► On Target

Martin Spring's private newsletter on global strategy

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Taking Risks Into Account When You Invest

Risk is obviously a most important factor to be considered when you make any investment decision. And some kinds of risk are not obvious.

The biggest risk is that you will lose your capital entirely, and with it any income from that capital. For practical purposes, you only face that risk if you invest in some private business venture, although it sometimes happens that holders of a stock-exchange-listed share have been wiped out.

The next largest risk is that the capital value of your investment may fall substantially, so when you come to redeem it – turn it back into cash – you have to take a capital loss that offsets or surpasses any income you have received.

There is a significant risk of this kind with ordinary shares, units of mutual funds/unit trusts and exchange-traded funds, real estate, and collectables. But it also affects other assets, such as preference shares, debentures and loan stocks, to a lesser degree.

There is also the risk that your income from investments may fall. This is most obvious in the case of ordinary shares, where the cutting or even passing of a dividend may occur when business is bad. But it also affects other investments. For example, if interest rates fall, so will your income flow from certain investments.

Then there is the inflation risk. If the purchasing power of your currency should decline at a faster rate in future than it has in the past, growth assets such as shares are likely to adjust upwards to accommodate the change. But, like acid, the higher inflation could eat away at the purchasing power of your income and of capital committed to fixed-income investments.

There are statistical techniques for measuring risk, but they require expert knowledge.

If the capital value of any asset has dropped sharply at any time over the past 20 years there is a real danger that a fall at least as great could occur again in future. However, income-producing assets such as ordinary shares do not usually produce declines in their income to the same extent as their capital values.

Generally speaking, the higher the risk you face, the higher the return you can obtain from investing your money. Only you can decide how much risk you are willing to accept, Obviously the stronger your personal financial position, the greater the risk you can afford to take with at least some of your capital.

A traditional approach to lessening your exposure to risk is to "spread" it by investing in diversity. For example, you might contribute to a retirement funding plan, buy a property on mortgage, have a share portfolio, keep an "emergency fund" in savings certificates, accumulate gold coins. Setbacks in one or more of these investment areas should then be offset to some extent by advances in other areas.

Bounceback from the Pandemic Economic Crisis

There are reasons to expect strong economic recovery from the global pandemic as many households maintained their incomes but were not able to spend so much, increasing their savings significantly, says NTAsset's chief Kenneth Ng. In advanced economies huge potential spending-power has been accumulated. We can expect much if not all of it to be spent.

Thanks to prodigious government handouts, in the US disposable incomes were 6 per cent higher last year even though private consumption contracted by 4 per cent. In Britain incomes were up slightly but consumption contracted sharply. In Germany there was no fall in incomes but consumption was squeezed down 6 per cent.

Higher-income families emerged stronger from a difficult year than lower-income households which were more likely to be hit by loss of jobs or income cuts. Most lower-income people worked in sectors such as construction, personal services and agriculture – jobs less adaptable to remote work compared to higher-income occupations.

Since most high-income households were able to continue working – mainly from home – they accumulated greater savings while their consumption was restricted by the pandemic. The savings rate of American families more than doubled last year, almost all of the increase occurring in high- and middle-income households.

The decline in consumer spending last year was mainly in the service industries such as restaurants, hospitality, tourism and entertainment, which set the 2020 recession apart from previous economic contractions.

China emerged from the pandemic faster and in much better shape than America and Western Europe. Its more effective response to the health crisis minimized the scale of disruption and in turn led to a shorter tail of side-effects. In addition, because of a lower share of private consumption in economic activity, and a lower share of services – 54 per cent of GDP versus 69 per cent in the US – the Chinese economy was less exposed to a services-driven consumption shock.

Once restrictions have been lifted, recovery in consumption has been strongest for luxury brands. In China, as soon as affluent consumers regained confidence, they did not hesitate to spend.

