INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

'It's ludicrous that a government can borrow at a negative interest rate and doesn't take advantage of that.' Sajid Javid, UK Chancellor, 7.12.19

At the peak in 2019 $17 trillion of global bonds carried a negative yield. One shouldn't lose sight of the fact of how odd it is to pay for owning bonds. When the German 10-year Bund yield fell to -0.7% it meant an investor would receive €93 in 10 years' time for the €100 invested today. By comparison in previous periods of financial stress bund yields had fallen to -0.1% in 2016, 1.2% in 2012 and 3% in 2008. It is confounding that these negative yields occurred during a period of economic expansion and employment growth, plus now the promise of coordinated fiscal expansion globally, all of which could see the competition for funding drive up the cost of money. Even Greek debt carries a negative yield. In 2012 the markets were closed to lending to Greece at any price, but now lenders pay for the privilege to lend their money for maturities under six months. Elsewhere in November Angola issued $3 billion of debt for 10 and 30 year maturities that was three times oversubscribed, despite a four year recession which has led to its debt to GDP jumping to 100%, a tumbling currency and the largest credit facility that the IMF has extended to an African country.

These historically low yields derive from Central Banks attempts to revive growth through reducing the cost of debt. However there is increasing evidence that rather than persuading people to spend, negative interest rates are persuading them to do the opposite, to save. Likewise the effectiveness of this debt is diminishing, generating about half as much GDP growth per unit of debt in the last decade as it did in the one before that. Instead the liquidity has flowed into financial assets. For example in the first quarter of 2019 the Eurozone's 3 largest economies of Germany, France and Italy added just €6 billion of growth, compared to their stock market capitalisations increasing by €516 billion. We seem to have reached the point of policy impotence with the monetary policies of the last decade. Hence governments are looking increasingly to fiscal stimulus measures, which are not bond friendly. As the quote at the top of the page shows populist politicians have spotted the opportunity to gorge on these historically low borrowing costs in order to finance the promises that helped get them elected. Austerity has failed in political terms, for example, in the US the deficit for 2020 is estimated at $1.2 trillion, which is less than the $1.4 trillion in 2009, but that was a year of crisis. Such a deficit extending into prosperous times suggests that it is structural, and will be very hard to reduce. Entering 2020 the US will have significant monetary and fiscal stimulus at a time of full employment as President Trump seeks to turbo charge the economy for his re-election campaign. This twin stimulus is occurring at a time when both core and median consumer prices are at decade highs. Elsewhere the Japanese government announced a $120 billion spending package, and across Europe governments are starting to accept the need for similar efforts. As debt issuance soars and growth slows common sense suggests that inflation will pay this money back eventually. The internet and globalisation have led to a long period of disinflation, but tight employment and populist support for increasing the minimum wage puts pressure on wages, and prices are starting to creep up in some areas. For example the prices of the fifty most sold items by Wal Mart rose 5.2%. Migration controls and trade conflicts are also potentially inflationary. A change in sentiment would affect all markets. At the end of 2018 when interest rates started to rise and liquidity tightened it created an extremely challenging environment for investors. The ingredients for a repeat of this situation remain.

Sentiment over the trade war between the US and China has fluctuated over the year. The final outcome of the negotiations were not clear at year end but even if a settlement is reached concerns will linger. When it started in early 2018 there were hopes that the issues would be settled quickly, but what first appeared to be a spat over the trade deficit has now revealed itself to be a confrontation across many issues including military influence, technological capacity, financial access as well as trade imbalances. Short term the uncertainty is likely to be compounded by the upcoming Presidential election in the US, but longer term it is shaping up to be a multi-year problem. To underlie the seriousness of this situation one has to consider that in passing the Hong Kong Act Republicans and Democrats, who can hardly bear to be in the same building together, came together in near total unanimity and speed, to pass the Act which is a direct insult to China. Trade disputes inject deep uncertainty into the business outlook. To the extent that this one threatens globalisation it is stagflationary because it lowers long term global growth potential, and introduces inefficiencies and costs as decisions are taken more from political than economic motives. On China's side they will accept slower growth in so far as it is consistent with social stability, but that growth will be focused more on their domestic economy, and therefore less of a boost to global activity.

