Shard Capital

MONTHLY REVIEW – JUNE 2024

OUR PERSPECTIVE

"THE EXPERIENCE WHICH WE HAVE HAD OVER THE LAST FEW HUNDRED YEARS FURNISHES ALMOST CONCLUSIVE EVIDENCE THAT ALL THE GREAT INFLATIONS WHICH WE HAVE WITNESSED HAVE BEEN CAUSED BY A DELIBERATE POLICY ON THE PART OF GOVERNMENTS." ~ Friedrich Hayek on inflation in his work "Money, Capital And Credit".

Rather than asking the usual question, we thought we would this month introduce a concept that we define as the Fiscal Age: a period where fiscal dominance will replace the era of central bank control.

Following a decade of monetary experimentation, policy makers and central bankers are unlikely to return to the world of negative or zero interest rates policy (NIRP / ZIRP) any time soon. However, the era we entered during the pandemic carries significant implications for investors and society as a whole. It is specifically the misaligned incentives and resulting policies that poses the greatest risks, perhaps most notably to the income dependant majority.

For years, central banks held the reins, manipulating interest rates in an attempt to manage inflation and labour market dynamics. The effectiveness of interest rate policy, and central banks generally, to manage the prices of goods and services, not least to impact economic growth, are justifiably being questioned. If anything, we might say the law of 'diminishing-effectiveness' is evident. This, coupled with the growing misalignment between economic reality and political incentives, creates a perilous investment environment.

Economists whose economic philosophies are based on the Austrian School of Economics – which have nothing really to do with Austria – have long warned of the pitfalls of fiat money and excessive money printing. Von Mises, Hayek and others argued that such practices devalue the purchasing power of money and exacerbate the business cycle. In a world already grappling with asset bubbles and unsustainable debt levels, these warnings should resonate more than ever. The risk is that misaligned policy makers desperate for short-term growth, and government officials with populist policies in search for voter support, might further exacerbate existing trends, leading to a reacceleration in inflation and the erosion of purchasing power.

Another economic giant, Joseph Schumpeter, who coined the term and theory of creative destruction, also warned against government overreach. He argued that innovation disrupts existing industries, creating opportunities while causing temporary economic dislocation. While central banks may attempt to smooth these cycles, Schumpeter believed that creative destruction is vital for long-term growth. In a ZIRP and NIRP monetary regime, creative destruction falls by the wayside, providing a lifeline to zombie companies, in turn allowing inefficiencies to persist. In the fiscal age this characteristic will likely persist. Policymakers might be tempted to prop up failing industries, hindering this crucial process and stifling economic dynamism.

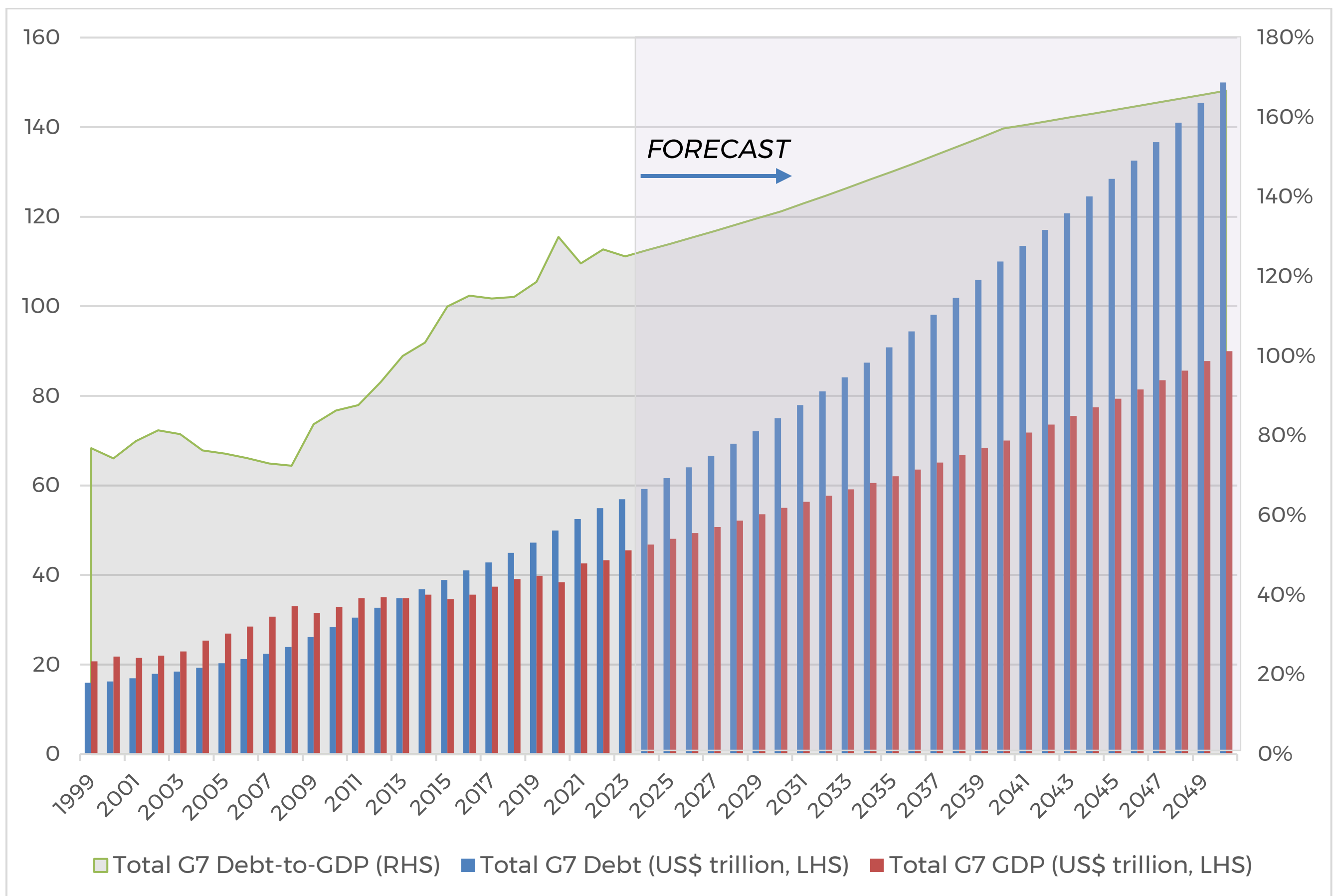
But why this misalignment? In a democratic governance regime, politicians facing sluggish growth and social pressures will prioritise short-term political gains over long-term economic health. Their objectives are to the get re-elected. They will do what they have to. It is

