FUTURE INSIGHTS
ANDREWS·GWYNNE
SPRING
2023

# THE POLARISED ECONOMY – THE FUTURE OF EXCESS

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"For, you see, so many out-of-the-way things had happened lately, that Alice began to think very few things indeed were really impossible." Lewis Caroll, Alice in Wonderland

In an uncharacteristically low-key fashion, Ferrari recently launched its new £315k+ SUV, the Purosangue (Pure Blood), in the Italian Alps and within a couple of months has ceased taking new orders, reports suggesting the entire production run had been sold out. Meanwhile, not so far away, Italy's fashion capital Milan has witnessed (like the rest of the developed world) growing queues outside food banks as the cost-of-living crisis takes a huge toll.

There is perhaps a very tired, "end-of-empire" feel to the level of inequality that society now takes for granted. More than a decade after the financial crisis we have seen incomes stagnate and growing debts, struggling families confronting TV and social media full of images of the glossy rich, their mega-mansions and super yachts. This very Gatsby-esque environment, some would argue, is a cost of the free markets, that inequality will always exist and even increase over time, yet the reality is that what we are seeing has been supercharged by the post crisis "trickle-up" policies of politicians and Central Bankers, pushing money away from the real drivers of growth, the ordinary consumer and business, into the dens of financial excess, great for the builders of exotic hyper-cars, less so for young families.

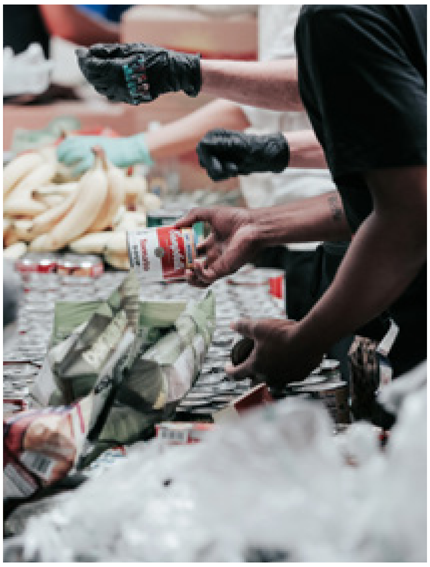
More importantly it has also **created a very fragile economic and market ecosystem** that has been struggling as interest rates have lifted at a radical pace, which is a perverse response to an energy crisis that had nothing to do with monetary policy. If we are to navigate the turbulent times ahead then, we need to understand the issues.

The post-GFC period of extreme excess has been driven primarily by the very tools of "loose" money used to "rescue" the world economy from the consequences of, ironically, unchecked financial excess, as we have pointed out for many years. We are thus grateful that the **San Francisco Federal Reserve has joined us**, pointing out in February that "a loose stance over an extended period of time leads to increased financial fragility" and "financial stability risk inherent in excessively loose monetary policy carries over to real economic activity". Bravo. Now as Central Banks raise interest rates, more than a decade too late and for the wrong reasons (as discussed in previous Future Insights) things are breaking, beginning with the UK pension debacle in September to the recent US bank failures while, worryingly, **US money supply has fallen faster than at anytime since the Great Depression**.

While equity markets have given up some of their excess, unlisted (and less liquid) assets remain at bubble highs and figures show that around **80% of loans** for US Commercial Real Estate (CRE) come from smaller banks. This is a major problem when the office vacancy rate (13%) is worse than at the height of the GFC, while up to a $1trillion worth of loans need to be refinanced (at much higher rates) annually. Meanwhile **highly leveraged private equity** (PE), at the heart of the Silicon Valley Bank (SVB) failure, have not even begun to write-down the "Mark-to-Magic" prices of their assets, many of which are thought to be worthless.

Despite this, and falling earnings, the US stock market has stabilised, but behind this façade has been an explosion of zero-day options, financial derivatives that expire the same day they are written and channel the market in a very narrow range, suppressing volatility. These absurd tools now dominate the derivative market that has now outgrown the stock market itself, making it an unhinged tool of wild speculation and no longer a mechanism for real price discovery.

At some point these huge distortions will unwind, perhaps dramatically, the question is how? While we can foresee a variety of scenarios we simply can't know as we are in genuinely uncharted territory. However, while the authorities seem to be on the wrong track they can react rapidly to hold back the worst and while we still fear a very volatile and uncomfortable time ahead the world will not end and, eventually, a more equitable, and probably more regulated future is likely to emerge.