The bull market of the last decade has been completely dominated by America. In the next decade the Rest of the World should perform better, given the elevated valuations in the US. The focus of equity markets may also broaden out, from the narrow concentration on a few tech and consumer staple companies. 2019 was noticeable for the tougher conditions encountered by so-called unicorns – companies with billion dollar valuations but no profits. Uber listed on the market in May but the stock price soon fell back as investors considered the merits of a company that had lost $20 billion dollars in the last five years. Other highly touted flotations like Lyft, Pinterest and Beyond Meat also floundered. Then in the last quarter the WeWork IPO collapsed and its parent company had to bail it out by investing at a valuation equivalent to $9bn, compared to the previous fund raising in January of $47bn. The charge of the unicorns has been halted, at least for the time being, and is an indication that the market will return to companies with solid profitability. The other risk in the market is in those stocks that have soared thanks to the strength of the bond market. If the bond market falls they will be vulnerable. These stocks benefited from loose monetary policy as they were re-rated significantly due to their defensive qualities, but their share prices have risen well ahead of their earnings growth. Initially the choice of these bond proxy stocks was sensible. Investors rationally decided to buy predictable long duration growth in a world that wasn't growing. The reliable nature of these businesses drove their valuations to extremely high levels due to the excess liquidity being pumped in. By contrast businesses that were exposed to the business cycle or uncertainty were shunned. However it seems that the limits of QE are being reached, and if QE is reduced that will remove a support for bonds and bond proxy stocks, and fiscal packages are likely to be more supportive for economically sensitive stocks than for defensive shares. There comes a point when it is less risky to own stocks that have some degree of uncertainty but are being priced for a very negative scenario, than it is to own stocks that have little risk to their earnings but are priced for perfection. Just how polarised valuations have become can be seen from the following. Apple's market capitalisation is greater than the whole of the US listed energy sector; both Apple and Microsoft each have market caps equivalent to the whole of the listed Australian market; Apple and Microsoft combined are equal to the entire Russell 2000 Index, but with only 18% of the revenues of those 2000 stocks; Facebook's market cap is roughly equal to the Indian market. Companies, sectors and countries who are exposed to uncertainty have under-performed dramatically. As a result they have found it hard to raise funding. Unlike the unicorns which had money thrown at them, they have been forced to manage their businesses tightly and to rationalise. Capacity has been squeezed out of these areas making for better competitive conditions and a better pricing environment. For example European steel capacity has shrunk, and significant capacity has been taken out of Europe's short haul airlines. Infinite financing destroys returns and breeds competition, and none of the unicorns has yet shown a template for sustainable profitability, while the ignored stocks with solid business fundamentals and balance sheets are in a much better position to produce strong returns and can enjoy a much less competitive environment than before. If the market does start to switch its attention more in the direction of value, then it will have wide ranging implications. In a momentum market such as been the case in recent years passive strategies outperform as active managers sell the shares they deem to be overvalued;

passive managers do not suffer the same way because the computer is brain dead. The scale of the turnaround may be most dramatic in a market like Japan. Exactly thirty years ago the Japanese market peaked and even now it remains 40% below that level, a period during which the Dow Jones has risen ten times. Back then Japan accounted for more than half the world's market cap, now it is one of the most unloved. The massive bust in Japan was centred on its banks and real estate. These problems have been worked through. Japanese companies spent years paying down their debt but now that has been completed they no longer need to listen to their bank, and can focus on their shareholders. There are two strands to the Japan story. First corporate governance and returns are improving, and the firepower for it to continue is considerable with $5 trillion of cash on corporate balance sheets, and $8 trillion of household savings sitting in bank accounts earning nothing. Second you can buy world class companies on lower valuations, and Japan remains a global leader in robotics, automation and electrification. This process should be helped by the world's private equity firms who are pouring into Japan as they sense an opportunity.

After such a strong year some consolidation should be expected. Equity markets are vulnerable to bond yields rising, or further economic slowdown. However if current economic conditions continue then stock pickers can deliver good returns. In a low growth world companies delivering above average growth will continue to be rewarded, while more attention will probably be paid to more cyclical companies which are on cheap valuations. The other factor that may become important is the dollar. If it strengthens it will draw investors back into the 'deflationary' trades, but a weaker dollar should push more money into the rest of the world. Political and central bank policy are converging to push the dollar lower, which should encourage investors to look more at investments outside the US, and beyond the growth areas that have dominated performance recently. At the same time the next decade is likely to be very different from the last one, and the long standing outperformance of growth stocks may start to wane if any sort of inflation returns. Tight labour markets, more protectionism, and more geopolitical troubles are all ingredients for this. Such a realignment, if it were to happen, would be deeply uncomfortable for most investors, most obviously bond holders, because indices and portfolios are set up for the last decade not this possible future. Any adjustment will inevitably be slow, but will present significant opportunity.