INVESTMENT OUTLOOK

Q3 2018

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QUATERLY INVESTMENT OUTLOOK

> *At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard for a company with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes that you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years I can maintain my current revenue rate….what were you thinking.*

Scott McNeely, CEO of Sun Microsystems at the time of the dotcom crash when the shares were selling at 10 times sales.

At mid-year world bond and equity markets have struggled, with bonds delivering a slightly negative return and equities fell 1.3% as measured by the MSCI World Index, a poor return given that S&P earnings are estimated to increase by 25% this year (largely thanks to the tax cut at the end of 2017). Emerging Markets have been particularly poor performers. The reason is that liquidity has been tightening. In the US, quantitative easing is being steadily drained from the system at a rate of $30 billion a month, which rises to $40 billion from July 1st, and then $50 billion on October 1st. The oil price has risen about 30% over the past year, which results in a severe drain of liquidity. Labour markets have also been tightening creating some wage pressure and with inflation measures trending higher, bond yields have risen. On top of all this investors have been unnerved by a number of political developments, most obviously the trade disputes as the Trump Administration has now specified particular areas against China and Europe, and in Europe an Italian political crisis has threatened the stability of the Eurozone. The US tax cuts achieved at the end of last year, are a clear positive for the stock market, representing a substantial infusion of cash to shareholders. However tightening liquidity, the threat of protectionism and inflation are unfriendly for markets, and constitute significant headwinds. Together they have made the outlook for financial assets much more murky than was the case a few months ago. All markets have been buoyed on an ocean of liquidity for the past few years, so as that is removed a major support to asset prices disappears.

It is unusual to have trade wars when activity is expanding; generally they are a reaction to weak economic activity. The problem is that low income households have not shared in the prosperity of the last thirty years since the Berlin Wall fell. Free trade may have made the world prosperous but too many people have been left behind, and wealth has been concentrated in the hands of relatively few. Protectionism may make the world poorer, but it could distribute wealth more equally. For the many losers in a world of free trade this is the appeal of Trump and the Five Star movement in Italy. It is all very well for the elite in Brussels to preach austerity and further wage deflation to Italian workers, but when life becomes intolerable, particularly in terms of youth unemployment, people will look at alternatives. In America wages for low income workers have stagnated for decades in real terms, and many manufacturing jobs have moved to Asia during that time. This was the background to Trump's Presidential bid, and his recent tariff threats are designed to appeal directly to his core support before the mid-term elections in November. Increasingly a feeling has grown in the US that the Rest of the World has been freeloading on America's provision of free security, free trade and cheap access to its markets. The shale oil revolution has made the US less beholden to foreign security issues, and this energy independence has allowed American policy makers to think the unthinkable: Does the pax Americana need changing? Of course Trump's threats to change it isn't popular with the Davos crowd who abhor his policies, but for the worker in America who is finally seeing some wage growth for the first time in twenty years things look different. Trump's diplomatic vulgarity is disagreeable but one can still hope that a new settlement can be reached which creates a fairer world, without derailing global growth because behind the bombastic rhetoric Trump's credibility ultimately rests on his credentials as a pro growth businessman. Moreover China no longer needs the trade concessions that it was granted in the early 1990's when it was undeveloped. In any case it is hard to retaliate with the US in a trade war because they have the trade deficit. If the trade war results in China lowering its protectionist barriers rather than everyone raising their tariffs then that would be a good result. However whatever the outcome unfortunately it promises to be a messy journey, and the attendant uncertainty will be unwelcome for financial markets.

