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The Transition to a New Global Financial Framework

Bayshore's Chief Investment Officer shares his thoughts on current events and topics.

When we launched *Views From the Top* last December, we promised to keep these letters short and concise. We are already violating this promise with our second issue, for which I'd like to apologize. That said, the Russian invasion of Ukraine is a game-changing event and caused us to refine our outlook. To explain our thinking in the appropriate context, we need to revisit some history. Thank you for bearing with me, and I promise to keep future issues on the shorter side.

Key take-aways:

- The war in Ukraine and the West's reaction to it are likely to accelerate the transition away from the US-centric global framework that fostered globalization and international trade.
- The sanctions against Russia are likely to motivate major global trading partners to diversify away from US dollar ("USD") and Euro exposure to secure their reserve assets.
- For the US, this will mean less demand for the USD and US debt, resulting in higher interest rates and a weaker dollar.
- A de-globalizing world will lose the benefits from globalization and face higher inflation.
- The US is well positioned to succeed under these new circumstances, leading to a rebalancing of trade and an opportunity to reduce debt levels.
- Investment implications include adding commodity exposure, gold, and possibly digital assets, while reducing bond exposure. Among fixed income investments, private debt stands out.

Bretton Woods (1944) and its demise (1971): For most of history, humans traded in a changing variety of currencies. To infuse trust into these forms of payment, they were initially made in physical coins of gold and silver. Later, countries issued "hard" paper currencies backed by precious metals. Under the post-WWII 1944 Bretton Woods agreement, a new world order under United States hegemony came into effect. It established the USD as the global reserve currency, resulting in the USD being used for most international trade, even among countries that did not use the dollar domestically. The USD was backed by gold (held in US vaults) at a fixed exchange rate, creating a check on US fiscal and monetary discipline, and via fixed exchange rates this discipline was extended to other countries and currencies. This arrangement ended in 1971 when Nixon abandoned the gold standard under pressure from markets who began doubting the true gold-backing of the dollar. With the "gold window" closed, the dollar became a soft "fiat" currency (i.e., a piece of paper that held value "by decree" only). Other countries dropped the fixed exchange rates, and the whole global currency system became fiat and floating, resulting in the USD losing c. 50%[1] of its value against the Deutschmark[2] during the 70s.

Birth of the petrodollar arrangement (1974): The heavy depreciation of the USD severely hurt oil exporting countries that priced their product in USD in a relatively regulated market. They wanted to raise prices but faced resistance from their buyers. The resulting conflict boiled over during the Arab-Israel war in

[1] All market references in this article are sourced via Refinitiv Datastream.
[2] The Deutschmark was the #2 global currency in the 70s and the predecessor of the EUR.

1973, and OPEC[3] embargoed oil exports to countries supporting Israel, leading to a quadrupling of oil prices and severe shortages in the US. On the back of this uncomfortable experience, the US and Saudi Arabia agreed to enter a secret agreement in 1974, resulting in what we today refer to as the petrodollar system, the framework that turbo-charged the globalization wave of the last 50 years.[4]

The deal was that the Saudis would guarantee supply of oil to the US (a big oil importer at that time) and would recycle their revenues back into the US government debt markets. In exchange, the US would provide the Kingdom with military security and guaranteed oil demand. This resulted in the USD becoming pseudo-backed by oil, as any global trader getting paid in USD could go to Saudi Arabia and exchange their paper USDs for a hard, storable commodity. Since most countries needed to buy oil anyway, they were happy to trade in USD if the oil price remained relatively stable. With the USD as the global reserve currency, they also preferred to deposit their excess USDs in the US treasury market, lending their savings back to the US. This made sense, as the US was seen not only as the dominant global power but also as a market economy with an independent banking system and the rule of law to guarantee property rights. As a result, both oil prices and the USD remained relatively stable within a generous trading band between 1980 and 2005.

