►On Target

Martin Spring's private newsletter on global strategy

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Easy Money… a Future Hard Landing

We all know that central banks have been flooding the world with money on a mind-boggling scale. Over the 15 years to 2018 they "printed" electronically about $22 trillion to buy government bonds and other securities. And they're persisting with this unconventional bubble-inflating policy.

Their aim has been to ward off recession and stimulate economic growth. They've been partially successful. But the unintended consequence is that they've been building a great pile of increasingly dangerous dynamite in the world's financial system. And creating distortions that are having very painful effects on savers.

The most visible evidence of this is in the bond markets. More than a quarter of all the world's government and corporate bonds listed on public markets -- some $17 trillion worth -- are now trading at negative yields. That means that, held to maturity (when the capital originally borrowed has to be repaid), their value will be significantly less than their market value today.

Instead of earning income from their investments, holders are now paying borrowers for using their capital. All of Germany's government bonds, for example, are now trading on negative yields. In Denmark a bank has launched the world's first negative-yield mortgage – effectively it is offering to pay a borrower to take its money and be rewarded for paying back less than the loan.

Why on earth are so many investors putting their money into securities, or keeping their capital in them, that means they must lose if they're held to maturity?

They are in four groups:

► Firstly the central banks, who don't care if they eventually lose money. They "print" as much of that as they want, with nothing limiting their capacity to do so.

► Secondly, financial institutions which have to invest safely their clients' savings for the future… an avalanche of cash flooding in every month. If yields of bonds that they already hold go negative that's not an immediate problem as they're still receiving interest at the rate at which they were originally bought. Capital values are higher.

There is a negative risk longer-term as prices will fall to maturity values, but that's not an immediate risk. The current problem is where to make new investments with yields so unattractive.

► Thirdly, individual investors prepared to pay a small fee for the security of having their capital cared for.

► Fourthly, speculators who see opportunities to make profits that are seemingly low-risk compared to, say, those from equities, because the bond markets (much more important than equity markets) are underwritten by the central banks. “To buy what central banks are buying or signalling they will soon be buying… is… the greatest front-running opportunity in recorded history,” as it’s been put.

Most of those buying – or holding on to – negative-yield bonds are confident that they can sell them if it becomes apparent that prices are going to fall. The risk – and it’s a big one – is that the markets are hit unexpectedly by another major financial crisis like 2007/8. Markets could suddenly evaporate as buyers disappear, leaving would-be sellers to sell… their profits wiped out.

David Stockman, an American commentator, gives an interesting example of how investors can be lured into high-risk securities.

In September 2017 Austria offered investors the opportunity to buy a new issue of its bonds yielding 2.1 per cent, but maturing in 100 years. They were asked to risk their capital in a state that had been twice almost wiped out in the past century (by Hitler in the 1930s and Stalin in the 1950s), which had suffered annual inflation of about 2 per cent over the past 70 years, with a welfare state that keeps growing and taxes that keep rising. Why investors would buy a 100-year bond “with the prospect of virtually no yield after inflation and taxes, and a reasonable doubt whether the Austrian state would survive to 2117, was… a bit of a mystery,” he says.

But the issue was a success – and the bond has been rising in price ever since. By last month the bond was trading at 186 per cent of its issue price and offering a yield to maturity of well below 1 per cent. If central banks continue to drive down bond yields by say another 50 basis points over the next year, then the Austrian bond’s value could easily balloon to perhaps 2½ times its issue price.

That’s a big capital gain potential for speculators. But would serious, conservative investors buy such stuff?

“Everywhere and always,” Stockman warns, “bonds will return to par [the price at which they were issued] at redemption. Collectively the traders and speculators who today are pleased to call themselves investors are going to lose their shirts. That much is guaranteed.

“Only thing at issue is how soon the bloodbath comes, and how violently the financial terror spreads from the bond markets to the rest of the financial system.”

Boris’s Revolutionary Plan for British Politics

Whether or when Brexit (Britain’s departure from the European Union) happens is still very uncertain. There is little chance of an agreed deal between London and Brussels before the October 31 deadline. That’s when Brexit will occur automatically (the default outcome) unless two things happen – the British government asks the EU for yet another delay, and the EU agrees to grant it.

