HALKIN SERVICES LIMITED

**INTERNATIONAL
RISK ANALYSIS AND ASSET ALLOCATION
SERVICE**

DIRECTORS:
Dr P.J. Warburton
R.J. Griffiths
C.D. Morris
D.A. Osman

Tel: +44 (0)20 8879 6116
Fax: +44 (0)20 8944 6920

email: halkin@halkinservices.co.uk

Company secretary:
Mrs P.A. Ranken
21 Vineyard Hill Road
London
SW19 7JL

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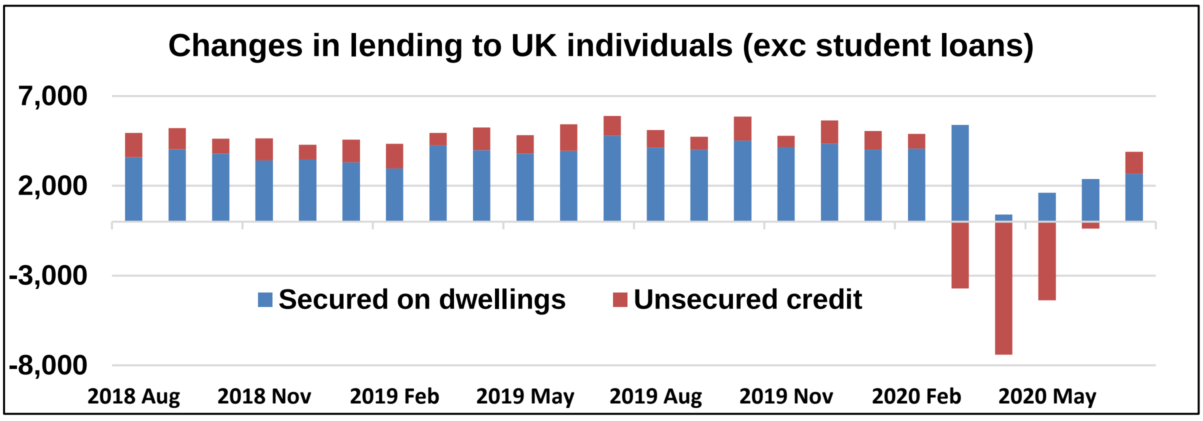
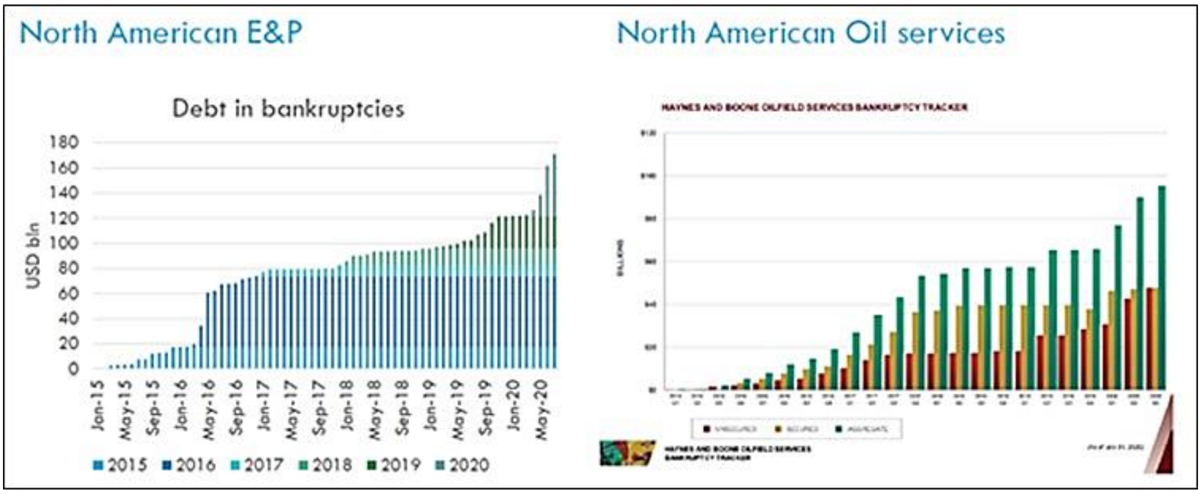
MUSINGS ON A DEBT JUBILEE: A BLAST FROM THE PAST

