ATLANTIC
FINANCIAL GROUP

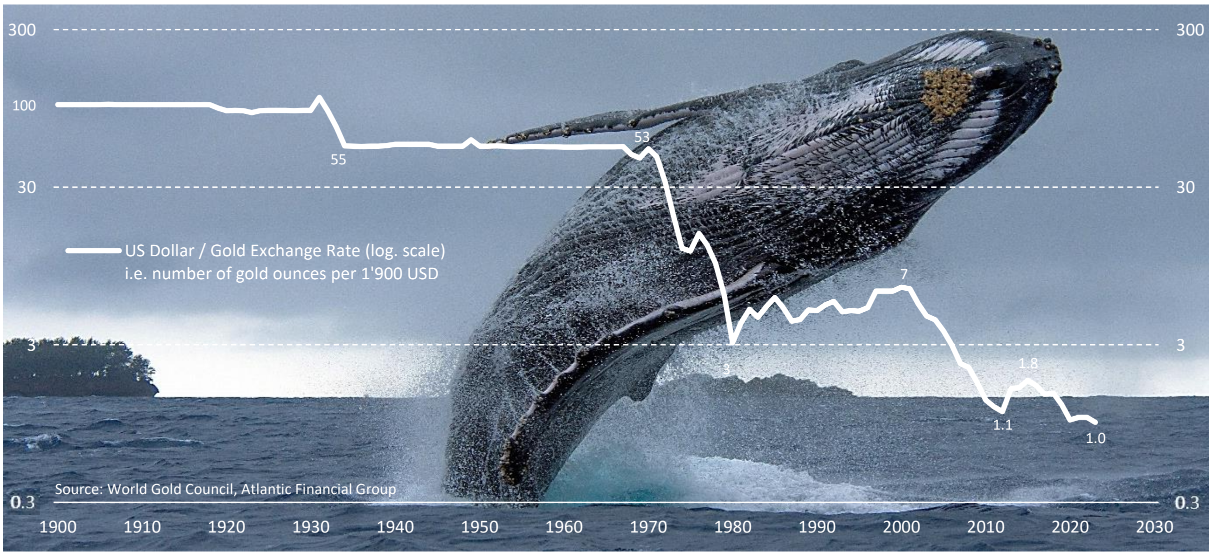
Weekly Investment Focus

27 March 2023

"ONLY A WHALE CAN STOP THE GRAY RHINO"

- To fight inflation, raising rates was required but doomed to failure
- Debt has become so high that it constrains central banks' intervention
- Monetary policy suffers from "fiscal dominance"; it is subordinate to fiscal policy
- Facing this disruption, investors will favour real assets such as gold

CHART OF THE WEEK: "The dollar has lost 99% of its value against gold since 1930"



FINANCIAL MARKETS ANALYSIS

Since January 2022, central banks have been trying to normalise the economic situation in general and their monetary policy in particular. By rapidly and sharply raising their key rates (see Fig. 2), they are seeking to combat rising prices so that inflation expectations remain anchored near 2% (see Fig. 3). Beyond the difficulty of meeting this challenge, as inflation is only partly the consequence of economic overheating but mostly the counterpart of a supply shock, **this process of raising rates is damaging**.

