Competence Finance

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By Alexandre Kateb

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Editorial: Green shoots and animal spirits

Most of the green shoots we are seeing, from PMIs sharply improving around the world following their free fall in March-April, to a surprisingly strong rebound in job creations in the US and marked resilience elsewhere, are false signals

A flurry of economic data is coming from everywhere but the signals are mixed to say the least. As described by Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co. in an interesting market commentary: **"The ongoing surge in COVID-19 cases in many newer U.S. hot spots continues to point to more of a "rolling Ws"-type recovery vs. a continuation of the V-type recovery seen in many shorter-term looks of economic data. Even without a full-scale shutdown of the economy—either at the federal or state/local level—economic activity is likely to be volatile and subject to consumers' and businesses' fears about the virus impacting activity and behavior."** Most of the green shoots we are seeing, from PMIs sharply improving around the world following their free fall in March-April, to a surprisingly strong rebound in job creations in the US and marked resilience elsewhere, are false signals as they relate to a normal "turn of the tide" effect. This is much like seawater withdrawing from the land after a devastating tsunami. As Liz Ann Sonders aptly points out in her commentary, the spectacular turnarounds in some economic indicators should not be misread, as they still remain far below their pre-crisis levels.

In the United States, much of the economic debate has been focused on employment and unemployment figures. The measurement of the unemployment rate continued to be biased downward by people misclassifying themselves as being "employed but absent from work". The jobless rate fell to 11.1% in June from 13.3% in May. Consumer sentiment has also improved. The Expectations Index – based on consumers' short-term outlook for income, business, and labor market conditions – compiled by The Conference Board increased from 97.6 in May to 106.0 this month - which puts in expansionary territory. The data for July will be released at the end of the month. It will be carefully scrutinised in the wake of a surge of coronavirus infections as of late in the Sun Belt States, from Florida to California. As Lynn Franco, Senior Director of Economic Indicators at The Conference Board says "**Looking ahead, consumers are less pessimistic about the short-term outlook, but do not foresee a significant pickup in economic activity. Faced with an uncertain and uneven path to recovery, and a potential COVID-19 resurgence, it's too soon to say that consumers have turned the corner and are ready to begin spending at pre-pandemic levels.**" In the world's largest world - in nominal terms - the consumer is king. Private consumption represents around two thirds of US GDP and it is the real driver of economic growth.

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Ethan Harris (BAML).

So far, the purchasing power of the US consumer has been preserved thanks to the massive fiscal stimulus that has been deployed early on. As stressed by Ethan Harris, Head of Global Economics at Bank of America, in a recent commentary, "**Between February and May, disposable income surged by $900 billion on an annualized basis – the biggest three month increase ever — even though labor income fell by nearly double that amount.**" Consumer confidence has been fuelled by the performance of the stock market which has been driven by the rise of Tech mega caps and other growth stocks at the expense of value stocks and small caps (cf. my analysis on this topic below in the "Chart of the Week" section). For Ethan Harris, "**The hope is that stimulus will continue to support consumer confidence until it becomes a self-fulfilling prophecy: The more people are confident about the future, the more they will spend, which in turn boosts businesses and helps to speed up the economic and labor-market recovery.**" As we can see, at the end of the day it all comes down to psychology and "Animal spirits", a concept emphasised by Sir. John Meynard Keynes almost a century ago. (**By the way** *a very nice book* **dedicated to this topic has been published in 2009 by two Nobel Laureates, Robert Schiller and George Akerlof**).

Looking for Green shoots one might as well go to China where the recovery has been gaining steam although it remains fragile. Chinese 2Q 2020 GDP figure are expected to be released imminently. Bank of China sees China's GDP growing by around 2.8% in the second quarter, after posting a 6.8% YoY plunge in the first quarter. One hint at the ongoing recovery in the world's second largest economy in nominal terms - albeit already the first in PPP terms - comes from copper. The price of this industrial metal, a bellwether for assessing the strength of the global economy, has surged recently on the back of record Chinese imports. Hedge funds are bullish on the red metal which is a critical input for construction and for the manufacturing industry. The Chinese authorities have finally woken up to the need for more stimulus to revive domestic demand and support the recovery - **the first response following the pandemic had been muted, as we analysed at length in** *this piece* **for premium subscribers published on The Multipolarity Report website** -, at a time when external demand is still in limbo (Despite some encouraging "green shoots" figures from China's customs for June showing a 0.5% year-over-year increase in exports that could be due to the release of pent-up demand following months of lockdowns all over the world).

