Absolute Return Partners

The Absolute Return Letter

February 2020

# Five Lessons from History

## Lesson #1: People suffering from sudden, unexpected hardship are likely to adopt views they previously thought unthinkable.

*"History never repeats itself. Man always does."*
**Voltaire**

### Why five lessons?

Every now and then a reader drops me a note, encouraging me to read this or that. Most of the time I follow the advice, as I don't think you can ever learn enough. When Noel (a long-standing reader of the Absolute Return Letter) dropped me a line in early December and suggested I read "Five Lessons from History" by Morgan Housel of the Collaborative Fund, at first, I just added it to my (already very long) list of Christmas readings and didn't think more about it. December is not exactly the month of the year with the most spare time!

Now, fast forward to my Christmas break. One bleak morning between Christmas and New Year, lying on the couch in my house in Denmark, I finally managed to read what had been so highly recommended to me, and it was indeed a treat. I actually enjoyed it so much that I, on the spot, decided that Noel had just given me no less than five Absolute Return Letters for 2020. Thank you, Noel.

In the paper, Morgan Housel picks up on five behavioural patterns that all have a significant impact on financial markets every day of the year. This month, I will deal with the first of Morgan's five lessons:

*"People suffering from sudden, unexpected hardship are likely to adopt views they previously thought unthinkable."*

It is a very powerful behavioural pattern that, over the years, have had, and will continue to have, enormous impact on *everything*. Let me explain.

### The meaning of hardship

Although one may suffer from hardship in more ways than one, e.g. through serious illness, let's remind ourselves that this is indeed a financial newsletter, so let's assume that we are dealing with financial hardship here.

Financial hardship is a relative concept. According to some, life isn't hard until the day you are forced out of your home, only to end up on the street. To others, if your financial situation is so bad that you are forced to replace the Lamborghini with a BMW, you are indeed suffering from financial hardship.

I am of the opinion that, to most ordinary people, financial hardship is the result of falling real wages. Suddenly, you cannot afford the living standards of yesterday, so something will have to give. And cutting back on living standards, even if it is only to a limited degree, usually results in some sort of financial hardship.

You may argue that, if earnings are not rising as fast as inflation for a while, it is always an option to dig into your savings, but that argument ignores the fact that a large percentage of households in many countries have no meaningful savings. Here in the UK, no less than 10 million households have no savings whatsoever, and almost 20 million households (71% of all households) have savings of less than £10,000 (source: The Money Charity).

In the US, the average household has about $175,000 in savings (source: CNBC), but that number masks enormous differences across wealth classes. Amongst the poorest 40% of all households, median savings are $0, meaning that at least 20% of all US households have no savings at all. Meanwhile, the wealthiest 1% of US households have savings of no less than $2,500,000.

## Examples of financial hardship and what it does to people

The two best examples of financial hardship in the West over the past century are probably (i) the period of hyperinflation in Germany in 1923 followed by years of depression and (ii) the Great Depression in the US in the 1930s. Millions lost their job in both Germany and the US at the time, and society was, in both instances, on the verge of breaking down.

In the US, Herbert Hoover won a landslide victory in 1928. Four years later, as financial hardship amongst ordinary Americans had begun to take its toll, Hoover lost by a similar margin, and the political landscape in the US changed profoundly (Exhibits 1-2).

| | Candidate | Party | Electoral Votes | Popular Votes |
|---|---|---|---|---|
| ✓ | Herbert C. Hoover | Republican | 444 | 21,391,381 |
| | Alfred E. Smith | Democratic | 87 | 15,016,443 |