A law passed by the British parliament last week instructs prime minister Boris Johnson to request such a delay. Johnson says in emphatic terms that he won’t do so. So we must be prepared for a major legal battle between parliament and

Johnson, even a constitutional crisis, reaching its peak in the few days between a deadline set in the law (October 19) and October 31.

Whatever the outcome, what does seem certain is that there will be a general election in November/December as the ruling Conservative party no longer commands a majority in the House of Commons. The key issue will be Brexit, whether or not it has happened by then. But all contesting parties will seek to fight on other major issues.

Does Johnson have a grand strategy to win the election and follow through with a rebuilding of his party's mass support?

Political strategist John McTernan, who has been an adviser to several Labour governments (and therefore is no Conservative), suggests Johnson will show "bold leadership" not only to recapture the support of voters lost by the party's shambolic leadership under David Cameron and Theresa May, but also to build a new core support among millions who feel they've been abandoned by Labour.

It seems likely that Michael Gove, the ablest administrator in the Conservative leadership, will be given the key role in implementing the new strategy.

If Johnson is able to deliver Brexit – "liberating" the UK from Europe, from the Brussels bureaucracy. European laws and courts, and from uncontrolled access for European immigrants – it will be his play to the nationalist instincts of the English lower classes.

That will be especially true in the great cities of the North and Midlands, Labour strongholds that have long felt neglected by the metro-elite in London, the heart of government. They've never recovered from the devastation by globalization of their traditional manufacturing industries.

By delivering Brexit, [or fighting hard to try to do so], Johnson "will have the largest amount of political capital a Tory leader has had" with conservative voters "since Thatcher won the miners' strike."

This will give him almost total political freedom. He will use it "to marshal new constituencies" among all "patriots" who worry about Labour leader Jeremy Corbyn's "uncritical approach to Russian president Vladimir Putin. Expect a large increase in defence spending."

But his grand strategy will embrace other classes, other political interests, with major initiatives:

► Big infrastructural projects such as high-speed rail links and new bridges across the Thames and the Mersey rivers.

► A revival of state-financed development corporations to transform the "left-behind" North.

► A massive public-sector house-building programme.

► Policies to embrace new priorities. McTernan says we can expect "legislation on animal rights and agricultural subsidies for carbon-neutral means of production… Don't be surprised if the legalization of cannabis moves closer – young people need a reason to vote Tory."

The key elements of the Johnsonian strategy will be "intervention, infrastructure, optimism, patriotism."

Evaluating a Buy-to-Rent Condo Investment

By Peggy and Chad Creveling

The following case study by Creveling & Creveling Private Wealth Advisory is a fictitious example designed to demonstrate the type of financial decision-making required to achieve financial security...

The Situation

To help invest for their retirement, Bill and Emily are considering using their cash savings to purchase a new condo in the Asian city where they live, and then renting it out to other expatriates. Purchasing the condo would take up a considerable amount of their retirement savings, and they want to make an informed decision before going ahead with the plan. However, they are not sure how to evaluate an individual property as an investment, nor how to compare it to other possible investment options.

Their real estate agent has told them they could get a gross rental yield of 5 to 6 per cent. Right now, their only benchmark for comparison is the 1 per cent a year they are receiving on bank deposit. In comparison, the agent's 5 to 6 per cent sounds attractive. However, the bank deposit is low risk and easily accessed, whereas there are a number of risks in the condo investment. And it could not be quickly liquidated.

Additionally, Bill and Emily are not sure if 5 to 6 per cent is realistic. For one, it doesn't factor in the costs they face in purchasing and maintaining the condo. They are also concerned that market oversupply may make it difficult to find a good tenant at the rental rate that the real estate agent is assuming. Some of their friends have lost money on real estate investments, and so they want to do their homework before making the decision to buy.

To make an informed decision before investing in a buy-to-rent condo, Bill and Emily need to compare their expected long-term return and risk in investing in the condo against their other options, including bank deposits and other types of investments. To do this, they will need to collect some data and run a comparative analysis.

Estimating the Return on a Rental Condo

Bill and Emily will want to calculate an expected net return on the money they would invest in the condo after all expenses are considered. They will need to consider all income as well as all costs, including closing costs on the purchase, expenses associated with renting and maintaining the property, and property taxes (if applicable).