In our world of instant communications, we readily assume that what appears on our screens is new. There have been numerous instances of an outpouring of public grief on social media over the passing of some entertainment icon who, it turns out, had died years earlier: folks just assumed they were reading breaking news. This week, I opened an email that recirculated an FT article written by the prominent, if maverick, economist Willem Buiter in July 2009, in the wake of the Global Financial Crisis. However, it was not until I had finished reading that I discovered its antiquity! So much of what I read was apt, pertinent and insightful that I believed that I was reading a piece that was recently written. I should add that I first encountered a pipe-smoking Willem at a conference in Oxford on the determination of exchange rates forty years ago and have been intimidated by his intelligence ever since. To him, I attribute the quip that there are three methods of proof in economics: proof by induction, proof by deduction and proof by repeated assertion. The article complained that central banks were providing solutions – Quantitative and Credit Easing and subsidised loans to the banking system – to a problem of illiquidity when the real problem was the threat of insolvency. He concluded: "Recapitalising the banks and paying off household debt through high unanticipated inflation would be possible, but undesirable. I propose a combination of mandatory recapitalisation of the banks and a debt jubilee for the household sector to remove the two key obstacles to an economic revival." While the recapitalisation of the banks duly occurred, courtesy of Basel3, it is not difficult to imagine a circumstance in which bank capital is depleted once again by bad loans. Significantly, Willem readily acknowledged the role that unanticipated inflation could play in the restoration of household solvency. His preference, in 2009, was for a debt jubilee: a scheduled cancellation of debts along Old Testament lines. Unsurprisingly, this idea has resurfaced in the context of coronavirus, not only as an echo to the Jubilee 2000 campaign that cancelled over US$100bn of poor country sovereign debt, but in parallel calls to write off student loans, grant extended payment holidays on mortgages and cap the rate of interest on consumer borrowing. Merryn Somerset Webb has argued that indebted consumers should take the opportunity of reduced spending commitments to pay down their own debt: a personal jubilee.



MAARTEN VAN MOURIK: OIL IN TIMES OF TROUBLE

We are grateful to Maarten Van Mourik for his talk this week on the state of the energy markets titled "Oil in times of trouble". He began by highlighting the importance of energy in human development. It has long been asserted that improved energy efficiency would lead to a sustained decline in demand, but a) that has not materialised and b) this view is a generalisation of an advanced country perspective: there are many emerging countries where per capita energy utilisation is rising rapidly. Maarten argues that energy is essential for economic development and growth. Currently global energy consumption is derived more than 80 per cent from fossil fuels, and while public opinion seems to be shifting away from this, there are few economically viable alternatives. In regions where there is little energy infrastructure then alternatives such as solar represent a major advance, but they cannot feasibly replace hydrocarbons at scale. Down the line it might be that nuclear energy offers a possible release from this constraint, if public opinion allows. Despite its continued importance (there is a very close relationship between energy input and GDP growth) the stock market seems to have accorded energy relatively little significance, with its weight in the equity index down to just 2 per cent from around 12 per cent a decade ago: Exxon Mobil was recently replaced in the Dow after nearly a century. The switch in investor preferences reflects the perceived embarrassment with fossil fuels and the rise of ESG investing, Some huge energy companies have made public statements of intent to move away from oil etc over the coming years (with some taking stakes in nuclear fusion). Maarten observes that some central banks have also started to incorporate climate change considerations in their analysis. Yet, without the contribution of rising shale oil production in recent years, energy markets would have been unbalanced and there would have most likely been a major leap in the oil price. Conventional oil production volumes have barely moved in 15 years, and shale has provided the marginal barrel. At first this was driven by technological developments, but latterly by malinvestment thanks to the prevailing low-interest rate environment. Over recent years, oil companies have failed to generate free cash flow, and capex has stalled – this fall has been precipitous in recent months. The current crisis has forced companies to focus exclusively on their most productive fields (high-grading) and therefore face difficulties in the longer term as they diminish the average quality of their residual assets. Bankruptcies have begun to rise (see below) and the oil service sector is incurring heavy losses. Maarten suggested that we could see a fall in shale output of around 2-3mbd taking it from around 8mbd to 5mbd over the course of 2020. As these constraints bite, we could see significant price volatility in the coming quarters, with a bias to the upside. The weight of energy costs in major economies means that oil has a major bearing on inflation. In the past, higher inflation has prompted monetary policy tightening, hollowing out consumer demand and placing a ceiling on the oil price. Jerome Powell's statement has moderated that concern. However, at current prices, marginal oil producers are unprofitable. The situation is worsened by public anti-fossil fuel sentiment and the pivot towards renewables by the major energy companies. Maarten concludes that the system is dysfunctional since the projects are not available that would generate an energy surplus. A rise in price would, in the short term, allow a substantial readjustment and wasteful demand to be cut but at the risk of igniting inflation at a time when governments and central bankers would be unlikely to counteract it. Maarten remains an oil price-bull and we thank him for a very thought-provoking presentation.



