FFM GESTION

Geneva, April 8, 2021

"While our financial results are still subject to detailed finalization and review, we would expect to report a pre-tax loss for 1Q 2021 of approximately CHF 900 million. This includes a charge of CHF 4.4 billion in respect of the failure by a US-based hedge fund to meet its margin commitments."

Credit Suisse trading update

Dear Sir, Dear Madam,

Well, it's officially been a year since this whole pandemic started to have a real impact on our lives. We have, since then, been able to sporadically have lunch in a restaurant, catch a plane or two and, for the happy few, receive vaccine shots. Overall, though, it's been a pretty drab period of confinement, store closures, and family holidays spent without families. As we write this, we are experiencing the third wave of the pandemic. In a plot twist worthy of the best movies, the countries that were doing the worst in the first phase, such as the United States and the United Kingdom, are doing the best in the vaccination phase while Europe is lagging badly behind.

All of this is enough to get one's spirits down. It seems little progress is being made, France is back in lockdown mode for a full month and, here is Switzerland, the vaccination process is painfully slow and cumbersome. The one place where spirits are still good, however, is the stock market. The S&P 500 Index has just broken through new record levels, hitting 4'000 points a couple of days ago while even European indices are doing well.

The dichotomy between the drabness of our everyday lives and the giddiness of the stock market has had many people (some of you among them) asking whether we are, again, experiencing a stock market bubble. One has to be careful answering that question because bubbles are only obvious after the fact, i.e., after they have burst. While they are ongoing, all sorts of justifications are found to legitimate said bubble. So, our answer can be an approximation at best, but it is something we have thought about a lot.

We believe there are two parts to this issue. The first is one we have mentioned in previous reports: bubbles are a natural part of markets and occur all the time, every year even. Generally, they occur in a tiny part of the market where expectations are high, then grow exponentially, then die of a natural death because too much capital has been injected in the sector and most companies go bankrupt or, at best, linger and bleed to death. One company may emerge victorious and, maybe, just maybe it is at that point that one could buy it.

We have given examples before, such as the 3D-printing craze of 2013 or the cannabis boom and bust of 2018. If we were to venture a guess on a current bubble, it would be the SPAC craze, which we mentioned in our last letter. We won't rehash the whole thing, but basically SPACs are blank check companies IPOed for the sole purpose of buying another company (public of private) in the two years following the IPO. In the first three months of 2021, the amount IPOed via SPACs (around USD 90 billion) was more than during the whole of 2020, which was already a record year. For further reference, the amount raised via SPACs in 2013 was a measly USD one billion.

So yes, a bubble for sure, although it seems the fever has already broken, since the latest SPAC IPOs found almost no buyers and had to be pulled. But again, while USD 100 billion (to use a nice, round, number) may seem like a lot of money, you need to remember that Apple is currently worth more than USD two trillion. All in all, while an impressive number, USD 100 billion has become just a drop in the bucket. The SPAC bubble will not, in our opinion, be the bubble that kills the market, but rather just another one of these tiny bubbles that occur naturally in the markets. Obviously, returns from investing in SPACs should prove subpar, as there are not that many great companies to be bought and the sheer number of SPACs chasing the same few good companies will raise the purchase price to levels that will make little economic sense. We will follow this whole saga in the coming months.

Now, of course, sometimes (rarely), a bubble becomes big enough that it then impacts the whole market and that is then remembered in the textbooks. This is the second point we wish to make about bubbles: when a bubble becomes big enough, you have to ask whether it is a productive or a destructive bubble. We had two such bubbles in the past thirty years, the internet/telecom bubble of 1995-2000 (a productive bubble) and the commodities/credit bubble of 2003-2007 (a destructive bubble).

Back in 2000, the internet/telecom bubble burst in March. Since it was a bubble purely based in the equity markets, there was little negative impact to the real economy. Sure, jobs were lost but the rest of the global economy kept on humming. Many people and companies had invested huge amounts of money in tech infrastructure around the world and, yes, these people and companies lost almost all that money but the infrastructure was in place and was useful.

You may have heard of the term "dark fiber" and that has its origin in 2000. Telecom actors laid out all that optical fiber all across the world in order for the internet to be available everywhere. It was a net benefit to the economy but the amount invested was so big that, until basically 2020, there still was unused optical fiber (hence, "dark fiber") laid twenty years earlier.

So, after March 2000, the stock prices of these companies went down by about 80 to 90%, many went bankrupt, some turned out to be scams (MCI Worldcom and Enron come to mind) and many, many investors lost their shirts. But, as we said before, the rest of the economy was fine and kept on going. As a matter of fact, a tech-less equity portfolio did just fine from 2000 to 2003.

This bubble, like most equity bubbles, turned out to be a net positive for the real economy: investors lost a lot of money but the investments allowed by these investors created a much better tech infrastructure across the world. All in all, a productive bubble.

The 2003-2007 commodities and credit bubble turned out much differently because although it was, on the one hand, a traditional equity bubble centered around the commodity, energy and financial sectors, it also was, on the other hand, a huge credit bubble centered around the financial sector (subprime mortgages anyone?). A credit bubble is much, much more detrimental to the real economy because somebody's debt is somebody else's asset and, if it is not repaid, can launch a pernicious chain reaction that reverberates across the financial sector. People stop trusting financial intermediaries such as banks and the whole financial system breaks down. That this did not happen in 2008 is purely due to essentially one man, Ben Bernanke, the then chairman of the Federal Reserve (the US central bank). We came very, very close to a total meltdown and, here in Switzerland, UBS would have gone under had not the Swiss National Bank taken over its USD 80 billion subprime debt book (on which it made quite a lot of money, by the way).