Food banks are increasingly under pressure in the "developed" world

# A BARBAROUS RELIC IN THE AGE OF DISRUPTION

**Few assets divide opinion as strongly as gold, with some dismissing it as simply a heavy shiny metal with no utility. Others will point out that only gold has a track record of being a store of wealth for literally millennia through, let's face it, some pretty volatile times, as empires have risen and fallen. This is important if volatile uncertainty is what we face today. Yet there are some who are even more bullish, arguing that its value will multiply as a foundation for a new international currency system that will slowly edge out the US Dollar from its central role in world trade.**

### Gold as the foundation of a currency system?

In our modern digital world it may seem absurd to think of a precious metal at the heart of the global financial system but, of course, it has been before. Indeed, there was a gold standard at the heart of the pre-WW1 one wave of globalisation, which was then reinstated in the chaotic years that followed the conflagration, arguably contributing to both the Great Depression and the rise of Hitler's Germany (prompting economist JM Keynes to describe the gold standard as a "barbarous relic"). Following World War II and the1944 Bretton Woods agreement world trade evolved around a dollar-based system that was pegged against a fixed value of US gold reserves. This held until 1971 when Richard Nixon infamously took the dollar off the gold standard, throwing the world into turmoil when he interrupted a Sunday afternoon showing of the hit TV Western series, "Bonanza", to make the announcement while markets were closed.

Will gold help edge out the US Dollar?

Some see this event as the primary cause of the inflation of the 1970's & 80's (incorrectly, it was largely energy driven) and the large-scale financialisaton that followed. Nonetheless, despite current (extreme) excesses, it is easy to lose sight of the fact that our modern floating exchange rates and easy ability to transfer money from country to country has both supported a growing global economy and is a relatively new phenomenon. Prior to the Nixon shock capital controls were part of everyday life and a drag on growth which many lose sight of when they focus purely on the ill effects of the explosive growth in debt that has occurred concurrently.

In reality it was the growing sophistication and demands of global businesses, set in motion before 1971, that forced Nixon's hand as the international dollar (Eurodollar) monetary system grew rapidly to fulfil the needs of world trade, denominated in dollars that the US was not supplying. A currency based upon a fixed supply of gold simply could not accommodate the needs of a rapidly globalising economic system. If a gold standard is so limiting though, it begs the question why we now see the accumulation of gold reserves by countries such as China, Russia and India?

As we suggested even prior to the invasion of Ukraine, we could see a logic of tying Russian (and, they hoped, Ukrainian) commodity strength with China's economic might to support a new digital currency to try and take on the dollar in international trade. This logic has become more mainstream since Putin's invasion and generally includes the idea that by adding Gold backing to this notional currency it would provide even more legitimacy. However while we, naturally, agree this might be the plan we also see it as a generational goal being shoehorned into an implausibly short window by deluded kleptocrats. It is true that China has been at the forefront of digital currency research but with (crucially) a closed capital account and slowing growth, it is still a long way from being able to change the key role of the dollar in international trade.

### Is this hard reality bad for gold?

Not at all, because these goals may be supporting the price at the moment. If we are correct, and we confront a period of increased financial, economic and geopolitical instability, gold's certainty, should become more attractive, not less. However, it is unlikely to travel in a straight line and may see some sharp pullbacks, so the appropriate weightings will be different for investors with different risk appetites, which we will manage accordingly.

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# CRUSHING CARDBOARD AND THE CONSUMER?

**While we try to put economic data into context that makes sense in the real world, we appreciate that doesn't always work well. Hence we try to find less abstract ways to explain what we see – this chart does that.**

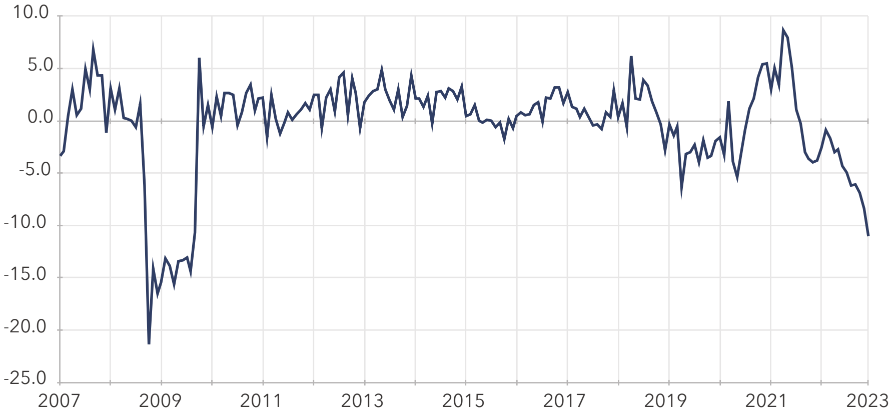
It shows the rate of change in the US production of cardboard containers, a key component in the modern Amazon/Home Delivery economy, and it is falling dramatically. Why? Simply the increase in inflation. **As the cost of essential goods and services goes up individuals have less to spend on discretionary items like new toys or smart clothes.**

The real-world impact can be seen when a clothing retailer like ASOS writes off £100m of stock due to poor sales, or while those selling essentials are often boosting their margins, which is why we are seeing a global manufacturing recession, while services (which include supermarkets) appear resilient (and keep driving inflation up, leaving us less to spend).

