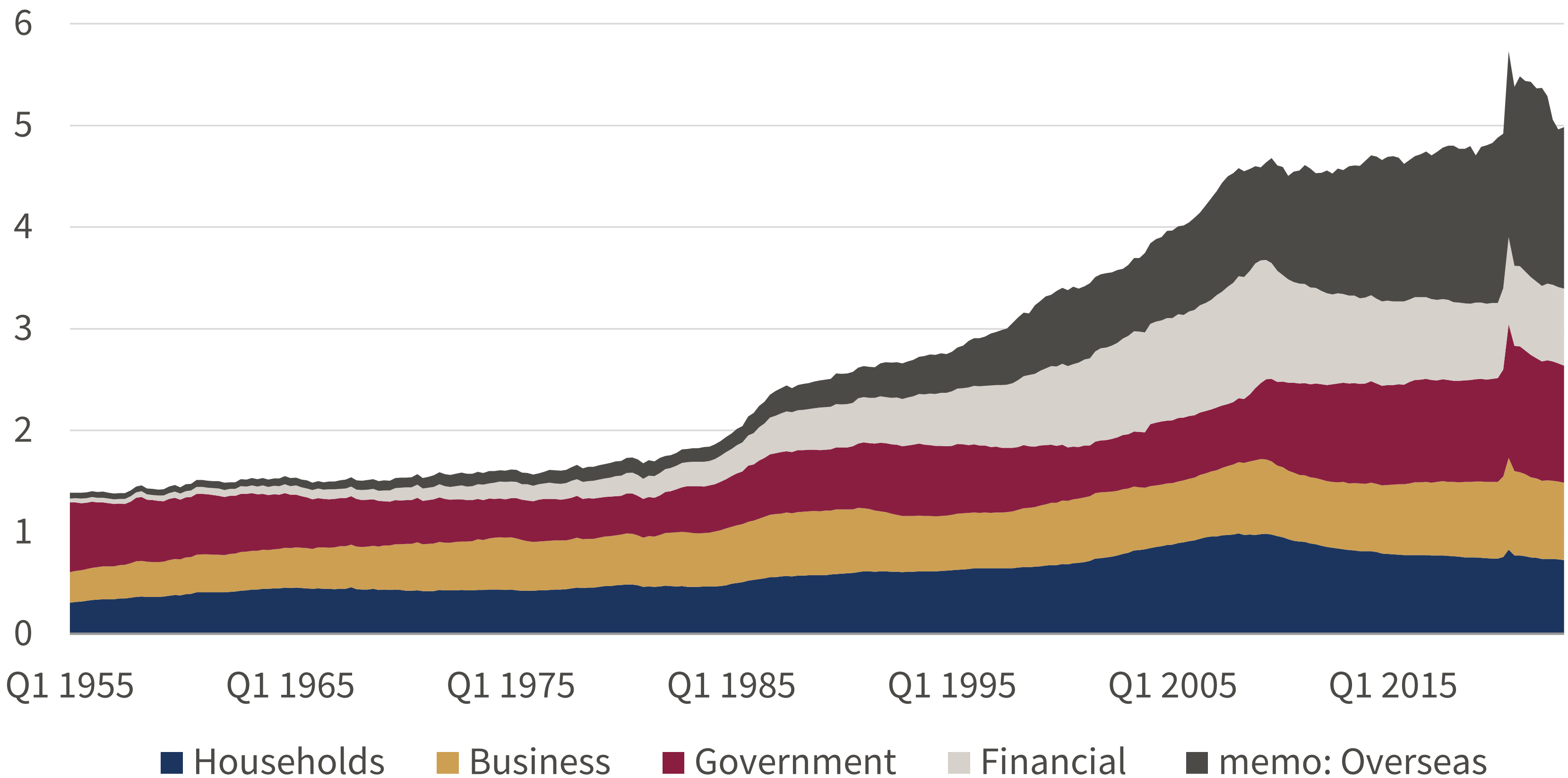
b. External (public plus private) Debt, 1970-2010 (debt as a percent of GDP)



Sources: Reinhart (2010).