Central Bankers Trim Policies to the Winds

A new form of political and fiscal activism is now in evidence worldwide -- a trend which has been accelerated by the pandemic, says Jefferies' global head of equity strategy Chris Wood.

This was on show in the G7 meeting in the UK with the relevant governments signing up to what could be described as "a new social democrat consensus to spend taxpayers' money to address fashionable concerns. The message sent is essentially that no amount of spending is too much if it is to address the two perceived ills facing modern mankind; namely global warming ('the race to zero') and inequality ('levelling up)".

If this is the overriding political context in the Western world, it is a consequent political reality that the central banks will be expected to finance such spending if additional tax revenues are not forthcoming.

The central bankers are in the process of becoming less important in the sense that, when the pressure is on, they will be forced to accommodate financially the need for more government spending.

This can be seen in the mission creep politically-motivated central bankers have begun to embrace in their desire to re-invent themselves and thereby remain relevant. Already. having faced legitimate criticism from both the political Right and Left for driving inequality via their quanto easing policies, they naturally want to change the narrative by linking monetary policy to the fashionable green agenda in some form or other.

Reasons for Optimism about Commodities

Are we on the threshold of a new commodities super-cycle? Liechtenstein investment consultancy Incrementum says a number of factors suggest we are…

► Commodities have been in a bear market for ten years, resulting in a significant lack of investment activity and declining production volumes. [This suggests there could be insufficient capacity to meet any strong pick-up in demand].

► Pent-up demand from months of pandemic shutdowns should stimulate demand once economies rebound fully. The increasing focus on fiscal stimulus (infrastructure projects, and so on) will add additional impetus.

► Institutional investors are still heavily underweighted or not allocated to commodities at all. However commodities – and real assets in general – will resume their historical role as safe havens.

► Growing inflation concerns will continue to provide a tailwind.

► Rising geopolitical tensions will encourage and challenge resource nationalism and geopolitical risk premia.

► The US dollar is in a secular bear market. [A weak dollar strengthens demand for real assets such as commodities].

Incrementum says it seems that everything is set for a new secular bull market in commodities. According to a study of long-term cycles by Ned Davis Research, the average price increase in such bull markets is 217 per cent. As the Bloomberg Commodity Index is currently only 50 per cent above its low of April last year, when it marked an 18-year low, the bull market could still be in an early stage of development.

However in the short-term, markets have been softening (except for oil) for a couple of months. This has given investors a good opportunity to place long-term bets.

Low Interest Rates Favour Growth Stocks

Growth stocks will be the biggest casualties if conditions change that lead to higher interest rates, as they eat into the value of earnings that lie further in the future – something that disproportionately hurts companies whose most profitable years are a long way off.

Eoin Treacy says low interest rates favour growth at the expense of value because expectations for future potential are stretched to the point of incredulity the longer an easy money regime persists. When interest rates change direction the enthusiastic outlook for valuations is harder to justify and the relative attraction of reliable earnings is burnished.

However, it's new-generation stocks that are now making little or no profits at all. The established giants… Big Tech… are well-positioned to ride the global economic recovery, says the *FT*'s Richard Waters.

"Strong secular growth trends that have underpinned them – the shift to digital advertising, the rise of e-commerce, the remaking of infotech through cloud computing – have room to run. The big platforms promise reliable, double-digit earnings growth."

Protecting Your Wealth During A War

In Barton Biggs' book *Wealth, War & Wisdom* he makes the case that to protect your capital during a war, investors need to own diversified portfolios of stocks and property in safe regions. The book chronicles the experience of investors during the Second World War whose wealth was destroyed and why. And what they could have done to protect their wealth.

Biggs comes to the conclusion that the following asset classes were best at preserving wealth, ranking from best to worst:

Survival goods: Prices for daily necessities shot up during the war, so the people who got rich were often the black marketeers. Theirs was the most lucrative profession and the best source of wealth What black marketeers did was hoard survival goods such as clothing and food and then sell them at high prices to desperate fellow citizens. Then they used their black money to buy and hoard gold.