human nature. This could lead to excessive spending, further inflating the debt burden, and rampant money printing to service it. The consequences of such misalignment are dire.

Ultimately fiat currencies will face the spectre of hyperinflation as governments resort to the printing press to finance their ambitions and fund burgeoning liabilities. This erodes the purchasing power of savings and might spark a flight from cash and a desperate search for alternative stores of value. Imagine a scenario where society lose trust in the value of our money – the Pound Sterling, the Euro or the US Dollar…supposedly stores of value – the very foundation of our financial system.

Investment strategies will need to adapt to this new reality. A new playbook is required. Commodities and real assets might offer some refuge, but government intervention, trade barriers and price controls could distort these markets. Active management and security selection will be paramount. Companies demonstrating strong fundamentals and pricing power positioned to weather the storm will no doubt benefit. Whilst industries reliant on cheap credit or government handouts could be vulnerable. The bond market is particularly exposed as investors are not protected against inflation, nor rewarded for the interest rate and credit risk they are taking. Gold on the other hand, will play the role it has for the last 5000 years: a hedge against political misalignment, social unrest and, if nothing else, a hedge against fiat devaluation.

Exhibit 1: Growth in government liabilities is set to significantly outpace growth in GDP. Increasing deficits will likely be funded through fiscal means, which will in turn create an unstable inflationary environment, likely accompanied by lower capital market valuations and increasing volatility. How governments manage ever increasing budget deficits as expenses outgrow tax revenues will be a key factor in the Fiscal Age.



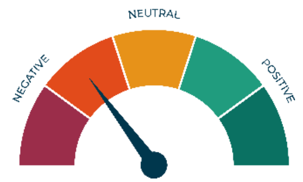
Source: CBO, IMF, OECD, ONS, World Bank, Shard Capital, as at Dec 2023

MARKET SNAPSHOT

	Index Series	Currency	Last Price	June	YTD	1 Year TR
			As at:	30/06/2024		
EQUITIES	Bloomberg World Equity Index	USD		2.21%	11.38%	19.51%
	Bloomberg World Equity - Growth	USD		3.85%	14.15%	22.25%
	Bloomberg World Equity - Value	USD		-1.32%	5.28%	12.72%
	Bloomberg UK Equity Index	USD		-1.69%	7.07%	11.75%
	Bloomberg US Equity Index	USD		3.53%	14.70%	24.46%
	Bloomberg Europe ex-UK Equity Index	USD		-2.28%	6.40%	12.49%
	Bloomberg Japan Equity Index	USD		-0.83%	7.05%	13.95%
	Bloomberg Asia ex-Japan Equity Index	USD		2.89%	7.60%	11.04%
	Bloomberg China Equity Index	USD		-2.40%	3.15%	-3.31%
	Bloomberg Emerging Market Equity Index	USD		3.04%	6.24%	10.84%
FIXED INCOME	Bloomberg Global Aggregate Index	USD		0.14%	-3.16%	0.93%
	Bloomberg US Treasury Index	USD		1.01%	-0.86%	1.55%
	Bloomberg US Treasury Inflation Protected Securities	USD		0.78%	0.70%	2.71%
	Bloomberg US Corporate Bond Index	USD		0.64%	-0.49%	4.63%
	Bloomberg UK Gilt Index	GBP		1.32%	-2.88%	4.67%
	Bloomberg UK Govt Inflation-Linked Bond Index	GBP		0.13%	-4.25%	-0.75%
	Bloomberg Sterling Corporate Bond Index	GBP		0.70%	-0.35%	10.55%
	Bloomberg Euro Agg Government Bond Index	EUR		0.23%	-1.85%	2.62%
	Bloomberg Euro Govt Inflation-Linked Bond Index	EUR		-0.84%	-2.18%	-0.11%
	Bloomberg Euro Aggregate Corporate Bond Index	EUR		0.66%	0.54%	6.45%
	Bloomberg EM Hard Currency Aggregate Index	USD		0.63%	2.22%	7.95%
	Bloomberg EM Local Currency Govt Index	USD		0.47%	-0.59%	3.78%
CURRENCIES	GBP Trade Weighted Index		£ 75.31	0.08%	2.25%	1.18%
	USD Trade Weighted Index		$ 91.56	0.85%	4.78%	3.63%
	EUR Trade Weighted Index		€ 124.03	-0.27%	0.72%	0.16%
	JPY Trade Weighted Index		¥ 79.79	-1.97%	-11.32%	-9.77%
COMMODITIES	Gold Spot $/Oz	USD	$ 2,324.03	-1.14%	12.65%	20.94%
	LME Copper Spot ($)	USD	$ 9,455.98	-8.91%	11.72%	14.49%
	Oil - Brent ($)	USD	$ 85.60	4.88%	11.11%	14.29%
	Bitcoin ($)	USD	$ 62,887.59	-7.17%	47.94%	105.56%