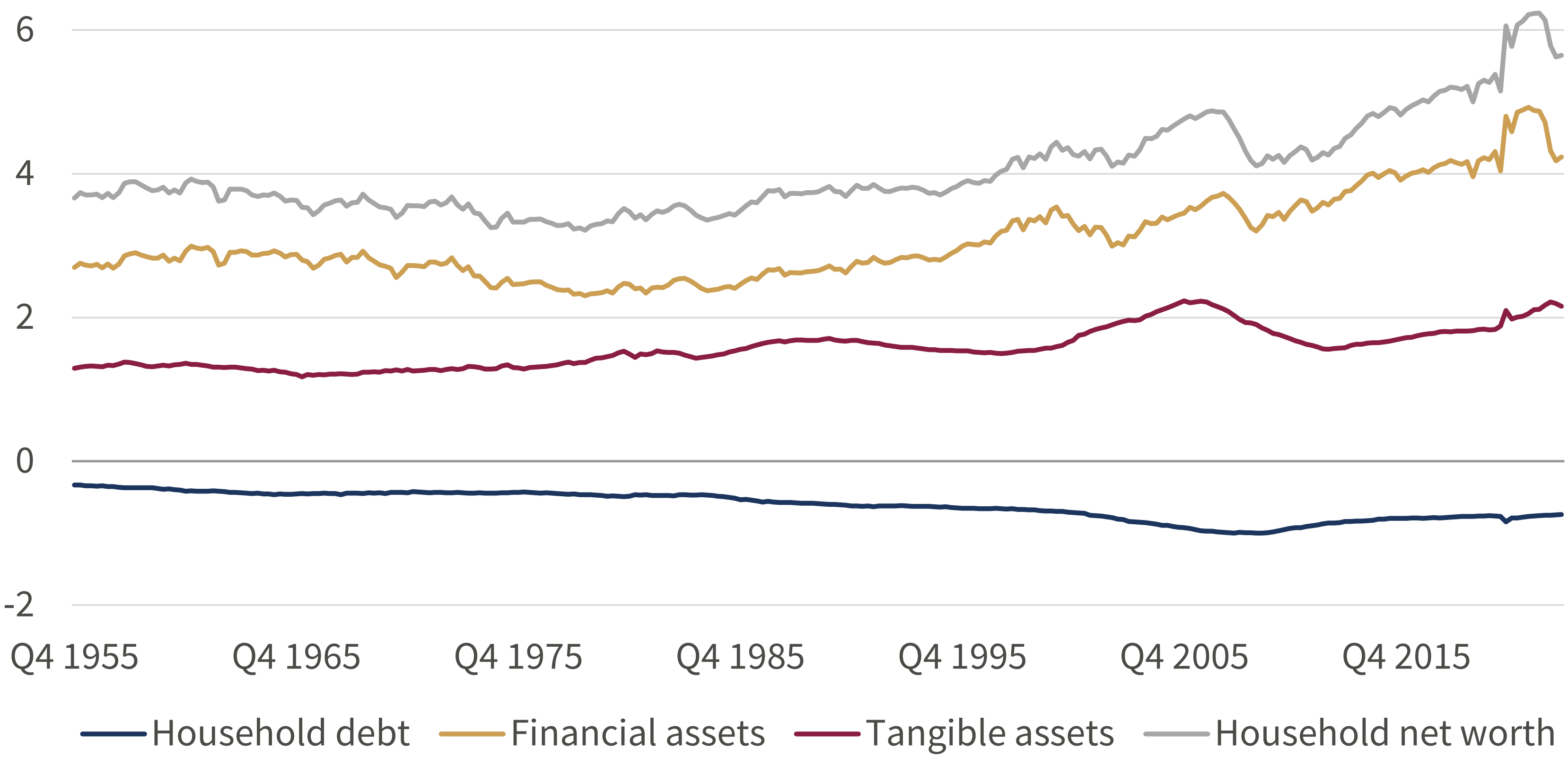
Source: Reinhart (2010)

US gross debt (x GDP)



