

9 March 2020

## **Why Interest Rates Could Rise**

... and why you shouldn't invest passively if that were to happen



# Disclaimer

My deep-rooted structural views continue to suggest that interest rates will remain low for many years to come, but that doesn't imply that interest rates cannot go up at all.

The following is a short to medium-term tactical call, dictated by the 'bankruptcy' of monetary policy – how interest rates could rise if governments finance their spending programmes by monetising debt (QE).

Part 1

# INVOLUTION





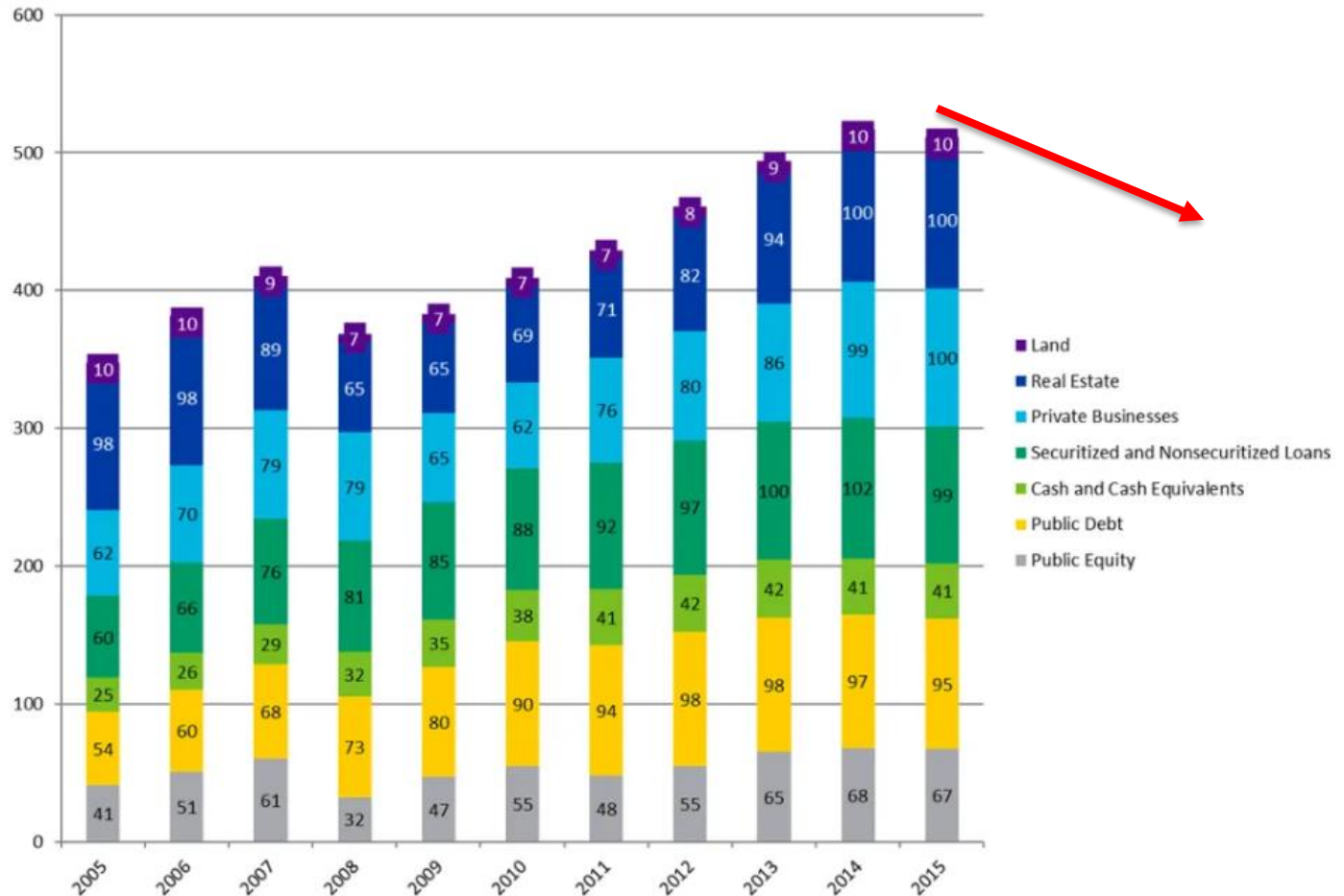
Involution is what happens to your body when you spend too much time in space – your muscles wither away.





What happens to the human body at zero G also happens to the capital stock at zero interest rates – it withers away.

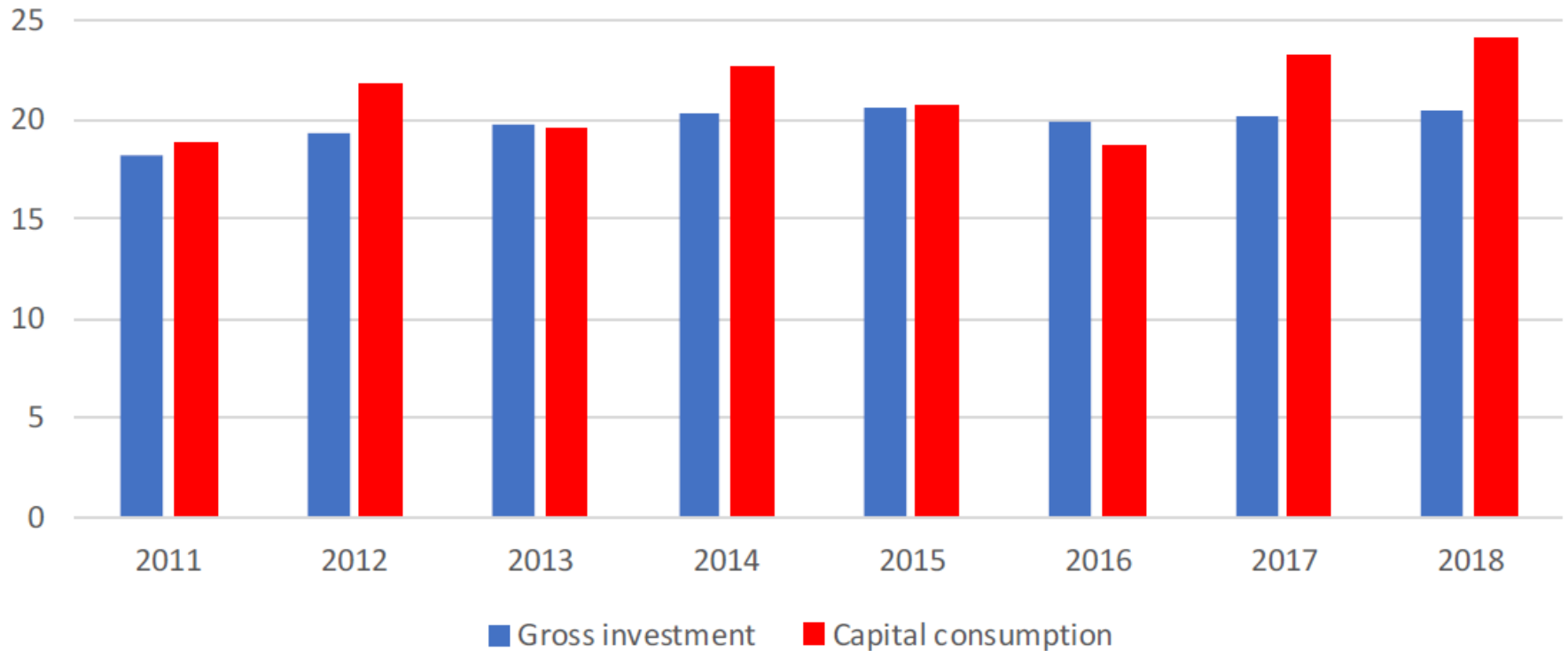
**Global Capital Stock per Asset Class (US\$ Tn)**





In the US, capital consumption has exceeded gross investments in most years since the Global Financial Crisis.