In Japan, people became increasingly desperate as the war progressed. Becoming cold and hungry, paying up for clothes, food and whatever other survival goods they could get their hands on. Even selling land at fire-sale prices in order to survive. Biggs tells stories of people involved in the sourcing of black market construction material for the rebuilding of bombed out cities, making fortunes in the process.

After liberation, known black marketeers were often physically abused and their property seized, especially in Italy. But others managed to use their ill-gotten wealth to buy real businesses after the war. In the end, black marketeers ended up ahead of almost everybody else.

Art, gold and jewellery: Gold and jewellery is portable, liquid and easily protected. Throughout the early 1940s it remained easy to transfer such assets to Switzerland from almost anywhere in Europe. So they played a crucial role in preserving wealth for anyone who stayed in an occupied country.

The difficulty was to hide jewellery from thieves and occupying forces. You could hide it in deposit boxes. But, as happened in France in the early 1940s, banks had to report to the Germans the contents of all safe deposit boxes. They were then transferred to Germany.

Another option was to stash jewellery at home. The downside of keeping valuable items inside your home is that bombing campaigns tend to lead to an increase in crime, as experienced in Britain throughout the 1940s. As Barton Biggs put it: *"war unravels the bonds of civil society".* A rich old lady he knew slept with jewellery instead of her husband for four years out of fear it would be stolen from her.

In Italy, some families banded together, moved their prized possessions to defensible villas in the hills and stood ready to fight for their lives. Desperate groups wandered the countryside searching for loot.

In countries occupied by Germany, informants told German officers where jewellery was stashed and large estates were often ransacked by them. Con artists flourished, often promising to hold jewellery safe on behalf of others, then running off with it.

A safety box outside the country would have kept jewellery safe. But you had to keep it secret. When your neighbours' children are starving they will do anything, - including reporting you to occupying forces.

Jewellery is more liquid than property, so it could readily be swapped for necessities such as food and medicine. At a discount, of course. In an occupied country filled with informers and treachery, you had to watch your back when transacting in jewellery. Or accept a large discount from better-known black market dealers.

In Soviet-occupied countries, soldiers often fancied watches and jewellery and had no qualms murdering to get them. The Red Army was also used by high Soviet officials to help plunder for them. Clothes, cars, fine china, jewellery, art, even grand pianos, were shipped back to Russia. So jewellery did not preserve wealth effectively in countries occupied by Soviet forces.

Keep your wealth somewhere safe… like Switzerland

Art performed poorly as a wealth preserver during the world war. It is vulnerable to destruction by fire, can easily be damaged, quickly plundered, and is difficult to hide. But if you had capital to buy prize works during the war, you would have made a fortune. Keynes famously went on a mission to Paris in the spring of 1940 to buy, to the sound of howitzers, two Cézannes and two Delacroix that subsequently appreciated 40 times in the next four decades.

Overseas assets: These helped preserve wealth, especially if kept in safe jurisdictions such as Switzerland. That was especially the case for individuals in occupied countries, whose domestic wealth was often confiscated by authorities. The key was to keep bank accounts in overseas countries secret - from tax authorities and even from friends and family.

That said, getting money out was not always easy, as exchange controls and taxes often ate up a large portion of the capital. For example, by the end of the 1930s Jewish business owners in Germany had to accept large discounts if they wanted to sell their businesses - often at 50 per cent of fair value. Even homes had to be sold at discounts. And if they wanted to take money out of the country, they had to pay exorbitant foreign exchange taxes of up to 90 per cent.

Overseas assets were expropriated in some cases. In the early 1940s the UK government became short of dollars for purchases of war materials. So the Chancellor of the Exchequer (finance minister) decreed that British citizens who owned US stocks had to report them to the Bank of England, and they were then sold to fund munitions purchases. The holders of US stocks received a credit in pounds for the proceeds of the sales.

Keeping your foreign assets secret remained key in avoiding confiscation.

