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Monetary Madness

The following whitepaper by Carnegie Asset Management (CAM) looks at the unintended consequences of central bank policies. We think this article very well articulates the doubt many have about the current monetary policies and thus would like to share it with clients and partners.

Based in Denmark, CAM utilizes an approach of bottom-up stock picking based on long-term global trends to generate asset growth for clients. We provided initial seed capital for the Luxemburg based Asian equity fund and have invested in other of their funds too.

Monetary Madness by Theme Specialist Morten Springborg, Carnegie Asset Management

Critics have begun to voice their concerns over the actions of the world's central banks. Since the financial crisis in 2007-2008, interest rate levels have dropped to historic lows, and some central banks have even introduced negative interest rates: something that defies all economic logic. We last wrote about this in our white paper 'Currency wars', which predicted that the focus would eventually turn to the unintentional consequences of such monetary policies. These unintended consequences have now become quite manifest, which is why the critical voices directed at the central banks are becoming louder.

Pumping out money in a zero interest rate environment

According to current conventional economic policies, printing money is a way to stimulate economic growth. However, in a world with an ageing population, it is a fact that a large part of the population will have to live off their savings. When interest rates just keep dropping, returns on savings grow smaller and smaller, which means that people have to save up more and spend less. This would seem to be quite the opposite of what the central banks intended with the implementation of aggressive monetary policies.

It becomes clear that this is relevant not only for economists and investors, but also for the general population, when you hear Germany's minister of finance, Wolfgang Schäuble, claiming that the European Central Bank (ECB) is partly responsible for the rise of the anti-euro, anti-immigration right-wing party Alternative für Deutschland (AfD) and, in turn, for the threat of a dramatic upheaval in German politics. Mr. Schäuble has also said that the ECB's zero per cent interest rate policy could ultimately end in disaster.

There is also growing support for the view that, after several years of printing money and with zero per cent interest rates, this is a policy that no longer has the same effect it once had. A thought that easily comes to mind is Albert Einstein's definition of madness: 'doing the same thing over and over again and expecting different results'. This seems to be the logic behind the current monetary policy of the Western world.

Technological acceleration means falling prices

The main trend in the global economy today is the accelerating rate of technology innovation, which more and more is leading to the disruption of existing business models and the emergence of new – and typically more cost-efficient – ways of doing things. This is a deflationary trend, but a benign one, because ultimately the lower prices will benefit consumers. We also see a deflationary trend in China, in the country's current transition from an industrial society to a service economy. This has a deflationary effect on the commodities sector and industrial enterprises.

The more you think about it, the more obvious it becomes that a fundamental economic shift is underway: a shift that coincides with the ageing of the global population. What all of this means is that we are witnessing an economy in which most prices will tend to fall, or at least not increase the way we have been accustomed to previously. The ability of the business sector to impose price increases on consumers – called 'pricing power' – has become rare. For global consumers, the decline in pricing power is a huge benefit because it increases their purchasing power, which is why we believe that falling or stagnant prices are a structurally good type of deflation.

Nevertheless, the current central bank leaders believe that a rate of inflation of 2% is a target to pursue. In a world characterized by structural deflation, it should be impossible to create inflation unless you destroy the economy through monetary mismanagement or simple incompetence: cases in point being the Weimar Republic, Venezuela, Argentina and Zimbabwe.

In our white paper 'Benefits of digitalization overlooked', we described the challenges of measuring growth correctly in an environment of accelerating digitalization and disruption. We believe that growth rates are actually higher than what the statistics indicate. Nevertheless, the central banks have supported asset prices by pumping out money, but they have not been able to lift the recorded growth rates, primarily because businesses are not investing as much as they ‘should’, which makes for disappointingly low productivity rates.

