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INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

In the third quarter world markets as measured by the MSCI World were flat. Year to date the S&P is up 18.7% and the MSCI World is up 15.7%, though much of this performance is recovering the steep losses of the fourth quarter of last year. Over the past twelve months the S&P is 2.1% and the MSCI World is down slightly.

The dominant feature of financial markets remains the low yields offered by bond markets, and in particular the increase in the quantity of bonds which carry negative yields. Approximately $15 trillion of debt is trading in the market with a negative yield, representing about a third of all Sovereign debt, which is the liquid part of the market. Perhaps more importantly about two thirds of all Sovereign bonds now offer a negative real yield (i.e. after taking inflation into account). This is historically unique, and truly bizarre in which one of the best investments this year would have been to buy assets that were already negative yielding at the start of the year, and therefore had a 100% guarantee to produce a loss if held to maturity. In such an environment investors have been desperate to find quality bonds with a positive yield. The US bond market has been one of the few that still does, partly explaining the strength of the dollar. The plunge in yields has led to some prices which would have been thought impossible a few years ago. For example at the end of 2017 Austria issued a 100 year bond with a coupon of 2.1%. This year it has risen 64%, in the third quarter alone rising by 23%. It now yields 0.8% for the remaining 98 years. Can a yield of 0.8% in a fiat currency that was only launched twenty years ago be deemed truly safe? A lot can happen in 100 years, and in the last 100 years a lot did happen in Austria. If interest rates were to rise by 1% it would take 26 years to break even on the current coupon. Equally bizarre is the performance of gilts which have soared despite the Brexit chaos, as the UK still offers a positive yield which is relatively attractive against other European countries where one pays for the privilege of lending to their governments. Such countries now include Latvia, Ireland and Slovenia, while Bulgaria, Lithuania and Spain are a hair's breadth from joining them in the negative yield club. The implications of these yields are wide ranging. Vast amounts of money is sacrificing purchasing power for the next decade, for example, at minus 1% a Swiss pension that buys the ten year bond guarantees a capital loss of 10%. Worse with the Swiss interest rates negative out to 50 years there are no Swiss government bonds available with a positive nominal yield, meaning that investors will lose money in any Swiss government bond held to maturity. How do such countries provide for the social claims of a rapidly ageing world? Even stranger is that this is taking place at a time of growth not recession. For comparison in the depths of the 1930's US depression when industrial production declined 25% the 10-year yield fell only to 2.31%. Today world growth is slowing but it is still positive. Moreover monetary policy is loose, fiscal stimulus is being advocated by most governments and wages are rising. Many of the conditions necessary for inflation are present at a time when the fixed income investor has no yield to cushion them. The last time fiscal policy was expanded at a time of full employment was in the early 1970's, an equally febrile political period, and inflation became a problem for the next decade. The integration of the labour force of the Emerging Markets mean that labour has less bargaining power than that period, but bond prices do not provide protection against a rise in inflation or the cost of living.

Such low interest rates beg profound questions for all capital markets. Indeed they have inverted the capitalist order. The rentier is paying the entrepreneur to survive. With negative yields a strong balance sheet is turned from a prudent asset to a liability. In such a distorted environment the normal criteria of valuing companies becomes similarly distorted. The traditional methods of valuing equity becomes almost arbitrary. For example the private equity financed company We Work is burning about $3 billion of cash as year. In January it raised money at a valuation of $47 billion, and in May Goldman Sachs hoped to bring the company to the stock exchange at a valuation of $65 billion. However in the last few weeks this flotation was abandoned when there was insufficient interest even in the $15 to 20 billion range. Examples like this suggest that capital markets may be growing more discriminating as the recently listed, and loss making, companies Uber and Lyft have both seen their share prices struggle under the scrutiny of a public listing. Likewise Tesla is no longer given the benefit of the doubt for promised growth, but is being judged on reported results. The lax financial conditions of the last five years have allowed Tesla to raise funds without regard for profitability, but with stricter criteria being brought to bear the share price is below where it traded five years ago, and 40% below its highs. However the speculative end of the market still produces surprising valuations. The artificial meat company, Beyond Meat, listed in May, reached a $14 billion valuation despite having only $250 million of sales. It may follow the pattern of a similarly fast growing concept stock, Tilray, a cannabis company, which listed a year ago and whose valuation rocketed from $2 billion to $30 billion before settling down at the current $4 billion. The challenge that all these companies face is their strong growth attracts competition from other start-ups and established companies.

