Portfolio Construction In The Time Of An Inflationary Reserve Currency

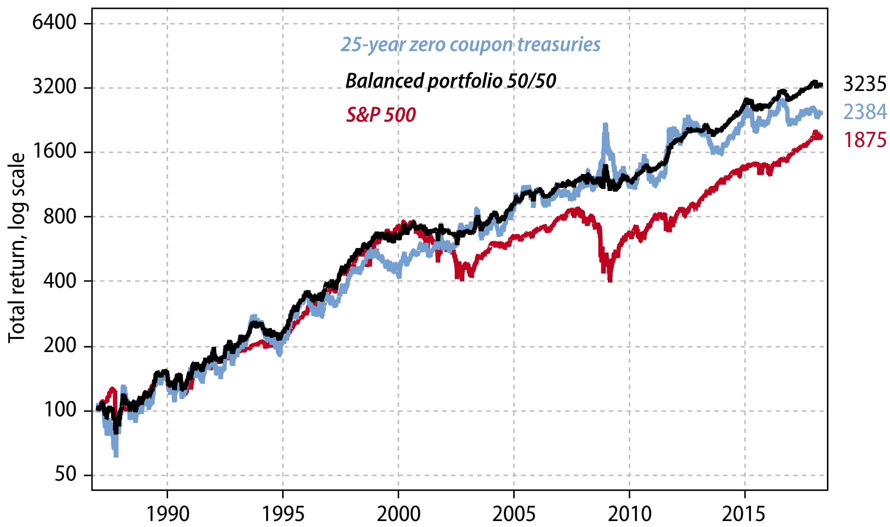
Charles Gave
cgave@gavekal.com

Portfolio construction tends to be easy when the economy behind the reserve currency faces either no inflation or mild deflation. This was most clearly the case from 2004 until about three months ago, when my main concern switched from deflation to inflation. In "easy" times the best passive portfolio has been a 50:50 split between treasuries and US equities, with regular re-balancing. As shown below, since the late 1980s such a portfolio delivered better performance than almost any other combination of bonds and equities.

Since the late 1980s the best portfolio has been a balanced 50:50 split between treasuries and US equities

The balanced porfolio has been a clear winner since 2004

Balanced portfolio, S&P 500 and 25-year zero coupon treasuries, rebased on 1/1/1988 to 100



Gavekal Data/Macrobond

I start the chart above in 1988 as that was when it became clear that the US had transitioned into a disinflationary period (oscillating between deflationary booms and busts) as defined by my well-worn four quadrants framework (see **Four Quadrants: A Wicksellian Analysis**). Hence in the 29 subsequent years, the best way to secure high returns on low volatility was not to hold gold or cash, but simply my US-based balanced portfolio.

A balanced portfolio did not work in the inflationary 1970s

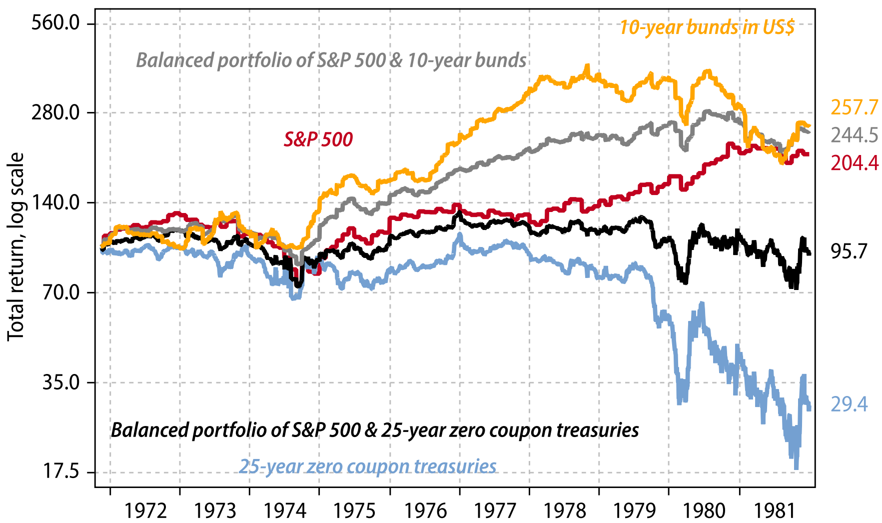
The problem is that this portfolio did not work well in the inflationary period from the late 1960s to early eighties. In such phases, bond values tend to fall in nominal as well real terms, and are also positively correlated with equities. Owning a balanced portfolio in these inflationary years delivered investors lower returns on higher volatility than the stock market alone. In this period, the diversifying assets proved to be gold and cash, although the upshot was a portfolio that offered only slightly higher returns, but a lot more volatility.

