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QUATERLY INVESTMENT OUTLOOK

"I think Trump may be one of those figures who appear in history from time to time to mark the end of an era and to force it to give up the old pretences."
Henry Kissinger. 21.7.18

The third quarter was difficult in financial markets. Tightening liquidity as a result of the Federal Reserve's increase in interest rates, escalating trade tensions, a rising oil price, and heightened worries on European stability with Brexit talks in a quagmire and a threat of Italy exiting the EU, all combined to undermine sentiment. However once again markets outside the US suffered most and by the end of the quarter the US equity market was at/near its highs. The US stock market is benefiting from a strong economy and the tax cuts that the Trump Administration achieved at the end of 2017. Goldman's have estimated that share buybacks could reach almost one trillion dollars this year. This performance has been despite the rise in interest rates and bond yields as the ten-year rate rose to 3.05%. Outside the US surplus liquidity has been drained from the system exposing the weakest links, Argentina and Turkey's currencies crashed and other Emerging Market assets suffered. This sharp divergence has been a feature of the last ten years. On the tenth anniversary of Lehman's collapse and the ensuing financial crisis the surprise has been that while the US has had a weak economic recovery it was accompanied by a soaring stock market. The comparison to the Japanese experience following their collapse in 1990 could not be starker. Ten years after the Japanese bubble burst the Japanese Topix index was half its pre-crash level, while the S&P is up more than twice, and more than four times off its lows. Their bubbles were different, but a significant driver of the S&P's recovery was the enormous share buybacks American companies have undertaken which Goldman Sachs estimates at $4.5 trillion over the last decade. This buyback program has been turbo charged by the Trump tax cuts with estimates that they will approach $1.5 trillion in 2018 alone.

US economic growth rose above 4% in the second quarter on the back of the tax cuts and deregulation effected by the Trump Administration, and this has translated into strong earnings performance. With the US economy in such good shape the risk to the market is rising costs, with signs of this in a number of areas. While starting from very low levels inflation is becoming more challenging. The labour market has been steadily tightening (unemployment claims are the lowest since 1969), and hourly earnings are now rising close to 3%, and more than doubling in some sectors. Energy and other commodity prices, such as steel, are sharply higher. Alongside this, capital expenditure, which has been subdued for years, is starting to pick up. The effects of the trade tariffs that are being imposed are hard to predict, but will certainly add to the pressure. All of this make higher yields in the bond market more likely. For the stock market the question will be how much of these costs companies can pass on. Analysts tend to take a rosier view of reality and predict higher earnings due to the strong current growth. However these changes may impose a reality that may be tougher than in the past few years. The likelihood is that earnings will face more headwinds from here. The US economy is unlikely to maintain 4% growth and as interest rates rise at the end of this long expansion, and with corporate debt high, there could be a slowdown or even recession. While unlikely before 2020 the stock market will anticipate it. A recession might be quite mild for the economy but it could be very damaging to the earnings structure and rating of the market. A recession or higher interest rates would create an environment where there are few natural buyers and many natural sellers. Areas to avoid are the areas where speculation has risen most. An obvious example was the crypto-currencies which have crashed this year. Bitcoin has halved this year. Current examples are the cannabis stocks. For example Tilray which IPO'd in July at $17,

reached $214 and then crashed to $100. At its peak its market cap was over $20 billion making it larger than companies like American Airlines or CBS, yet it is not obvious what the barrier to entry is in the cannabis market. Companies with substantial debt are also at risk. Care is also needed in the technology sector, including the FAANGs. These five companies have performed superbly and account for a large part of the S&P's rise this year. However their sheer size calls into question their valuation. Apple's valuation has passed the $1 trillion mark which makes it almost as large as Spain's GDP. Together these five companies have a larger market cap than the GDP of France and Switzerland combined. Apple and Amazon are about 5% of US GDP each, and Google close to that. Historically the norm for market cap to GDP, excluding financials, has been about 60%, and at market lows like 1974 and 1982 closer to 30%. The FAANGs' 11% weighting in the S&P means that indexed strategies are forced buyers the larger they get, so the valuation expands regardless of fundamentals. The big index trackers like Vanguard and Blackrock are receiving $40 billion in a month. They prefer to cap their ownership at 10% of a company for liquidity reasons, and they are well below that with the FAANGS, and so whatever flows they receive are disproportionately allocated to these stocks. However the higher the valuation of a stock the bigger the bet on an unknowable future. Even for the FAANGs much is uncertain. What are the political and regulatory risks? Will they end up competing against each other? What is the duration of their business models in an era of constant disruption and technological change? In this context it was alarming in July to see Facebook lose a fifth of its market value in just 24 hours.