The condo they are most interested in purchasing is a new two-bedroom unit with a price equivalent to USD 250,000. Some similar condos in the same building have recently rented for $1,000 per month, so they have decided to use these figures as a starting point. Additionally, Bill and Emily do some research and make the following assumptions:

Assumptions	**Estimated Amount**	**Notes**
Purchase price	250,000	Translated from local currency equivalent
Closing costs, % of purchase price	5.0%	Real estate agent, transaction and legal fees
Rental rate	1,000	Per-month rental rate of similar condos in the building
Occupancy rate	91.7%	Average 11 out of 12 months each year
Rent price inflation rate	2.0%	Average per year
Rent cost inflation rate	2.0%	Average per year
Building maintenance fees	1,200	$1 per sq metre x 100 sq metres x 12 months
Agent booking fee	1,000	One month's rent per year
Contents and liability insurance	1,000	Cost per year for fire and liability insurance
Annual wear & tear (WAT)	500	Minimum cost of annual repaint
Major maintenance fund	2,500	Average of 1% of total value per year — budgeted for major maintenance and appliance replacement over time

Net rental yield: Using the above figures, Bill and Emily estimate that their annual net rental income would be about 1.8 per cent a year, after all costs (building fees, standard wear and tear, vacancy rates, and occasional major maintenance) are considered This is considerably less than the gross rental income of 5–6 per cent a year that the real estate agent indicated. This is also a pretax figure. At this point, Bill and Emily believe that if they figure in depreciation costs, they may not have to pay income tax on their investment. However, if they hold the property long enough or if the tax code changes, they may also owe some tax on the rental income.

Price appreciation: Bill and Emily are unsure of how the value of their condo may change over time. Originally, they thought they could make a good return when they sell, especially since the asking prices of new property projects being launched in the city have been steadily increasing over the past few years. After researching the market, however, they have concluded that secondary market prices have not done as well — buyers seem to prefer new buildings, there are relatively few resale transactions, and many buildings are not maintained well after a few years.

They decide they would plan to sell their unit in five years before it begins to look shabby, and hope that its value would at least keep up with the expected local wage inflation rate of 2 per cent a year. After closing costs and tax on the gain, their total return on investment (net rental income + appreciation) would average 1.6 per cent a per year.

Risks to Condo Investment

Next, Bill and Emily will need to consider what risks they may be taking in purchasing the condo. Some of these include risks to the return estimate they calculated, risk from holding most of their savings in one undiversified investment, and risk associated with holding an illiquid asset.

Risks to return calculation: A number of risks could result in the actual return that Bill and Emily receive being lower than the figure that they have calculated.

For example, given their concerns about market oversupply, one area they will need to consider is whether the rental rate they are expecting could come under pressure, and if the vacancy rate of one month per year is realistic. Even relatively small changes in these assumptions would lower the net rental yield and overall expected return.

They will also need to consider whether their cost assumptions are realistic.

Finally, if property prices are in a bubble or if their building is not well-maintained, they also have to consider whether their condo can be sold at a gain in a couple of years. It is possible that their overall return on investment could be negative.

Undiversified risk: Bill and Emily will also need to consider whether they can afford to effectively "hold all of their eggs in one basket" in the form of using a large portion of their savings to purchase a single undiversified asset. Being undiversified means they face a greater risk of loss than if they were diversified, but they do not enjoy a greater expected return to compensate them for this risk.

Illiquidity: Finally, Bill and Emily will need to consider the consequences they may face in purchasing an illiquid asset. For example, selling their unit could take anywhere from 3/4 months to two years, depending on market conditions. They would not be able to sell just a few shares in the condo if they needed to raise cash — their only option would be to sell the entire unit. They are unlikely to be able to sell it quickly unless they are willing to take a substantial price cut.

Comparison: Rental Condo vs. Diversified Portfolio

Bill and Emily are considering the rental condo investment because of the low interest rate they are receiving on their bank deposits. However, there are other investment options that they could consider besides bank deposits or the condo.

One choice that could make sense would be to construct a well-diversified global investment portfolio that holds low-cost exchange-traded funds (ETFs). This would give them exposure to a variety of global assets in small amounts, including stocks, fixed income, and alternative investments such as REITs, commodities, and specialized bond funds.

Portfolio expected return: While the market value of such a diversified portfolio may vary from year to year with market fluctuations, over time its value will increase. Depending on their proportion of risky assets, a well-diversified portfolio might have a long-term average expected nominal return of 6 to 7 per cent a year (assuming 2 per cent annual inflation), based on historic averages.