Coming back to cardboard boxes there has been a near 13% reduction, year-on-year, pointing to a deep and fundamental problem. Will this worsen to levels seen in 2008/09 GFC? We will have to see.

**Mark Smith**, Partner

Rate of change in the US production of cardboard containers



Source: FRED, Andrews Gwynne

# IS THE UNITED STATES RUNNING OUT OF MONEY?

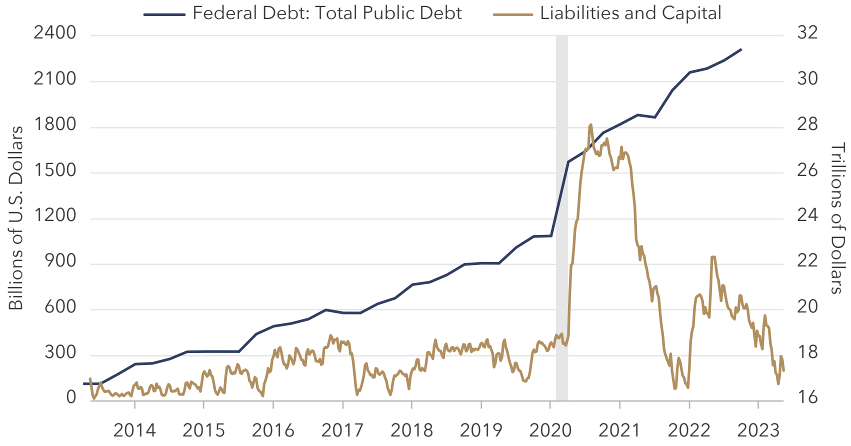
**David Scott**
Investment Manager

**On 19th January 2023 the US Government appeared to run out of money as total debt reached the "debt ceiling" of $31.4tn – see the blue line on the chart (value on right axis). While this sounds dramatic, the debt ceiling was a normal part of US political life and has been increased 78 times since 1960, mostly (62%) by Republican administrations.**

However, in 2013 it became a crisis when the limit of (just!) $16.4tn was reached under Obama and the Republicans used it as political tool, threatening to "default" on US debt, a game that is playing out again a decade later exacerbating the credit crunch that is hobbling the banking sector.

The crisis is aggravated as the US Treasury General Account (think of it as a Government cash buffer) where stimulus cash was parked before being drawn upon,is being pulled down dramatically and government cash is running low – see the gold line on the chart (value on left axis).

Federal Debt vs Liabilities and Capital



Source: FRED, Andrews Gwynne

# BEWARE OF THE CRAFTY INLAND REVENUE!

**Sorting out a loved one's estate after death is naturally going to be a worrying and potentially confusing time for many. Getting the submissions to HMRC correct may take time and provide some anxiety, so once any Inheritance Tax (IHT) payable is paid, most will be glad the exercise is over. But is it?**

Most people though are unaware that HMRC can in fact carry out IHT investigations called an 'enquiry notice', potentially several years after the tax payment has been settled.

It is not a surprise to learn that it is the value of the deceased's home that is the main influence and therefore focus of any investigation. In recent years, at least before the swift increase in interest rates, house prices appreciated rapidly. Hence the value of a deceased's home declared on the grant of probate could potentially be much less than its value at final sale. If the home has been sold within two years for a higher price, then HMRC could contest that more tax is due on the increased value.

Figures obtained from HMRC by NFU Mutual show HMRC recovered £326m from these enquiries in 2021-22, up from £254m in 2020/21, a 28% increase.

So, how do individuals protect themselves from this threat of enquiry? This is a tough question to answer. Using an accurate and market rate valuation is obvious. However, it seems difficult to have to account for potential future house price growth at calculation. Turning it around, should HMRC refund those in future where house prices may have fallen? We doubt they would.

The important thing in our view is to bear this in mind and if a house sells for more than expected beneficiaries should keep a cash buffer in place, at least for a while.

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**Mark Smith**
Partner

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