### Total US Gross Investments vs. Capital Consumption (% of GDP)





... causing the capital stock to wither away.

### US Net Productive Investments (% of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018
Gross private fixed investment	15	16.2	16.8	17.4	17.7	17	17.3	17.6
Government investment	3.2	3.1	3.0	2.9	2.9	2.9	2.8	2.8
Private consumption of fixed capital	12.8	12.7	12.8	12.9	13	13.1	13.2	13.3
Government consumption of fixed capital	3.1	3	3	2.9	2.8	2.8	2.8	2.8
Consumption of natural resources	2	2	2	2	2	2	2	2
Wicksell misallocation	0.2	3.3	1	4.1	2.2	0.1	4.5	5.2
Government malinvestment	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7
<b>Net productive investment % GDP</b>	<b>-0.7</b>	<b>-2.5</b>	<b>0.3</b>	<b>-2.3</b>	<b>-0.1</b>	<b>1.1</b>	<b>-3.1</b>	<b>-3.6</b>

Part 2

# THE CAPITAL STOCK







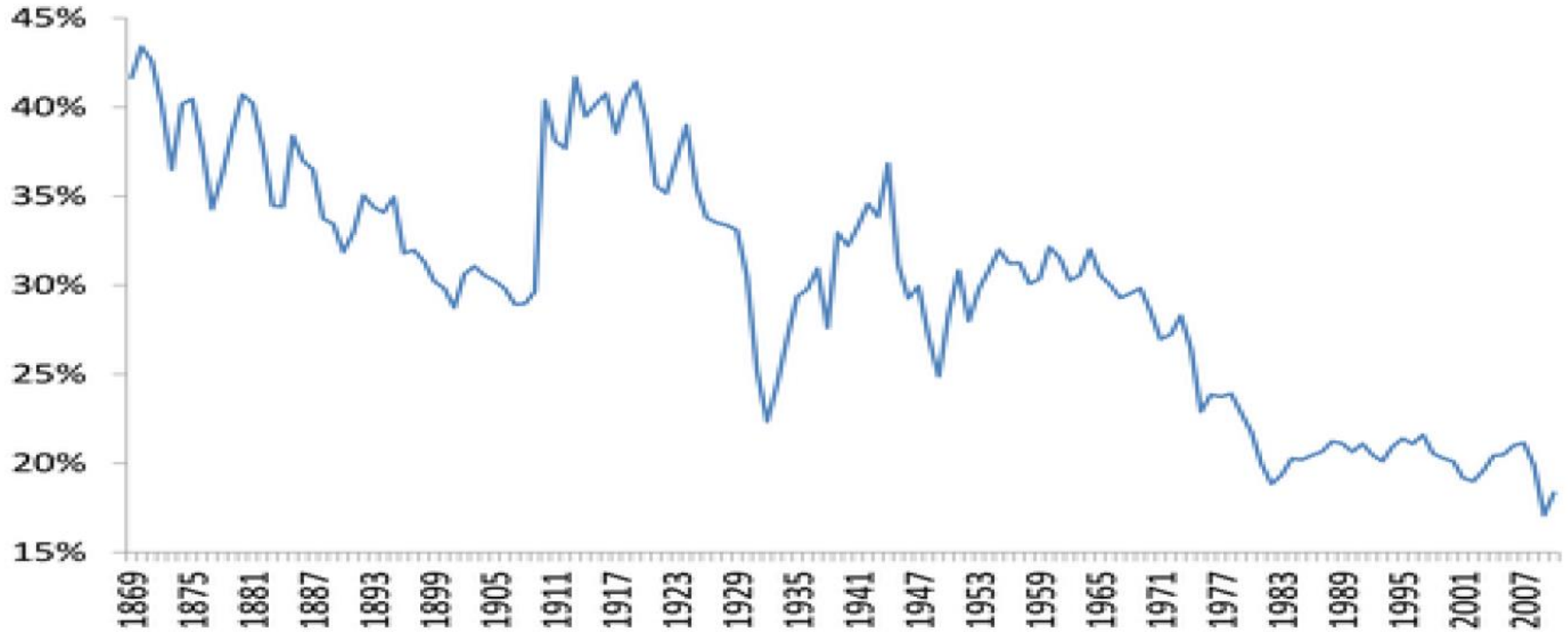
## Definition

The capital stock in an economy is the current value of all capital inputs in that economy whether monetary or physical.



A growing proportion of the capital stock is unproductive, not creating the return to pay for itself.

### Corporate Profits as % of the Cumulative Capital Stock (Globally)

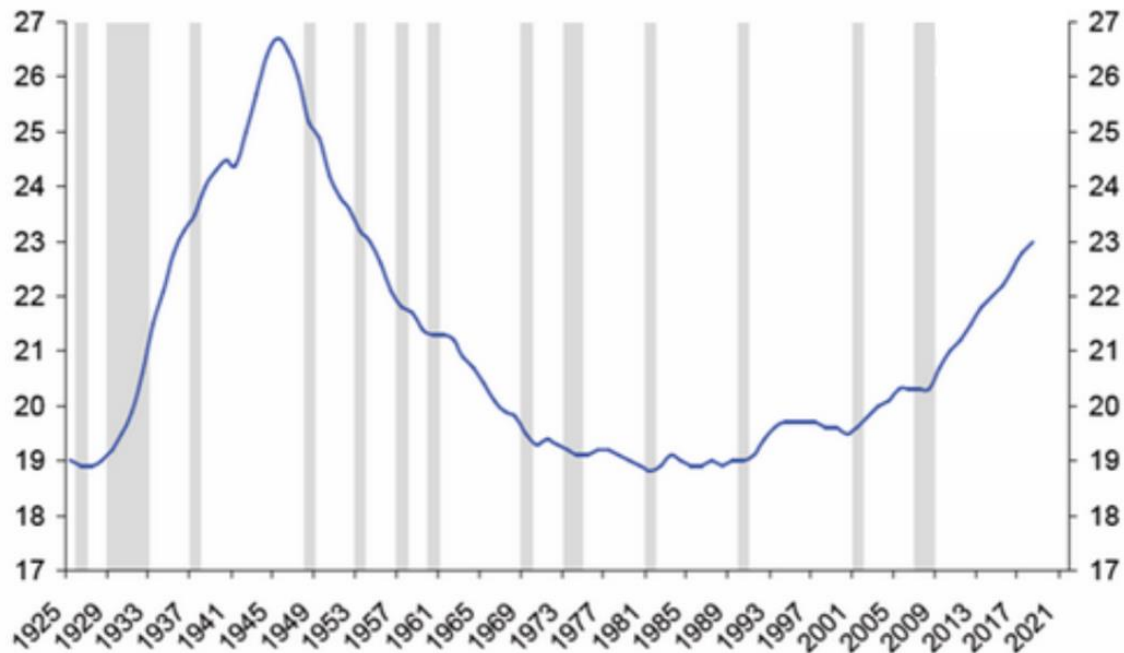




The decline in productivity more recently infers that the global capital stock has peaked and has started to decline.