Winners and losers in an unsustainable system: Controlling the global reserve currency has been called an "exorbitant privilege." The petrodollar system handed the United States the keys to the global money printing press and a credit card without credit limit and very low APR. All the United States had to do was supply the global economy with sufficient USDs, because for global trade to function there cannot be a shortage. For the US, this meant continuously importing more than exporting; or spending more than earning. With control of the printing press and an unlimited credit card, this was no difficult task.

On the face of it, the results were a success, delivering fast global growth and globalization. The United States' dominance provided the security blanket and the universally accepted USD limited trading risk and friction. In the 90s, the fall of the USSR and the opening of China provided even more tailwind for the framework, while the launch of the Euro created friendly competition but never threatened the USD's leading role. Direct investments in emerging countries with their vast young, low-wage labor pools boomed, and the US consumer benefitted from the double-whammy of cheap products and lower interest rates. It led to massive wealth creation in the US with the S&P 500 Index up by nearly 50x over the petrodollar period.

Unfortunately, the one-sided trade flows this system fostered came with stark long-term side effects, and the petrodollar system is responsible for today's dominant economic problems. With high demand for the global risk-free asset, United States government indebtedness increased more than 60x over the period. Domestically, the need to run structural trade deficits led to the exportation of manufacturing jobs to lower wage countries. Over the years, the domestic industrial base eroded, and local economies suffered, leaving many workers disenfranchised and resentful.

The reversal of globalization and transition into a new order: The petrodollar system had started to show first cracks even before the financial crisis, and the summer of 2008 probably marked the turning point of globalization.[5] Occupy Wall Street in 2011 was a harbinger of things to come, but it was the desperate rust-belt voters in 2016 that produced the pivotal political earthquake, delivering Trump to the White

[3] The Organization of the Petroleum Exporting Countries.
[4] Globalization and de-globalization tend to move in cycles (e.g., there was a strong globalization period in the decades before 1914, terminated by the First World War, which subsequently led to decades of deglobalization).
[5] The pseudo-peg to oil had been silently dropped in 2004/2005 to spare the US economy from another downturn.

House with a mandate to put "America first" and change a system that seemed to have stopped working for them. Trump's most significant action may have been the frontal attack on China's tech crown jewel, Huawei, in 2018.[6] It did what none of the trade-tariff-brawling did: convincing China that the US is "out to get them." It also made clear to the rest of the world how an escalation of the economic war between the United States and China could drag the whole global economy into the mud, given how much a globalized economy relied on uninhibited trade.

COVID, the Ukraine war, and the resurgence of global commodity prices are adding more momentum to the unravelling of the status quo. The pandemic made us painfully aware of our dependence on perfectly functioning global trade, and the war shows us how risks in a post-US-hegemony world will increase. Crucially, with the freezing of Russian Central Bank assets by the Fed and the ECB and the exclusion of Russia from the global payment system (SWIFT), a rubicon has been crossed. Sanctions like these have been used on smaller countries before but never on a global power like Russia. To be clear, we are not condoning Russia's actions; we are simply drawing our conclusions from what is happening in the world of finance and geopolitics.

While past reports of the imminent death of the USD as the global reserve currency were exaggerated, the weaponization of the leading global reserve currencies against a country like Russia will have game-changing consequences. While the main Western global powers are united in their response to Russia's actions, many other large countries have retained a neutral stance, even including NATO-friendly nations, such as South Africa, Mexico, and Brazil. Many countries have been increasingly worried about the power over them that the dollar hands the US and may decide that this is the moment to accelerate a transition. In our view, it is likely that parts of the world will now push for a move away from the USD as a widely accepted medium of exchange. China, India, Pakistan, Iran, Turkey, Saudi Arabia, and other countries with a history of ending up in the crosshairs of the West are unlikely to keep reserves at the Fed or the ECB if these can be easily confiscated. They, and others, will speed up their plans to move bilateral trade away from the USD and the EUR.[7] The message from the West, not just to Russia, was clear: "Take your assets elsewhere; your money is no good here, and we may seize it if we deem you a bad citizen." That said, this transition will likely be more gradual than sudden, as many countries have existing USD-denominated debt outstanding and continue to need dollars to service this debt.