Depending on their nationality, country of residence, and where they intend to hold the portfolio, they may be subject to tax on their returns.

Portfolio risk: Risks involved in investing in a diversified portfolio include short-term market volatility, which can affect the value of the portfolio from year to year.

Many of the risks that are associated with investing in the condo unit aren't relevant to investing in an investment portfolio. In particular, the investment portfolio is diversified, so the chances of the value of the portfolio being much lower than expected over the long run are lower than with the condo investment. Additionally, the portfolio is a liquid asset that can easily and quickly be sold in part or even in whole if needed.

For the condo to make more sense as an investment, the expected return that Bill and Emily have calculated ideally should be significantly greater than other options, such as the diversified portfolio. This is both to compensate them for the possibility that their return could be significantly lower than they expect, and also for the time that they would need to spend managing the property.

Additionally, as this investment will make up a significant portion of their personal retirement savings, it may not make much sense for their particular situation even if the expected return was substantially higher. If they want to include property in their investments, they may wish to look for a different way to do so. They could purchase a stake in a property partnership, property fund or REIT with a better risk-return profile.

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America Is Losing Mideast Allies

Mainstream media are strangely reluctant to report the major changes in the Mideast that are strengthening Iran's negotiating position relative to its enemies.

According to Yossef Bodansky of GIS/Defense & Foreign, both Saudi Arabia and the United Arab Emirates are engulfed in a major crisis in their relations with the US.

Arab leaders urged America to strike Iran hard in retaliation for shooting down the Global Hawk drone. Trump refused to do that. Both the Saudi crown prince, Mohammed bin Salman ("MBS") and the crown prince of Abu Dhabi, Mohammed bin Zayed ("MBZ"), considered the last-minute cancellation of the retaliatory strike a personal affront and humiliation.

Both have for a long time suspected that the US has been hiding major matters from them. That got confirmed last month when the US ambassador to Iraq, Matthew Tuellier, publicly admitted: "We have direct communication channels with Tehran." Bodansky says "both Riyadh and Doha were stunned and humiliated, because the Trump White House did not bother to inform them of the Baghdad back-channel… while pressuring them to avoid all contacts and negotiations with Iran."

However the deterioration in relations between the US and its anti-Iran allies goes far beyond the current tiff.

Reaching out to China

MBS, MBZ and most other major Arab leaders have become increasingly convinced that, notwithstanding the bluster and assertiveness of the Trump administration, the US will sooner or later withdraw from the Persian Gulf and the greater Mideast. So they have decided to downgrade the traditional close ties with America. They are now reaching out to China to provide a substitute strategic umbrella.

Beijing has offered to oversee and guarantee the establishment of a regional collective security regime, based on Russian proposals and ideas first raised in late July. This option "is now getting considerable positive attention from both shores of the Persian Gulf… In early August the Gulf sheikhdoms and Saudi Arabia agreed to seek and accept the PRC [Chinese] umbrella as proposed to them, and so notified Beijing."

Other important developments are these…

► The UAE is switching from hostility to Iran to a policy of good relations. On July 26 an Emirati "peace delegation" arrived in Tehran for secret discussions about a "rapprochement" in bilateral relations and new security arrangements in the Persian Gulf and Yemen (where the UAE is withdrawing its military support for Saudi Arabia in its war against the Iran-supported Houthi rebels). On July 30 the UAE dispatched a high-level Coast Guard delegation to Tehran.

► Pakistan, Saudi Arabia's longtime ally, has switched sides on Iran. It is now expediting the shipping of huge quantities of Iranian gas via interconnected pipelines from the Fars fields through Pakistan to western China. Both Pakistan and China are openly defying anti-Iran sanctions.

► Following a visit to Russia by the commander of its navy in July, Iran has signed a secret deal providing for a new level of co-operation between the two countries' armed forces. Among other things, the Russians have been given "base-level" installations at several Iranian naval ports and the use of a naval aviation airbase near Bandr-e-Bushehr. Russian technical, logistics and communications personnel will be stationed there as well as Spetsnaz special forces.

On August 3 aides of the Iranian leader Ali Khomanei "conducted sensitive talks with a secret delegation of Russian officials." Tehran wanted to ascertain the

Russian reaction to a US attack on Iran in case of a major escalation. The Russians stated “without equivocation” that an attack on Iran “would be an attack on Russia.”

