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INVESTMENT OUTLOOK

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Written by James Macpherson

QUATERLY INVESTMENT OUTLOOK

After the strong performance in almost every equity market in 2017, characterised by a remarkable lack of volatility, the financial weather changed abruptly in the middle of the last quarter. The trigger was a stronger than expected jump in US hourly wages in January. This inflationary fright rattled markets and led to a steep sell off in bonds and equities. As the quarter progressed a less alarming picture of inflation emerged. However markets had become extended and they have not settled down, while further anxiety was caused by President Trump threatening trade tariffs which could upset the global trade system that has been in place for the last thirty years, and a scandal involving Facebook, one of the market leaders.

Markets took Trump's election victory calmly with the S&P 500 recording gains in every month of 2017. One of the positive features of his Administration has been the reduction of regulations. For example the number of pages of the Federal Register has risen steadily since World War II. In the past year they have dropped from almost 100,000 pages to 54,153, partly due to the Trump program requiring two regulations to be cut for every one added. They cut more on top of that. This is a dramatic change that gives American business considerably more operating flexibility. The tax cut he pushed through in December led to a spike in the stock market in December and January, but the inflation number and some geopolitical rumbles caused the market to be more sceptical of Trump. On the economic side the concern for the bond market is the substantial supply of bonds that will be needed to finance the recent tax cuts. The US budget deficit is forecast to expand from 3.5% to 6%, at a time when the Federal Reserve is withdrawing its policy of QE by reducing their purchases of bonds at a rate that will reach $50bn a month by October, so the bond market faces significant negative changes to both supply and demand. The tax stimulus is coming at a time of nearly full employment so the market is particularly sensitive to wage increases. On top of this the market must contend with the capricious nature of the President, whose policies frequently appear to be unanchored. It is never quite clear what his strategy is, and he has shown a far greater tendency to shift position on a policy than previous incumbents. One example of this is there has been an uncomfortably high turnover of White House staff during his tenure. This is unsettling for markets which prefer clear signals from global leaders on which they can base their decisions. President Trump also seems uninterested in the global bodies that have dominated the world over the past half century such as WTO, NATO and the UN. Whatever the merits of his view that these organisations constitute a bad deal for the US, the danger arises that if the US show less commitment to them then the world is left without a night watchman at a time when security fears are growing, creating further uncertainty. Another concern is the proposal of tariffs being imposed by the US. Anything that inhibits free trade is a negative, so the threat of protectionism weighed on the market at the end of the quarter. However the greatest threat may come from the changes that President Trump made to his senior team in March, which points to a far more hawkish approach on foreign policy, particularly towards countries that the US perceive as rogue states like North Korea and Iran. As a consequence geopolitical tensions have risen considerably this year. While any serious international rift effects markets, an action against Iran would directly affect the oil price and is therefore of more concern.

The oil price has risen steadily over the past year from a combination of stronger demand and OPEC restricting supply. As a result oil inventories have fallen dramatically, though not to critical levels. The chaotic situation in Venezuela, where production is crumbling, is exacerbating this. With Mike Pompeo and John Bolton replacing Rex Tillerson and General McMaster as Secretary of State and National Security Advisor respectively, a far more bellicose agenda is likely to be pursued by the White House towards Iran in particular. With the oil market already tight, further disruptions to supply will likely drive the price higher. Furthermore the last few years have been a period when little investment was made in developing new oil production, and from 2019 the effects will be felt as little fresh supply will be coming thorough. If any action is taken against

Iran then the oil price could jump significantly. The US are relatively protected from this as it would help their shale producers, but the general economic effects would be depressing.

For a variety of reasons bond yields have been rising. World growth has been strong and synchronised, and in many countries labour markets are tight, and therefore wage pressures are increasing. Loose fiscal policy and lack of investment in new capacity add to the pressure. Perhaps the most potent inflationary force is the return of corporate confidence. Evidence is building that the long bull market in bonds that started in 1981, ended in July 2016 when the US ten year yield reached a low of 1.36%, and when the volume of sovereign debt trading at negative yields reached $14 trillion. Yields remain at rock bottom levels by historical standards, and highly distorted. The Greek ten year bond yields are just 1.6% more than the US equivalent which is ludicrous. Globally Central Bank support for the bond market is diminishing. In 2016 and 2017 Central Banks were injecting $150 billion a month into the economic system. This support is being withdrawn at a time of greater debt issuance in the case of the US. Buyers will be found but it is likely that it will be at yields higher than today. Rising yields will be a new experience for many. Virtually nobody in the business today has witnessed a bear market in bonds. Sovereign bonds have always been the safe haven asset that could be retreated to in times of turmoil. It will be disconcerting if that safe retreat becomes a more dangerous place. Instead of being a stabiliser of portfolios, bonds could become an amplifier of risk. This is at a time when most portfolios around the world are heavily invested in bonds, due in part to regulations for pension funds that their assets must meet their long term liabilities, and as at the end of any peak in a bull market, the holdings in the asset that has worked best is most widely held at the wrong moment. A rout is unlikely given the still considerable deflationary forces, most obviously evident in the retail sector, but more and more problems are mounting up.