Domestic stocks: Shares generally did preserve wealth, but had substantially higher returns if their home country was on the winning side. Losing the war and becoming occupied destroyed equities.

The US stock market was sleepy during the war and stock prices fell to very low levels. Price/earnings ratios stayed low throughout the war. In 1942, the median P/E ratio for 600 representative stocks was only 5.3. Only 10 per cent of stocks traded at a P/E multiple over 10 times trailing earnings.

German shares peaked when the troops reached Moscow

Stocks reflected the success of each country's military advances or setbacks. The British stock market bottomed just before the Battle of Britain in 1940, when it successfully staved off a German invasion. The German market peaked when German troops reached Moscow in 1941. The bottom for the US market in May 1942 coincided with the Battle of Midway, when US forces dealt a decisive blow to the Japanese navy.

So if you own stock in a particular country, you better have conviction that it can win a war and avoid becoming occupied territory.

War spending via budget deficits was generally positive for the domestic stock market in nominal terms (not in real – inflation-adjusted -- terms. From 1932 until the 1937-38 high -- a period of record deficit spending -- Germany was the best

stock market in the world. After a brief respite, the market continued to rally all the way to the Battle of Stalingrad.

This period was characterized by booming military production and eventually soaring profits from low-cost forced labour from France, Poland and Holland. Eventually, however, budget deficits led to a drain of foreign currency reserves that made it difficult to keep up elevated spending levels. Stock prices stopped rising.

After Germany's defeat at the Battle of Stalingrad, the Nazi government finally imposed controls on stock prices for the remainder of the war to conceal the damage. No German could legally sell shares without first offering them to the Reichsbank (central bank), which had the option of buying them at 1941 prices in exchange for rapidly depreciating government bonds. After the war the German stock market collapsed.

Holding stocks through the war required nerves of steel. At market bottoms in the US, the UK and elsewhere, newspaper commentary was consistently negative and pessimistic. In every allied country the market bottomed during major negative events, such as the Dunkirk evacuation and the fall of France to the Nazis.

Likewise, the US stock market bottomed during the Battle of Midway, when newspaper commentary was largely negative. By the time of German surrender at Stalingrad, the US market had already risen well over 50 per cent. So owners of US stocks had to stomach holding these stocks in the face of negative -- or even catastrophic --news.

In Japan, newspapers and radio broadcast only good news about the course of the war. But in elite tea houses in Tokyo, information about the progress of the war was passed around to intelligent observers. Hence, the stock market correctly discounted Japan's prospects of a victory in the war.

The spectacular defeat in 1945

The market fell gradually as the war progressed and collapsed completely in 1945 as Japan was defeated in a final blow. In real terms, Japan's stock prices fell roughly 26 per cent a year from 1940 to 1949. Stocks actually rose despite the spectacular defeat in 1945, but only in nominal… not real… terms.

Stock markets in occupied territories performed poorly during the war. Inflation was almost twice as high in the loser countries than in the countries that managed to avoid the war. The countries at risk of becoming occupied were primarily those in close proximity to Germany, the Soviet Union, Italy and Japan: European countries and Southeast Asia.

During the war a number of stock markets had "permanent breaks" with markets closing and never restarting again. That happened in Hungary, Czechoslovakia,

Romania and Poland when they were taken over by the Soviet Union. Communism is clearly the greatest enemy of wealth preservation.

Private wealth in Singapore and Hong Kong also suffered immensely in 1942-45 when they were occupied by Japan.

Stock markets in countries that were occupied by the Germans also suffered, though some emerged unscathed: including Austria, Denmark and Holland. Many families in Holland were able to keep their homes, land and small enterprises during the entire occupation. But if you were Jewish or classified as an enemy of the state, your property was seized just like in Germany.

France was treated poorly by their German occupiers. The French were deemed not Aryan enough to be treated as equals. French patents, equipment and skilled workers were “temporarily” transferred to Germany, gutting French industry of its intellectual property assets.