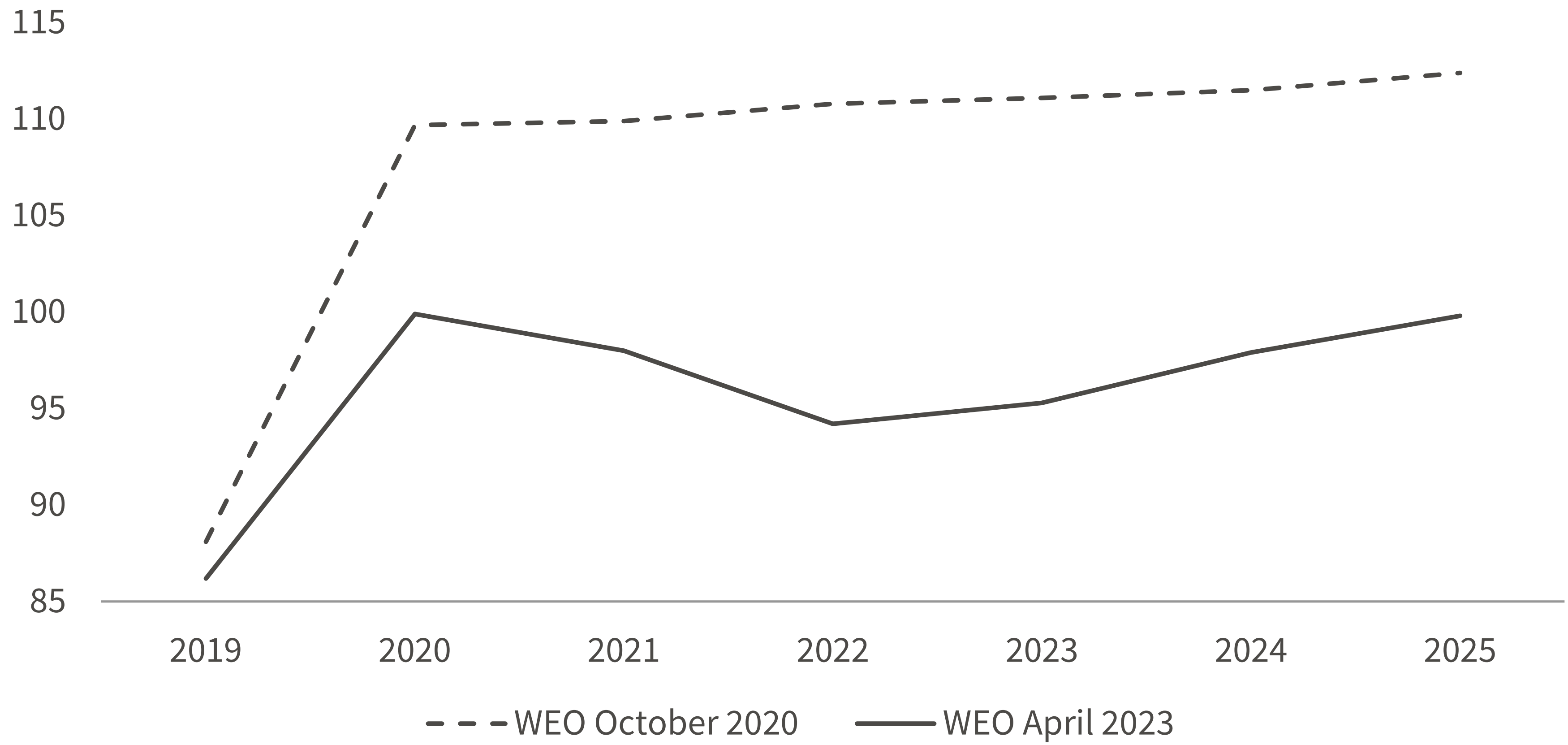
Source: Rothschild & Co, Refinitiv Datastream, Federal Reserve

US household net worth (x GDP)



Source: Rothschild & Co, Refinitiv Datastream, Federal Reserve

IMF forecasts for G7 net govt debt (% GDP)