Bond markets are facing a number of challenges. The United States budget deficit is increasing from $700 billion in 2017 to $1 trillion in 2019. Indeed keeping purse strings tight is out of fashion with most governments as years of austerity have boosted the case of populist parties who are demanding greater spending. The introduction of trade tariffs may make some countries, like China, less willing to buy US debt both for protest reasons and that they have less surplus liquidity as their surpluses shrink. The world's main central banks are also reducing their purchases of government debt, ten years after the crisis. October marks the date when Quantitative Easing becomes Quantitative Tightening globally. Initially this will withdraw $9 billion a month from markets, which will rise to $24 billion in January. Also undermining low yields in the US are the introduction of tariffs because it will increase the price of imported goods and shift production away from the most efficient locations, and deter investment across the global supply chain. Labour markets are tight creating clear pressure on wage growth. In the Federal Reserve's July Beige book every one of the nine Fed regions reported an absence of slack in their labour markets. While it is a gradual move it looks as though the long US bond bull market that started in 1981 finished in July 2016 when the ten-year yield reached 1.36%. As price pressures grow and put upward pressure on this most important of all prices, other asset prices will have to adjust accordingly.

Emerging Markets have experienced a poor quarter, which extends a longer period of underperformance over the past few years. One way of illustrating this is to look at the comparative performance of the Developed Market (DM) and Emerging Market (EM) funds managed by Terry Smith, the well-known fund manager, since the launch of his EM fund in June 2014. The Developed fund has returned 85% while the Emerging fund has fallen 9%. Western, and particularly the US, markets have rewarded the quality growth stocks that this manager favours through a combination of seeking more yield, extravagant share buybacks and substantial PE re-ratings. Indeed since the collapse of the Berlin Wall thirty years ago DM stocks have often been the better way to benefit from EM talent. The US has been particularly successful in attracting talented entrepreneurs from EM. This has been because the US has offered far better rule of law, property rights, and intellectual property protection. Many of the FAANG founders have an EM background – Steve Jobs of Apple had Syrian parentage, Sergey Brin of Google was born in Russia, Eduardo Saverib of Facebook is Brazilian, and Jeff Bezos of Amazon's father was Cuban. Nonetheless EM have made huge progress. Chinese growth has averaged 9.6% since 1989. China has more millennials than the US has people. It is estimated that 35

million people enter the middle class each year, who are demanding financial products, healthcare, education and travel. The EM's financial profile has been transformed since the big crises that beset them twenty years ago. Many of these countries have vast reserves, in contrast to the Western countries huge deficits. One of the most important developments is that with the abolition of fixed exchange rates Sovereign debt today is usually issued in local currency allowing much greater flexibility. While currencies have fallen they now look on the cheap side. As an illustration Russia has built up large savings, it has a 5% trade surplus, and is a beneficiary of the higher oil price. Investors may worry about its political leadership but it is in a far stronger position financially than in previous EM upheavals. The long term growth prospects of EM are too compelling to ignore, and the PE ratio in the MSCI EM Index under 11 times represents an attractive valuation. Moreover the outlook could brighten if the rhetoric changes between the US and China, particularly if China were to agree to switch buying oil from the US that it has been purchasing from Iran, which would reduce the size of the trade deficit that President Trump makes so much of.

After a difficult summer, markets, apart from the US, have de-rated. Unless the trade talks deteriorate markedly or inflation accelerates significantly it is hard to be too pessimistic at the moment. World growth is robust, and corporate profitability strong. While interest rates are rising the return to a more normal level is to be welcomed. The rise in rates and reduction in liquidity will at some stage weigh on the market so bonds remain unappealing, but there are plenty of areas in equity markets where values look undemanding, especially after the setback in Emerging Markets. Growth stocks may face more headwinds as interest rates rise which is not supportive of high PE ratios, but elsewhere it remains an attractive market for stock pickers.

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