- In most OECD countries, slowing productivity growth has made it uneconomical to invest, causing the capital stock to age.
- Allowing the capital stock to age has saved US industry from investing \$7-800Bn every year, which has boosted profitability short term, but there is a long-term cost.

### Average Age of US Private Fixed Assets (years)





The accrual of capital stock is the bedrock of human progress. If the capital stock is in decline, we are putting the entire process of civilisation into reverse.

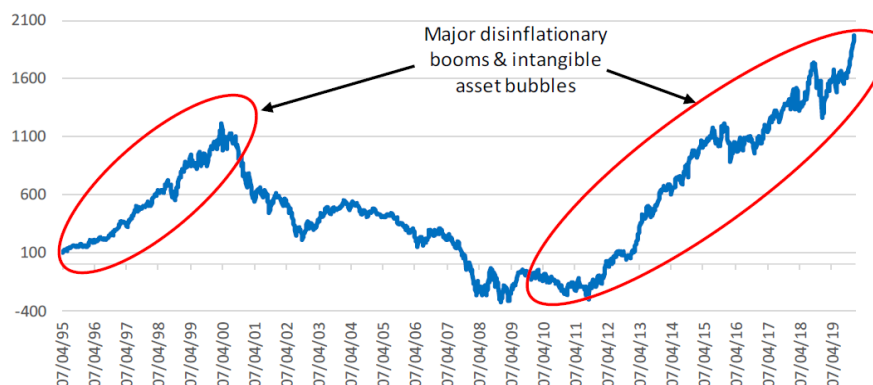
- As productivity growth started to slow, to begin with, it was still positive, hence the capital stock continued to grow even if the pace of growth slowed.
- Now, with productivity stagnant or even in decline in some countries, the capital stock must also be standing still or even falling.
- The loss of capital stock applies at all levels of society – not only monetary capital but also human, political and geopolitical capital.
- By allowing the capital stock to decline, we are effectively borrowing economic growth from the future.



When the capital stock is in decline, the economy becomes unable to support GDP growth and unable to support incomes at current levels. What should one do?

- The inability to support further growth is inherently deflationary.
- The only way to prevent a chaotic clearing of the system is to cut rates to zero and to grow the monetary base aggressively (QE).
- This has two implications:
  - On a tactical (ST) basis, it indicates that, if much liquidity is injected, risk assets will probably continue to rise in price. If not, we will end up with a deflationary bust.
  - Longer term, if we see a shift away from monetary policy towards fiscal policy funded by QE, inflation will almost certainly rise at some point.

### The MacroStrategy Disinflationary Boom Index:





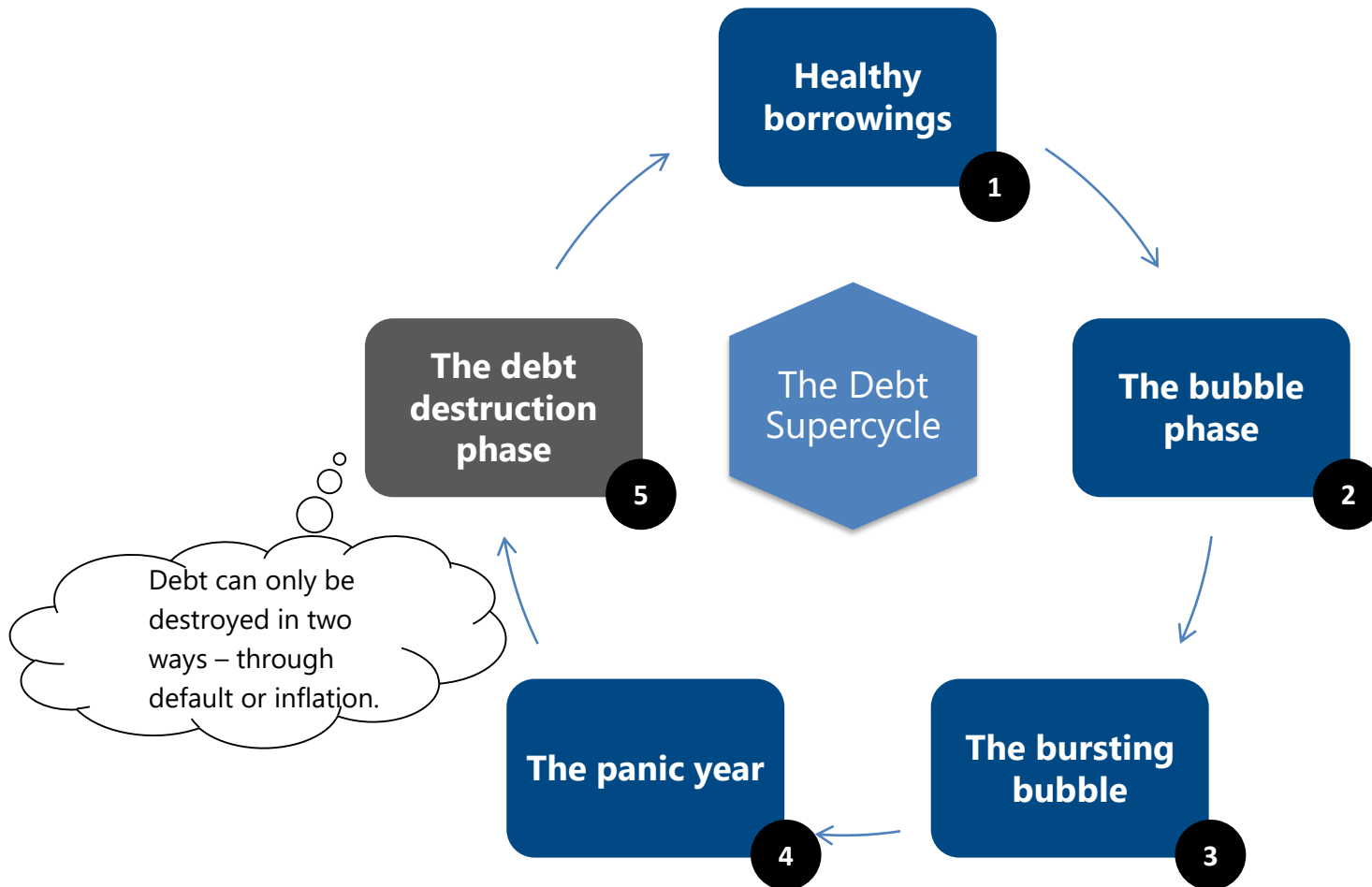
The central banks of QE countries already hold 1/3 of all government debt. If governments do as I suspect, that number will rise in the years to come.