Other French companies prospered mightily from military contracts. Inflation was 20 per cent a year during the war, rising to 60 per cent in the years following it, destroying the economy. In France stocks helped preserve wealth somewhat, but in real terms the stock market fell drastically throughout the 1940s.

Real estate: Physical property is a dangerous thing to possess in wartime. It often gets stolen, bombed, destroyed or expropriated.

In Nazi Germany, unless you were Jewish, property rights were generally respected. But in occupied countries of Eastern Europe prime real estate was almost always expropriated. Mansions and similar large properties were often used by the Wehrmacht or confiscated to become country estates for top German officers. In Hong Kong the Chinese found that all their money and homes on Victoria Peak were worth very little when the Japanese occupied the city in 1942.

Hyperinflation caused a particular problem as interest rates rose to radical levels. Landowners who had paid off their mortgages on the other hand survived, and business owners who had repaid their loans became unencumbered owners of real property.

If you left property, getting it back after the war proved to be difficult in many cases. But if local property records remained intact, land often preserved wealth.

UK and US real estate lost value during the war, with prices falling to very low levels. Rents in Wall Street office buildings were as low as one dollar a square foot. A seller of a New York hotel had difficulty finding a buyer, even at a price of only one time annual earnings.

The best investment is a working farm

A working farm often protected both wealth and your life, providing safety and food. There are numbers of anecdotes of affluent French families that shuttered

their Paris houses in 1940 and retreated with their most precious possessions to family farms in the deep countryside, living out the war in relative comfort.

Fixed income securities: Budget deficits and war spending spell disaster for ownership of government bonds. Even in loser countries stocks tends to outperform bonds; bonds tend to beat short-term bills and demand deposits.

Due to Japan's deficit spending on war materials, prices rose 3,280 per cent from 1930 to 1949. Government bonds lost roughly 17 per cent a year. German government bonds saw their purchasing power erode roughly 21 per cent a year in the 1940s. In Italy owners of fixed income securities were even more impoverished by the war -- government bonds lost 27 per cent a year in real terms in the 1940s. Other European countries did not fare much better.

Conclusion: The best *in-country* stores of wealth are non-ostentatious property, such as remote farmland or vineyards. Just make sure the mortgages are paid off. Jewellery and gold are crucial since they can be readily exchanged for daily necessities.

The best *out-of-country* stores of wealth are equities, jewellery and land**.** They should be located or stored in safe jurisdictions, protected by geography, rule of law and a strong national defence. The United States, New Zealand, the United Kingdom and Switzerland come to mind.

Don't be tempted to sell just because news goes from bad to worse. And maintain a well-diversified portfolio of stocks.

Those are the key investing lessons from the Second World War.

When Energy Supplies Fail, Depend on Diesel

The woke obsession with renewables is diverting attention from the need for continuing investment in cheap and reliable fossil-fuel supplies.

John Dizard reports that both California and Texas have moved quickly to install tax-favoured wind and solar generators, but slowly to ensure the flexibility and resilience required to support renewables whose supply is subject to violent fluctuation.

Texas was caught short when a freeze shut down fossil-fuel supplies supposed to make up for fluctuations in wind-power. California has taken for granted hydro-power to offset huge swings in solar and wind output – but drought has spread across the region,

To ensure that they always have reliable power to run their airconditioning and internet services, hundreds of thousands of Americans are now buying backup systems for their homes and businesses. Typically they're spending $15,000-20,000 for a diesel generator; $75,000 for one of the new petrol-powered Ford pick-up with built-in 7.5 kilowatt generators.

Why Gold Got Clobbered Last Month

The US Federal Reserve took markets by surprise with its optimistic outlook last month. Chairman Jay Powell and his fellow central bank officials embraced a far more positive view of America's economic rebound and laid the ground for a turn towards tighter policies.