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Turning to Europe, it will be interesting to watch the squabbling over the European Union's Budget and the €750 Next Generation Recovery Plan proposed by the European Commission in May (*read our comprehensive analysis of this proposal* **on The Multipolarity Report website**). Brussels has accustomed us to lengthy discussions, fierce chip bargaining and political gesturing that generally ended up with an agreement reached at the eleventh hour. Such an agreement may not be reached this week-end as German Chancellor Angela Merkel who has assumed for the last time of her career the Presidency of the European Union has herself acknowledged it. But this week's summit will pave the road toward a financial and political compromise between a profligate Southern coalition and a frugal Northern alliance - with Germany standing in between as an arbiter and as a deal facilitator.

As the effect of the first round of fiscal and monetary stimulus starts to peter out, the EU Member states are set to implement new stimulus measures leaving for brighter days any concerns about public debt sustainability. In France, President Emmanuel Macron has announced on Bastill day a new fiscal package to the tune of €100 billion in order to help battered businesses and to jump start a protracted recovery that follows an unprecedented fall in economic activity. Germany itself has a lot more of fiscal firepower to deploy thanks to its years-long conservative fiscal policy prior to the coronavirus outbreak. Hence, collective recovery efforts should be focused toward helping the EU's weakest economies, with Italy being at the top priority of the agenda given its systemic importance for the EU as a whole. Yield curve control which is practiced in stealth mode by the ECB through its PEPP programme might help the Italian Treasury. Indeed, every additional basis point of interest on its debt costs the Italian Treasury €3 billion. However, beyond an accommodating monetary policy, Italy is in dire need of a massive fiscal stimulus package to break with years of austerity politics that led to crumbling infrastructure, entrenched polarisation between the country's industrial North and its rural South - the Mezzogiorno -, falling literacy across the board a deterioration of healthcare standards as illustrated by the healthcare crisis, and last but not least skyrocketing youth unemployment pushing the country's best and brightest to seek their fortunes abroad. It will certainly take more than animal spirits, vaudou economics or any kind of political magic to solve this quagmire.

Alexandre Kateb

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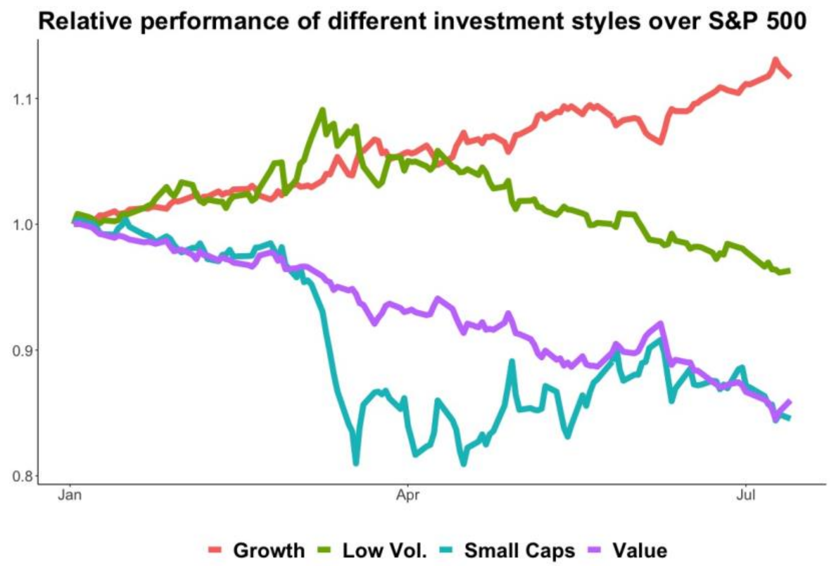
Chart of the week: How smart is Smart Beta?



Since the beginning of the year, as the chart above shows, there have been a puzzling disconnect between "growth stocks" or "momentum stocks" on one hand - and both "value stocks" and small cap stocks on the other hand, whatever the methodology for selecting those stocks.

Professional Investors are familial with the Fama-French Factor model developed by Nobel Prize Laureate Eugene Fama with his colleague Kenneth French in the 1990s. According to this model, the expected return on a stock is a combination of the general equity market premium - the so-called beta of the single risk factor model - to which one must add a "size premium" - on the premise that small cap stocks are expected to generate higher returns than large caps - and a "value premium" which is a reflection of a depreciated stock's price convergence potential with other stocks which trade higher, on the basis of their expected earnings or other metrics. This academic theory is at the heart of the so-called "smart beta" strategy based on ETFs - Exchange Traded Funds - which seeks to replicate an exposure to the risk factors identified by Fama-French and other pundits.