### Average % of Government Debt in QE Countries Held by their Central Bank





We are in the very late stages of the current debt supercycle. Are governments (central banks) preparing to destroy debt?



## Part 3

WHAT SHOULD YOU DO?





## Recommendation #1

FAVOUR VALUE OVER GROWTH





Over the past 14 years, value stocks have dramatically underperformed growth stocks – the biggest decline in relative performance for almost 50 years.

### Value vs. Growth MSCI World

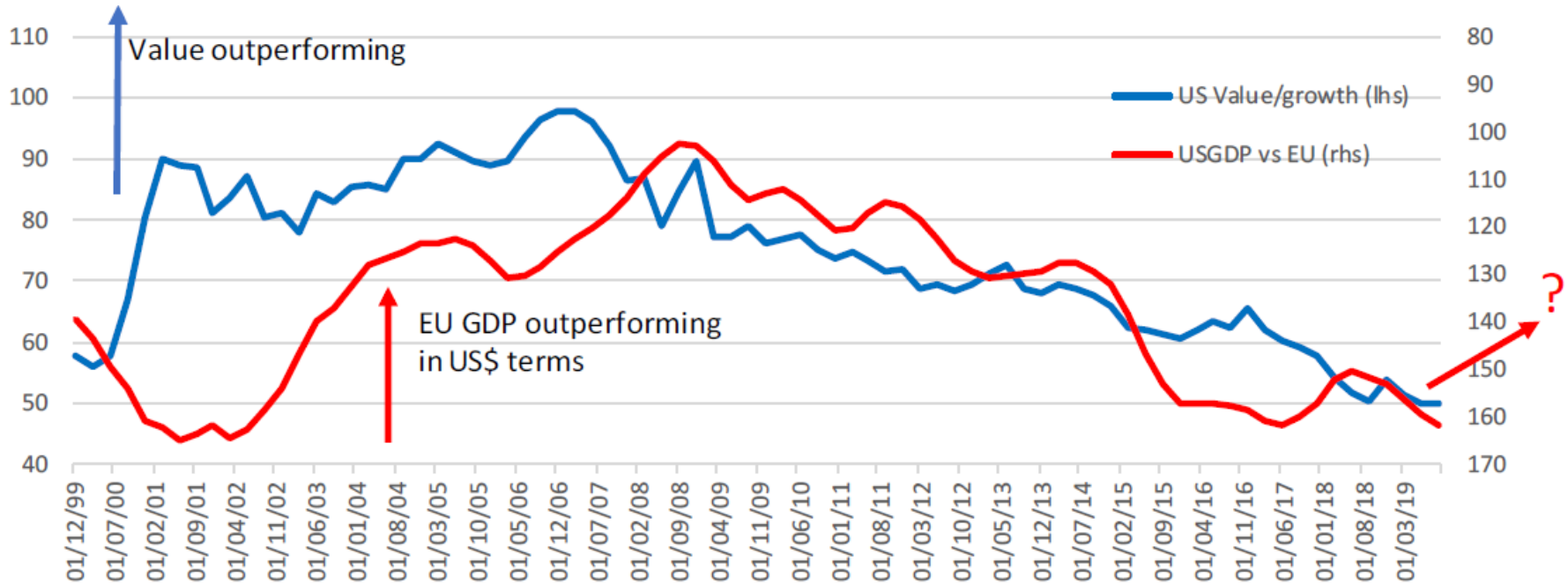




Value usually outperforms growth when US GDP growth is low, and particularly when US GDP growth is lower than RoW GDP growth in USD terms.

