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INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

"The Fed is following the markets, not the other way round."

Christopher Wood

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. It also assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10-years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at USD 64? Do you realize how ridiculous those basic assumptions are? ….. What were you thinking?"

Scott McNealy of Sun Microsystems,
leading tech company of the 1980s

Equity markets recovered further during the third quarter to leave their performance for the year to date at 4.1% in the case of the S&P and 0.3% for the MSCI World, while Europe's index lagged behind being down 14.3%.

The investment environment remains highly unusual. While the global economy has suffered its largest contraction since the 1930's, financial markets have rebounded strongly from the March lows courtesy of the extraordinary measures by Governments and Central Banks around the world. This stimulus is the sole reason that they have recovered. To put the scale of the stimulus in perspective the western Central Banks have purchased USD 6 trillion of public and private debt in the last six months, which is four times the amount of all the programmes in the five years following the 2008 crisis. Similarly they have announced USD 13 trillion (and rising) of fiscal stimulus, which is 15% of global GDP, which compares to 2% in the post 2008 period. As a result, we have seen a stark divergence of economies and market performance. However the market has discriminated between sectors according to how the pandemic has affected different companies. Broadly speaking the old economy industrial and retail sectors are pricing in the damage caused by the Covid virus, while the new economy technology sectors are pricing in the benefits of zero interest rates and the shift to digital services that the virus has accelerated. Meanwhile the gigantic liquidity that has been pumped into the system has started to cause some disturbing moves.

Effectively most bond markets have been put into a coma. Citi Private Bank estimates that the global bond market now yields just 1%, even including high-yield and emerging markets. Over USD 15 trillion of global bonds carry a negative yield, meaning that investors pay for the privilege of owning them. The real yield (i.e. inflation adjusted) of the US 30-year bond is -0.5% showing that investors are prepared to lend a dollar today and receive back 86 cents of purchasing power in 2050. In the UK to generate an income of GBP 50,000 from the UK 10-year bond requires an investment of GBP 25 million. For investors who need income life has

become extremely difficult. These paltry rates may have a far greater effect on the world's wealth in the long run than the Covid virus. More immediately with bond yields so low there is no protection against any return of inflation, so a crucial question is what are the chances of such a return? Even before the pandemic, there were concerns about inflation. De-globalisation, disrupted supply chains, stronger bargaining power for labour via the rise of populist politicians, and the oligopolisation of the large technology companies leading to greater pricing power were all threats to the long period of disinflation that the world has enjoyed since the early 1980's. The huge monetary and fiscal stimulus this year adds more force to upward pressures on prices. The similar policies taken in 2009 never triggered inflation, but the scale of the current efforts are much larger, and most of the monetary stimulus after 2008 was absorbed by broken banking systems needing to rebuild their balance sheets. This time it is targeted at the general economy, with governments getting more directly involved in the process. The money is being put into the hands of people who need to spend it on wages and supplies, and is being promoted by politicians who have an eye on re-election. This is a much more inflationary cocktail than a decade ago. Still for inflation to rise requires this money to roll around the economy, and that would occur if unemployment starts to decline, and the output gap shrinks.

This abundant liquidity has already leaked into stock markets, with some technology related shares showing signs of bubble-like excess. In August, for example, Apple and Tesla made stock splits and, with little other news, a few weeks later their valuation had risen by a combined amount of more than USD 800bn, comfortably more than, for example, the entire market capitalisation of Warren Buffett's Berkshire Hathaway's USD 520bn. In early September Apple then lost USD 180bn of market cap in a day, an amount greater than the total market cap of 470 of the 500 constituents of the S&P 500 Index. Such moves are uncomfortable because they are disconnected from fundamentals and show that these prices are being driven by liquidity and emotion. Moreover the market has narrowed to an unnerving degree. The dominance of the largest tech companies is illustrated by the fact that the five largest are as large as the entire index was at the 2009 low. These technology companies are outstanding businesses, but there is a growing sense that some of their valuations are becoming detached from fundamentals. This is illustrated by Salesforce replacing Exxon in the Dow Jones Index. Salesforce trades at over 12 times sales. Microsoft, Facebook, Tesla and Visa all trade over ten times sales. Historically these look stretched levels, and that is even more the case for companies with less secure fundamentals, and before considering the so-called unicorns which are companies with billion dollar valuations that have no earnings, and often little revenues. The quote at the top of this outlook highlights the potential dangers when valuations rise to these levels. The risk for these popular stocks is either that they fail to deliver on investors' high hopes, or that the money that has driven up their prices migrates elsewhere, which could happen if the economy recovers and the prospects for more economically sensitive stocks improves. In the last mania in the US market in 2000 if an investor had invested in the ten largest tech companies their total return would have been 1.4% per annum over the subsequent twenty years. The technology sector is intensely competitive, and even the largest companies can be cannibalised by their competitors. For the moment the market is showing little concern. The tech giants are dominating the performance of the indices, but some caution is needed given the signs of froth which have indicated danger in the past.

