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Investment Outlook Q3 2015

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- During the second quarter equity markets moved sideways while bond yields rose sharply, albeit from exceptionally low levels. However these moves were overshadowed at the end of June by the crisis in Greece, which looks likely to mean that Greece will default on its IMF and other debt payments. While this default puts Greece in the company of Zimbabwe, Sudan and Cuba as one of the few countries that has defaulted on an IMF loan, the default has arrived at a time when the European authorities are far better prepared for it than they were five years ago when the Eurozone's peripheral countries' debt problems first rattled markets. Greece's economy is quite small, but more importantly its debt is now in the hands of supra national bodies like the IMF and ECB so it is far easier to contain problems. Moreover the problems have been evident for so long that markets have adjusted to them, and even an exit of Greece from the euro would not be a surprise. The Greek situation is more a political problem as if Greece did exit the EU it would show that membership is not irreversible. The endless summits discussing Greece show how much of politics is about how to manage near bankruptcy. Greece is not the only country to have uncomfortably high debt to GDP ratios so this is a warning of what happens when market confidence is lost. It is also a warning of how badly markets can misjudge political risk. Just a year ago in April 2014 an issue of €3bn of five year Greek debt with a yield under 5% was oversubscribed seven times. This bond has almost halved in value since launch.

- In the long term events in the bond markets will be far more important than Greece. It is possible that in April the great bond bull market that started in the early 1980's finally peaked. In mid April the German ten year bond reached a yield of just 5 basis points. Short term bonds in many other countries were negative, and some corporate bonds such as Nestle and Royal Dutch had negative yields. In an extreme bizarre example of negative yields a sex therapist in Denmark was able to take out a bank loan at a negative interest rate. She borrowed money for three years from Realkredit Danmark at minus 0.0172% meaning that the bank pays her DKr7 for every month of the loan. Low or negative yields such as this distort financial behaviour. In the 2008 crisis Central Banks cut interest rates to almost zero as a 'temporary' measure, but it has now endured seven years. Such low interest rates make people save more because they cannot anticipate earning safe income on their savings. It makes retirees spend less because they have less interest income and need to stretch their savings further. Both dynamics create less spending and a slower recovery. Moreover how can you justify owning a bond with a negative or near zero yield for ten years? Logically interest rates should always be positive. So how have interest rates become so suppressed that investors are prepared to take the duration risk, the liquidity risk and the credit risk for almost no compensation? The reason is regulation. Investors are forced to hold sovereign bonds to satisfy the new banking rules, as government bonds are deemed to be lower risk than cash. Monetary policy and regulation have combined to herd investors into what seems an overpriced asset class with potentially destructive implications. This danger is greatest in the corporate bond area. Corporate bond dealers have reduced the inventory they hold from $300bn in 2008 to $50bn today, while over this period the stock of US high-grade bonds has risen from $2.8tn to $5tn. Changes in bank capital regulation have reduced market-makers' ability to warehouse risk. As a result, there are few shock absorbers in the system to dampen price swings, so well intentioned regulation has made the financial world a more risky place. Much of this corporate credit has been purchased by mutual funds who offer daily liquidity. Should interest rates continue to rise and force these funds to sell, the only selling price may be at rock bottom prices which is what happened to sub-prime assets in 2008. Effectively the only entity that could step in to bring order to this market would be the government but they would be reluctant to do this, so tensions are building in this area. Any sudden -sell off in bonds could be harmful, but for savers and, particularly, pension funds yields need to rise for them to meet their long term liabilities. The Federal Reserve has not raised interest rates since 2006 but a return to an interest rate cycle would be welcome and would re-introduce some discipline into markets. For example Ryanair recently issued an eight year bond with a yield of 1 1/8%. There is no more cyclical business than an airline but this bond is priced as though there is no cycle. A return to a cycle should be seen as healthy.

- Part of the reason that interest rates are heading higher is that there is more evidence of strength in the US economy. US employment and wages are firm, retail sales and auto sales are strong, and the impact of the higher US dollar and fall in oil related capital expenditure is fading. Profit margins remain high and compared with the past investors are still underweight equities in their portfolios. However the leadership in the market may be changing. Most equity markets have been driven by a fairly small number of so-called growth stocks. These stocks have been the natural alternative to bonds for investors looking for a reliable stream of income, and their predictable earnings and strong balance sheets have given reassurance that while equity prices can be volatile, if held for the long term the performance should exceed that of the bond market. In the last few years' low yield environment a company with such predictable, compounding earnings has been attractive for its yield of over 3% of inflation-proofed earnings. Consequently such companies have soared in value and their PE ratios expanded considerably. However the earnings of these stocks have underperformed the expectations that people had of them a few years ago. Over the past five years companies like Novartis, Unilever and Reckitt & Benckiser (and many others) have doubled in value, while their earnings have risen by less than 40%. Their excellent stock market performance reflects low rates rather than strong earnings. Investors have been crowding into these safe equities driving up their valuations. The risks are rising here. First these stocks are vulnerable to a change of mood by investors because why would you need to pay so much for safe assets if a recovery comes through. Second these growth companies can experience growth difficulties. Nestle, the ultimate safe growth stock, has just announced that its African growth strategy has failed. They hoped that Africa would be the next Asia but in their words 'the middle class in the region is extremely small and it is not really growing'. They are cutting staff in twenty one countries. The opportunities in stock markets lie more in stocks that will benefit from a cyclical upturn and are selling at much lower ratings.

- Japan remains the most attractive market in the main economies. The 120% rise in the stock market under Abe has been supported entirely by earnings growth and improving fundamentals. While vulnerable to a global equity decline Japanese stocks look good value with profits rising 12% this year. Employment is strong and wages are starting to rise. There has been an increase of full time labour from part time which brings employees extra benefits beyond just wages. The yen is as competitive as it has been for forty years and GDP growth as strong as at any time since 1997. After a two decade battle against deflation Japan looks to be heading for a period of mild reflation. Signs of this can be seen in rising wages, rents, commercial property and bank lending. More importantly for the stock market companies are increasingly focusing on returns to shareholders by increasing dividends and share buybacks, and improving return on equity. On reasonable estimates Japan's total return to shareholders for the year ending March 2017 could be 6% compared 5.3% in the US. That represents compelling value in a world struggling for yield.

- In China there has been further evidence of the economy slowing. It is hard to overstate the importance of China to the global economy. Having grown at almost 10% a year since the late 1970's China is now the second largest economy, and by some criteria the largest. Together with the US it is the world's growth locomotive. China's build up of debt has been an increasing concern and as growth slows it may become more so. The stock market has ballooned as locals have redirected their savings from property into stocks but with margin lending having quintupled over the past year, and insider selling at record levels a cautious approach continues to be warranted. However the Chinese government has shown a formidable ability to control events and will likely continue to try and guide the economy to a soft landing.

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