### US Value/Growth vs. EUR/USD

US Dollars



## Recommendation #2

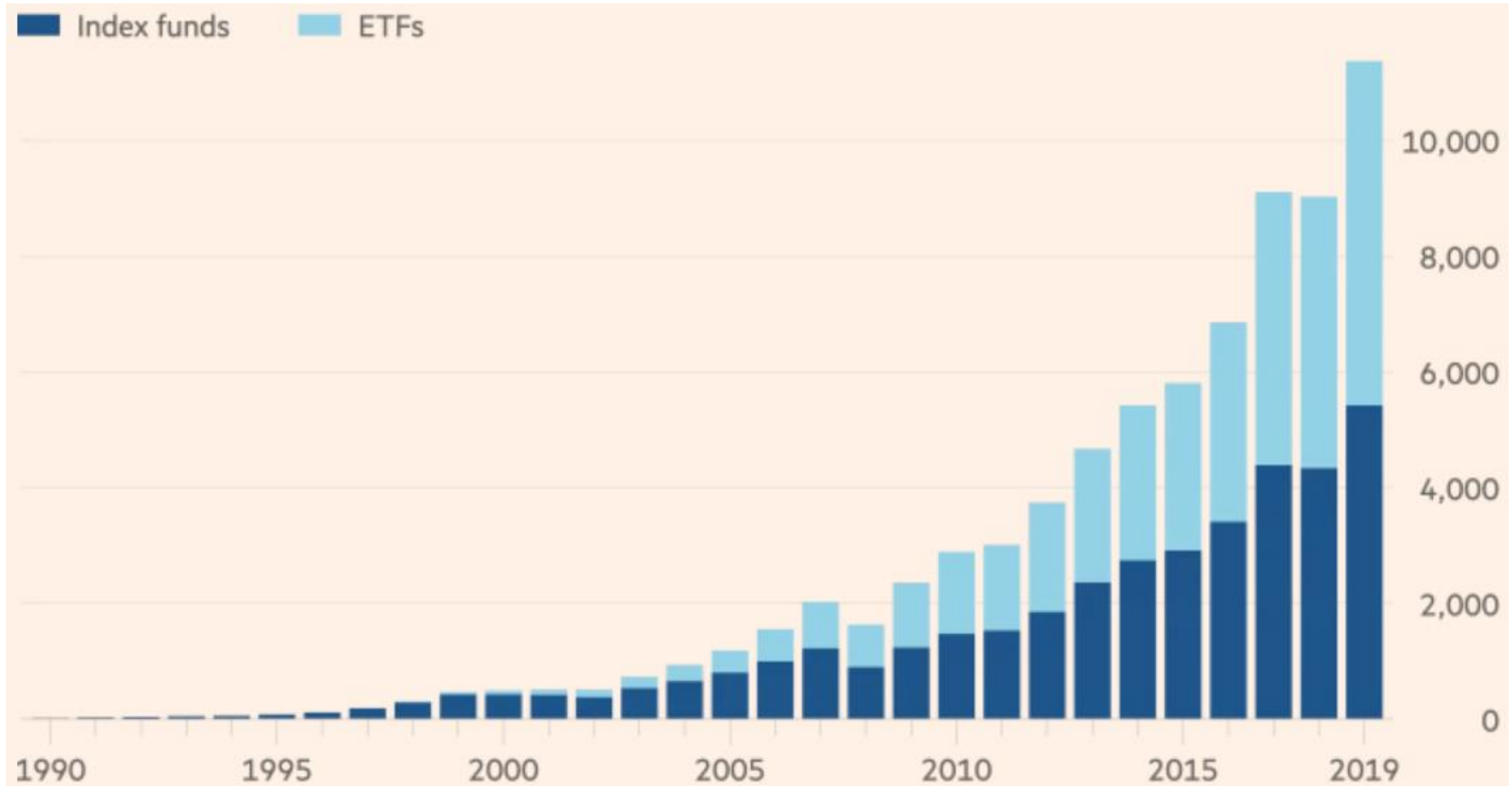
REDUCE YOUR PASSIVE INVESTMENTS





Involution will lead to difficult conditions for equity investors, and the most exposed are all those who have invested passively.

### Global AuM Managed Passively (\$Bn)



## Recommendation #3

ALLOCATE MORE TO UNCORRELATED STRATEGIES





Even if you don't want much equity beta exposure in your portfolio, it is indeed possible to identify many attractive investment opportunities in equities.

**Example: An equity L/S fund targeting both winners and losers in the digital revolution**

**Investment Overview**

- This allows you to capture disruption without taking meaningful equity beta risk.
- Disruption creates dispersion and that leads to opportunities.
- ARP has identified a manager who is long the disruptors and short the incumbents.

**Expected Returns**

- Our base case is for annual returns net of all fees to average at least 10%.
- Our base case is *not* contingent on strong equity markets. As you can see below, this investment manager has performed very well in adverse market conditions.

	# Months	Market Return	Fund Return	Capture
Market Up	32	113.4%	10.7%	9.4%
Market Down	8	-32.5%	21.0%	-64.7%

	Mar-17	Feb-18	Mar-18	Oct-18	Dec-18	May-19	Jan-20	Feb-20	Total
S&P 500 Return	-0.04%	-3.89%	-2.69%	-6.94%	-9.18%	-6.58%	-0.16%	-8.41%	-37.89%
Fund Net Return	-0.80%	2.57%	3.76%	-0.22%	4.00%	6.10%	2.56%	1.54%	19.50%

*Note, February 2020 is estimated net return*

Appendix A

# THE SIX MEGATRENDS







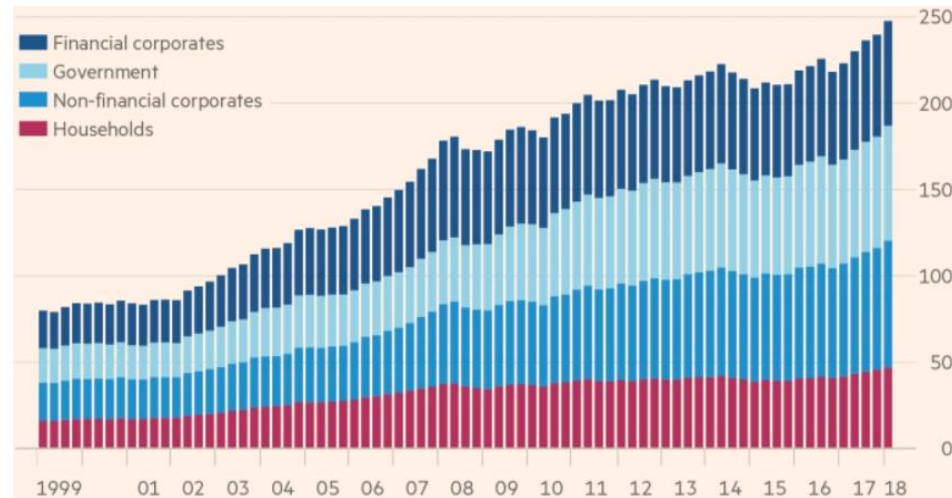
# Megatrend #1

## The End of the Debt Supercycle



- In the early stages of a typical debt supercycle, GDP and debt grows 1:1, but that ratio deteriorates as the cycle matures. All prior debt supercycles have come to an end when GDP grows only \$0.20-0.25 for every dollar of added debt. China is now at 0.21 and the US at 0.28.
- The fact that  $\Delta$ Productivity and  $\Delta$ GDP are both struggling to gain momentum at present are powerful indications that we are fast approaching the end of the current debt supercycle.

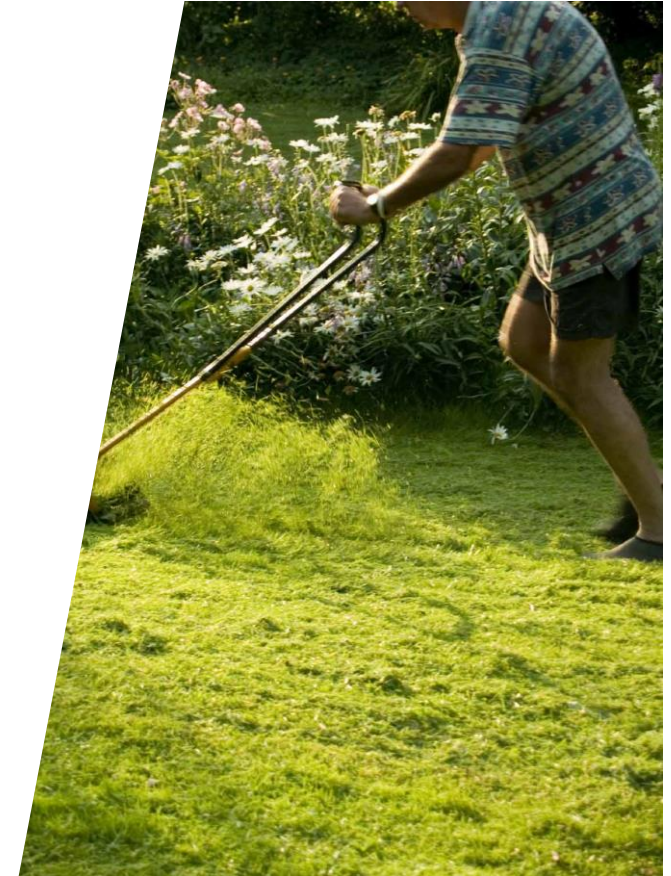
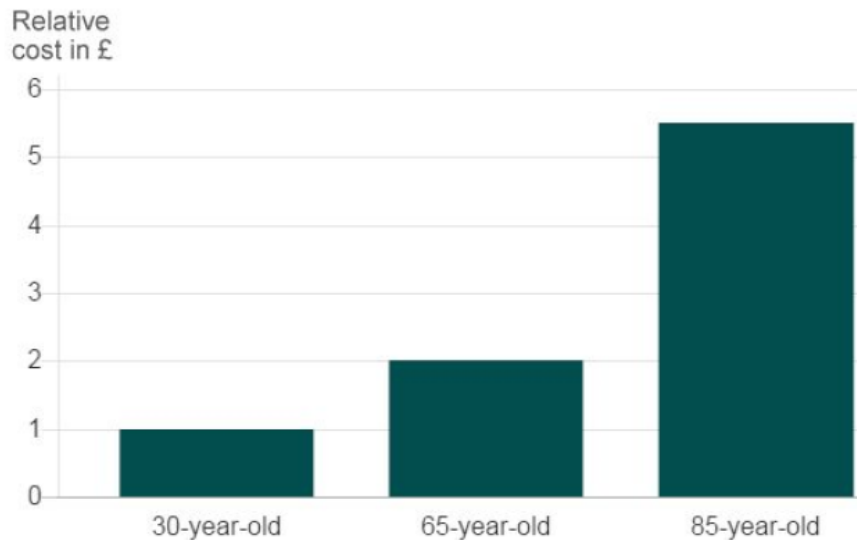
**Total Global Debt (\$Tn)**