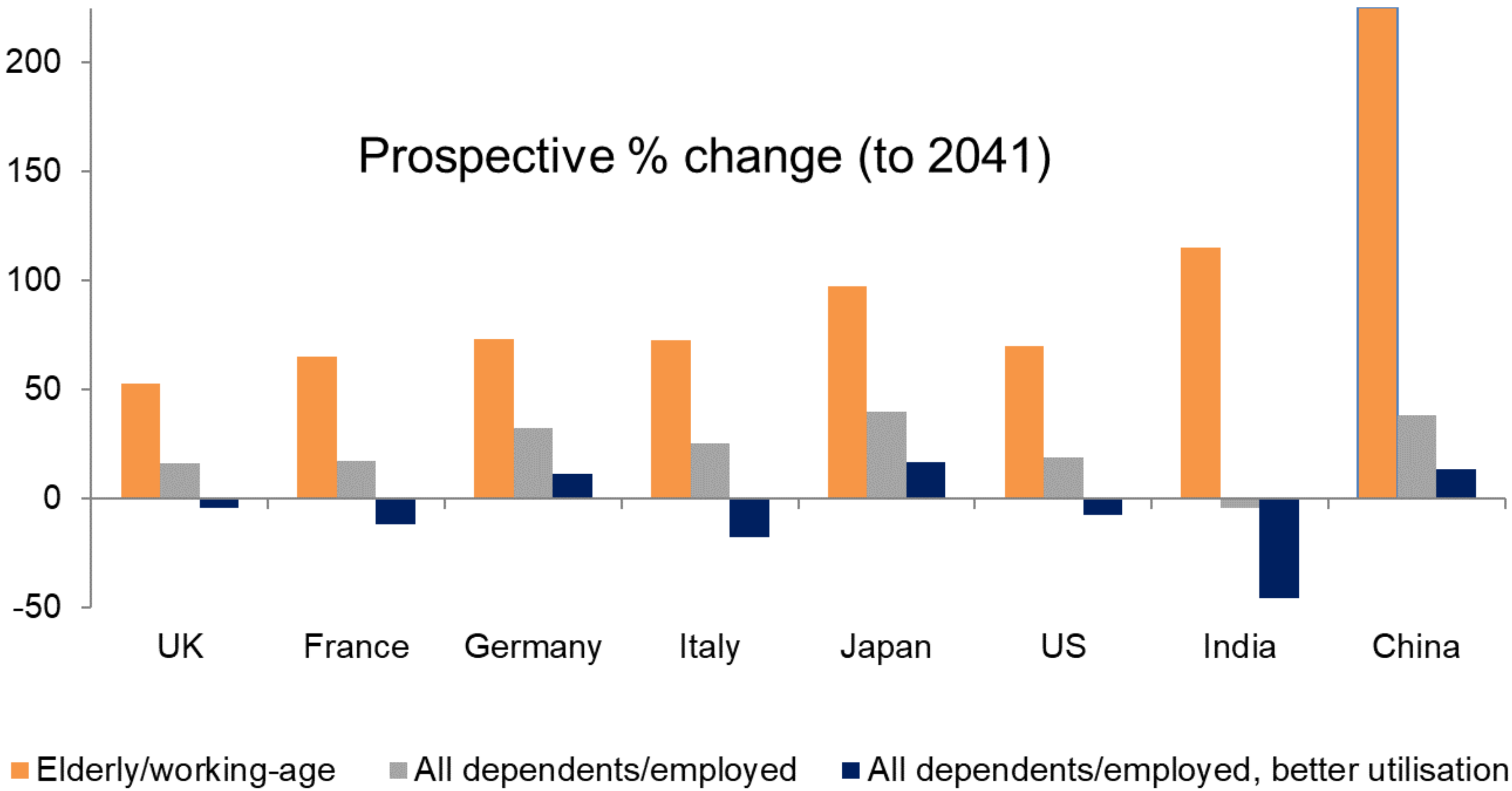
Source: Rothschild & Co, IMF

Demography – not to be confused with dependency

- An aging population need not imply a binding shortage of labour
- Participation and employment rates vary: dependency arithmetic is highly sensitive
- Small changes in working hours and retirement ages can also make a big difference
- Meanwhile, productivity *can* still grow (technology, learning curve)

Prospective dependency scenarios, as they looked a decade ago

The elderly are not the only dependents, and not all working-age people are employed



Source: "Making Sense of Markets", Kevin Gardiner, 2015; US international Bureau of Census

Duration – the pensions problem

- Collectively, PAYG… ultimately paid from output, not savings
- The form of administration – “funded”, private, public, DB, DC – may not make a big difference to the aggregate outcome…
- … but of course matters hugely to individuals and sponsors
- Questions for the administrative (distributional?) context: which assets have longest duration? Did DB schemes close too soon? Did we just redistribute risk – to sponsors initially, now members?