In 1968-83, the US followed an overt inflationary policy (a "guns and butter" approach to fiscal policy together with negative real interest rates and currency devaluations). The same thing looks to be unfolding today. Back then, however, not all countries followed suit, notably Germany. An interesting question is whether US equity positions could have been protected using a long-dated German bund—i.e, could a non-inflationary bond market outside of the US have been used to protect a US equity position?

In the previous inflationary period, investors could have used a non-inflationary bond market outside the US as protection

In the inflationary 70s a bund-based balanced portfolio was best

Rebased in 11/16/1971 to 100



Gavekal Data/Macrobond

The answer is yes. If held from 1971 to the end of 1981, a 50:50 portfolio comprising US long-bonds and US equities would have ended the period slightly below its base value of 100; if the bond part was replaced by bunds, the ending value would have been a decidedly more impressive 244.

Hence, even in a generally inflationary period it was possible to diversify a US portfolio using bonds from a "non-inflationary" economy, where yields were not artificially depressed by central bank interventions. If the German case can be replicated today, the implication is that investors do not need to make a call on the US inflation rate, but rather monitor the chosen "non-inflationary" market to see if it is sticking with the macro discipline.

Chinese bonds satisfy the role played by bunds in the 1970s and 80s

Such a mantle no longer applies to Germany as bund yields are completely disconnected from the economy's fundamentals. Rather, they reflect desperate policymaking to prevent the disintegration of Europe's single currency system. The only market that I can see that passes the test is China.

Chinese bonds as an equity hedge for non-Chinese equities

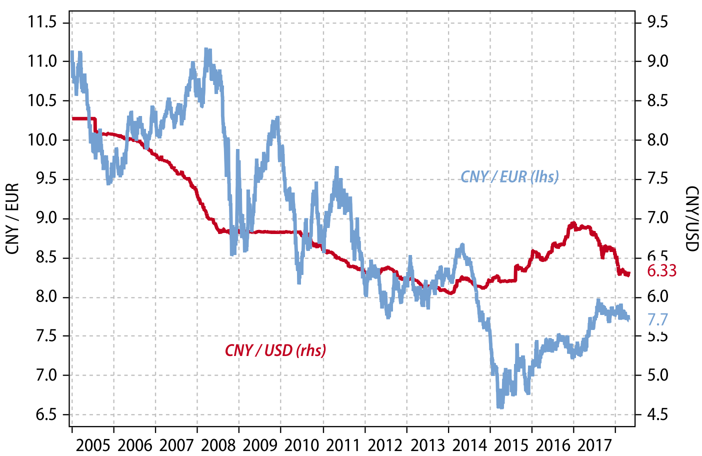
Let me summarize some key points we have made for years on China's motivations for renminbi internationalization.

- China wants to de-dollarize intra-Asian trade
- China wants to de-dollarize oil
- China cannot accept non-US entities being subject to US legal interventions just because they have done business in dollars—the "weaponization" of the dollar (see **On Protectionism**)
- China thus wants to offer a substitute for the US dollar (see today's daily **The Upcoming Monetary War, With Gold As An Arbiter**).

- In order to succeed, China needs a strong currency that is viewed as a unit of account, a means of exchange and a genuine store of value, so that other central banks keep renminbi as reserves.

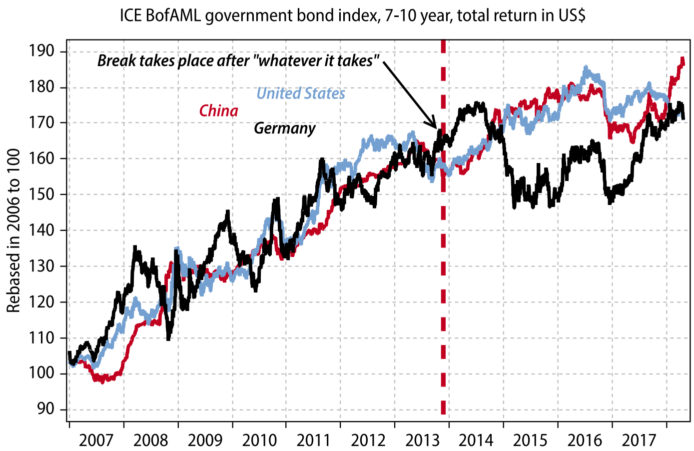
On this score it is worth noting that the renminbi now has a decent track record of maintaining strength against the US dollar and the euro.

