PRUDENTIAL
INVESTMENT MANAGERS

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Book Review: Is the future all about wealth preservation amid chaos?

"Aftermath: Seven secrets of wealth preservation in the coming chaos" touches on many economic and geopolitical scenarios and themes, some undoubtedly unpleasant, but nevertheless makes for a fascinating read. The author, James Rickards, is an American lawyer, speaker, gold speculator, media commentator, author on financial topics, and precious metals expert. He is the author of Currency Wars: The Making of the Next Global Crisis (2011) and five other books.

In this, his latest forward-looking tome, Rickards holds quite a pessimistic view of what is likely to unfold from the current global economic conditions. He believes that a US recession – even a global economic crisis – is coming and that the US Federal Reserve (Fed) will be powerless to fight it. Investors, therefore, should be primarily concerned with preserving their wealth in the years ahead.
There is a large focus on the "aftermath" of the 2008 Global Financial Crisis (GFC) and policy actions taken by central bankers to revive growth.

Rickards contends that this crisis never really ended and that more is to come. I will touch on the themes I consider to be most relevant today: the Fed, public debt and income inequality.

The Fed

Rickards contends that the Fed is not ready for the next recession, since, according to historic research it takes 300 to 500 basis points (3-5%) of interest rate cuts to pull the US economy out of recession. Meanwhile, at the beginning of 2019 the Fed Funds rate was 2.5%, so it is impossible to cut it by 3% to 5% to fend off another recession. A fourth round of quantitative easing (bond purchases, or QE4) would be another alternative tool to soften the blow of a recession; however the Fed has not normalised its balance sheet, which has expanded from US$800bn to US$4.4trn by printing new money in previous rounds of QE. In addition, he argues, the beneficial wealth effects of previous QE programmes never transpired into additional borrowing and consumption by consumers, only into higher asset values which have, in turn, translated into bond and equity market bubbles. And these, are now **bubbles waiting to burst**.

So any QE4 plan would start from a higher base (almost R4trn) compared to R800 billion when QE1 was first initiated. There are some academics who see no problem with the Fed printing an unlimited amount of money, but Rickards believes this is flawed as there is an **invisible confidence boundary** beyond which everyday citizens will lose confidence in the Fed and the US dollar. Where this boundary is no one knows, but as he says, it's best no one finds out the hard way!

Addressing the idea of using fiscal policy to spend the US and other countries out of a recession by going further into debt, he cites research by professors Carmen Reinhart and Kenneth Rogoff, which shows that once a nation's debt/GDP ratio passes the 90% level, the stimulative impact from additional debt is negative, with median growth rates falling by about 1%. "The law of diminishing marginal returns start to bind."

At lower debt/GDP ratios, the research suggests, the relationship between debt and GDP is not strong and other factors guide growth, including tax, monetary policy, and trade policy, etc. Once the 90% debt/GDP level is breached, debt becomes a dominant factor. This is corroborated by research performed by the European Central Bank (ECB) and the Bank for International Settlements (BIS) on the impact of government debt on growth. The ECB report concludes that "a higher public debt/GDP ratio of

90% to 100% is associated on average with lower long-term growth rates". As expected, there are other economists who are scathing of the above and advocate fiscal stimulus to prevent structural unemployment in an economy due to lost skills.

Since the 2008 GFC, the US national debt has roughly doubled from $10trn to $20trn - debt which is unsustainable given the low growth over the past 10 years compared to previous post-recession growth rates, Rickards says. This environment of slow growth, high debt and income inequality is a global phenomenon and not confined to the US only.

So what should the Fed do?

According to Rickards, the central bank needs to raise rates slowly, reduce its balance sheet (by selling bonds) and hope that the recession does not occur before it gets policy rates and leverage back to normal levels, which he thinks could happen by 2021. Unfortunately, he also believes that the odds of a recession occurring before 2021 are high, and that when a recession hits the US it may last for decades - much like Japan, which has now lost three decades of growth.

For him the Fed is in a difficult position: it may cause the very recession it is trying to avoid if it acts too quickly. Alternatively, move too slowly and it may run out of time. Any resulting recession and deflationary period is a central banker's worst nightmare, as it increases the real value of debt, leading to defaults. It discourages consumption and increases the real standard of living of consumers, which cannot be taxed.