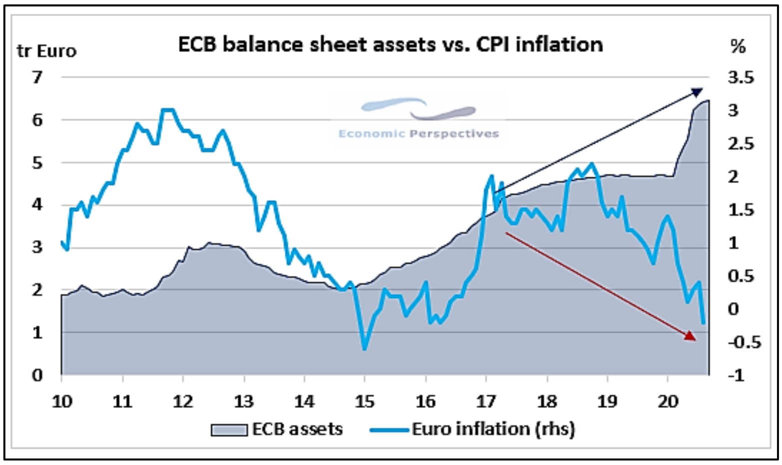
ZOOM CALL DIARY DATES

At noon on Wednesday 9th September, Tony Plummer will be our guest presenter, taking a long-term technical perspective on the impact of change.

Peter Warburton and Tom Traill

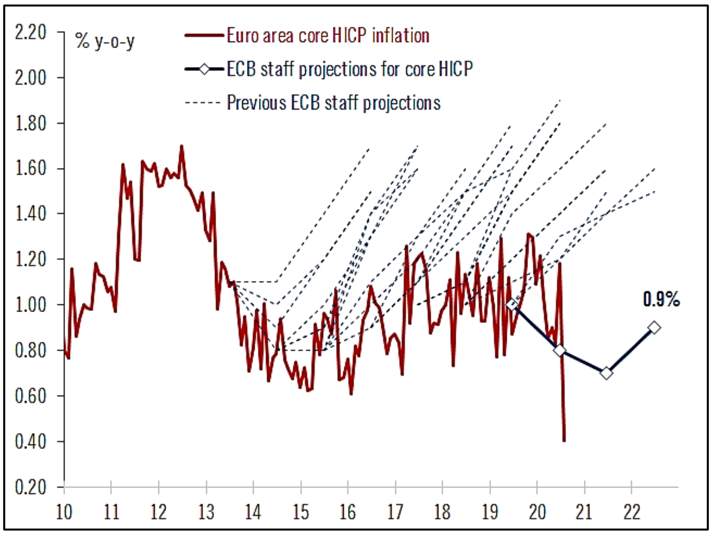
WHAT MORE CAN THE ECB DO?