Fig. 2 – Central bank policy rates

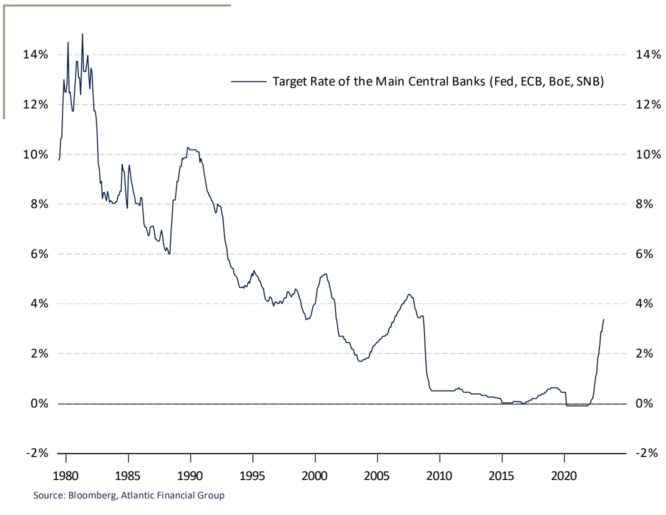
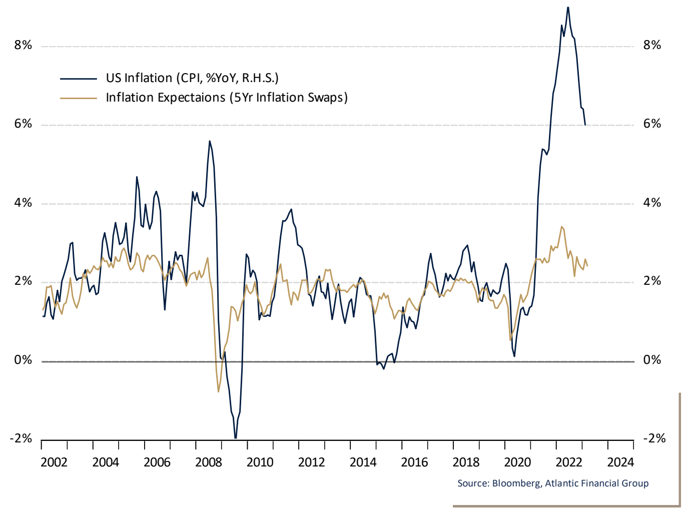


Fig. 3 – Inflation rate and expectations in the US



Over the last two weeks, central banks have confirmed their restrictive monetary policy stance. The European Central Bank (ECB) led the way on 16 March by raising its key rates by 50 basis points. The US Federal Reserve (Fed), the Bank of England (BoE) and the Swiss National Bank (SNB) followed suit last week, with increases of 25, 25 and 50 basis points respectively.

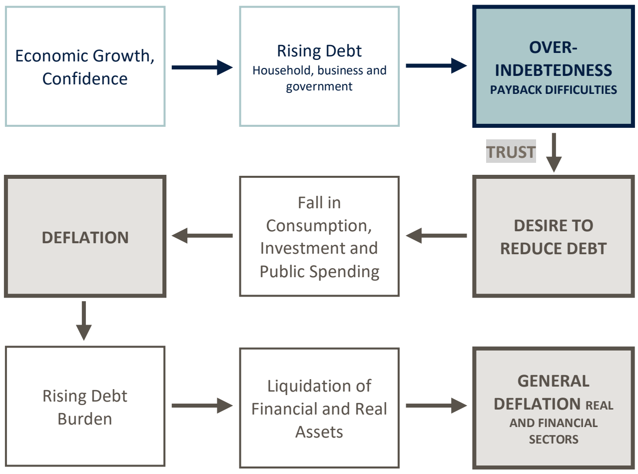
Continued rate hikes in a crisis environment allow central bankers to signal that they still have a priority to dampen inflation, which remains too high for comfort. **They are also clearly signalling that they do not consider the stability of the financial system to be in danger and that they are in no way responsible for the recent setbacks of banks, insurers, or investment funds.** Finally, they seek to take into account the psychology of investors, an important component in times of fear. Not raising rates would have meant that they were really worried, whereas they had adopted an optimistic tone and restrictive measures over the last 15 months. Thus, counter-intuitively, these rate hikes underline that the crisis is under control.

From a numerical point of view, the difference between the option of raising rates or pausing was minimal. In either case, the cost of money remains high, and its negative impact will continue to spread through the economy for many quarters. Macroeconomic time is a long time, but **there will come a day when the damage done by this restrictive monetary policy will be severe enough that central banks will have no choice but to "pivot"**. The stability of the financial system will be in the balance (see Outlook 2023). It is still too early. The setbacks of pension funds in the UK, the life insurer Eurovita in Italy, the US regional banks and Credit Suisse do not seem to have been enough.

In a previous article, we detailed the cause of the problem, which some strategists call "the mother of all bubbles" and which we compare to a "gray rhino": **debt** (see Weekly Investment Focus of 30 January 2023). **In this report, we will develop its consequences not only for central banks, but also for investors**.

