



December 21st, 2020

Lessons from 2020

- **Debt is not a problem unless you are small**
- **The biggest risk to everything - inflation.**
- **Government bonds are for risk hedging not income**
- **US global political power may just have (really) peaked.**
- **Policymakers may remain in denial of risks to mankind despite the warning from COVID.**
- **North Sea cod is more important than oil (for some)**

Debt is not a problem unless you are small.

COVID19 has substantially increased the level of global indebtedness, but in most cases, there is no sense of panic. If you are a big enough borrower (government or large corporate), you can continue to borrow more. Even corporate bond yields have trended towards zero with the cost of servicing debt extremely low. By some estimates reported by Bloomberg, the amount of negatively yielding corporate debt has risen to \$13 billion globally. If you are a government, you can almost with impunity just ask your central bank to fund you. Today the Bank of Japan owns half of Japanese Government Bond market. The Federal Reserve holds around \$4trillion of US debt equivalent to about 30% of GDP. The ECB has set negative interest rates which in essence means that most European government won't have to repay all of their debts.

With the government borrowing at such low rates, it almost encourages them to bail out anything that gets into trouble, hence the \$18trillion of support for the global economy from government support/handouts.

However, for those companies that don't have such easy access to debt interest rates are far higher and the credit terms penal. Among SMEs double-digit rates of interest for loans is the norm.

The biggest risk to everything – inflation

Markets have almost doubled down on their being little inflation and by implication no significant interest rate rises over the medium term. The global economy is extremely vulnerable if the consensus is wrong, Global debt is at a peak, and large swathes of assets have been re-priced on the basis of near zero interest rates. Inflated asset prices need near-zero interest rates. The good news for asset prices is that, at least for the moment, central bankers look likely to be quite tolerant of any pickup in inflation. The Fed, ECB and Bank of Japan are committed to maintaining near zero interest rates until inflation is well established. Something to keep an eye on - the market is currently pricing a good measure of inflation risk at least in inflation linked bonds. The US 10 year break even inflation has risen to near 2% (Chart below).

Chart 1: US 10-year breakeven inflation



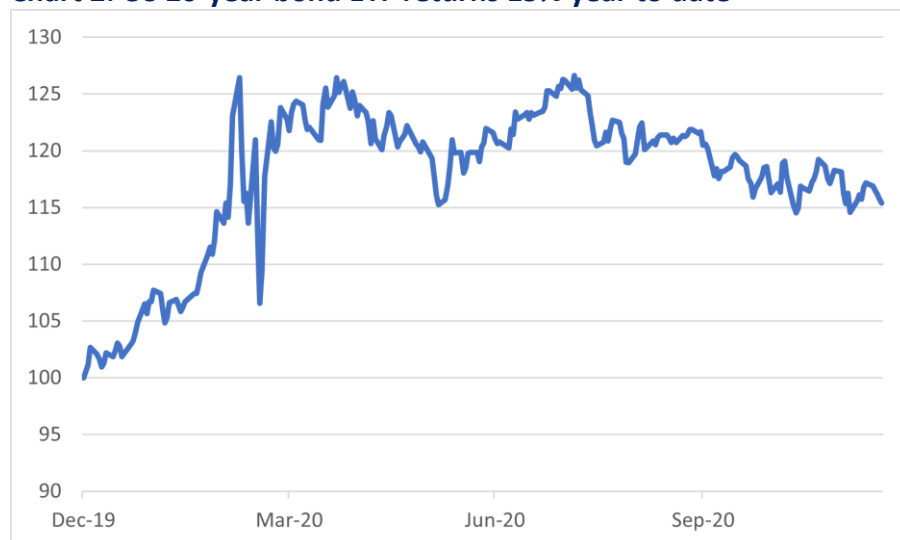
Source: Bloomberg

Government bonds are for risk hedging, not for income.

Asset allocator's commentary at the start of 2020 is full with references to the obsolescence of government bonds carrying no yield, or negative yield. Investors were advised then, as they are now, to rethink their asset allocation processes to reflect the changed nature of government bonds. Given their absence of yield, the idea was to look for relatively low-risk alternatives that would serve as portfolio diversifiers (where equities were part of the allocation) that also carried some yield.

This argument is OK as far as it goes, but it misses an important about one of the functions of government bonds. They absorb portfolio losses when needed most: they are handy to have around in a tight spot. The reason for this is simple. As yields have collapsed to zero or below in the G& world, the amount of interest rate sensitivity (as measured by duration) carried by government bonds has increased. Thus, even if they yield zero, when there is a flight to quality, for example, when a global pandemic strikes, they rally in price. At one point this year, the total return for the US 20Y Treasury bond had exceeded 20% (Chart 2). That is a tidy outcome at a time when the rest of the investor's portfolio is underwater.