The consequence of de-dollarization and de-globalization is that we will likely be entering a transition period under a multi-currency system of regional trading zones, creating friction to free trade and free flow of goods and capital. With the benefits of the petrodollar system reversing, the price of goods (i.e., inflation) and money (i.e., interest rates) are likely to increase, creating headwinds for the global economy and increasing the risk of crisis. What triggers the crisis is specific to the vulnerabilities of the individual countries. It could be a debt crisis in the United States, an energy crisis in the EU, and a food crisis in China. They will all be expressed through a domestic economic and political crisis, and some may spill out into external conflict and war, as history has shown. The resolution of this crisis will give rise to a new order, and the cycle begins anew. This process is nothing new; in fact, human history shows that we go through it about every 80-100 years. What we can't predict, however, is how disruptive and violent the process will be this time around.

[6] Resulting in its slow starvation, deprived of Western semiconductors.

[7] Russia has been selling oil to China for Renminbi for a while, but this relationship will certainly expand. Saudi Arabia is reported to consider the same to be able to compete. Russia is demanding Europe pay for its gas and oil in Rubles. India is likely to increase its oil purchases from Russia for Rubles.

The United States in a deglobalizing world: For the United States, the gradual reduction of global financial dominance may bring some transitory pain, with the severity depending on how fast the shift happens. Fewer foreign buyers of treasuries means upward pressure on interest rates, as deficits now must be financed domestically. The US is a highly leveraged economy, and the government may have to cap the rise of interest rates to avoid a wave of defaults. The USD will be the pressure valve, weakening in the process against currencies of less indebted nations. Inflation is likely to stay high as the disinflationary benefits of globalization fade, and the world deals with shortages across a variety of goods and commodities. However, the United States is better prepared than others for a deglobalizing world. The country will have an opportunity to re-industrialize and bring key industries back home. Demand for skilled labor should be strong and increase wages in areas with catch-up potential. Exports should benefit from a lower dollar, helping to rebalance the US trade position. Domestic companies with pricing power should benefit from high nominal growth rates, reducing the burden of fixed liabilities (e.g., debt, pensions). The government can engage in financial repression, running inflation on the hotter side while keeping interest rates capped, reducing the debt burden. Lastly, of all the global powers, the United States is least dependent on international trade, as it is nearly self-sufficient with regards to food and energy. It is protected from aggressors by two oceans, and it has access to two friendly neighbors with an abundance of cheap labor and energy, respectively. With good execution and a bit of luck, the US economy will be in a good position to weather the coming challenges.

This takes us to what this all means and what the implications are for investors:

Inflation: The war in Ukraine changes our view on inflation. Multi-year elevated inflation (4-6%) has now become our base case. A weakening USD will push inflation higher via more expensive imports. Accelerating deglobalization is inflationary, as the cost of trade rises and the benefits of labor arbitrage disappear. War is inflationary; it destroys human and physical capital and promotes hoarding. It increases protectionism and spurs unproductive defense spending, which must be paid with deficits and money printing. With war raging between two of the most important wheat, potash, and energy exporters, it is hard to imagine how the world is not in for a severe food and energy price shock. Even in the case of a ceasefire, restoring normal energy production and exports could take a long time. International oil companies have left Russia, and some sold joint venture stakes. If the war drags on and Russia is completely sanctioned, WTI could hit $200 or more, especially if China gets COVID under control and reopens its economy. We hear that the supply situation on the food side is very precarious. Ukraine and Russia are important suppliers of wheat to China, the Middle East, and Africa, and we are looking at the possibility of broad-based famine. Many other farmers around the world will be unable to afford or secure fertilizers, increasing the risk of harvest failures. The risk of a global food crisis in the second half of 2022 is very real. The last global food crisis in 2011 triggered the "Arab Spring" with all its instability and mass migration.