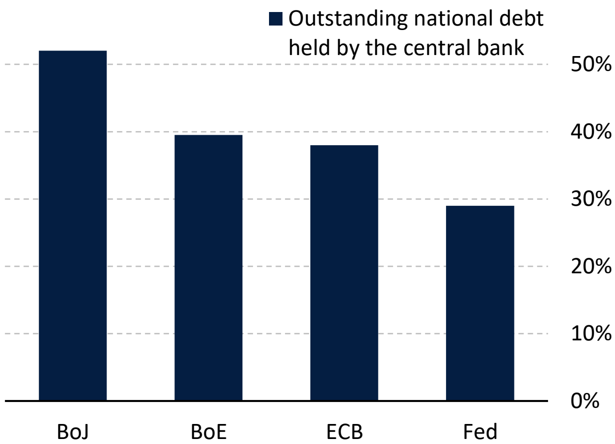
For the record, central banks have multiple objectives. First and foremost, although this point is sometimes overlooked by investors, their mission is to ensure the stability of the financial system. Secondly, they seek to keep inflation close to 2% per year. Finally, for some of them, the third objective is to promote employment growth (and thus economic activity). In recent years, debt ratios have become so high that any attempt to raise interest rates places an unsustainable burden on governments, corporates, and households. Bankruptcies and defaults will multiply until banks and insurance companies are in trouble. In the end, the entire financial system will be at risk (objective n°1 is not achieved). As bad news never comes alone, growth will slow down sharply until the economy goes into recession (objective n°3 is not achieved) and the risks of deflation reappear (objective n°2 is not achieved). In 1933, four years after the Great Depression, the economist Irving Fisher had already identified this problem of debt deflation (see Fig. 4 & Weekly Investment Focus of 6 April 2020).

Fig. 4 – Debt deflation



Source: Atlantic Financial Group

Fig. 5 – Sovereign debt held by the central bank



Source: Bloomberg, Atlantic Financial Group

Thus, by increasing the cost of money significantly and rapidly, central banks are in the process of "breaking" something in the economy. To restore the situation, they will have no choice but to reverse the decisions they have taken over the past 15 months and "pivot" by bringing key rates close to zero as quickly as possible. **The bottom line is that as long as debt remains so high, central banks will have no real option to raise rates. Their monetary policy choices are therefore constrained.**

Going further in the analysis, it is also possible to conclude that if governments decide to increase their deficits, central banks will be forced to buy this additional debt to prevent interest rates from rising. **Monetary policy is thus no longer really independent of fiscal policy** but is subordinate to it. This is what the economists Sargent and Wallace called "fiscal dominance" as early as 1981, and what Cecchetti and Schoenholtz now describe as the "fiscalisation" of monetary policy. The expression is watered down but it refers to the notion of debt monetisation. Indeed, in the absence of sufficient demand from private investors to absorb this abundant supply, central banks print money in order to buy up the excess debt and prevent soaring interest charges from causing a systemic crisis. The monetisation of debt can even be amplified if investors lose confidence in the state and turn to other assets (capital flight). In this case, the central bank buys public debt almost exclusively.

The policy of the Bank of Japan (BoJ) is a perfect example of this process. Since February 1999, the monetary institution has been printing yen (or expanding its balance sheet for quantitative easing, as economists would say). Since September 2016, it has gone even further by controlling the yield curve: it buys all Japanese sovereign bonds with yields above 0.1%. The BoJ thus holds 52% of the debt issued by the government (see Fig. 5). The yen-denominated sovereign debt market no longer operates in a free market. **Without the "whale" that is the Japanese central bank, it would be lifeless.** The major developed countries, notably the US and Europe, are following the same path as Japan. They are just a few years behind.

For readers who appreciate metaphors, the situation can be summarised as follows:

- The "Grey Rhino" (the world debt bubble) has been growing steadily for 40 years.
- The "whales" (central banks) are replacing the fish (commercial banks, insurance companies, investment funds, private investors) to absorb a large part of the bond issues.