However, since the beginning of the year, as the chart above shows, there have been a puzzling disconnect between "growth stocks" or "momentum stocks" on one hand - and both "value stocks" and small cap stocks on the other hand, whatever the methodology for selecting those stocks. This divergence in favor of growth stocks seems to run counter Fama-French's model or counter the common intuition that in order to make money one has to buy cheap stocks and to sell expensive ones. Warren Buffett may have been practicing "smart beta" for years, the terrible performance of his flagship investment vehicle, Berkshire Hathaway; which has fallen of a cliff when the market crashed in February and remains stuck deep in the red, is yet another testimony to the ongoing market schizophrenia.

Most of the growth stocks are to be found in the Nasdaq - mostly IT, online retail, entertainment services and a few consumer discretionary stocks like Tesla. All those stocks prices are climbing from one record to another while the good old fashioned value stocks remain in limbo. The recession actually amplified an ongoing secular trend which started in 2007 and which saw a gradual erosion in the over-performance of value stocks and small caps. This should be examined together with the general trend toward increased stock market concentration and lax monetary and tax policy that allowed large tech companies to boost significantly their stocks through shares buybacks. Beyond the coronavirus pandemic, this practice might well continue to dominate the market, provided that interest rates remain at their current record low levels.

In the spotlight: Central Banks and the future of money

Central banks have been stepping up efforts to create new electronic currencies in an attempt to counter the threat posed to their monetary power by private currencies such as Facebook's Libra. However, the so-called CBDCs might prove to be too little too late to shape the future of money. When you cannot fight a trend, it is better to embrace it.

If you lived in France or traveled to it in the 1980s you might remember the **Minitel.** This small electronic terminal looking very much like the first models of Amstrad Micro-computers released in the early 1980s. Yet, the Minitel was connected to a limited public network - an Internet before the arrival of the real Internet. At that time, it was indeed a brilliant idea. One of today's established French billionaires, Xavier Niel, actually started his successful entrepreneurial career by selling services like classified adds on the Minitel.

In fact the Minitel was so successful that it is probably one of the reasons why France missed the first wave of the Internet, in the early 1990s. At that time, the country's technocrats and entrepreneurs simply did not see the need for another Minitel, confusing the convenience of a proprietary hardware with the peer-to-peer and software-as-a-service principles sustaining the world wide web. Of course, it did not help that the Minitel was operated at that time by the Country's government-owned Telecom company, France Telecom, which enjoyed a monopoly over it. However, it did not last and anyone born in France after 2000 has never heard of the Minitel, except as an artefact displayed in a Museum. For his part, Xavier Niel founded Free, one of the first French ISP (Internet Service Provider).

Contrary to the Minitel, the idea of CBDCs (Central Bank Digital Currencies) could be doomed even before being deployed. What is a CBDC? It is a hybrid between physical cash and an electronic payment service. It takes to another scale the concept of "digital wallet" that had been launched more than a decade ago. The Bank of International Settlements (BIS) stands behind a concerted efforts by Central Banks to remain relevant in a cashless world and increasingly in a world which could soon skip traditional financial intermediation altogether. An optimist tone is voiced in the chapter dedicated to CBDCs included in the BIS latest annual economic report published last month. According to the BIS, "**CBDCs, if properly designed, have the potential to give rise to a new payment mechanism that is interoperable by default, fosters competition among private sector intermediaries, and sets high standards for safety and risk management.**".

Before the rise of cryptocurrencies, the only successful large scale electronic payments experiment has not been created in an advanced OECD country but in Sub-Saharan Africa. The success story of M-Pesa - **Pesa** meaning "money" in Swahili and "M" standing for mobile - is well known. It is now being taught in Management schools all around the world as an example of frugal innovation. Although it was launched by Kenya's Telco Safaricom with the technical support of Vodafone, M-Pesa is a truly African success story, a David versus Goliath tale in the world of electronic payments. Indeed, not only did M-Pesa took by surprise the world's established cash transfer services (Western Union, Moneygram) which used for decade to grab exuberant fees for their service from the world's poorest and most disenfranchised people. M-Pesa actually created a whole ecosystem - a concept transposed from environmental sciences -, allowing it to build multiple layers of services on top of a very lean physical infrastructure, by making its solution incredibly easy to use, and by taking the best of both worlds from (mobile) telecommunications and (micro-)financial services.

