Crossbow Partners
Experience & Discipline

Monaco Trip Report

Morgan Stanley European Hedge Fund Forum

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Executive Summary

The sharp rebound of 2019 has erased losses of 2018 and improved the confidence for good results this year

The policy change of the FED and ECB prolongs the market put provided by the central banks for the foreseeable future

Interest rate yields are re-testing their record lows of July 2016 when markets were under pressure from the Brexit vote

Equity markets are experiencing a further melt-up due to the lack of liquid alternative investment opportunities

At this point, the Japanese scenario of low growth and deflation seems to be more likely for the world than normalized growth, higher rates and inflation

The trade war and global leadership considerations will ultimately lead to disruption and volatility

The coming Paradigm Shift

Ray Dalio is the co-Chief Investment Officer & co-Chairman of Bridgewater Associates, the world largest hedge fund. They have delivered outstanding results over several decades by understanding the markets well and positioning their bets accordingly. The summary below is from a recent article published by Ray Dalio. It analyses paradigms and paradigm shifts over the past 100 year. In our view, it is worthwhile to read his assessment of the coming paradigm shift. Neither bonds nor equities will be a safe place, but gold or uncorrelated investment strategies, such as macro funds.

Ray Dalio, Bridgewater Associates, July 2019

While I'm not sure exactly when or how the paradigm shift will occur, I will share my thoughts about it. I think that it is highly likely that sometime in the next few years, 1) central banks will run out of stimulant to boost the markets and the economy when the economy is weak, and 2) there will be an enormous amount of debt and non-debt liabilities (e.g., pension and healthcare) that will increasingly be coming due and won't be able to be funded with assets. Said differently, I think that the paradigm that we are in will most likely end when a) real interest rate returns are pushed so low that investors holding the debt won't want to hold it and will start to move to something they think is better and b) simultaneously, the large need for money to fund liabilities will contribute to the "big squeeze." At that point, there won't be enough money to meet the needs for it, so there will have to be some combination of large deficits that are monetized, currency depreciations, and large tax increases, and these circumstances will likely increase the conflicts between the capitalist haves and the socialist have-nots. Most likely, during this time, holders of debt will receive very low or negative nominal and real returns in currencies that are weakening, which will de facto be a wealth tax.

Right now, approximately 13 trillion dollars' worth of investors' money is held in zero or below-zero interest-rate-earning debt. That means that these investments are worthless for producing income (unless they are funded by liabilities that have even more negative interest rates). So these investments can at best be considered safe places to hold principal until they're not safe because they offer terrible real returns (which is probable) or because rates rise and their prices go down (which we doubt central bankers will allow).

Thus far, investors have been happy about the rate/return decline because investors pay more attention to the price gains that result from falling interest rates than the falling future rates of return. When interest rates go down, that causes the present value of assets to rise, which gives the illusion that investments are providing good returns, when in reality the returns are just future returns being pulled forward by the "present value effect." As a result future returns will be lower.

That will end when interest rates reach their lower limits (slightly below 0%), when the prospective returns for risky assets are pushed down to near the expected return for cash, and when the demand for money to pay for debt, pension, and healthcare liabilities increases. While there is still a little room left for stimulation to produce a bit more of this present value effect and a bit more of shrinking risk premiums, there's not much.

At the same time, the liabilities will be coming due, so it's unlikely that there will be enough money pushed into the system to meet those obligations. Then it is likely that there will be a battle over 1) how much of those promises won't be kept (which will make those who are owed them angry), 2) how much they will be met with higher taxes (which will make the rich poorer, which will make them angry), and 3) how much they will be met via much bigger deficits that will be monetized (which will depreciate the value of money and depreciate the real returns of investments, which will hurt those with investments, especially those holding debt).

History has shown and logic tells that there is no limit to the ability of central banks to hold nominal and real interest rates down via their purchases by flooding the world with more money, and that it is the creditor who suffers from the low return.

Said differently: The enormous amounts of money in no- and low-returning investments won't be nearly enough to fund the liabilities, even though the pile looks like a lot. That is because they don't provide adequate income. In fact, most of them won't provide any income, so they are worthless for that purpose. They just provide a "safe" place to store principal. As a result, to finance their expenditures, owners of them will have to sell off principal, which will diminish the amount of principal that they have left, so that they a) will need progressively higher and higher returns on the dwindling amounts (which they have no prospect of getting) or b) they will have to accelerate their eating away at principal until the money runs out.

That will happen at the same time that there will be greater internal conflicts (mostly between socialists and capitalists) about how to divide the pie and greater external conflicts (mostly between countries about how to divide both the global economic pie and global influence). In such a world, storing one's money in cash and bonds will no longer be safe. Bonds are a claim on money and governments are likely to continue printing money to pay their debts with devalued money. That's the easiest and least controversial way to reduce the debt burdens and without raising taxes. My guess is that bonds will provide bad real and nominal returns for those who hold them, but not lead to significant price declines and higher interest rates because I think that it is most likely that central banks will buy more of them to hold interest rates down and keep prices up. In other words, I suspect that the new paradigm will be characterized by large debt monetization that will be most similar to those that occurred in the 1940s war years.

So, the big question worth pondering at this time is which investments will perform well in a reflationary environment accompanied by large liabilities coming due and with significant internal conflict between capitalists and socialists, as well as external conflicts. It is also a good time to ask what will be the next-best currency or storehold of wealth to have when most reserve currency central bankers want to devalue their currencies in a fiat currency system.

Most people now believe the best "risky investments" will continue to be equity and equity-like investments, such as leveraged private equity, leveraged real estate, and venture capital, and this is especially true when central banks are reflating. As a result, the world is leveraged long, holding assets that have low real and nominal expected returns that are also providing historically low returns relative to cash returns (because of the enormous amount of money that has been pumped into the hands of investors by central banks and because of other economic forces that are making companies flush with cash). I think these are unlikely to be good real returning investments and that those that will most likely do best will be those that do well when the value of money is being depreciated and domestic and international conflicts are significant, such as gold.