Investment

Family office risk – the inevitability of quantitative tightening

by **Keith Johnston FOC**
20th November 2018

Quantitative easing changed everything, and quantitative tightening will do the same, says Philip Higson, the managing director of Carylon, a Zurich-based consultancy which works with many family offices.

In a new report from Carylon, Higson explains how a global tightening cycle is underway and anticipates markets will transition, with a hefty bump, to a "different asset pricing regime". This will lead to a debt-driven crash/correction and, for many, what you own isn't going to be worth what you thought it was.

This bearish outlook, produced in partnership with insights from the family office membership group Club b, presents the most important risks for family offices in the years ahead, but also presents opportunities.

Equity and debt valuations will change significantly, with debt sustainability concerns increasing, particularly for governments and corporations. Political risks will come to the fore for the super-rich as populist-led spending plans will lead to higher tax rates and greater demands for wealth transparency. As such, governments will target the rich even more.

The good news is that those with sufficient liquidity to participate in bargain hunting will flourish and value investing will come to the fore

The idea that this market cycle is going to come to an unhappy end sooner rather than later has been talked about for some time. But the report explores this from a family office perspective.

Crisis measures have stimulated high debt and equity growth since 2010. Global debt is up 29% to $241 trillion since the beginning of the decade. Yet, as Higson notes, this is not spread evenly.

Financial institutions debt has been held in check by regulators and household debt by fear. But sovereign and corporate debt has ballooned. Sovereign debt is up 49% to $64 trillion, while corporate debt is up 43% to $70 trillion. What's more, China had taken on more than its fair share while remaining opaque in the way it reports its economic numbers.

The current wave of debt is of particular concern in countries such as Argentina, Greece, Turkey, Egypt, and Italy, where imbalances remain very high and could cause even greater problems for these economies in the near future.

Safe havens, as defined by Higson as those countries with low credit default swap spreads, include Australia, Denmark, Norway, Germany, Sweden, and Switzerland. The very high US budget deficit is offset by its reserve currency status as well as growth from recent tax cuts.

Simply put, low rates have only deferred historically anticipated defaults while creating the conditions for new ones.

Meanwhile, asset mispricing means that, compared with long-term averages, real yields and credit spreads are too low in developed markets and in many cases too high in emerging markets. Higson says: “Equities, based on enterprise value to sales ratios, look expensive in North America, but are becoming cheap in Germany and are already cheap in Spain, Japan, Korea, Russia.”

Higson expects these trends will provide new investment opportunities for family offices such as high returns from public infrastructure projects and a much enlarged distressed asset pool.

And the good news is that those with sufficient liquidity to participate in bargain hunting will flourish and value investing will come to the fore again.

Yet there is some doubt whether all family offices will be able to benefit from the new conditions.

Higson says that between 2010 and 2018 family offices significantly increased allocation to alternatives, specifically illiquid longer-term assets. Investment in alternatives including real estate went from 26% of their portfolio in 2010 to 39% in 2018.

And as many have historically high levels of illiquid assets in their portfolios, the ability to access some of these opportunities from the turning of the cycle will be limited.