36 South Views

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Never cross a river that is on average four feet deep when you can't swim…

There are two ways to drown whilst crossing the river.

One, assume that it is 4 feet deep all the way across. It only takes one hole to disappear beneath the water and drown in one's attempted journey to the other side.

The other is for the management of the dam above the river to release a lot of water at once and drown any non-swimmers that do not have flotation devices.

Both are possible…

Wealth accumulation is such a journey.

It is easy thinking to just accumulate assets, invest in equities, private equity, private credit, bitcoin and bonds and just enjoy the casual wade across time to the other side.

Deflation is the equivalent of falling in a deep hole in the river. You may panic and sell, leaving you unable to compound effectively for retirement i.e. reach the other side.

Inflation is akin to the release of water. Central banks have been raising the water level consistently over the last 30 years. Without inflation friendly assets i.e. equities, the same fate awaits your terminal value which, whilst being nominally up, buys you precious little at the time you need it.

All thinking is easy when you ignore reality. When I see millions of investors, encouraged by the fact that the water looks safe (and shallow) are wading into the compounding river with nary a thought to what happens if it becomes too deep. I have a deflationary bust outlook.

Actually, it might be me that is ignoring reality. How is it possible for the equity market to do down when the US deficit went up 1.8 TRILLION since June (according to Macrostrategy 22th November 2023 New Review).

To keep perspective that is over half the entire US budget deficit in 1979!

China, Europe and Japan are following suit...global debt has increased 25% in the last 5 years to 310 trillion.

The equity markets will, like a buoy, just rise alongside the rising tide…

How then can the equity markets be at risk, how can the financial markets in general be "fragile"?

Shouldn't we just go risk on 100% and enjoy the ride?

If this kind of financial alchemy worked, Zimbabwe, Argentina and Venezuela would be the poster children of posterity, but they not. They have collapsed both their financial and their real economies.

It would be unwise to assume that we the remaining, have savvy enough people in the corridors of power to correctly dose the economy with enough credit and money printing to produce the goldilocks economy going forward. Their tools of choice… interest rates and fiscal spending.

Too much fiscal spending and inflation will rear its ugly ahead again closely followed by rising interest rates and a fast or slow deflating credit bubble. Real economy to follow in short order.

We have seen the first chapter in that playbook.

Too little fiscal spending or too tight a monetary policy and the real economy splutters and drags the financial assets with it.

My guess is the former, latest increases in the debt levels notwithstanding the high interest rate burden indicates to me the Government is going for growth at all costs. The scorpion does what the scorpion does. Inflation can and does thrive in spite of a real economy deflation. In fact, it is the hallmark of stagflation, the worst of all inflations.

We are in the end game of a gargantuan credit bubble fueled by a divorce between accountability and responsibility of our respective nation's finances. It has been going on for over 30 years.

The equity markets will surely crash… The only question is UP or DOWN.

Whilst the credit bubble is expanding, the asset markets will rise... and vice versa.

When interest rates started to rise, the credit bubble went into shock sending the real markets into a slow-moving train crash. I can only assume that governments around the world, reluctant to call the party over (so much of their budgets now are deemed non-negotiable), responded with fiscal stimulus to compensate for the monetary call to discipline.

And onward and upwards we continue… to infinity and beyond as Buzz Lightyear famously quipped.

But all credit bubbles eventually implode on themselves, the bigger the bubble the bigger mess.

But old school anecdotal evidence points an earlier rather than later.

Three step and stumble rule …if interest rates go up 3 full percentage points, the equity markets invariably stumble.

The trend to private credit… investors tend to accumulate in the sub asset class most likely to be decimated near the end of the cycle.

The narrowing of the leadership …. The magnificent seven?

The "easy thinking" memes which abound.

The inexorable rise of passive investing… akin to everyone being in the same theatre when someone shouts fire.

The fragile geopolitical situation.

We all have to cross the compounding river or die trying.

Assets which participate to the upside (flotation devices) coupled with downside protection in case of the inevitable holes which will occur along the way seems like a sensible way to cross the compounding river.

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