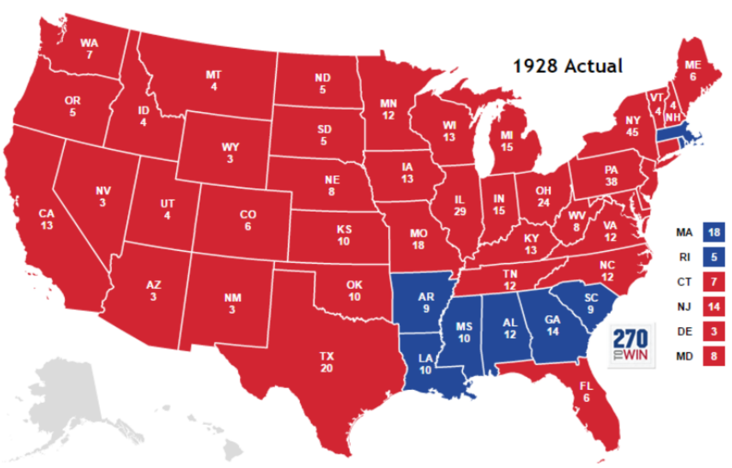


**Exhibit 1: 1928 US presidential election results**
*Source: Wikipedia*

Meanwhile, in Germany, Adolf Hitler gained power at a rapid rate. In the May 1928 Reichstag election, the National Socialist German Workers' Party (the Nazi Party) had entered the Reichstag for the first time with 12.2% of the popular vote. Following a succession of Reichstag elections, by March 1933, the Nazi Party was the largest party in Germany with 43.4% of the popular vote. That landslide drove the influential German journalist, Theodor Wolff, to write the now infamous lines in Frankfurter Zeitung:

*"It is a hopeless misjudgement to think that one could force a dictatorial regime upon the German nation. The diversity of the German people calls for democracy."*

Yet, a few months later, Hitler began his regime of terror and dictatorship. By November the same year, political parties other than the Nazi Party had been outlawed and, in the November 1933 election, the Nazi Party got 92.1% of the popular vote. Although I cannot prove it, I am convinced that financial hardship played a major role in all of this.

| | Candidate | Party | Electoral Votes | Popular Votes |
|---|---|---|---|---|
| ✓ | Franklin D. Roosevelt | Democratic | 472 | 22,821,857 |
| | Herbert C. Hoover (I) | Republican | 59 | 15,761,841 |

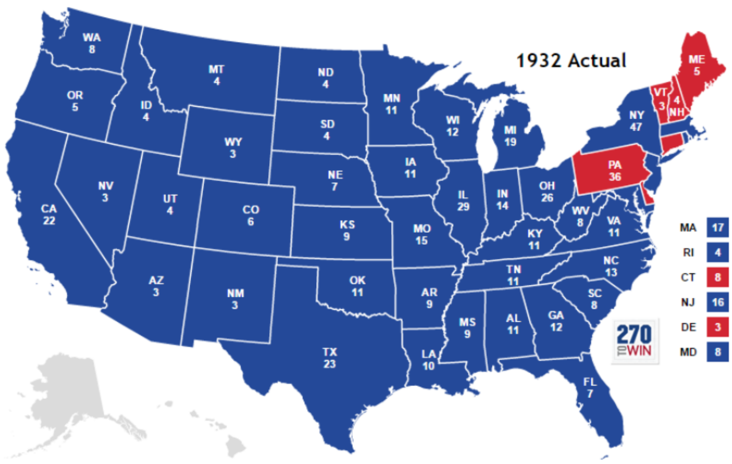


**Exhibit 2: 1932 US presidential election results**
*Source: Wikipedia*

And before you start e-mailing me to protest that this could never happen in your country, let me ask you one simple question: Do you know the name Smedley Butler? Smedley Butler was a Major General in the United States Marine Corps and, at the time of his death in 1940, the most decorated Marine in US history.

In 1933, Butler claimed that he had been approached by a group of leading US businessmen who had asked him to overthrow President Roosevelt and take control of the country. Although Butler's claim has never been proven, there is now widespread agreement that something dodgy was definitely going on. We might not have been far away from the US turning into another dictatorship.

I could list many more examples but will finish this brief history of financial hardship with a mention of three obvious examples from the recent past. Three countries in the OECD have, over the past couple of decades seen more financial hardship amongst ordinary people than most other countries, and those three countries are the US, Italy and the UK.

In the US, that brought us Donald Trump. In Italy, we ended up with a comedian as the leader of the largest party and, in the UK, we chose to blame Brussels and the EU for all our misery. I am not at all suggesting that any of those countries will end up like Germany in the 1930s. All I am saying is that you should prepare for the unpredictable when ordinary people struggle to make ends meet.

## Real wages in various countries

In many countries, real – or inflation-adjusted – wages have not risen meaningfully since the dark days of 2008 and, as you can see in Exhibit 3 below, that is particularly the case in the developed part of the world. In the OECD, the country with the highest annual growth rate in real earnings since the Global Financial Crisis is Poland in 38$^{th}$ place – i.e. there are 37 EM countries in which real wages have grown faster.

Near the bottom of the league table, as you can see, average real wages in Greece have dropped 3.6% annually but, within the OECD, Greece is an extreme case, bearing the crisis there in mind. (FYI – the two countries doing worse than Greece are Jamaica and Sri Lanka – both at -4.2%.)