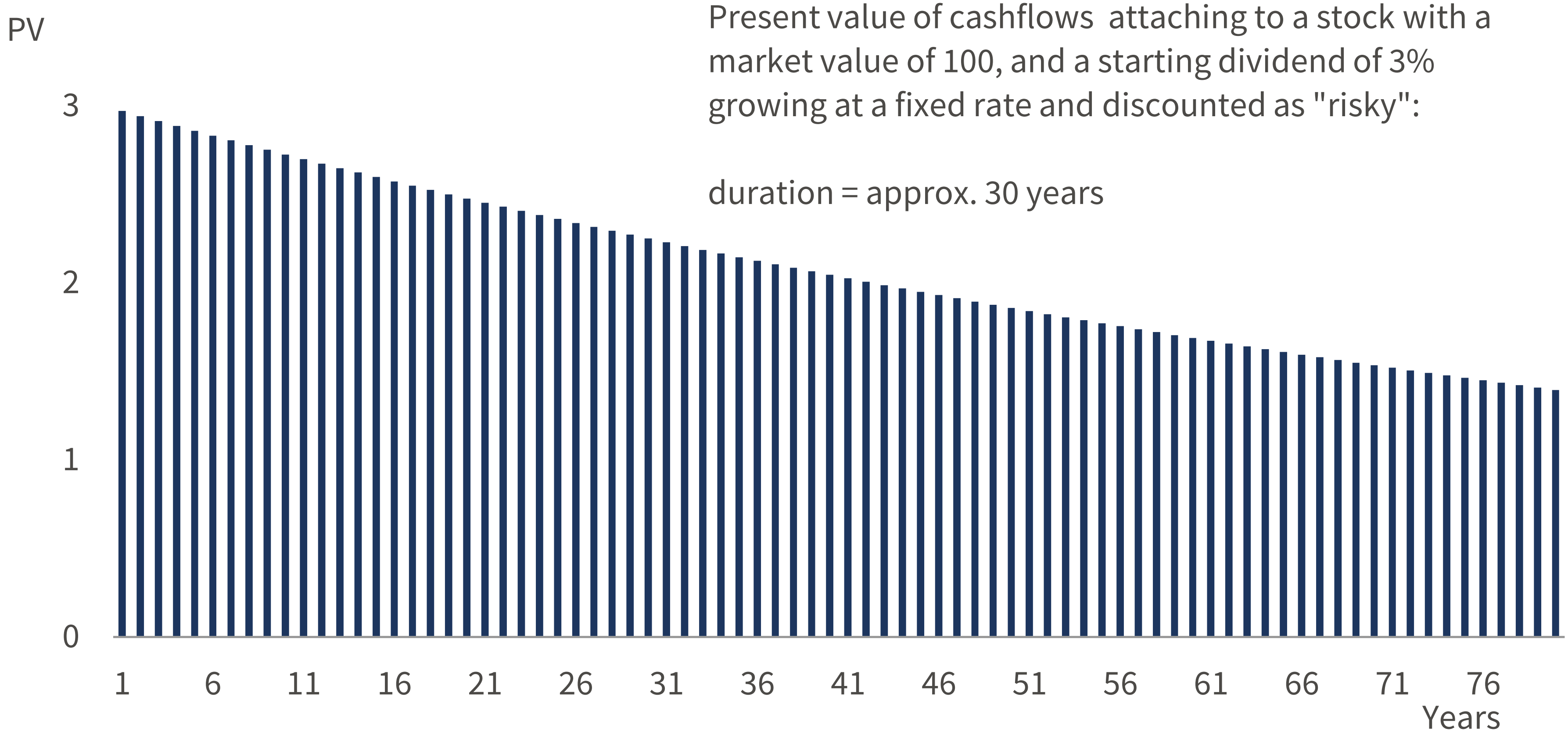
Duration: bond

Source: Author’s calculations

Duration: stock

Present value of cashflows attaching to a stock with a market value of 100, and a starting dividend of 3% growing at a fixed rate and discounted as "risky":

duration = approx. 30 years



Source: Author’s calculations

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Conclusion

Conclusion

- Memo to central banks: there have been no hyperdeflations. Stability requires credible money
- All markets are potentially unstable, but finance more than most. Volatility has been suppressed – but when was it not?
- There is a case for monetary reform (but not a return to metal)
- Nonetheless: recent crises can be seen as a “richness of embarrassments” – as financial farce, not (yet) economic tragedy
- The asset allocator’s advice? Own real assets – or title to them

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