They have begun talks on reducing the pace of the $120 billion a month bond buying programme and signalled an earlier date for starting to raise interest rates.

The prospect of an earlier-than-expected tightening cycle triggered the biggest daily rally in the dollar since the global shutdown, a big drop in long-end Treasury bond yields to the lowest since February, the biggest drop in prices of gold and some commodities in a year – and a new record high in the NASDAQ share index.

Governments Declare War on Tax Havens

The US is leading a campaign to get all countries to agree to tax companies at least 15 per cent of their profits. Here are those that currently have a corporate rate less than that…

Ireland, Cyprus and Liechtenstein: 12½ per cent. Moldova: 12 per cent. Bosnia, Bulgaria, Paraguay, Qatar: 10 per cent.

Hungary, Montenegro: 9 per cent. Uzbekistan: 7½ per cent. Barbados: 5½ per cent. Bahamas, Bahrain, Bermuda, Cayman Islands, Isle of Man, United Arab Emirates: 0 per cent.

If the global tax reform deal goes ahead with its proposed 15 per cent minimum rate of corporate tax, Ireland will sacrifice a fifth of its corporate tax revenue – its rate is currently 12½ per cent – as well as losing its appeal to international companies as a tax haven.

However, says finance minister Paschal Donohue, Ireland would not lose its other selling points: an efficient economy, the English language, access to the European single market and a highly qualified workforce.

Tailpieces

The problem Harris doesn't want to know about: It's so embarrassing that the pro-Democrat mainstream media prefer to downplay it, or even ignore it. Since vice-president Kamala Harris was put in charge of dealing with the problem of illegal immigrants three months ago, half a million of them have poured in over the Mexican border. And that's just the number apprehended by the Customs & Border Protection agency.

Few are being shipped back whence they came.

Harris is trying to ignore the whole toxic business as the Democrats made such a fuss attacking Donald Trump for trying to stem the inflow. She has made only one visit to the border to see what's happening, carefully choosing a location where inflow is least of a problem.

Gold: Future strength is forecast by Victor Dergunov of the Albright Investment Group for these reasons…

► Catch-up potential. The gold price has a close correlation with expansion of the US monetary base. If gold had matched the 600 per cent expansion of money since 2008, it would now be at $5,600, not below $1,900

► Despite higher inflation the Federal Reserve's Funds rate and Treasury bond yields are likely to remain lower for longer.

► The current monetary, debt, inflation and interest-rate dynamic is favourable for gold.

Renewables: Two-thirds of the renewable energy in the European Union comes from "biomass" – mainly burning wood chips – dwarfing output from wind and solar power. "I hate the images of whole forests being cut down to be put in an incinerator… it's indefensible" says Frans Timmermans, EU vice-president for the Green Deal.

Vaxx deaths: EudraVigilance reports 15,472 deaths from adverse Covid vaccination reactions in Europe as of June 19; the US Vaccine Adverse Events Reporting System logged 5,993 deaths to June 11; the British Yellow Card system reported 1,332 deaths following Covid vaccinations to June 9.

Where to invest: It's time to retreat from cyclical equities and re-focus portfolios on growth stocks, advises Michael Howell of CrossBorder Capital. "Favour tech, healthcare, consumer staples, e-commerce" and some secular recovery themes. "Gold should offer safety; be wary of banks" and cyclical stocks.

Insurance: Following the SARS scare the managers of Wimbledon, the iconic tennis venue, paid £27 million in premiums over 17 years for cover against the risk of a pandemic. What a good bet that turned out to be. Last year it paid out £174 million when the virus forced the annual Grand Slam meeting to be abandoned.

Wisdom: "Do we still think that after over ten years… of the most extraordinary monetary experimentation in history, the lowest interest rates in history and some of the slowest growth in history, that the world's central bankers… have everything under control?" asks *Tim Price*.

Accumulated buying power: Moody's says American families accumulated excess savings during the pandemic equivalent to 12 per cent of GDP.

Martin

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