Disappointingly low corporate capital expenditure

So, the question is why are businesses not taking advantage of the extremely low interest rates to invest more, giving us more productivity- driven growth? Listed companies all over the world have recovered to very high profitability levels following the financial crisis and are now able to finance their investment needs at very low rates of interest. The problem is that the aggressive monetary policies have had unintended consequences. Low rates of interest ought to spur more investment, but in fact the opposite has occurred. According to Citibank, the world’s listed companies invested 2% less in 2015 than they did in 2014, and investment bank CLSA believe that corporate capital expenditure will drop 10% in 2016.

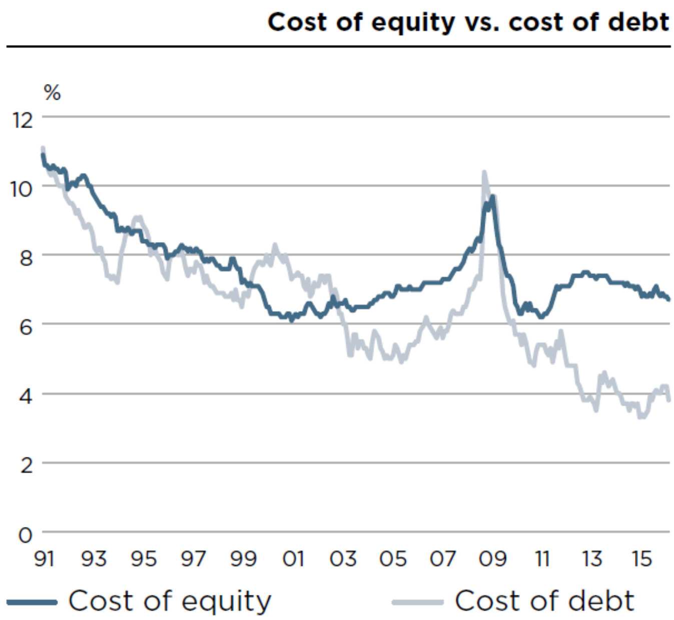
We believe that the reason for the lack of investment appetite is to be found in the equity markets. The equity markets do not want businesses to invest. The signals being sent are quite clear: investors are looking more for companies to pay dividends, buy back shares or acquire competing businesses. According to Citibank, in today’s market, companies with high capex levels are being ‘punished’ with a low share price, whereas companies that return a great deal of capital to investors are rewarded with a higher share price.

This reflects an unintended consequence of the interest rate manipulation performed by the central banks. As interest rates have gradually fallen, investors needing current income have been forced away from fixed income investments and into dividend- paying equity investments, which carry a higher risk. These investors – we could call them ‘fixed income tourists’ – are first and foremost looking for stable returns, not larger – and more risky – returns over the long term. Companies looking to attract this type of investor have to adapt to the preferences of such new investors, meaning they have to distribute more and invest less.

Cost of equity remains high

Unlike the cost of debt, the cost of equity has not fallen, as illustrated by the chart below:

Figure 1:



Source: Citigroup

The big differential between the cost of debt and the cost of equity is much of the explanation why businesses are investing too little in capex today. The extent of debt-funded company acquisitions in today's equity markets has never been greater, and it is a reflection of an arbitrage between the cost of borrowing and the cost of equity. When the price of listed companies is low (and the cost of equity is high), and it is also possible to borrow money at exceedingly low rates of interest, most corporate executives will choose to acquire existing assets rather than invest in relatively riskier new capacity that may not produce a return until a few years after the investment has been completed. Why run the risk of building a new factory when you can buy one that already exists?

Buying back a company's own shares is also an arbitrage, as mentioned above. Why invest in future growth if you can raise debt at a cheap rate and buy back your company's shares, and thus increase your earnings per share? As most investors will know, this is a phenomenon that has been a significant factor behind the earnings growth in the USA in recent years. Companies that have gone down this path have been rewarded because their shares have outperformed companies that have not bought back shares. From the perspective of a short-term investor, this makes good sense, but looking a little further ahead it could mean that companies invest too little, thereby reducing their long-term earnings growth and with it the general rate of economic growth.

