INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

Both bond and equity markets rose during the second quarter. With interest rates so low, and little sign of inflation, money has continued to flow into financial assets. The strength of the bond market was perhaps more understandable given the prominence of a number of concerns that investors have. In early May negotiations between the US and China broke down, having seemed close to an agreement. Other issues to encourage investors to seek the sanctuary of the bond market included some fears that global growth was slowing, partly because of the threat to global trade; fears of more regulation on big technology companies; and concerns over European growth and particularly the European banking sector as witnessed by the fact that the total market capitalisation of the Eurozone banking sector is approximately equal to that of JP Morgan.

The performance and current level of the world bond markets are extraordinary. For example the 10-year German bond issued at 100 last August with a coupon of 0.25% per annum, now trades at 105.79, giving a yield of minus 0.37%, implying more than twenty three years of payments for a bond that will only be in issue for ten years. Some German mortgage banks also have negative yields, meaning investors are paying for the privilege of lending their money, and in Denmark some borrowers are being offered ‘negative mortgages’ that pay the borrower interest. Incredibly, bond investors would have made money this year by buying bonds that already sported a negative yield in January. More than $12 trillion of bonds have fallen into negative yield territory, creating a real problem for insurers, pension funds and other asset managers that rely on long term streams of (positive) income. French, Spanish, Portuguese and Greek yields all hit new lows, with ten year French yields turning negative for the first time, as did Austrian, Finnish and Swedish bonds. The French example illustrates the bizarreness of this situation. French government debt reached €2.3 trillion at the end of 2018 and is estimated to expand by a further €80 billion this year, largely as a result of President Macron’s concessions to the gilet jaunes protestors. This puts its debt to GDP ratio at close to 100%, not as large as Italy’s but France’s debt is growing more quickly. France has not run a budget surplus since 1974 (before the current President was born), state spending is the highest of any country in the developed world at 56% of GDP, and it will be hard to raise taxes further as they are already the highest in the developed world at 46% of GDP having just overtaken Denmark, and the gilet jaunes movement indicates that the limits have been reached. It will also be challenging to grow out of this problem as economic growth has been lacklustre for several years. Most concerning of all is that France owes its debt in a currency that it does not control and cannot print, and most of it is borrowed from outside France (unlike say Italy where most of the debt is held internally). France has an outstanding credit record, not having defaulted since 1812, but it stands out among the negative yielding sovereign issuers for the combination of the poor profile of its finances and its inability to print money independently. It is irrational that such an issuer is paid for the debt it issues. For context, in the depths of the Great Depression of the early 1930’s when industrial production fell by a quarter the US ten year bond bottomed at a yield of 2.31%. Japan and a number of European countries’ debt markets are suggesting depression conditions, even though their economies are still growing. Equally sovereign bonds in the US and UK, while they offer a positive return, give very little yield after taking inflation into account, and both countries have shown a disposition to print money to try and stimulate growth. When the environment finally changes and some growth or inflation returns, these bonds may be seen as one of the greatest bubbles in financial history. It is a far cry from the 1970’s when instead of being viewed as safe havens bonds were viewed as certificates of confiscation. Central Banks policy is desperately trying to engineer inflation, and if successful, this would devastate bond portfolios. Investors could suffer nasty losses if more rational yields prevail. While this may currently seem unlikely, even a decade ago when German corporate yields were 5% it seemed equally impossible to imagine that negative rates would prevail today. While Developed Market bonds appear high risk and with deteriorating fundamentals, many Emerging Market bonds display far better characteristics and offer much more attractive yields. Many have run tight policies for years and have built up substantial reserves. Several also have large pension assets: Brazil, Chile, Malaysia, Mexico and South Africa each have larger private pension systems in US dollars than any Eurozone country other than Germany and the Netherlands. Viewed objectively there appear to be far better opportunities for those in need of yield than in the traditional first world countries.