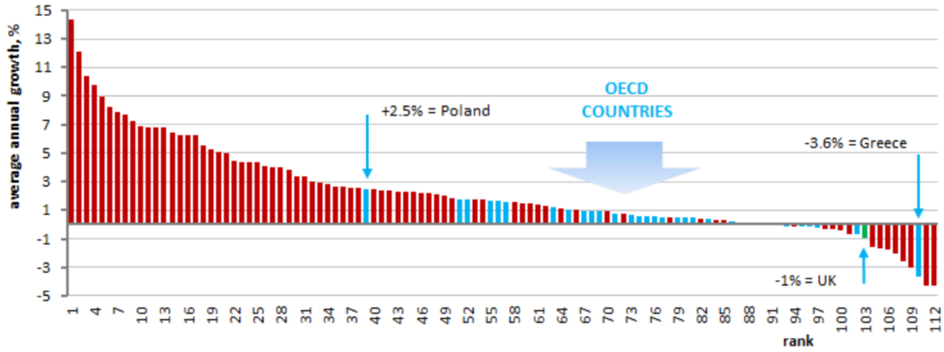


**Exhibit 3: Average annual real wage growth since the Global Financial Crisis**
*Source:* *TUC*

Of all the ‘non-crisis’ countries within the OECD, the UK is actually the worst-performing country with real wages falling 1% annually since 2008, closely followed by Italy with -0.7%. Other OECD countries in which real wages have dropped since the crisis would include Japan (-0.2%), Netherlands (-0.1%), Spain (-0.1%), Cyprus (-0.1%) and Ireland (-0.1%). Out of the 112 countries in the study, the UK comes in as a paltry 103rd.

## A special mention of the US

Earlier in the letter, I mentioned that financial hardship in the US has brought us Donald Trump but, according to Exhibit 3, the US has actually done OK, if not spectacularly well, since 2008 (+0.5% annually). How do I explain that?

US median income, when measured in real terms, fell from a peak of about $57,0000 in 1999 to $52,000 in 2013 (source: FAS.org). In other words, going into the presidential elections in November 2016, the median American household had just been through 14 years of financial hardship and wanted something to change, even if it wasn’t always clear to those people what it was that needed to change.

As a side note, given that real wages are rising again under Trump’s stewardship, he will most likely get re-elected in November. I think only a recession between now and then could prevent that from happening. We’d better get used to him!

Adding to the point I made above regarding financial hardship when measured in absolute terms, one could argue that it can also be measured in relative terms. On that basis, the 90% poorest Americans continue to suffer from financial hardship – a trend that was first established in the mid-1980s (Exhibit 4).

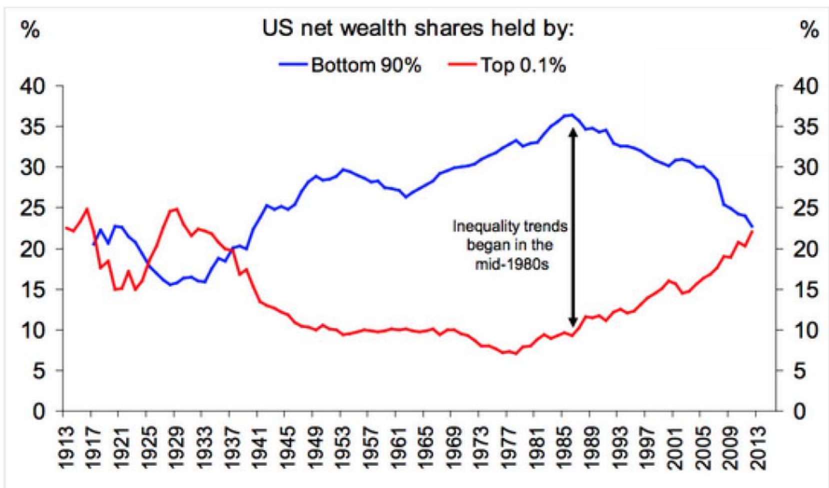


**Exhibit 4: Share of US wealth held by bottom 90% and top 0.1%**
*Source:* *Deutsche Bank*

It is not an uncommon phenomenon that, even if you are doing ok, if somebody else is doing dramatically better, you still feel worse off. And I would hasten to add that, in the US, the elite has managed to get away with murder more recently. As you can see in Exhibit 4, since the mid-1980s, the wealthiest 0.1% of all Americans have more than doubled their share of total wealth in the country – from 10% in the mid-1980s to more than 20% now – whereas the bottom 90% have found that their share of total wealth has fallen dramatically and is now no more than that of the top 0.1%.

Long-term trends in the US are not much prettier. The average American worker has only experienced a 12% rise in real wages over the past 55 years (Exhibit 5). Considering how tight the US labour market has been for a while, that is actually quite remarkable. Should the Philips curve normalise in 2020, as I discussed in the January Absolute Return Letter (see here), inflation could rise meaningfully.