The renminbi as a strong currency



Gavekal Data/Macrobond

Total US$ returns on 7-10 year government bonds



Gavekal Data/Macrobond

China has taken a number of steps to ensure the appeal of the renminbi

Since 2006, the renminbi has risen by 28% against the US dollar and by 24% against the euro. Hence, on almost any measure (return, maximum draw-down or volatility) in this period China's has been the world's best performing government bond market. In pursuit of their goals the Chinese authorities have created new institutions like the Asian Infrastructure Investment Bank, while the People's Bank of China has offered multiple swap lines to foreign central banks so that big emerging economies can get funding for their current account deficits and support in the event of a crisis.

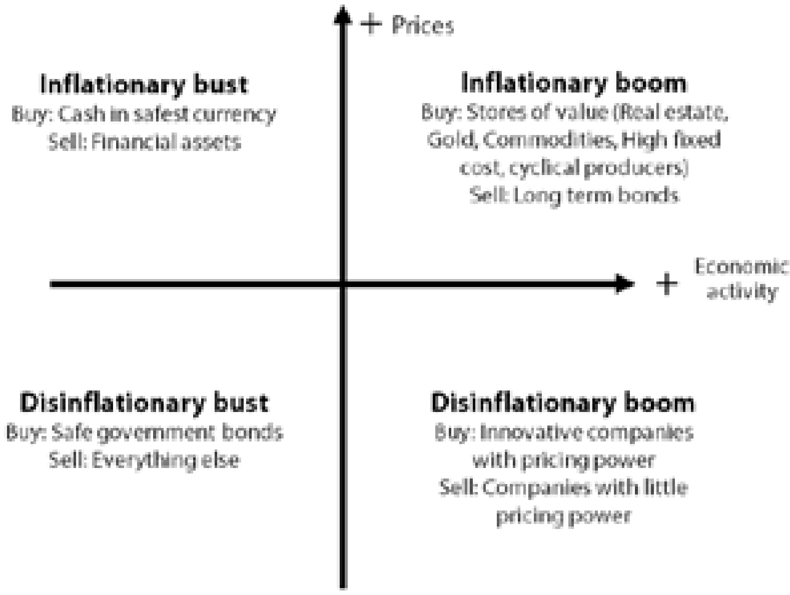
This is pretty much a copy-and-paste of the US Marshall Plan for Europe in the 1950s. A key effect of that initiative was to cause a convergence of long rates. In the 1950s, German long-rates were at 7% and the American ones at 2%. By the 1960s, both were at the same level (see **Back To The Future**).

There is likely to be a convergence of yields between China and other big emerging markets that it assists

Right now, Chinese 10-year yields of about 3.5% are roughly half that of similar Indonesian bonds. The next five or so years should see Indonesian, Russian, Brazilian and even Indian long rates converge towards Chinese levels. The only requirement is that these economies' central banks pursue a monetary policy that aims to reduce inflation rates through targeting policies. When long rates decline in nominal terms, three assets always outperform: long-duration bonds, real estate, which is a very long-duration asset and, of course, growth stocks which are also long-duration in nature.

In short, it looks as if a group of emerging economies are set to move from the top (inflationary) half of the four quadrants to the bottom (disinflationary) half at the same time as the Federal Reserve and European Central Bank are trying to engineer a move for their economies up into the top inflationary section (see chart overleaf). At the same time, Japan has escaped 25 years trapped in the bottom-left "deflationary bust" segment of the four quadrants and looks to be moving into a disinflationary boom.

The Four Quadrants framework



Europe and the US look to be moving into the upper inflationary area of my four quadrants just as China and other emerging economies move into the lower disinflationary section

Because it is what central bankers want, this difference in long-term goals implies that Asian currencies will appreciate structurally versus the US dollar and euro. As a result, bond markets in the aforementioned EMs should outperform those of the US and Europe on a total return basis.

China changes the finance game

Let me conclude with a simple idea. **The Chinese will do in the next twenty years to our financial world what they have done in the last two decades to the industrial sphere.**

Moreover, financial hubs are always at the "center" of the regions that have excess savings. In the next twenty years, Europe and then the US will move to having a structural lack of savings, while Asia will have excess savings. China's government sees no reason why the recycling of these excess savings should be done by the US. Allowing the US to maintain this role may have worked for Europe, Japan, Korea and Taiwan, because of the US's military might, but it will not do for its strategic competitor, China.

Hong Kong and Singapore should benefit hugely from the trade in the risk-free asset of the future, Chinese bonds

Hence, the dominant financial centers of the future will likely be Hong Kong and Singapore, where the risk-free asset (by then the Chinese bond market) will be traded at a much lower yield than its US or European counterparts. London should maintain a role as it will be a prime conduit between Asian excess savings, the old Commonwealth and the rest of the world.