Ostensibly the dispute between the US and China has been about trade, but it has become clear that it is also about dominance in technology, and geopolitical and strategic influence. The dispute matters because it is disruptive to the two largest economies in the world, which will inevitably grow more slowly if they are in conflict. The post 1945 era saw a steady fall in trade barriers and a rise in policy clarity as the US promoted and defended global trade. The actions of the US over the last year suggest that this era may be over. Many companies have organised their supply chains over the past few decades to maximise their global resources. The uncertainty caused by the trade talks may mean that they will have to reorganise decades of investment. In the adjustment they will deliver fewer goods at higher cost; some of this cost will be absorbed by companies accepting lower profits, and some will be borne by consumers paying higher prices. Globally it will amount to lower growth and lower profits, and possibly higher prices. Moreover, some supply chains are virtually impossible to change quickly, for example, how would Germany extract itself from its dependence on Russian energy? The Chinese company Huawei has $120 billion of sales; imagine how difficult it is to swap a company of this size and integration out of the telecom network. Yet much depends on President Trump. Facing the Presidential contest next year, it is hard to assess his position as he oscillates between seeming to want a deal and then to escalate tensions. Clearly if the conflict deepens then Apple, Boeing, Coca-Cola, Ford GM, McDonalds, Starbucks and a range of other American companies could suffer. Whatever the outcome a different environment is likely to prevail because, after witnessing the near destruction of Huawei, China must conclude that if it wants to be a technologically independent nation it will have to build its own eco-system in most industries. Moreover, the next step in trade disputes may be that the US expands the discussions globally. In March, the US imported more from Mexico than China. Much of the criticism that President Trump has hurled at China could be more accurately deployed against Germany. It is hard to see the tensions being reversed, and markets will probably have to adjust to the loss of the tailwind of globalisation and liberalisation they have enjoyed for the last forty years. The question for investors will be how countries and companies adapt to this new environment. For example, how will Japan position itself? It is the US's major ally in the Pacific and reliant on them for their defence, but much of their growth comes from exports to their neighbour China. At the corporate level Apple will have a delicate balancing act - 20% of their sales are in China, while a large part of their supply chain operates there. Allocating capital has become difficult for companies because they don't know what the rules are. Companies need to invest on a five to ten year view, not just the next year. Today it is hard for an international company to make investment plans that don't include China, so the current uncertainty means plans are being delayed till the picture is clearer. The longer this delay continues the greater the drag on the global economy.

Equities have enjoyed a strong rebound this year. Investors have again responded to the uncertainty by buying companies with defensive growth characteristics which provide an assured earnings stream, leading these stocks to trade at a high premium. By contrast they have been reluctant to touch anything cyclical. This has led to the PE valuation spread between the top and bottom quintiles of the S&P to be extreme. Historically the top quintile has enjoyed a spread of 9 PE points over the bottom quintile. Today it is 15 points above. At some point this ratio will normalise. This process has left a number of companies with solid balance sheets and cash flows on low teen PEs which seem undervalued given the low bond yield environment. Samsung, for example, is selling at book value, a much lower rating than it has enjoyed historically, despite the fact that most of its businesses have consolidated into oligopolies and have huge barriers to entry. A company like

Glencore trades at about ten times earnings, despite commodity prices being depressed, whereas Salesforce sells on over fifty times earnings while its profits are slowing. It is hard to know what will change the fashion for high multiple growth stocks. A pick up in global growth, or a rise in interest rates would have some effect. There are some signs that investors preference for pure growth is changing. The big technology companies like Microsoft, Amazon and Google have immensely strong earnings power, but there are increasing questions about those companies whose earnings are further out in the future. Tesla is an example, and it is now at the same price it was five years ago. A company like Tesla is the product of the environment of ultra-low interest rates. It would surely have struggled even more if interest rates had been 5% during this period. Similar companies may also start to be challenged. The easy money environment allowed companies like Lyft to come to the market in April with the largest loss ($911m) recorded by an American company in the twelve months before listing. Uber then beat that record in May when it came to the market having recorded a loss of $800m the previous quarter. Both launches were disappointing and may make it harder for similar companies to list. WeWork, the office landlord, is intending to list later this year; it recorded a loss of $2.3 billion last year, and Bernstein Research estimate that it may require another $19.7 billion before it breaks even in 2026. This charge of the unicorns contains its own dangers. New funds are seldom invested in these type of new issues, rather they must be found by selling existing positions. Such speculative flotations are often a sign of the market being late in the cycle. Nonetheless American business remains healthy and is benefiting from the tax cuts President Trump effected at the end of 2017, and his removal of various regulatory impediments. The overall effect of this can be seen in the fact that from 2009 to 2016 S&P profits rose 1.9% per year, and since 2017 they have been rising 15.9%. It is perhaps for this reason that he has not come in for more criticism at home on the trade issues. And the US enjoys tremendous advantages. Alone among the world's powers, only the United States is geographically wealthy, demographically robust and energy secure. Yet the market is likely to become more nuanced. Companies exposed to global trade may experience more headwinds, likewise many companies have accumulated considerable debt in the recent easy money period, and there are signs of economic slowdown in various parts of the economy. Stock selection will become more important and companies that flourish in this environment will deserve to be re-rated. Equally as earnings growth becomes more challenging shorting stocks should play more of a role than in the momentum driven market of the last few years.

The investment world has steadied from the panic at the end of last year but it remains fragile, as witnessed by the rise in gold, which has risen more from fear than inflation. The trade dispute with China, and the threat that this dispute will widen to Germany and elsewhere means that the uncertainty will continue. On top of this the price of oil, perhaps the most important of commodities, has become more volatile owing to the escalating tensions with Iran. With a few exceptions the bond markets offer little attractive, and potentially may become distinctly unattractive. In contrast to bond markets that are at all-time highs, some stock markets are at the same level as two decades ago. It continues to be the case that the best strategy for investors is in a spread of well selected equities, including the opportunities afforded by long/short strategies.