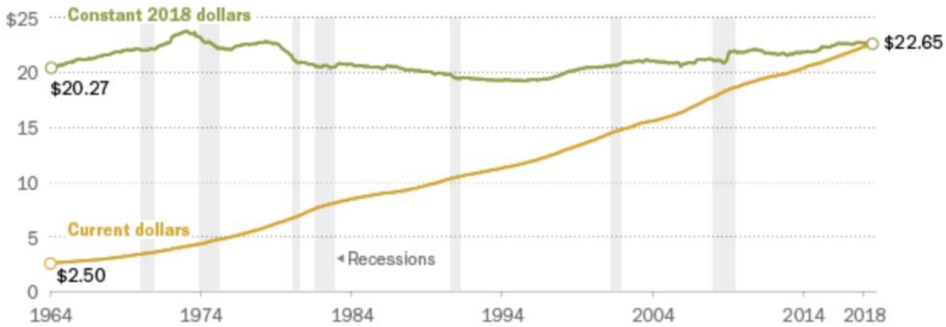


**Exhibit 5: Average hourly wages in the US (seasonally adjusted)**
*Source:* *Pew Research Center*

## Any extreme views, Mr. Hardship?

It is, almost by definition, virtually impossible to predict which views people in financial hardship are likely to adopt, assuming those views were previously unthinkable, so I am not going to speculate. That said, allow me to mention one or two which are baked in already.

The obvious one that sticks out is the loathing of foreigners. In the US, Donald Trump has guided that dislike towards the Mexicans and, here in the UK, Boris Johnson and his allies have pointed fingers at the Eastern Europeans. Having said that, in all fairness, I should stress that the US and the UK are far from the only countries suffering from an unhealthy degree of xenophobia. These days, it is prevalent in *many* countries around the world.

Another problem, specific to the UK, is the rise that I expect in consumer price inflation, following the UK's departure from the EU. With real wage growth already being negative in this country, another jump in consumer prices, even if it is only temporary, can only add to the xenophobia that is already widespread throughout the UK (and I know, as I am at the receiving end of it).

An obvious consequence of mounting xenophobia is a rise in radical political views. In other words, the gap between the left and the right will probably rise. That is less of an issue in the US which, for all intents and purposes, have a two-party system but, here in Europe, both the extreme right *and* the extreme left will most likely gain in power across the continent, whereas the more consensus-seeking parties in the middle stand to lose out.

## Financial market implications

Global trade, hence global GDP growth, is going to suffer quite badly from rising xenophobia. Let me explain. When global trade is on the rise, effectively, the production of many goods is moved from less to more efficient/cheaper producers in other countries.

Such a move costs jobs in some countries, whereas it creates jobs in other countries, but the evidence available to me suggests that it does improve overall economic efficiency in the world, i.e. the aggregate effect is positive. The evidence I am referring to comes from different corners of the political arena and includes both micro and macro measures of efficiency (source: Our World in Data).

Furthermore, on the whole, the evidence provided suggests that not only does trade between nations drive national average incomes (Exhibit 6), but macroeconomic productivity (GDP per worker) does also benefit over the long run.