The 2008 credit implosion still had lasting, negative effects, in particular in Europe where governments pivoted way too early to austerity policies based on totally faulty assumptions (the exact same ones that prolonged the Great Depression) and condemned the whole continent to a lost economic decade that hasn't yet completely ended. While surplus optical fiber is a net positive for the economy, empty houses across the world are not, and this is a great example of a destructive bubble. It was as if someone had devised a weapon that would destroy the economy while leaving the infrastructure intact, something straight of a James Bond villain's mind.

So, what of today, are we in a similar situation? Is it like 2000? Or, even worse, is it like 2008? To both questions we have to answer "No". On the equity side, there are indeed pockets of bubbliciousness (hello SPACs, hello some software names with no earnings). On the debt side, financial institutions have been so tightly regulated since 2009 that they are unable to reach leverage levels that could cause damage. Yes, some unregulated entities, such as hedge funds, can reach dangerous amounts of leverage (we had a USD 15 billion family office that just lost everything in the past days, more on that later) but the amounts are not significant enough to have systemwide impact.

Some, some of you indeed, are worried about public debt, especially the all-important public debt to GDP ratio. Ironically enough, these ratios are so high because states decided to apply austerity policies just at the same time as the private sector had to rebuild its balance sheet (2009). Since both public and private sectors retrenched at the same time, GDP barely grew, unemployment stayed high and, mathematically, public debt to GDP crept higher.

It is a sad state of affairs that Keynes had already exposed all this back in the 1930s ("the fallacy of composition", as he then called it) but that we had to make the exact same mistakes seventy years later.

And yes, public debt to GDP will keep on going higher, as the pandemic forced most states to adopt aggressive expansionary fiscal policies. This is not only a nice thing to have, but a necessity at a time when a big part of the economy is still semi-closed by orders of these same governments. The good news is that we have a template for all this: Japan. Japan has experienced extremely low interest rates, extremely high debt to GDP ratios (north of 200%) and anemic GDP growth for the past twenty years. And yet, nothing bad has happened: its currency is stable, its government is still able to issue debt that finds willing buyers. We will address the issue of public debt in more details in another letter since it would just take too much space in this one.

As for the past quarter, well, it seems a lifetime ago that Donald Trump was still president in the US, egging on his supporters to storm the Capitol, but it was only in January. Many, many things have happened over the past three months, in particular in the financial markets. It started with retail investors piling in very specific stocks, such as Gamestop, sending them to the moon (and now back, mostly), it continued with Credit Suisse having to close its supply chain funds after suffering a catastrophic loss on them following the demise of Australian financier Lex Greensill, who was its partner, and it finally ended with a family office losing a whopping USD 15 billion dollars on leveraged equity trades. Here again, Credit Suisse got hit, losing almost USD 5 billion on its loans to said family office.

Many stories have been written about these financial hiccups but the one that truly boggles the mind is when you realize that Archegos, the aforementioned family office, was managing the money of a single person, Bill Hwang, a former hedge fund manager who had been previously charged for insider trading (don't ask…) and who had managed to turn his USD 200 million fortune into USD 15 billion by investing in stocks using a lot of leverage (some suspect he was partly behind the huge rise in Gamestop's stock price back in January). Apparently, USD 15 billion still wasn't enough because he was leveraged 5X when it all started to go wrong in March. He lost every single last dollar in the span of two weeks and managed to inflict huge losses to Nomura and Credit Suisse, which were some of the banks that had supplied the loans for the leveraged trades.

I mean, if this was a TV series you would think the plot was very poorly written. But reality is often stranger than fiction, in particular in the financial world. And this illustrates an important point of our investment philosophy: we don't like to invest in banks (or insurance companies, for that matter). There are many, many reasons for this but one of the most important ones is that you never really know what is on the bank's balance sheet. You never really know where the next accident will come from. Will it be a rogue trader hiding his losses? Will it be irresponsible lending to some entity because everybody else is doing it? Will it be loans turning sour? It simply impossible to forecast.

More worrying, it seems that, at Credit Suisse, not even the Chief Risk Officer or the head of its investment bank arm were more aware than we were of all the potential issues. Both are now gone. As an aside, had you invested in Credit Suisse shares at their IPO, October 23, 1989, you would have lost 58% of your initial investment. Ah, yes, you would have received some dividends, of course and, had you reinvested them all in the company, you would "only" have lost 3% over the same period. For reference, the Swiss Market Index is up 538% (1162% with dividends reinvested) over the same period.

Investing in banks, much like smoking, is hazardous to your health.

Finally, please note that, at the request of some clients, we will launch a Biotech certificate with the help of sector specialists that we were lucky enough to meet in the course of our activities at FFM Gestion. We had never ventured in the biotech sector before and would never have done so if we hadn't met the right people. That is the beauty of being independent.

Kind Regards,

Julien Devaux

Chief Investment Officer

Wealth Management