What about emerging markets?

In Rickards' scenario, emerging markets will not be left unscathed. Emerging market debt has been growing at a record pace fuelled by investors chasing higher yields. He thinks we are in the midst of another emerging markets debt crisis, based on the current examples of Turkey, Argentina and Venezuela, while South Africa, Ukraine and Chile are "highly vulnerable" to a run on their reserves and a default on their foreign currency-denominated debt.

Prudential differs with Rickards' view that South Africa is highly vulnerable to a run on reserves or default on its foreign currency debt, primarily because its foreign currency-denominated debt is a small proportion of its overall debt stock (only around 10%). This could be financed in the local market if necessary. Also, South Africa has one of the world's longest government debt maturity profiles (second only to the

UK), so that its debt (both foreign and rand-denominated) is largely repaid over long periods of time. And although almost 37% of South Africa's overall debt stock is held by foreign investors, we would argue that South Africa is in a relatively strong position as far as exposure to external debt is concerned.

Interestingly, he notes that the problem is not generally with individual sovereign defaults, but one of **contagion**. When one emerging market defaults, funders lose confidence and panic sets in; emerging market assets are simply sold off with no buyers in sight, resulting in a sudden fall in asset prices.
Rickards contends that the debt crisis has already begun and a full-blown emerging market debt crisis is likely to occur soon. He predicts that the IMF will run short of resources, European countries will focus on their own problems and the US with Trump's "America First" rhetoric will decline to assist.

Income, Inequality and Levelling
The author paints quite a grim series of future scenarios which seem rather unlikely, for example financial disruptions that go beyond capital market dislocation impacting critical infrastructure and then a breakdown of social order. He contends that research performed by sociologists and historians suggests that once critical systems break down, it takes three days before the "law of the jungle" prevails and civilisation as we know breaks down. Violence, looting and the formation of vigilante groups emerge, amongst others.

One may think that surviving a societal collapse requires one to have access to bunkers, private jets and fire arms. Not so, he says, community will serve you better, a community that is willing to share food, water and labour. Cities will fare worse than the countryside because cities rely on electricity and complex networks that are vulnerable to sabotage.
In South Africa and generally abroad there is growing income inequality. Rickards refers to Walter Scheidel's book, "The Great Leveler", which examines income inequality and its remedies. Remedies most people are familiar with include land redistribution, progressive income tax and higher estate taxation, free education, access to good schools and pre-school programs, and universal health care, amongst others.

The author concludes that none of these solutions has any chance of becoming law on a meaningful scale to materially impact on income inequality in the US. Key to note, though, is that this does not mean income inequality is never levelled. Societies periodically experience what Scheidel calls **levelling** - the gap between rich and poor is narrowed. However, as he highlights, this happens under the most of unfortunate circumstances: death and violence in the form of war, revolution, plague or systemic collapse.

So, if Rickards' predictions (however unlikely) hold true, all will not be well with the wealthy in the future. He offers some investment ideas that could prove helpful, which are listed below in conclusion.

Seven secrets of wealth preservation in the coming chaos

- Tariffs and trade surpluses are back. Prepare for a more mercantilist world as Trump refuses to play the free trade game. He suggests America will find new domestic champions in areas of steel, renewables, autos and transportation. The hallmarks of mercantilism are the accumulation of gold and silver.
- Prepare for slow growth and periodic recessions for decades to come.
- Beware of behavioural manipulation nudging you in a certain direction.
- Diversify away from exchange-traded markets. Allocate to cash, gold (preferably held in a safe, non-bank place) and alternative assets.
- Low productivity may mean inflation or deflation.
- Prepare for new currencies backed by physical gold.
- Allocate to alternative assets.

Of course Prudential does not suggest that investors follow this advice (apart from #3 which is a well-accepted investment guideline). Our own analysis is rather less apocalyptic; local and global equities both appear priced to deliver decent real returns over the next five years as long as the world economy avoids a recession. Local bonds are also pricing a good dose of negative news, with real yields approaching mid-single digits, a substantial risk premium. Prudential multi-asset portfolios are overweight both. Nevertheless, a robust contrary view such as that proposed by

Rickards provides a useful sounding board to conventional thinking and to that extent we recommend it to our clients.

For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.