The real threat posed to fiat currencies and to their electronic avatars backed by Central Banks does not come from Bitcoin and its gemelli*. Large tech giants like Facebook, Apple, Alphabet, Amazon, Tencent and Alibaba could become more challenging rivals for the Bank of England, the European Central Bank and the likes.*

A currency is more than a payment system, it has to fulfil three basic functions. It has to be a medium of exchange, a unit of account, and a store of value. The first generation cryptocurrencies like Bitcoin, Ethereum and Ripple can easily fulfil the two first functions. But the high volatility of these crypto-coins prices, when expressed in US dollars or in other major fiat currencies, has prevented them so far from becoming stores of value in their own right and fulfilling the third function that is expected from a genuine currency. There have also been many (cyber-)security and privacy issues which have risen public concerns over their future. In addition, there are problems in terms of interoperability between these different crypto-assets or cryptocurrencies (the jury is still out on their legal status). The announced public listing of Coinbase, one of the world's major cryptocurrency exchanges might not entirely assuage those concerns but it is a step in the right direction.

However, the real threat posed to fiat currencies and to their electronic avatars backed by Central Banks does not come from Bitcoin and its *gemelli*. Large tech giants like Facebook, Apple, Alphabet, Amazon, Tencent and Alibaba could become more challenging rivals for the Bank of England, the European Central Bank and the likes. These tech conglomerates have already billions of customers around the world. Apple and Ali Baba have already developed their own proprietary electronic payment system, respectively Apple Pay and Ali Pay. The latter claims through its dedicated financial payment subsidiary Ant Financial 1.3 billion annual active users as of March. The majority of its users came from China, while the rest were brought by its nine e-wallet partners in India, Thailand, South Korea, the Philippines, Bangladesh, Hong Kong, Malaysia, Indonesia, and Pakistan.

While Alibaba and Tencent are unlikely to challenge their domestic regulators, considering China's top-down political and institutional system, the tech-libertarian spirit behind Facebook's Libra project has been met with resistance from financial regulators and central banks all around the world, including the majority of Congress Members and most Board Members at the Federal Reserve. Libra would be a “stablecoin” backed by a basket of sovereign currencies such as the dollar, the euro and the yen. It would be made freely available to its customers - a stark departure from the fees earned by Central Banks every time they issue banknotes, or "monetary seigniorage". Although it continues to face regulatory and political hurdles, the Libra project has quietly moved forward from a technical and operational perspective. “The Swiss Financial Market Supervisory Authority FINMA has received an application from the Geneva-based Libra Association for a payment system license. This marks the start of the licensing process under Swiss supervisory law,” FINMA said in a statement in April. Libra has been endorsed by some public figures like Timothy G. Massad, a former chairman of the Commodity Futures Trading Commission and Former Assistant Treasury Secretary for Financial Stability. In a report published in June by the Brookings Institution, Massad concluded that "**the United States should create a reasonable regulatory approach for private digital stablecoins like Libra"**. CBDCs and private cryptocurrencies might coexist for a while. Only time will tell if the fate of the CBDCs will resemble more the Minitel or the Internet. However, historical evidence shows that governments and central banks are better at creating enabling environments for new technologies and services than by providing these services in their own right.

Alexandre Kateb

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What we are reading

... but don't necessarily endorse

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Sheri Berman, Crises Only Sometimes Lead to Change. Here's Why.
Foreign Policy, July 4, 2020.

"It is easy to assume that crises trigger the collapse of an existing order and its replacement by a new one. But this view is fundamentally flawed, most obviously because it does not fit the historical record. Crises are fairly common; fundamental transformations are rare."

"History teaches us that new ideas and the mobilization of discontent are necessary but not sufficient to trigger transformation. Ideas need to be forged into coherent critiques of the old order as well as attractive, viable plans for a new one. And advocates of change need to unite around such plans to help protect against infighting, the dissipation of discontent, and pushback from defenders of the status quo. Only then can they gain and maintain the power necessary to implement plans for long-term change."

Lionel Shriver, The vanity of 'white guilt'
The Spectator, July 11, 2020.

"It's entirely sensible to feel regret, sorrow and abhorrence about the likes of slavery. It's commendable to be informed about the past and to try to understand the nature of its wretchedness, as it's also commendable to strain to leave the world a little better than you found it. But claiming that what happened before you were born is all your fault is not only ridiculous. It's vain."

Moises Naim, 'The Three Amigos'
El Pais, July 12, 2020.

"Algunas de las fotos icónicas que quedarán de esta pandemia serán las de estos tres presidentes y sus más leales seguidores exponiendo sus caras, desafiantes y sin ningún tipo de protección. Y otras fotos serán las de la gente con la mascarilla puesta, ilustrando así un mundo dividido entre los promáscara y los antimáscara."

COMPETENCE FINANCE SAS

91, rue du Faubourg Saint-Honoré
Paris 75008
France

CONTACT US:
contact@multipolarity.info

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