The low interest rate environment has also made its effect felt in the wider market. High quality companies are being attributed a multi-decade high premium. As returns from bonds dwindle investors have been forced to seek returns elsewhere and the natural place to look in equities is for those companies with a history of reliable earnings and dividends. The valuations applied to the projected earnings of perceived low risk and growth stocks has led to a dramatic rerating of these stocks. Investors have chased themselves into the strongest performers of the recent past, leading to a mania for expensive stocks. The likes of Microsoft and Alphabet (Google) probably deserve these high ratings. Indeed if economic growth remains subdued then those companies that do deliver strong sustainable growth could be rerated far higher than they already are. But many other companies have less powerful franchises and in some cases are barely growing. Just as value stocks can store future returns, so overvalued stocks can store negative future returns. This is clearly the case with bonds with negative yields, and it is likely the same with a number of highly valued growth companies. Meanwhile the disconnect between ‘safe’ companies and ‘risky’ ones continues to widen. S&P Growth index ratio to the S&P Value index is close to the levels reached in 2000. However many companies with low valuations have restructured, reduced capacity, and are consolidating which should lead to improved returns. Ironically the companies that are being ignored often provide the income that investors are desperately seeking. The increased influence of passive investment and ETFs has also pushed stocks to extreme valuations in both directions. An unfashionable sector like high street retailing is an example. Traditional retailers have been decimated by internet shopping, yet many have adapted to the online world and most are now omni-channel rather than reliant purely on their physical stores. Testament to the fact that physical locations are still important was seen when Amazon bought Whole Foods which has approximately 500 stores. The physical sites have uses beyond simple transaction, as they offer advertising channels for merchandisers, act as logistics centres and there is still a role for a three dimensional experience when appraising potential purchases. Those retail chains that can combine compelling online and physical selling experience should have a future. One of the best known retailers in the US, Macy’s, has an enterprise value half the value of its property and is on a dividend yield of almost 10%, well covered by earnings, yet 20% of its freefloat is sold short. Even more extreme is the department store chain Dillard which owns 85% of its properties, relatively little debt, and healthy free cash flow. Over the past decade the company has reduced its share count by over 60%. Yet 93% of the freefloat is sold short! Why do these situations arise? Because ETFs generate their revenue through lending their shares out rather than through management fees. This is a specific example but in general the more capital intensive businesses have been de-rated, sometimes unfairly. Incumbents have great resilience, and these businesses which have not felt the boosting effects of QE have been forced to adopt strong capital discipline and consequently improving returns.

The dramatic falls in stock markets in the final quarter of last year was a stark illustration of how vulnerable stock markets are to any tightening of liquidity. Markets have become extraordinarily dependent on monetary policy, and if more restrictive conditions arrive investors will find conditions considerably more uncomfortable. For the time being there is little sign of this given that political conditions remain nervous with the US entering a Presidential year, China having to cope with a domestic economic slowdown as well as the protests in HK and Taiwanese elections in January, Middle East tensions heating up, and the Brexit mess becoming ever more complicated, while Europe is equally unsettled. Economic growth is uninspiring. The usual hiding place for investors in such a period of uncertainty would be the bond market but this hideout has been destroyed by central banks. The safer areas of the equity market have also been made unappealing where prices have been inflated beyond fundamental earnings. Investors need to construct a portfolio out of a combination of companies with real earning power that continue to be attractive in a low growth world, and value companies where modest improvements should inspire a rerating. For those who are able to take short positions there is also abundant opportunity. This strategy is unlikely to provide a comfortable journey. The distortion in markets now evident means that those companies that are most risky in valuation terms have the most defensive underlying qualities, while those that offer some of the best rewards continue to have significant challenges. Buying value over growth is a contrarian view. Before it ends the best place to be is in the bubble. You never feel a bad day. And the endurance of this bull market makes you ask how will it ever die? But the correct question is what are its reasons to live?