

Investment Policy Notes

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Notes on Investment Policy Meeting held on Tuesday 10th January 2012

- Over the past decade financial markets have become increasingly political. China's accession to the WTO, the advent of the euro, and the consequences of the 9/11 outrage saw governments playing a larger role in economies. When the banking crisis reached its acute stage in 2008 governments accelerated their intervention. This had the effect of making the cost of capital too low, and government spending is not subject to the creative destruction so necessary in capitalism. Moreover this government largesse has not led to strong growth, and in particular it has not led to significant job creation.
- The likelihood is that Europe is in for a long and sustained recession. Governments are able to reduce the severity of recessions, but usually at the cost of extending the duration. This process will also be complicated by the electoral cycle both in Europe and elsewhere, as it is likely that austerity measures will be compromised by electoral needs. The tension between social instability and market pressure will add to the confusion. Nonetheless the endgame is clearer. Europe has been consuming above its means for many years and reform of its welfare provision is overdue. Short term bail outs are one thing, but over the long term it is unreasonable to expect Germans to pay for Greeks to retire in their fifties. Having struggled to hold the euro project together as a perfect unity it is likely that European leaders will be forced to accept a more flexible solution. It would not be a surprise if Greece leaves the euro at some point in 2012, or if one or two other countries will leave after Greece. However it is unfortunate that the system remains fragile entering 2012. The current status whereby sovereign countries underwrite their national banks while the same banks buy their sovereign debt to provide the money to finance this operation has an obviously unsatisfactory circularity and is flawed. It is a high wire confidence act with everyone hoping that someone doesn't sneeze at the wrong moment: for sneeze read policy error.
- Nonetheless it is usually in such dark times that the greatest opportunities present themselves. Wealth accrues in good times but fortunes can be made out of disaster. Pessimism today is pervasive. Many investors have reduced their equity holdings to low levels, and within this allocation their weighting in Europe is low. Alarming as the problems are there is a sense now that the authorities are beginning to get to grips with them, albeit clumsily. The recession in Europe is still quite mild and elsewhere the picture is brighter. The US is growing slowly and there are even signs that job creation is finally picking up. The Emerging Markets, which now represent 50% of global GDP, grow steadily. Taken together this creates a respectable global GDP growth rate. Companies exposed to this growth can prosper.

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- More pertinent for equity markets is that many company balance sheets are in excellent shape. There is a huge amount of cash held by companies. That and virtually negligible interest rates make defaults by companies unlikely. The general de-rating of markets has meant that individual equities and credit securities now trade at attractive valuations. Credit with solid credentials yield 12% or more, and many equities have earnings yield higher than that.
- It is significant that the major market which performed best in 2011 was the one in which government intervention was the least. The US stock market has been rising as the US private sector is flourishing. Underpinning this rise are companies that have taken advantage of revolutionary technologies. For example, there is a revolution in the distribution of goods which is allowing the costs of distribution to plunge, and much of the benefit of this cost saving is passed on to the consumer. Every \$1m of sales by Amazon requires one employee compared to the 4 employees required by Wal-Mart. In manufacturing labour is becoming a smaller proportion of the cost of production. Due mainly to the advances the Japanese have made in robotics the need for manpower has been reduced. An interesting offshoot of this is that the location of a factory becomes less important. If labour is a smaller component you don't need your factory in China, you can put it closer to its market. Likewise, advances in technology to extract oil and gas mean that previously uneconomic or unreachable reserves are now economic. This is reflected in the estimate that within ten years the US could be energy self-sufficient once again, with all the implications that holds for the US current account deficit as well as geopolitics. Equally positive for the US current account could be the arrival of Boeing's Dreamliner. Boeing have an order book of over 1000 planes, and if production reaches 5-10 planes a month that would be a major boost. The world feels full of hidden monsters but at a company level there are lots of opportunities. Reflecting the dynamism of American industry the US dollar may well be the best of the major currencies in 2012. Currencies are often thermometers of the health of a country, and while the US government has significant problems, corporate and private balance sheets are all moving in the right direction.

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- The Chinese stock market had a disappointing year in 2011. China's astonishing rise over the past thirty years which has lifted hundreds of millions of people out of poverty is extraordinary. It has often been compared to the industrialisation of the US in the nineteenth century. However what is often forgotten in the comparison is that the US's rise was built on the hard money regime of the dollar being fixed to the gold standard. This regime exacted a severe discipline in which capital invested required a high return. By contrast China has been built on fiat money which can be created at will. Capital has not been deployed under the discipline of seeking high returns. Instead capital has been allocated to generate employment. The consequence has been over-investment leading to poor returns on investment. Critically it has led to consumption being a low proportion of Chinese GDP. Consumption has fallen from 56% of GDP in 1980 to 32% today. The challenge for China is to raise consumption. To do this they need to raise wages, strengthen the currency, and allow higher returns on invested capital. This is a delicate challenge. A large part of the Chinese growth model of the last twenty years, low cost labour and high exports, would be undermined by these changes. Transition periods such as the one that China is facing tend to be volatile.
- The world feels an uncomfortable place entering 2012. The coming year is full of elections which will add to the uncertainty. The upheavals in the Arab world, and increased uncertainty in Iran and North Korea, only add to jitters in a nervous environment. It seems highly likely that 2012 will see considerable social unrest, in particular in Europe. However against this must be put the strength of parts of the corporate sector. Despite three of its largest industries (banking, housing and autos) being on their knees the US still managed decent growth last year. By necessity governments are going to have to rein in their spending and the history of capitalism has shown that the private sector tends to flourish when this happens. Yesterday the German government sold, for the first time, six month bonds with a negative yield. Investors face the choice of investing in this type of asset, which in many ways looks less safe than is traditionally assumed, or investing in the credit or equity of companies, which despite the chaotic background, are striving and managing to grow. It is the opposite of human instinct but, ironically, the most volatile place may be the safest in the long term.

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