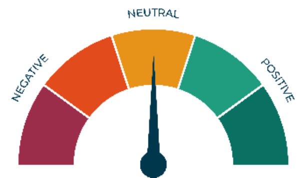
Source: Bloomberg L.P., 30/06/2024

EQUITIES



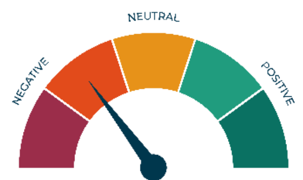
Over the course of the month the biggest winners were Apple, Nvidia and semiconductors generally, and Asian economies, including Taiwan, South Korea and India. Secular trends remain in place: the miracle that is India, the revival of Japan, the convergence of AI and the Life Sciences industry, to name a few. However, at headline level, equities remain expensive, driven by US equity valuations and we retain our UW.

FIXED INCOME



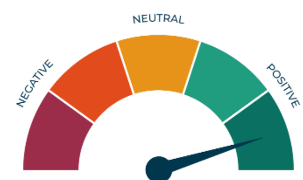
The markets optimism in the soft-landing narrative is very much dependant on rate cuts, which we believe is unlikely in the absence of a significant deterioration in economic activity. Any slowdown is likely to be driven by significant deterioration in the labour market or a credit crisis. This implies rate cuts and sentiment is more dependent on inflation data. Whilst the latest print was encouraging and showing inflation trends continue towards central bank targets, the risks of inflation reaccelerating are rising. We like the absolute yield on offer on shorter-dated Government bonds, including Inflation-linked Government Bonds. Credit spreads remain very tight and given the significant rise in interest rates and material refinancing risks, credit markets are not being priced accordingly and we remain underweight.

REAL ASSETS



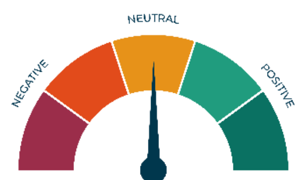
Whilst oil was up mid-to-high single digits, most other commodities finished the month flat or down. A weaker than expected inflation print and risk-off sentiment generally weighed on commodity prices over the course of the month. We retain significant gold exposure, which was flat over the month. As previously mentioned, we see $2000 as the new floor, with the price in a strong medium-term up trend, the upside could be very significant. Given the aforementioned Fiscal Age we are entering, alongside election risks across the global this year, we especially like the hedge it provides against medium-term monetary devaluation and shorter-term event risk.

SPECIALIST STRATEGIES



Our specialist strategies continue to play a significant stabilising role within our portfolios. Our managed futures & trend following exposures had a varying month as those with significant exposure to fixed income trading strategies got caught in the bond volatility. We retain significant conviction in their role in our portfolios. As mentioned previously, we specifically retain conviction in the sustainability of the competitive advantage of the strategies we own, and the alignment of interest between the managers, and us and our clients. As for private markets exposure, we retain limited exposure to these, both credit and equity, given our concerns regarding debt and the refinancing cycle.

CURRENCIES



We remain broadly neutral on currencies. On the margin we note that growth and inflation expectations could support a weaker USD, whilst interest rate differentials are pulling it upwards. The US Dollar remains the global reserve currency of choice, and in a severe market dislocation, we expect it to strengthen despite high relative exchange rate values. We retain our positive view on the Japanese Yen, which we believe is undervalued and offers significant optionality alongside the potential catalysts for a revaluation.

CONTACT US

For further information on any of our services, or if you would like to arrange a meeting with an investment manager to see how we can work with you, please get in touch.

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