For those who prefer historical references, the comparison can be made as follows:

- By repealing the Glass Steagall Act in 1999, which was set up after the Great Depression of 1929 to separate deposit banks from investment banks, the United States made the Great Financial Crisis of 2008 much more complicated than it needed to be, increasing the risk of the financial system imploding.
- By reducing the independence of monetary policy from fiscal policy in 2008, governments weakened the ability of central banks to respect their mandates, creating the risk of inflation and financial system implosion. In doing so, they paved the way for this crisis to be far more complicated than it should be.

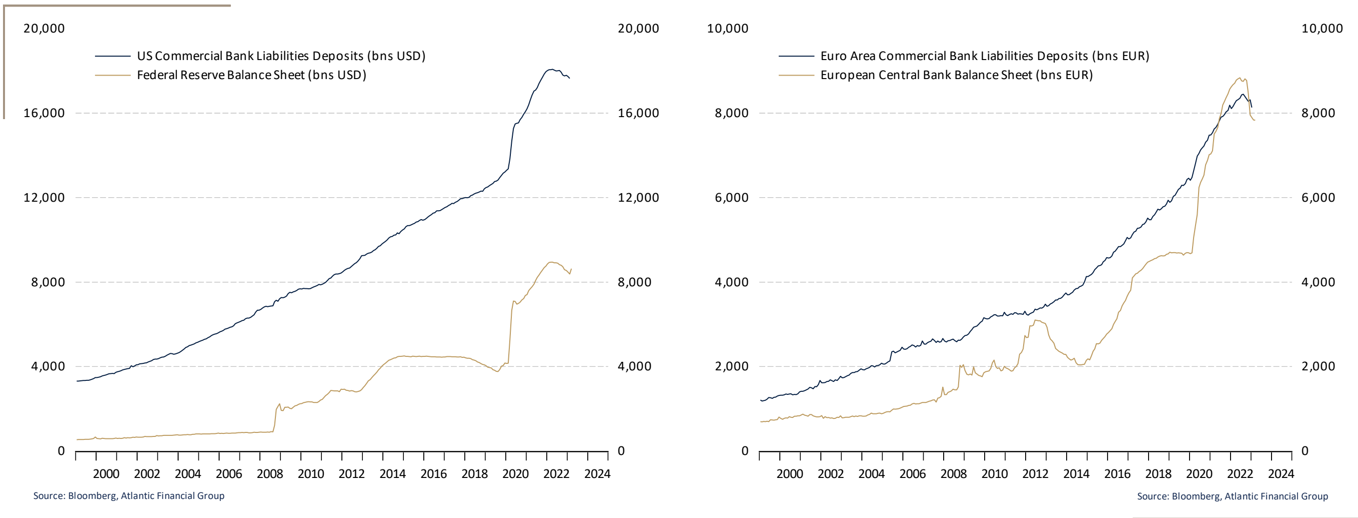
This time, the vulnerability of the financial system is not taking place at the level of commercial banks but at the top level, that of central banks (see Strategy and Themes of 28 June 2021). Ironically, the most famous architect of this imbalance, former Fed Chairman Ben Bernanke, has just received the Nobel Prize in Economics for his work on financial crises.

The independence of central banks has thus become illusory, insofar as in order to respect their mandate of financial stability they have no choice but to monetise the debt by printing money. **Between a debt crisis and a currency crisis, central bankers will always choose the second option because it is the only way to avoid a collapse of the financial system. It is not optimal, but it is the best thing to do.**

Another reassuring fact is that investors have experienced many currency crises in the past. Central banks acquired a monopoly on issuing money in the mid-19th century but have only been independent since the 1990s. **Before that, governments had control over central banks and Treasury Secretaries**

regularly succumbed to the temptation to pay their debts by printing more money. In this respect, it is interesting to note that last week Janet Yellen's teams proposed to guarantee all deposits in banks. One of the ideas put forward is to introduce a temporary tiered price system in which depositors can pay to guarantee their deposits above $250,000. Although the Secretary of the Treasury retracted the idea the next day, it has been widely reported. Can the US Treasury afford to guarantee 18,000 billion deposits, given that it takes on more debt every year to balance its budget? What about the Euro Area? This would only be possible if the Fed and the ECB were to guarantee liquidity to governments... at the risk of printing more dollars and euros (see Fig. 6 & 7).