Chart 2: US 20-year bond ETF returns 15% year to date



Source Bloomberg

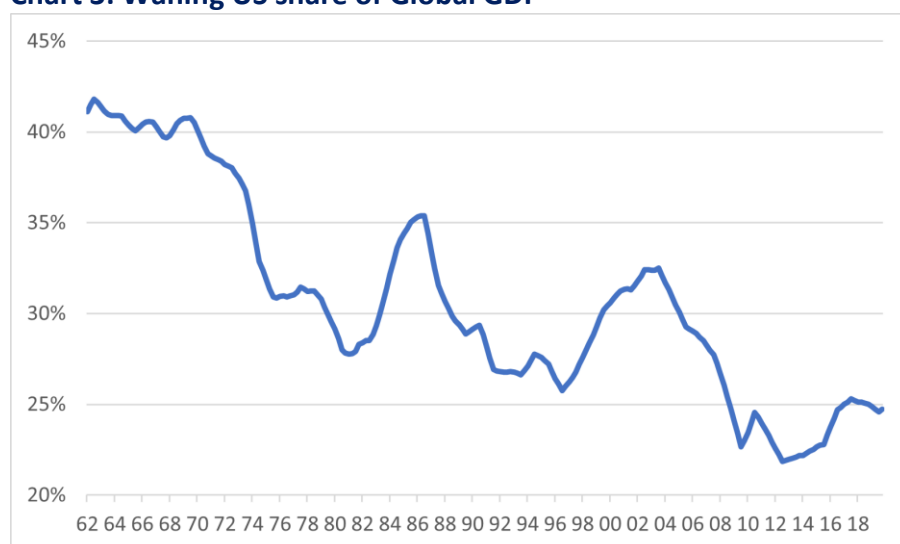
Another advantage of high-duration bonds is that their heightened sensitivity to downward rate moves means that the amount that one needs in a portfolio to have a noticeable impact on performance is

smaller than the “old days” when they carried some yield. In the new normal, risk-free bonds come with a safety premium.

US global political power may just have (really) peaked.

Academics have argued for years that the US is past its best. However, it didn't stop the US asset markets remaining preeminent. But the trade wars with China and the mess of the US presidential election are perhaps more anecdotal evidence of the demise of the US as a preeminent global power. Although many will hope that a President Biden will more constructively engage with the rest of the world in both trade and geopolitics, you sense that the US is no longer the powerhouse that it was in the past; for example, in 2020 China surpassed the US in trade with the EU. When internal conflict makes more headlines than global leadership, you know that that country is on a slow path of decline. US equities today account for 63% of global developed equity markets. We doubt that the US represents 63% of the future returns or opportunity in global asset markets over the next decade.

Chart 3: Waning US share of Global GDP



Source: Bloomberg

Irrespective of what President Trump has said, Asian countries have made it clear that they want to engage with China given its economic power. The recent RCEP trade agreement showed that most Asian countries are willing to engage with China to create a trading zone that brings together Asian countries in a way that hasn't been seen for a long time.

Policymakers may remain in denial of risks to mankind despite the warning from COVID.

People are in denial of the real risks to the globe. We learned as much from the COVID19 crisis. Policymakers, despite all warnings over previous decades, were not prepared. I remember in the year 2000 listening to the Surgeon General of the United States speaking to the advisory board of one of the US's largest banks, describing a virus as well overdue and that it could do significant damage to the US economy. As Stephen Morse, a professor of epidemiology at Columbia University, put it when asked what is the worst mistake you could make? His answer "To be prematurely right."

What is worse, is that when faced with the reality of the crisis, the first reaction is denial. The delayed response while touting without foundation the merits of building herd immunity and the failure to immediately close borders are just two instances of muddled thinking that only added to the mess of a reaction in too many parts of the world.

Policymakers could tackle climate change if they wanted to.

Estimates of how much it would take to end global climate change range between \$300 billion and \$50 trillion over the next two decades. COVID19 brought \$19trillion of support in a matter of months. If the authorities saw the scale of needed spending to offset the pending crisis, couldn't they just tap their

friendly central bank for another run of the printing presses? Unfortunately, it will take a real climate crisis on the doorstep of a major developed country before the spending happens when quite frankly it will be too late.



North Sea cod is more important than oil (for some)

As we go to press, we still do not know the outcome of Brexit. What we have learnt, however, is that for France, the UK and possibly others too, the 0.12% contribution made by the fishing industry is important enough to push negotiations to the very edge. It is a graphic illustration of the triumph of special interest groups over the greater economic good. It also puts in stark relief the major role played by ego and the desire be seen as a champion of the people by politicians on both sides of the channel. We might have thought that Brexit has been relegated down the list of potential pitfalls waiting to trip up markets in 2021. Kippers anyone?

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