Fixed income: We believe that inflation and rising rates are already helping to slow down the economy so that the Fed can ease off the existing aggressive tightening plans. The largest risk is that the economy slows, and inflation stays high, a condition called stagflation. In either case, we believe the Fed will continue to target real interest rates in negative territory (i.e., a 10-year treasury rate clearly below inflation). This complicates the case for holding bonds. With the current yield below inflation, the real return is negative (i.e., it leads to a loss of purchasing power). To make a case for bonds, one must believe that bonds will continue to be an "antifragile asset" (i.e., that they will protect from a sell-off in other risk assets). While this was reliably the case for bonds since 1980, we are finding ourselves in a new environment of rising rates and high inflation, which messes with the correlation between bonds and

other risk assets, such as equities. This means that it is quite likely that bonds will fall in tandem with equities (since both don't like rising rates). This makes bonds a risk asset like any other, removing the key reason for holding bonds over the last 40 years. That said, we are in a very fluid economic environment with many different currents and very active feedback loops, and it has become hard to predict how asset classes will move relative to each other. Liquid fixed income can still be part of a portfolio, but we would complement it with other potential antifragile assets for this environment, such as gold, commodities, and possibly bitcoin. Further, we believe that for anyone looking for the safety of fixed income, an allocation to private credit makes a lot of sense, if one can accept the illiquidity of such private assets. Private credit has very strong capital protection characteristics, good protection against rising rates (as many underlying loans are adjusting to changes in rates), and a yield high enough to compensate for inflation.

Gold/Commodities: In our view, commodities in general and gold (or major gold miners) are likely the antifragile assets for the current inflationary environment. This is because inflation debases the value of fiat currencies, but it can't debase the value of hard assets. Further, it is hard to imagine how central banks around the world will not accumulate more gold going forward if they want to wean themselves off Western central banks. It is also likely that gold-backing of currencies will become a topic again, maybe even in combination with other commodities; Russia has already hinted towards a combined backing of gold and crude oil for the Ruble. Gold is a low volatility asset, so only a meaningful allocation to it (e.g., 20%) will have any material impact on a portfolio. Other commodities are more volatile and must be sized smaller on a risk-adjusted basis.

Equities: This will be a tough one. Many businesses offer decent inflation protection, but multiples tend to compress during times of inflation and higher interest rates. In the absence of a severe escalation of the war creating chaos in the commodity markets, equity indices should be able to offer reasonable upside. There has been fierce rotation within the market, so the gap between winners and losers is likely to continue to be very large. Asset-heavy, industrial, and commodity equities have a lot of catching up to do, supported by an inflationary environment. Strong technology companies can continue to benefit from digitalization and disruption. Earnings multiples are likely to generally contract, so companies will have to grow into their new lower ratios; the time is up for extreme valuations not justified by respective growth and cash flow. Should the USD weaken substantially, it would lead to an outperformance of non-US equities, especially emerging markets. Latin America seems well positioned to benefit from a commodity bull market.

Digital assets: We believe digital assets will continue to attract capital as digitalization gains market share, irrespective of what happens with the global trading system. The example of fiat currencies getting seized is helping the concept of decentralized finance. The Fed or the ECB simply can't seize your bitcoins, and with other store-of-value assets under pressure (i.e., bonds, USD), it could find new admirers. There is even an outside chance that bitcoin could become part of the collateral backing a new global trading currency, which of course would be a huge win for the community. But at the very least, bitcoin has come a long way to be accepted in the circle of assets that can serve as a store of value, despite its sometimes-wild swings. Bitcoin can't be debased, as most coins have already been mined, and the total amount of bitcoins is fixed. In the current environment, any accepted asset that can't be debased will find buyers.

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