## Megatrend #2

## Changing Demographics

- 150 million OECD workers will retire between now and 2050.
- Servicing the elderly is extremely costly. According to the NHS, servicing a man in his mid-80s is 5-6 times more expensive than servicing a man at the age of 30 (see below).

**NHS Spending on People by Age**

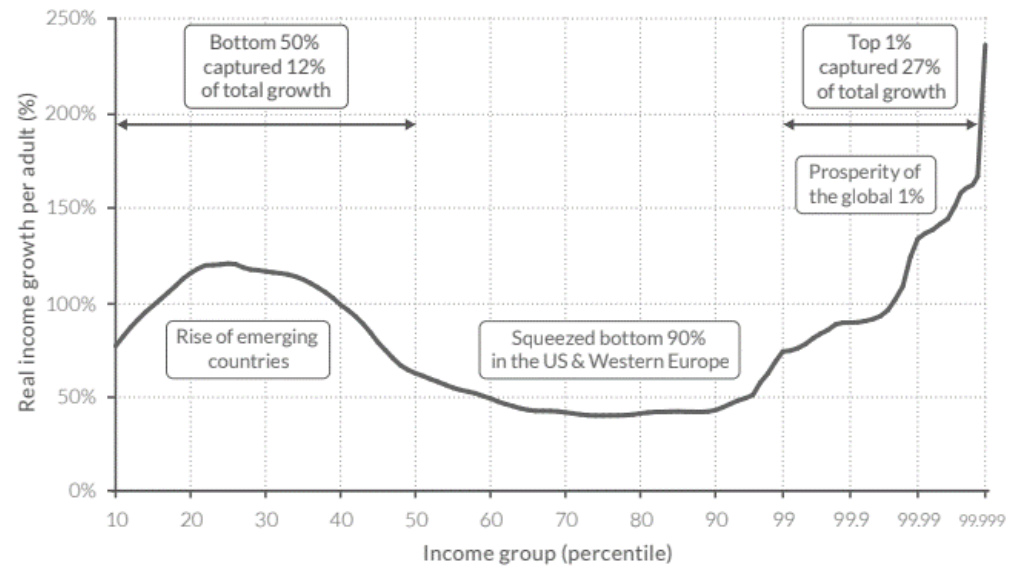
## Megatrend #3

## The Rising Gap between Rich and Poor

- Workers in many countries have not experienced any meaningful growth in real wages for years.
- Low or no real wage growth negatively affects aggregate demand and partly explains why GDP growth is so low everywhere.



### Global Inequality





Megatrend #4

# Rise of the East

- In PPP terms, China has more middle class families now than the US.
- The first thing people spend more money on when living standards rise is more and better quality food – almost always more protein-rich food.
- One should seek exposure to the phenomenal growth in the Chinese economy without being exposed to the over-leveraged financial system in China.



### Chinese GDP Catch-Up under Various Assumptions

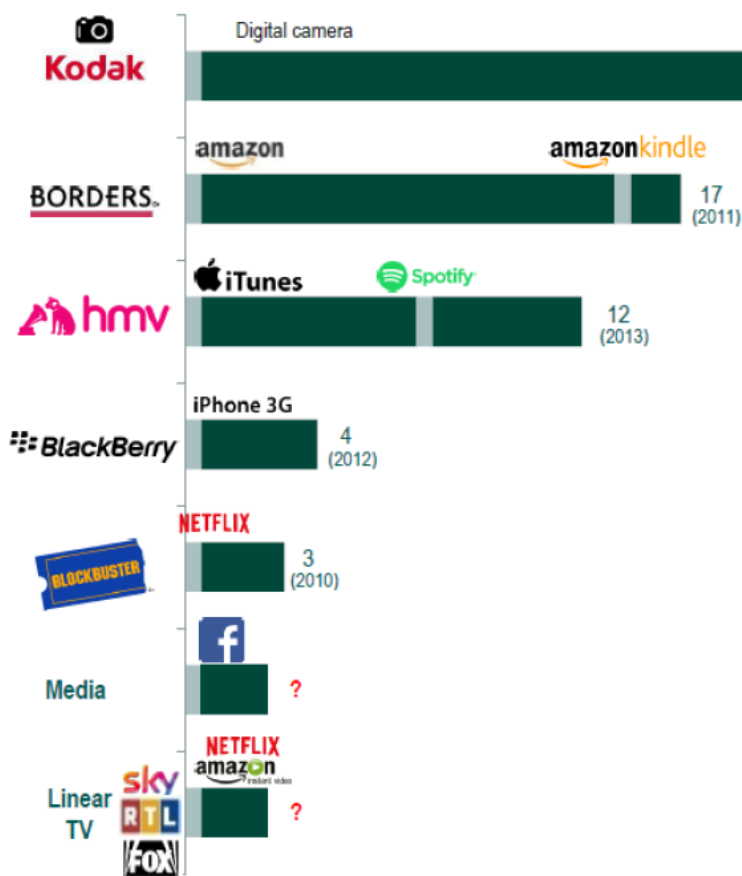
		Annual Chinese GDP Growth		
		3.00%	5.00%	7.00%
Annual	1.00%	2047	2032	2027
US GDP	1.50%	2057	2034	2028
Growth	2.50%	n/a	2041	2030



Megatrend #5

# The Age of Disruption

## No. of Years to Disrupt Incumbent's Businesses



- Some disruptive businesses succeed whereas others don't; it is a misconception that entrants are disruptive by virtue of their success.
- Disruption has accelerated as a result of digitisation, but it is not at all limited to the technology industry.