This backdrop creates challenges for the equity market. The US two-year bond yield now exceed the yield on the S&P 500 for the first time since 2008. If bond yields and the oil price are rising that is a tough environment for the price earnings ratio to rise, and means that equities would have to rely entirely on earnings. Earnings growth has been better recently. After a sluggish five year period, 2017 saw stronger earnings, and they will be helped this year by the improved growth fundamentals and in the US by the tax cuts. But share buybacks have been a strong component of rising earnings – one US broker estimates that the $4 trillion of buybacks by US companies since 2012 have been responsible for 72% of earnings growth. Higher rates will curtail buy back activity so this could be another negative consequence of rising rates. Rising rates will also hurt highly indebted companies. The ‘rescue culture’ can damage an economy’s health as corporate zombies suck capital from more promising businesses. Zombie companies, which are defined as those companies whose earnings do not cover their debt servicing costs, have doubled to 10.4% of all global listed companies since 2008. In the 1990’s this ratio was 2-3%. If interest rates do rise significantly then the corporate mortality rate could be high. Volatility and higher rates will return markets to a healthier process of price discovery, as opposed to the recent experience of rewarding earnings momentum regardless of price, and price momentum. It will make fundamental analysis more relevant. If we are entering a different world then most portfolios, which are still built around the trends of the past five years, will experience some hiccups. The dominance of ETFs and passive strategies has led to many people owning the same assets, but the people who make passive investments may not always behave passively. If they sell who will buy from them? A buyers’ strike could be incredibly destructive. Companies like Tesla and Netflix (and Uber) who have had no difficulty raising money from both the debt and equity markets may have a less easy run as interest rates rise. Wall Street can no longer take for granted the invincibility of big tech. The opportunity could turn to more traditional value sectors which have been neglected. It was noticeable that all of Warren Buffett’s purchases in 2017 were in cyclical industries – a travel operator, housebuilders, a floor covering business and a maker of piping systems.

Many assets are fairly to grossly overvalued but there is still a pool of assets that the robots/ETFs have ignored.

Markets appear to be at an inflection point. There are clear positives and negatives. On the positive side of the ledger, employment is strong, business and consumer confidence high, and the recent tax cuts and the Trump fiscal boost will support economic growth. On the negative side, there is record debt, a near record low in the household savings rate, and without wage growth the consumer, who is the juggernaut of the economy, is tapped out. The MSCI World Index ex-US has still not recovered the 2007 high due to a combination of the euro crisis, the collapse of profitability in Emerging Markets, and Japan deflation after the crisis ten years ago. The FTSE-100 Index remains at its level of 2000. The US Index has been mainly driven by the FANGs recently. However with better growth many problems have been addressed. It is clear that Japan's deflation is over, Emerging Market profitability is improving, and while Europe still has many problems a lot of progress has been made. We should be entering a stock picking environment. An extreme example of how this can work can be seen looking at China. A $100 investment in the MSCI China Index at launch in 1992 would be worth $93 today. China has seen an economic miracle, not a stock market one. However by avoiding bad sectors and selecting the stronger companies a good return was possible over that period. Today rising bond yields and geopolitical tensions pose a clear threat to all financial markets, but with discriminating investment there are opportunities. As an example Bitcoin crashed in the first quarter, but bitcoin is just one of the currencies of the blockchain, which is truly revolutionary. Consider the improvement that blockchain can deliver in unexpected areas. Frank Yiannis, Walmart's Vice President of food safety, made this comment recently: 'Before the Blockchain test, it took Walmart six days, 18 hours and 26 minutes to trace the mangoes back to their original source. Blockchain cut that time down to 2.2 seconds…. That transparency leads to accountability, and accountability leads to responsibility. When people know they are being held accountable, generally they govern their actions.' Technology will continue to upset some apple carts, but also provide plenty of reward for those that harness it creatively.