Fig. 6 & 7 – Central banks' balance sheets vs. corporate and household deposits



Like any tradable good, the price of a currency (its exchange rate) is subject to the balance between supply and demand: everything rare is expensive, and vice versa. When the institution issuing the currency does so excessively, then its value depreciates: slowly at first, then rapidly if investors lose confidence. If there is more than one currency in circulation, Gresham's law states that "bad money drives out good money". In concrete terms, economic actors will have a natural tendency to hoard the better-quality currency, i.e. to save it, while they will trade the perceived worse currency, seeking to get rid of it as soon as possible. **Given the current economic fundamentals, the Chinese yuan and the Swiss franc will be retained and appreciate, while the dollar, the euro, the pound or the yen will depreciate.**

If this currency devaluation is carried out by several countries simultaneously (thanks to an agreement such as the Louvre agreement, for example, to avoid a currency war), **the only way to be protected is to hold "safe haven" assets, such as gold** (a tangible asset, see Chart of the Week), agricultural commodities, arable land (food production) or, more fashionably, crypto-currencies (independent of states).

For the latter, it remains to consider their characteristics and in particular that they are not issued in an infinite way. Indeed, nothing regulates the amount of money issued in cryptocurrencies. Today, if most of them have a limited issue quantity, taken as a whole they represent an unlimited supply. **It should also be considered that, as long as there are states, politics will always have the upper hand over the economy. This means that states can ban the holding of cryptocurrencies at any time.** If they are struggling to stabilise their national currencies during an acute crisis, the likelihood that they will allow savers to hold private currencies is very low. Those who doubt this can look back in history to 5 April 1933 (see Fig. 8).

Fig. 8 – The devaluation of the dollar against gold in 1933

- On 24 October 1929, "Black Thursday", the most famous financial crisis in history began.
- Four years later, the Great Depression resulted in a 50% drop in employment and an average 67% drop in wages.
- On 4 March 1933, when President F. D. Roosevelt took office, he faced a banking crisis so acute that he had to close the banks for several days (Banking Holiday). However, the United States suffered a large outflow of gold.
- On 5 April 1933, **the government forced individuals and companies to sell their gold to the Fed** at a price of $20.67 per ounce, on pain of fines (up to $10,000) and imprisonment (up to 10 years).
- On 20 April 1933, the US finally abandoned the gold standard, causing the dollar to fall.
- The objective of the United States was to increase prices, particularly in agriculture, to get the country out of the crisis.
- Most debt contracts, both private and public, included a clause providing for repayment in gold if necessary.
- On 5 June 1933, **Congress cancelled all "gold clauses" in contracts, even that has been signed.** This was a thunderclap in a country renowned for its respect of contractual commitments.
- On 31 January 1934, **Roosevelt devalued the dollar by 69%,** setting the price of gold at $35 per ounce.
- On 3 July 1934, a New York district court ruled that the abrogating Gold Clause was constitutional. The plaintiff's lawyer stated that he was willing to take the case all the way to the Supreme Court.
- On 18 February 1935, **the Supreme Court dismissed the plaintiffs,** concluding that the repeal of the "gold clause" was unconstitutional, but that the plaintiff had not suffered any prejudice in terms of purchasing power. Without it, the debt would have increased by 69%.
- History has held that the default was "excusable", the government having acted out of "necessity".

Source: Atlantic Financial Group

According to the American humourist Will Rogers (1879 - 1935), there have been three great inventions since the beginning of time: fire, the wheel, and the central bank. Beyond the joke, associating central banking with fire and the wheel is meaningful. It suggests that it has existed for a very long time and that it has a revolutionary utility for the development and well-being of humanity. Will Rogers probably did not imagine that 90 years later, central banks would be more central than ever. **However, if central banks are rightly seen as the arm of capitalism, they should not necessarily be seen as the arm of liberalism... because they can be used for massive public interventionism.**

Conclusion:

With the high level of debt, central banks can no longer raise interest rates without causing a crisis in the financial system. They have lost their independence. The "pivot" of central banks will be in favour of bonds and duration. As money printing is the only way to avoid such a crisis, currencies will depreciate. The strongest of them, such as the Swiss franc and the Chinese yuan, will benefit.