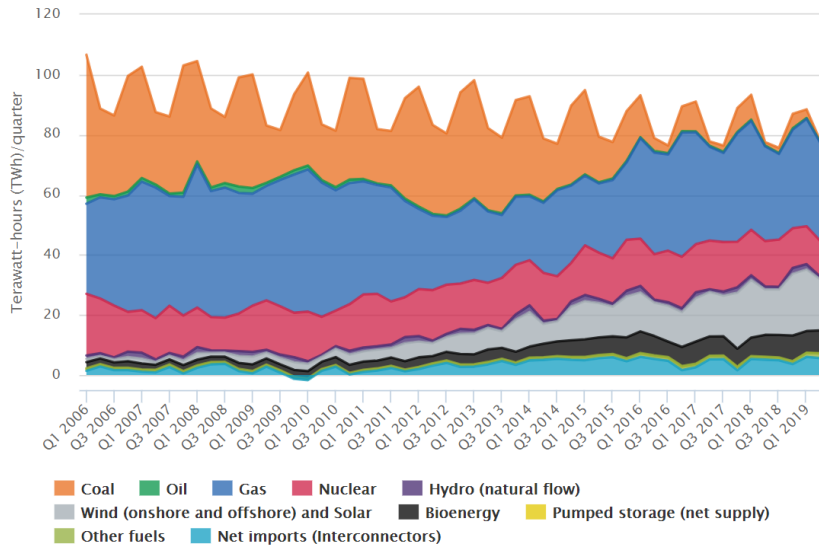


# Megatrend #6

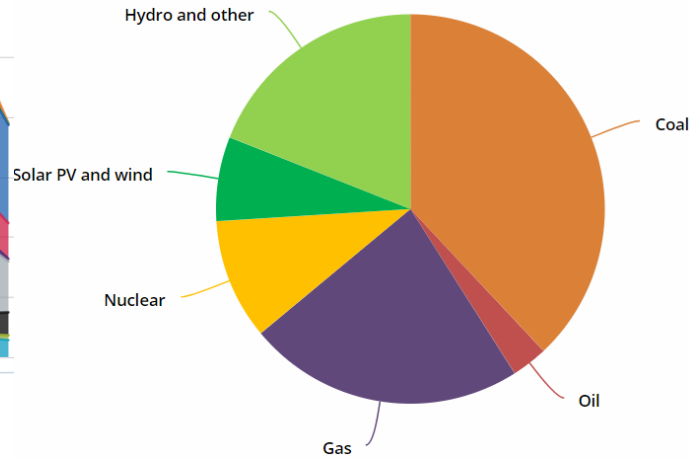
## Climate Change

- The fight against global warming will drive governments all over the world to electrify most transportation and heating, dramatically reduce demand for fossil fuels.
- Food production must rise 60% in the next 20 years, and food production accounts for nearly 70% of all freshwater consumption globally. With the climate change doing damage to our water supplies, how will this pan out?

### UK Fuel Mix in Electricity Generation



### Global Fuel Mix (2018)





... and the aggregate result of those six megatrends

## Mean Reversion of Wealth-to-GDP

- Asset prices have grown much faster than GDP since the mid 1980s and, in the long run, one *cannot* outgrow the other.
- Every single time wealth has deviated meaningfully from its long-term mean value, it has regressed to the mean, and US wealth is now 520% of US nominal GDP against a long-term mean value of 380%.



**Total US Household Wealth as % of GDP since 1950**



Appendix B

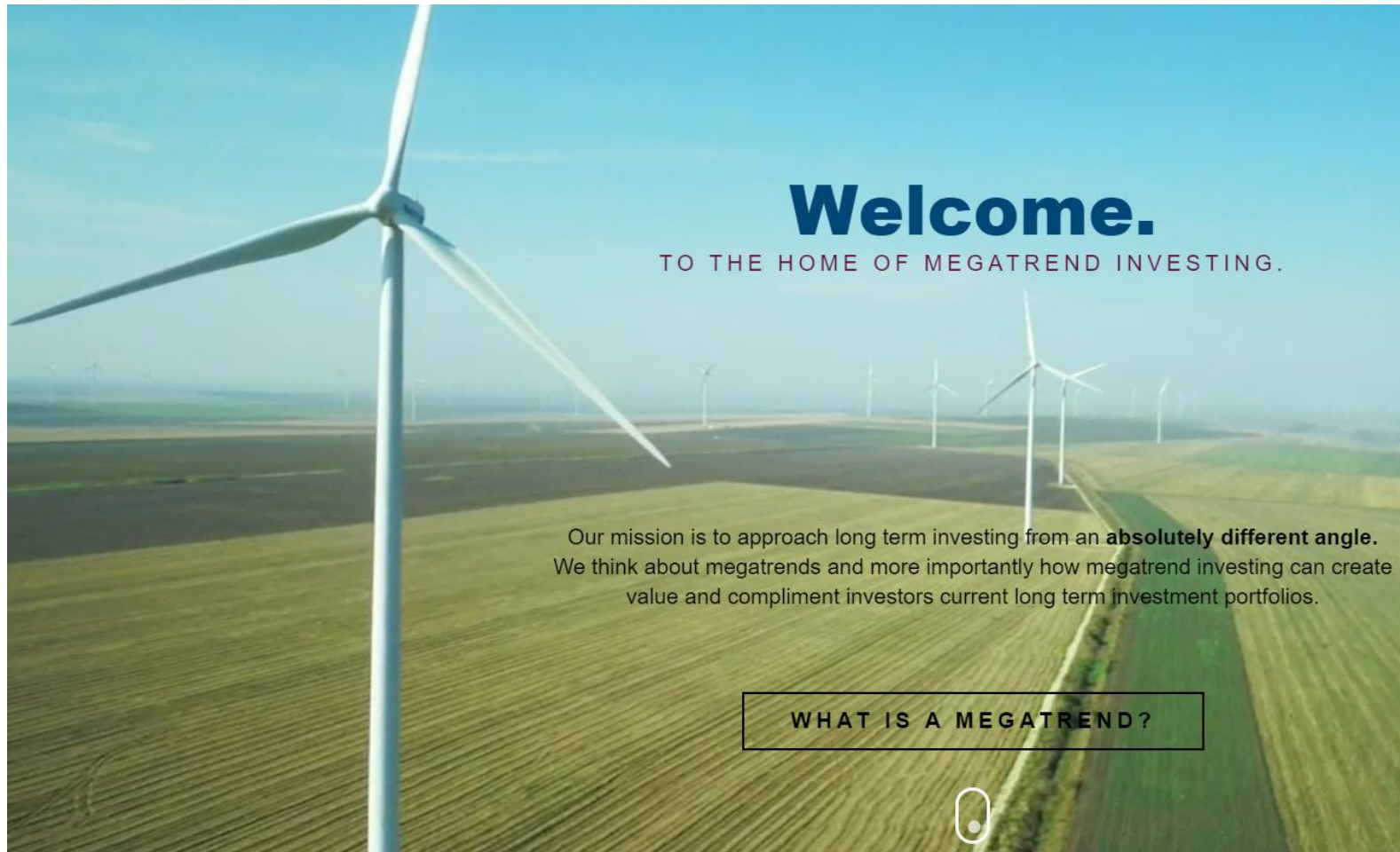
ABSOLUTEGRAY CAPITAL







Absolute Return Partners have, in conjunction with GraySwan of South Africa, established a new company – AbsoluteGray Capital (AGC) – which will launch several megatrend funds in the years to come.