While central banks have been intervening continuously since March to prevent their economies from falling into a deflationary depression, Euro area CPI fell to -0.2 per cent YoY in August, its lowest level since 2016, which raises the question about what the ECB will do next. In addition, core inflation, which strips off volatile items such as food and energy prices, shrank to 0.4 per cent YoY after oscillating at around 1 per cent for the past 4 years. Even though the latest decline is mainly coming from the lagged effect of the Covid-19 shock that generated a significant sell-off in equities and oil prices in March and April, we stand far below the ECB's 2 per cent target. It is interesting to see that despite Euro policymakers' effort to increase inflationary pressures in the 19-nation economy, mainly by increasing the size of the central bank balance sheet assets by €2.5tr in the past 3½ years, inflation had already been trending lower since its high of 2.2 per cent reached in October 2018. In addition, the spectacular rise in the Euro, which is up over 13 per cent against the US dollar since its March lows, is also weighing on inflation expectations. We previously said that policymakers will be comfortable with a EURUSD exchange rate up to 1.25 and that more strength will 'force' the ECB to act as it will dramatically weigh on the 'recovery'. Will the response be simply more QE?



EURO INFLATION: OPTIMISM VERSUS REALITY

In the past few years, we heard several times Draghi commenting on the low level of inflation in the Euro area and that EZ policymakers will do 'whatever it takes' to prevent a further slippage in underlying inflation. It has been anchored around 1 percent, which was also the case for core CPI as the chart shows. It is fair to say that the ECB has been desperately trying to bring back inflation towards 2 percent in the past cycle, and has repeatedly failed in doing so. One striking observation from the chart is the perennial optimism in the ECB staff projections; since 2013, economists have always predicted an upward move in inflation, which raises the question: are the current projections for core HICP too optimistic? ECB staff projects core CPI to fall moderately within the next 12 months before starting to pick up again in 2022. In addition, inflation would have to average 3 to 4 percent in the coming years in order to balance out the previous 5 years of low inflation. Will the ECB be able to achieve that?



Yvan Berthoux

CHINA'S URGENCY TO REBALANCE THE ECONOMY

At the May politburo, President Xi's administration introduced the 'dual circulation' strategy (DCS) – a programme designed to re-orientate the economy from export-led (the first, international, circulation) to more domestically orientated (the second, internal, circulation). The Center for Strategic and International Studies (CSIS) think tank says that this move "stems from Beijing's belief that China has entered a new paradigm that combines rising global uncertainty and an increasingly hostile external environment with new opportunities afforded by a floundering and listless United States, which China has long viewed as its most important geopolitical rival." The economic climate being what it is – with China seemingly having emerged from the pandemic less damaged than the US and tensions between the countries seemingly elevated – coupled with the 14th five-year plan being due in the next couple of months has heightened interest in the DCS. CNBC reports that "economists at ICBC International, the Hong Kong-based subsidiary of the giant state-owned Chinese bank, have issued a series of notes in the last few weeks on 'dual circulation.' One of the reports discussed the implications of the Chinese policy for the next round of globalization. The authors used two charts [below]. The first showed an international economy focused on the U.S. as a global demand hub. The second painted a world divided into three parts — Europe, North America and Asia — which would interact with each other on a regional scale. China and its "internal circulation" stood at the centre of Asia." A rebalancing of the economy makes sense, as China's past reliance on exports may become hazardous in a climate of diminished trust and cooperation between the two super-powers (tariff tensions have already dented trade between the countries). Vast amounts of increasingly unproductive investment have contributed to the growing levels of Chinese indebtedness. The potential for China to mobilise its 1.4bn population as consumers presumes that the wage share in national income will be encouraged to rise. However, the DCS has come under criticism for being rather vague, effectively restating previous intentions and unlikely to work in its current form. George Magnus highlights that it presupposes that the government is willing and able to pass extensive reforms to allow private companies much freer rein, which they are unlikely to be willing to do. Michael Pettis writes in the FT that a significant increase in domestic consumption would require a transfer in wealth, and thus political power, a move that the administration would find distasteful. Furthermore, if the workers are to have more economic power then this means that they will need a larger share of what they produce – reducing China's international competitiveness. The CSIS concludes that "Fundamentally, efforts along these lines, and under the guise of the DCS, should be seen as part of China's plan to push forward decoupling on its own terms. This further demonstrates that Chinese leaders are clear-eyed that bifurcation is not a question of if, but of when and how fast. The DCS was born out of a reaction to this diagnosis, and it is meant to posit a proactive strategy for China to shape the parameters of the divorce, not to shy away from it." Currently the DCS is big on ambition and short on details, but if the programme gains traction then it will constrain Chinese goods exports in coming years and replace a deflationary global impulse with an inflationary one.

Tom Traill