In the event of an agreement between the major economies, a currency war can be avoided, but currencies will fall together against real assets. Precious metals such as gold, agricultural commodities and arable land will be highly sought after.

After a significant correction phase, other commodities such as energy and non-precious metals, as well as real estate, paintings, or other private collections will be in demand. And once the storm has passed, then equities will bounce back to the top of the asset performance podium.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2023 Year-to-Date (%)	2022 (%)	2021 (%)
Equities							
World (MSCI)	625.1	47.52	1.5%	-0.2%	3.7%	-17.9%	19.0%
USA (S&P 500)	3 971	49.99	1.4%	0.2%	3.8%	-18.1%	28.7%
USA (Dow Jones)	32 238	44.56	1.2%	-1.5%	-2.2%	-6.9%	20.9%
USA (Nasdaq)	11 824	57.14	1.7%	3.9%	13.2%	-32.5%	22.2%
Euro Area (DJ EuroStoxx)	437.9	42.34	1.1%	-2.6%	7.2%	-11.4%	23.5%
UK (FTSE 100)	7 405	36.12	1.1%	-5.5%	0.4%	4.6%	18.4%
Switzerland (SMI)	10 634	37.96	0.2%	-3.7%	0.4%	-14.3%	23.7%
Japan (Nikkei)	27 518	47.81	0.2%	-0.2%	5.0%	-7.3%	6.7%
Emerging (MSCI)	972	49.57	2.2%	0.3%	2.0%	-19.8%	-2.3%
Brasil (IBOVESPA)	98 829	30.90	-3.1%	-6.6%	-9.9%	4.7%	-11.9%
Russia (MOEX)	2 392	70.45	3.0%	8.3%	11.3%	-36.9%	21.9%
India (SENSEX)	57 689	35.72	-0.8%	-3.3%	-5.3%	5.8%	23.2%
China (CSI)	4 008	49.69	1.7%	-0.8%	4.0%	-19.8%	-3.5%
Communication Serv. (MSCI Worl	81.08	64.64	3.5%	7.4%	15.4%	-35.3%	10.9%
Consumer Discret. (MSCI World)	300.1	46.65	1.3%	-0.4%	8.5%	-31.5%	9.2%
Consumer Staples (MSCI World)	268.5	60.58	2.1%	1.6%	1.0%	-6.0%	11.7%
Energy (MSCI World)	218.7	34.77	1.5%	-7.1%	-8.2%	34.6%	37.5%
Financials (MSCI World)	124.9	30.45	0.8%	-9.3%	-5.0%	-9.2%	25.1%
Health Care (MSCI World)	327.6	49.57	1.6%	0.0%	-3.8%	-5.7%	18.0%
Industrials (MSCI World)	290.1	42.14	0.8%	-1.3%	2.6%	-12.6%	16.6%
Info. Tech. (MSCI World)	456.9	64.02	2.0%	6.3%	16.7%	-30.9%	27.6%
Materials (MSCI World)	312.0	38.30	1.6%	-1.8%	0.9%	-11.0%	15.4%
Real Estate (MSCI World)	165.6	31.87	-1.3%	-5.7%	-3.2%	-24.0%	23.6%
Utilities (MSCI World)	144.5	47.55	-0.4%	0.0%	-3.9%	-3.8%	11.1%
Bonds (FTSE)							
USA (7-10 Yr)	3.39%	63.36	0.1%	4.8%	4.4%	-14.5%	-2.4%
Euro Area (7-10 Yr)	2.80%	60.95	0.2%	3.4%	4.6%	-19.4%	-2.9%
Germany (7-10 Yr)	2.13%	60.14	-0.2%	3.1%	3.4%	-17.8%	-2.7%
UK (7-10 Yr)	3.28%	63.40	0.1%	4.1%	4.6%	-17.1%	-4.9%