► On August 6 the Chinese ambassador to the UAE formally informed Abu Dhabi that, should there be a deterioration in the security situation in the Persian Gulf, the Chinese navy will be sent to escort tankers and other commercial vessels. In July Beijing published a new commitment to expand its navy to provide “far seas” capacity, enabling China to “build itself into a maritime power.”

Gold, Bonds and the Markets

Commenting on the recent strong correlation between the two asset classes gold and bonds – both have been rising strongly in value – leading technical analyst Eoin Treacy says it is important to highlight the difference between an acceleration following an already well-established and lengthy bull markets) and an acceleration out of a base formation (gold). “The former is a trend-ending signal; the latter is a trend-beginning signal.”

He describes the acceleration in European bonds, in particular, as being in the mania stage. “Nevertheless there is scant evidence, just yet, [that] the trend has ended.”

Gold is being priced for its safe-haven characteristics at a time when there’s a surge in the supply of bonds. “At the end of its cycle, it will be favoured for its hedge against inflation.”

Asset values generally are surging because monetary policy is easing everywhere at the same time that governments “are lining up to provide stimulus,” while their willingness to devalue their currencies is a central theme. There is clear evidence of a bubble in bonds, and by extension in private equity valuations. Yet there is a large quantity of cash on the sidelines. and globally equity markets are picking up following an 18-month hiatus.

These factors suggest “a bubble is more of a near-term risk than a major decline.”

Look at the facts, says David Rosenberg, chief economist at stockbrokers Glaskin Sheff… Gold prices surging. Bond yields plunging. Central banks in a confused state. The breakdown of the world order. A trade and currency war going on between the world’s two dominant powers – with no end-game in sight.

“This sounds a lot like the 1930s to me. Back then it became a real war that cost millions in lives. This war won’t cost lives. But it will cost livelihoods.”

His investment recommendation: cash, gold, silver, long-dated US bonds. “Limit your equity exposure to [companies in] non-cyclical sectors with strong balance sheets and reliable dividend/cashflow streams… Most important – be as liquid as possible for the next several months.”

Hong Kong: What Will Happen?

The protests will probably continue for the rest of the year or even longer, concludes a research report by Jefferies.

The investment bank's Christopher Wood says that the Chinese government is most unlikely to give in to the protestors' demand that the restrictive system for electing the territory's chief executive and legislative council -- geared to favour Beijing's interests and its allies in the business elite -- be scrapped and replaced by universal suffrage. This unacceptable demand provides the potential for a protracted standoff.

However, the last thing Beijing wants to do is intervene directly in the territory using the Chinese army to restore order. It's important for its national interest that Hong Kong continues to thrive as Asia's main financial centre. It's also keen that the "one country, two systems" structure succeeds as a model -- to encourage the reintegration of Taiwan.

As for investments in Hong Kong itself, Jefferies argues that its stockmarket has a history of resilience in terms of always bouncing back after crises, and eventually reaching new highs, as it did after the student revolt in 1989, the Asian financial crisis, the SARS medical panic and the global financial crisis.

Tailpieces

Income yields: Because of falling yields on bonds, equities have become very attractive sources of income for those who need it. CNBC recently reported that the average dividend yield of America's 500 biggest listed companies has overtaken the yield on 30-year Treasury bonds.

The attraction of equities for yield-hungry investors is even greater in other countries. In the UK the 100 biggest firms offer an average yield of 5.13 per cent, ten-year government Gilts only 0.48 per cent. In Australia an equivalent comparison is 4.64 to 0.87 per cent. In Europe the 50 largest companies have an average dividend yield of 3.65 per cent while the most favoured bonds, the German Bunds, offer a negative yield of 0.69 per cent.

Who favours gold? For many years it's been Asians, while Americans and Europeans largely ignored the yellow metal's investment attractions. No longer. I see that in August, when holdings of gold-backed ETFs and similar products attracted $6 billion of inflows, only nine tons went into funds listed in Asia, but 78 tons were added in North America, 33 in Europe.

Food for thought: Commenting on investment group GAM's abrupt exit from the bonds of London-list litigation services company Burford Capital, the *FT*'s Robert Smith asks: "If active managers stampede away in the wake of third-party analysis of existing public information, what value are they really adding?"

Martin

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