Where should investors look for opportunities if market leadership does change? The problem is that the sectors that are thriving due to the virus accelerating their business are overvalued, while the old economy sectors are often loaded with debt and are structurally challenged, so are cheap for a reason. The answer will also depend on the speed and effectiveness of a vaccine coming through, but on the assumption that a reasonably effective one arrives in about six months the most powerful impact will be on the ignored sectors.

Growth has been scarce in the past few years but as growth comes back more companies will benefit and more of the market will participate. Underneath the bull market there has been a stealth bear market which has created attractive valuations, and companies have been forced to cut costs so that when sales grow the profit rebound will be all the stronger. Cyclical parts of the US and European markets like travel, leisure and hotels are obvious areas. Banks, commodities, energy and industrials would also react well if there is strong evidence of a return to something more normal. Clearly, though, the longer the virus forces economies into lockdown the more damage will be sustained, and the more permanent the effects of that damage, so it is safest to play these sectors through the highest quality names with the least debt. Geographically Asia stands out having managed the crisis better and with economic activity already expanding there, so some of these markets could do well.

The uncertain climate has been made cloudier by the unsettled international climate. The US election is the most bitter in modern times, and even on November 4th there is a chance that the result may not be clear, with both sides threatening to dispute the outcome. If this happens it will be damaging, because it will threaten the notion that the Western model is superior. The authoritarian approach of the Chinese has allowed it to address the virus problems more effectively than the West, while they have allowed market forces to operate in a way the old USSR never did. This mixed model is a serious challenge to the West where large parts of the economy have become stagnant and there is significant government intervention, leading to a smaller number of companies enjoying outsize profits, with the rest debt-laden and barely profitable but still responsible for most employment. This situation is worst in Europe with its burdensome welfare state and protectionist regulations. The West's model often appears a poor combination of the worst of socialism and capitalism. But China's recent assertiveness on the world stage has pitted it against many countries who were previously well disposed. The actions of Beijing in Hong Kong has become a rallying point internationally. A lengthening list of actions is now building to 'contain' China, for example: the US banning the 5G Chinese company Huawei, Japan building its first aircraft carrier in 75 years, the Philippines reopening a large US naval base, Australia calling for an independent inquiry into Covid, and the EU making unusually frank criticisms of the HK situation. The unwinding of the pax Americana is a general worry for the market leaving a global leadership vacuum, but will also provide opportunities in areas like defence.

The remarkable run in equity markets over the last six months has boosted investor morale, but the situation remains unsettled. Markets have been floated off the rocks by the liquidity provided by the Central Banks. It is essential for their confidence that this liquidity continues. Amid such uncertainty it is natural that investors should have herded into the companies that offer the greatest clarity on current and future earnings. However these companies have now reached valuations that allow them little room for disappointment. Equities' performance also reflects the lack of fixed income alternatives. The reality is that if one sells equities one ends up with uninsured cash at the bank (the figure varies by country but usually amounts above EUR 75,000), or bonds yielding 1% or less. The perfect illustration of this was Warren Buffett investing in blue chip companies in Japan yielding 4% financed by issuing debt costing 0.67%. Possibly investors are facing an inflection point on bond yields after four decades of falling interest rates. If signs of inflation picking up then the rotation from the disinflationary winners could be violent. There are a myriad of concerns but investors should mainly focus on two. First the arrival of a credible vaccine will boost growth and confidence enormously. Second if inflation picks up that will alter the structure of the market profoundly, potentially marking a fundamental change in direction for the first time in forty years.

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