We should embrace creative destruction

Economist Joseph Schumpeter used the concept of 'creative destruction' to describe how the economy constantly develops through a 'process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one'. This is raw capitalism, a type of capitalism that the central banks apparently want to destroy with monetary abundance and the resultant low interest rates and policies that keep businesses and excessively indebted states alive that ought to have gone bankrupt or defaulted. The accelerating advance of technology will impact more and more industries and economies in coming years, and central banks will be compelled to print more and more money if they insist on holding on to their outdated ideas of inflation targeting.

Several key economists believe that the current low-growth environment is due to demand being too weak. The central banks have used up all of their ammunition, and what is often called "helicopter money" could be their last resort: printing money and distributing it to the entire population. The only means left for creating growth would then be government investment – financed at zero per cent interest through the bond markets.

However, we believe there is a better solution. The world needs to embrace creative disruption, both because it gives purchasing power to consumers and because the best means of resource allocation is to allow viable businesses to have reasonable market conditions by allowing competitors to die that would otherwise only survive because of the monetary abundance created by the central banks. If you are willing to accept that the economy is cyclical and that zombie businesses should be allowed to fail, however painful that may be in the short term, we would achieve a far better resource allocation, and deflation would subside.

Higher interest rates would also mean that private savers would receive a return on their savings, allowing them to start spending more money instead of having to save up due to their ever diminishing returns. Perhaps the best example of how the current scenario of monetary abundance has led to excessive misallocation of capital is how hugely indebted governments can raise financing at negative interest rates. This madness will have to end at some point.

Conclusion

However, that day will probably be a long time coming, as the consequences of higher interest rates in an indebted world are extremely unpredictable. Presumably, the current monetary policies will continue for a number of years yet, meaning that weak economic growth will persist. In such an environment, interest rates will remain low and fixed income markets will provide zero returns.

On the other hand, we believe that the equity markets will offer a reasonable return potential over the next few years, but that investors will have to be extremely selective in their stock picks.

First of all, a considerable number of listed companies do not generate a free cash flow. A company's free cash flow is the cash available to investors, and if a company does not – either now or in the future – generate a free cash flow, it is basically without value.

Other companies that have historically generated healthy free cash flows will be subjected to massive changes in coming years. The technology acceleration driven by Moore's law (read more about this in our white paper 'Second half of the chessboard: Moore's law') spells accelerating disruption for industries that were previously shielded. Investing is just as much an act of rejection as it is of selection, and rejection will become increasingly important in future years.

And then there are the business models which will remain unaffected by technology acceleration both today and tomorrow and that also generate a fair cash flow. Companies like Nestlé, Unilever, Novo Nordisk and Visa and tobacco companies like BAT and Reynolds American – all of which have a great deal of pricing power – will largely be able to maintain their growth rates over the coming years because the markets for their products will be growing and are not exposed to the technology changes that have otherwise been so dominant in recent years.

Finally, there are the companies that can be characterized as the long-term winners in this world of disruption and technology acceleration. Our choices in this category are companies like Alphabet (formerly Google) and Facebook, which we believe will dominate the market for online marketing for many years to come. These companies can make a huge difference to returns, and they are must-haves in any portfolio for investors looking for a return in excess of five or six per cent per annum over the next years.

Over the past seven years – since February of 2009 – according to Jonathan Wilmot of Credit Suisse, real annual returns (in USD terms) have been at about 5% in US bond markets and about 17% in US equity markets. We believe that the next seven years will be much different and that bond markets will probably generate negative returns, with equity market returns falling to about 5%. This would be a highly unpleasant cocktail in a world where the population is ageing and in need of returns to finance their retirement. In such an environment, investing in passive products that simply buy an index will be a risky venture, and the value of active asset management will increase. The ability to generate a return that outperforms the market by three to five per cent p.a. will make all the difference between skimpy and reasonable retirement savings.

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