# The first thematic fund to be launched (subject to regulatory approval) will be *The Thematic Credit Fund*, expected to go live on 1<sup>st</sup> April or 1<sup>st</sup> May.

MARCH 2020

## THEMATIC CREDIT FUND

# ABSOLUTE GRAY

CAPITAL

**RISK PROFILE**

Low    Low Medium    **Medium**    Medium High    High

Less Risk/Return → More Risk/Return

**FUND STRATEGY**  
To generate stable capital returns by investing in niche, lowly-correlated private and public alternative credit strategies.

**TARGET LAUNCH**  
Q2 2020

**STRUCTURE**  
Malta Notified AIF

**TARGET RETURN**  
5-7% net return p.a.

**MIN SUBSCRIPTION**  
\$100K

**CURRENCY**  
USD initially

**LIQUIDITY**  
Quarterly with 180 days notice (20% Fund level gate)

**MANAGEMENT FEE**  
Class A: 0.7% p.a.

**PERFORMANCE FEE**  
None

**INVESTMENT STRATEGY**

- Delivering stable net returns by investing in alternative credit assets.
- Building long-term relationships with best-in-class specialist partners.
- 5+ investment strategies including Trade Finance and Structured Credit.
- Broadly diversified by loan type, geography, tenor and underlying asset.
- Lowly correlated to public equity and credit markets.

**WHY INVEST IN ALTERNATIVE THEMATIC CREDIT?**

- The End of the Debt Super Cycle is the mega-trend that underpins the Fund.
- Bank deleveraging is driving meaningful opportunities for alternative lenders to bridge the financing gap to companies.
- Targeting companies who lack scale to access the global capital markets through bond issuances.

**MEGATREND - THE END OF THE DEBT SUPER CYCLE SHAPES OUR THINKING**

**Activity in the US leveraged market remains subdued**

Source: KKR Credit (2017)

**European Banks under severe balance sheet pressure**

Source: Bluebird Asset Management (2018)

**Growth of the leveraged finance market has been strong**

Source: BofA Merrill Lynch Global Research; LCD (2018)

**SEVERAL SUB-ASSETS HAVE BEEN BENEFICIARIES OF THE ONGOING IMBALANCES**

**TRADE FINANCE**  
Exposure to short-dated, self-liquidating, asset-backed debt solutions for middle-market borrowers. Supported by a positive outlook for global trade flows and a large addressable trade finance gap, the strategy offers a high degree of diversification by geography, sector and borrower.

**SUPPLY TRADE FINANCE**  
Exposure to short-to-medium dated, asset-backed, debt solutions for middle-market borrowers that are more complex than traditional trade finance. By financing multiple legs of the supply chain, the strategy offers a high degree of diversification by geography, sector and borrower.

**STRUCTURED CREDIT**  
Underlying assets reference high-yield corporate, consumer or real estate loans, as well as other types of collateral. Returns may be generated via coupon, price appreciation, the identification of structural nuances or the prospect of early repayment, among others.

**DIRECT LENDING**  
Committed private loan facilities that are senior-secured in nature to middle market borrowers to support growth, refinancing and acquisition. The market is supported by structural changes at banks which has created a lending gap for alternative financiers to fill.

**OTHER STRATEGIES INCLUDE**  
Relative Value Credit, Bridge Lending, Index Tranche Trading.

MARCH 2020

## THEMATIC CREDIT FUND

# ABSOLUTE GRAY

CAPITAL

**STRATEGY CHARACTERISTICS**

	Yield Premium	Current Income	Volatility	Correlation	Tenor / Feature	Asset Secured	Asset Diversification
Trade Finance							
Supply Chain Finance							
Direct Lending							
Structured Credit							

Source: Yield Premium measured relative to Barclays Global Aggregate Total Return Index (illustrative only). AbsoluteGray Capital has identified a number of strategies, but not limited to these, that will be included in the portfolio. The table above provides AbsoluteGray's assessment of each category which is intended to be illustrative and indicative only.

**WHY ABSOLUTEGRAY CAPITAL?**

- Founded in 2019, AbsoluteGray Capital is a joint venture between *Absolute Return Partners* and *GraySwan Investments* with an overriding objective to approach investing through long term structural mega-trends.
- Four offices across London, Cape Town, Johannesburg and Durban.
- Research and innovation is underpinned by a highly experienced team across Europe and Africa.
- An agile approach to manager origination complemented by a deep network built over many years.
- Combined AUA: >\$1Bn.
- Signatories of UNPRI.

Niels Clemens Jensen has over 30 years of investment banking and investment management experience. Niels founded Absolute Return Partners in 2002 and is Chief Investment Officer.

Duncan Theron has 23 years' investment experience of which 18 years as an investment consultant and 5 years in offshore alternative investment management. Duncan founded GraySwan in 2010 and is Chief Executive Officer.

**CONTACT US**

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11 March 2020

## The Forthcoming Shift in Economic Policy

### The 'bankruptcy' of monetary policy

Those of you attending the March 2020 ARP+ webinar a couple of days ago will most likely be aware that I missed a key point in my presentation, namely the overwhelmingly likely shift away from monetary policy towards fiscal policy.

I mentioned the possibility of such a shift on page 13 of my presentation, but I missed the point completely in my oral presentation, and that has bothered me since; hence this brief follow-up note.

Obviously, different countries will take a different approach, but I would expect at least the US and the UK to make such a shift in economic policy relatively soon. Both President Trump and Prime Minister Johnson have indicated that increased infrastructure spending is high on their priority list, so such a shift shouldn't come as a major surprise to anybody.

The reality is that monetary policy has arrived at the end of the road in terms of its effectiveness. When interest rates are as low as they currently are, cutting rates by 0.25% or even by 0.50%, as the Fed and the BoE have both done over the last few days, has little effect on economic activity. Neither does it impact the economy much when the central bank spends billions on buying government bonds as part of its QE programme. The only meaningful effect of that is the impact it has on risk assets which appreciate in value, i.e. the gap between rich and poor gets bigger.

### Why interest rates could rise as a result

Given how indebted many countries already are, financing such a shift could be challenging – at least for some of the more indebted countries around the world. In the years to come, I firmly expect more countries to follow Japan's example of recent years, encouraging (instructing?) their central bank to monetize a significant share of the increased government spending. Such monetization is easily effectuated, and Japan's success in doing so – i.e. by monetizing its debt without affecting the rate of inflation – will only encourage other countries to follow a similar path. There is a problem, though.

Japan has managed to get away with this strategy for two reasons. As I have discussed regularly in my papers over the last few years, the global economy is currently in a very powerful dis-inflationary, possibly even deflationary, mode, but that will not last forever. Secondly, virtually all Japanese government debt is on domestic hands, but that is not the case in the US and Europe where the reliance on foreign investors is substantial, and they cannot be relied upon to support government policy the same way.

As a consequence, I think a shift in economic policy away from monetary policy towards fiscal policy could result in higher interest rates, whether such a shift is financed ‘properly’ (i.e. not by monetizing the debt) or it is financed the Japanese way.

**Niels C. Jensen**

*11 March 2020*

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