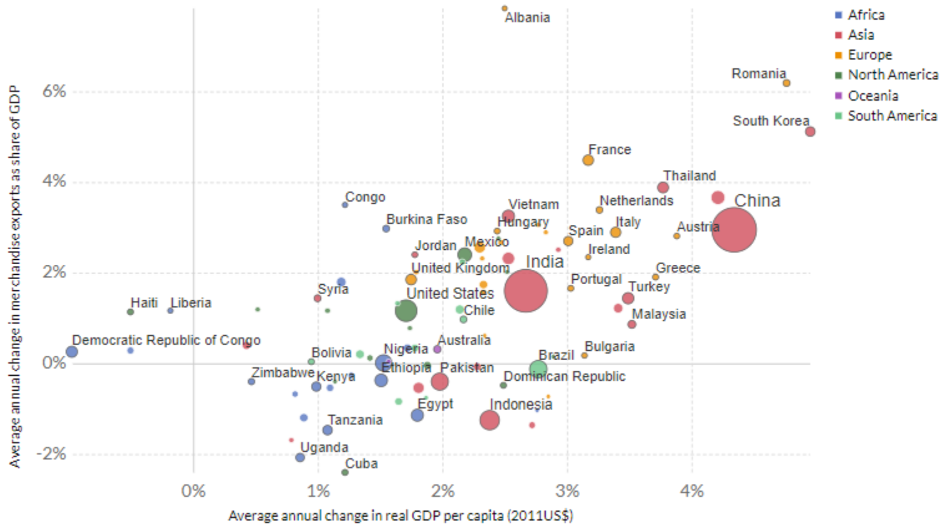


**Exhibit 6: Average annual change in GDP per capita vs. average annual change in export volumes**

*Source:* *[Our World in Data]*

This result is important as it illustrates how the ongoing battle to keep foreigners out will hurt GDP growth in the years to come. As GDP growth is a key driver of corporate earnings growth, equity markets will most likely also suffer. The problem we are up against is that a meaningful share of the workforce in developed countries stand to lose out from the combined effect of globalisation and automation. We need to find a way forward so that the efficiency gains of international trade and automation are shared more equally.

That brings me to my final point. As you may or may not be aware, at Absolute Return Partners, our investment strategy is built upon the impact the megatrends that we have identified will have in the years to come. In the context of this month's Absolute Return Letter, megatrend #8, *Mean Reversion of Wealth-to-GDP*, is relevant.

In the long run, wealth in society *cannot* grow faster than nominal GDP, and all countries have a well-defined mean value when measuring wealth-to-GDP in percentage terms. That percentage is not the same everywhere, as capital efficiency varies from country to country. Think of wealth-to-GDP as a measure of capital-to-output – how much capital that is required to generate $1 of output – so wealth-to-GDP is effectively a measure of capital efficiency and, the lower wealth-to-GDP is, the more capital efficient the country is.

In the US, where the efficiency of capital is high, the long-term mean value is about 380%, i.e. wealth is on average 3.8 times higher than annual GDP. Given that *everything* has rallied in recent years, wealth is now c. 520% of GDP. In other words, in the not so distant future, much of the wealth that has been created in the US since the Global Financial Crisis will have to be given up again.

I suggest you take a quick look at Exhibit 7 below. From looking at that chart, it is pretty obvious that US wealth has risen too fast more recently when compared to the growth of nominal GDP. As I have just stated, that *cannot* continue forever!

The three most important drivers of wealth in society are property, equity, whether listed equity or equity in private businesses (mostly family owned) and bonds, held mostly through pension savings. Therefore, we also know that, at some point in the future, at least one of those three asset classes will take a *massive* hit. What we don't know is when that will happen and which of the three asset classes that will be affected the most.

Given that many governments around the world *cannot* afford for bond yields to rise much, I am pretty sure that central bankers will collude with politicians all over the world to ensure that doesn't happen, which effectively leaves the pain to be felt by property and equity owners.

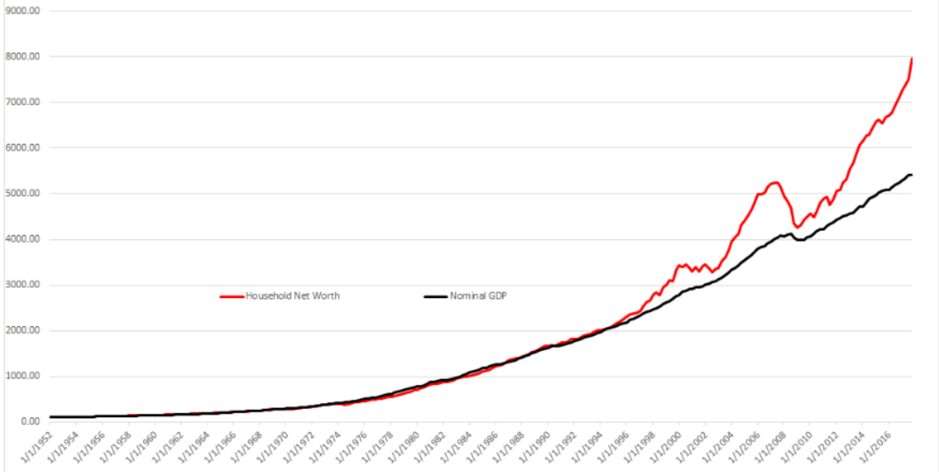


**Exhibit 7:** **US household net worth vs. nominal GDP**
*Source:* [*Zero Hedge*]

Next month, I will discuss lesson #2 from Morgan Housel's paper:

*Reversion to the mean occurs because people persuasive enough to make something grow don't have the kind of personalities that allow them to stop before pushing too far.*

That will bring up a subject I rarely discuss, namely the inevitability of mean reversion. Already looking forward to it!

*Niels C. Jensen*
*3 February 2020*

## Important Notice



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