Switzerland (7-10 Yr)	1.14%	56.12	-1.7%	1.9%	3.5%	-12.5%	-2.3%
Japan (5-10 Yr)	0.29%	68.27	0.1%	1.8%	1.8%	-2.8%	0.0%
Emerging (5-10 Yr)	7.98%	55.48	1.0%	0.6%	1.5%	-17.4%	-2.3%
USA (IG Corp.)	5.14%	64.07	1.2%	2.7%	3.3%	-15.8%	-1.0%
Euro Area (IG Corp.)	4.12%	57.96	0.7%	1.0%	2.1%	-13.6%	-1.0%
Emerging (IG Corp.)	7.72%	52.93	0.6%	0.6%	1.4%	-14.9%	-3.0%
USA (HY Corp.)	8.93%	45.90	0.5%	-0.6%	1.8%	-11.2%	5.3%
Euro Area (HY Corp.)	8.07%	39.77	0.9%	-1.4%	1.9%	-10.6%	3.4%
Emerging (HY Corp.)	11.37%	41.53	0.9%	-1.6%	0.0%	-12.4%	-3.2%
World (Convertibles)	367.3	40.69	0.6%	-1.6%	2.4%	-18.2%	2.4%
USA (Convertibles)	484.3	40.08	0.4%	-2.1%	2.2%	-20.1%	3.1%
Euro Area (Convertibles)	185	41.55	0.4%	-1.2%	2.5%	-12.1%	1.2%
Switzerland (Convertibles)	173.9	50.82	-0.6%	0.0%	1.1%	-7.5%	-0.5%
Japan (Convertibles)	202.4	43.85	-0.3%	-1.0%	2.2%	-1.3%	3.3%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	741	65.02	n.a.	-0.9%	0.9%	1.0%	8.2%
Distressed	938	58.49	n.a.	0.1%	1.5%	-4.5%	12.5%
Event Driven	771	54.76	n.a.	-0.4%	1.8%	-6.8%	12.9%
Fixed Income	397	69.75	n.a.	0.6%	2.0%	-1.0%	5.2%
Global Macro	1365	56.89	n.a.	-4.8%	-2.2%	15.9%	9.6%
Long/Short	895	50.99	n.a.	-0.9%	2.4%	-5.8%	8.3%
CTA's	403	62.97	n.a.	1.8%	-0.9%	19.1%	8.2%
Market Neutral	296	64.16	n.a.	-0.4%	0.4%	1.7%	6.2%
Multi-Strategy	712	63.98	n.a.	0.3%	0.8%	1.3%	7.0%
Volatility							
VIX	21.74	49.13	-14.8%	0.3%	0.3%	25.8%	-24.3%
VSTOXX	24.88	54.01	-17.2%	14.8%	19.1%	8.4%	-17.6%
Commodities							
Commodities (CRB)	544.8	n.a.	0.4%	-0.9%	-1.8%	-4.1%	30.3%
Gold (Troy Ounce)	1 972	63.22	-0.3%	8.5%	8.1%	-0.3%	-3.6%
Oil (WTI, Barrel)	69.31	n.a.	3.9%	-9.2%	-13.6%	4.2%	58.7%
Oil (Brent, Barrel)	74.28	n.a.	1.6%	-9.0%	-12.6%	9.7%	51.4%
Currencies (vs USD)							
USD (Dollar Index)	103.07	43.78	-0.2%	-1.5%	-0.4%	8.2%	6.4%
EUR	1.0768	54.98	0.4%	1.5%	0.6%	-5.8%	-7.5%
JPY	130.87	61.89	0.3%	4.1%	0.2%	-12.2%	-10.2%
GBP	1.2237	56.51	-0.3%	1.4%	1.3%	-10.7%	-1.0%
AUD	0.6653	42.62	-1.0%	-1.3%	-2.3%	-6.2%	-5.6%
CAD	1.3730	43.07	-0.5%	-1.1%	-1.3%	-6.8%	0.7%
CHF	0.9185	55.76	1.2%	1.9%	0.7%	-1.3%	-3.0%
CNY	6.8769	50.78	0.0%	1.0%	0.3%	-7.9%	2.7%
MXN	18.431	53.37	2.2%	-0.3%	5.8%	5.3%	-3.0%
EM (Emerging Index)	1 685.2	57.35	0.6%	1.1%	1.5%	-4.3%	0.9%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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