With growth reasonably strong, which underpin earnings, an accident is most likely to come from the bond market. Investors have crowded into bond funds in an attempt to avoid risk. There is clearly room for disappointment. Financial markets which have been awash with liquidity from the accommodative policies of governments and central banks are facing a change of music. Conditions are still supportive, but steadily less so. The fiscal boost is coming on top of a tight labour market and inflation pressures. Although yields have risen in the last two years they remain at historically low levels. Given the level of debt rising interest rates would be an increasing problem. The scale of the debt problem is worth considering. In 2000 US Government debt was about $6 trillion and the debt service on this about 6% or $360bn. Today the debt has grown to $20 trillion, with the debt service about 2.25% or $450bn. So the debt has more than tripled while the interest cost has only risen 25%. On top of this the budget deficit is estimated to grow by $1 trillion a year. As interest rates rise and the debt grows, the cost of servicing the debt will rise accordingly. With the 10-year bond yield approaching 3%, up from 2.4% at the start of the year this may become more of a concern for the market. Corporate debt is also significant with non-financial corporate debt rising from $6.5 billion to $14 billion between 2000 and now. Again the effects of this have not been felt because of low rates. However, according to the Bank of International Settlements, nearly 16% of companies in the US and 10% in the Eurozone can't cover their interest payments (calculated as interest expense exceeding earnings before interest and taxes). The traditional sources of late cycle inflation like oil and wages are rising so pressure is likely to increase. A common assumption is that the level of debt is such that if interest rates do rise further then it will tip the economy into recession, and then rates will fall back again. Based on the experience of the bull market from 1982 onwards this would be the case, but that was a period of structural deflation. The forty year period before 1982 experienced a bear market during which the 10-year bond yield rose from under 2% to over 15%. During that period the US had nine recessions. Yields did fall during the recessions but the structural trend was for them to rise. The worry must be that the July 2016 low in the 10-year yield of 1.36% marked the turn into a multi decade inflation cycle. If this turns out to be true then it will profoundly change the way that portfolios need to be run. The mounting evidence of brewing inflation from tightening labour markets, reduced disinflation from Asian manufacturing, and political exhaustion on austerity policies all point to the possibility that bonds have finally turned. At present inflation is a slow creep, but the foundation for something much larger is being built. In a world where the majority of fund managers did not experience the 2008 crisis, there is hardly anyone who had to cope with the 1970's. Portfolios are naturally constructed on the basis of the last 35 years experience. There is potentially a huge upheaval coming if they need to be reorganised for a different world. As one illustration imagine how owners of bond proxies such as a 'growth' stocks will start to question why they are owning something which gives only 1% more yield than a government bond but which could lose 30% of its value if interest rates spike. Judging the inflation cycle from here could be absolutely critical.

In equity markets stock picking has become paramount. The last few years stock markets have been increasingly dominated by either growth or momentum strategies, and this trend has been exacerbated by ETFs. The most successful area has been technology and within that the FANGs. However the FANGs have lost their sense of invincibility this year, chiefly due to questions surrounding the privacy of personal data. Issues of monopoly power and fiscal avoidance could cause legal, regulatory and tax costs to soar. There was an interesting comment in May by Satya Nadella, the CEO of Microsoft: 'Every company will need to ask 'Are you creating surplus around you or are you extracting surplus for yourself'. When that equation gets unbalanced things just have to correct. The problem with the current ecosystems is how closed they are.' The quote at the head of this Outlook by Scott McNally from a Fortune interview is relevant today with some companies. There are 28 companies in the S&P 500 trading at over 10 times revenues, compared to 29 at the peak of dotcom mania in 2000. The likes of Facebook, Nvidia and Netflix fall into this category, though they have far more robust business models than were the case of some companies in 2000. Technology and growth stocks, like long duration bonds, have benefited from declining interest rates. At the other end of the spectrum value as an investing style has not worked for ten years. The long term opportunity is more likely to be in this neglected area, rather than the highly owned, aggressively promoted index and ETF dominating stocks. Value always feels lonely, which is the reason it has outperformed as a style over the last hundred years, because a stock only becomes a bargain when something very uncomfortable has happened to it. In any event investors are likely to have to be far more discriminating from this point onward, and if interest rates rise much from here stock picking skills will become valued for the first time in more than a decade.