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INVESTMENT OUTLOOK

Q2 2017

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The first quarter was considerably calmer than that of 2016. On the political front the Dutch election was won by the sitting Prime Minister, which marked a break of a string of losses by incumbents in recent major elections. With predictions for the French election pointing to M. Macron as the likely winner the rise of the extremist parties in Europe seems to have been halted for the time being. In the US President Trump took office. Trump's election on the pledge that he would throttle the State ('drain the swamp') was an attractive pitch, and brought the voice of the middle states to the elitist coast. However by the end of the quarter the complexity of getting anything done in Washington was starting to restrain him, as his first major legislative test to overturn Obamacare failed. That said business confidence has perked up following Trump's election, partly due to the hope of tax cuts, but also to a revival of energy in middle class entrepreneurs.

To the extent that Mr. Trump gets any of his manifesto through Congress, his policies look inflationary. Cutting taxes, boosting infrastructure spending, reducing regulation, deporting blue collar illegal immigrants, increasing bank lending and taking a protectionist stance on foreign competitors would all put upward pressure on prices. This is at a time of tightening employment and wages are starting to increase. There have been many comparisons of the Trump agenda to that of Reagan in the early 1980's, but the starting points are very different. The budget deficit was far lower when Reagan took office, interest rates and inflation were much higher and falling, and global trade was a much lower percentage of GDP. Fiscal spending has been ongoing for the past decade with US government debt rising from 72% to 104% of GDP between 2008 and June 2016, compared to approximately 30% when Reagan was inaugurated. Government spending is never a free panacea, it withdraws funds from the private sector either via taxation or borrowing. As the debt mounts the challenge of financing it increases. In the next two years approximately $20tn of debt matures in the US so any interest rate rise will add to interest rate costs. Of more concern could be that the reflation of the economy finally works. US banks hold two trillion dollars of excess reserves (compared to $1.7 billion in December 2007). Normally excess reserves circulate. If these dollars are deployed they could support $20 trillion of new bank credit. Lending on this scale won't happen but all these factors can make life difficult for Mr. Trump who is starting his term when debt is already at record levels, price pressures are rising, and the lack of capital expenditure over several years on capital equipment has lowered the economy's productivity growth and made it more prone to inflation. US ten-year bond yields are still lower than those that prevailed during the Great Depression in the early 1930's when industrial production declined 25%. They present neither a safe refuge for cash, nor protection against inflation. These abnormally low yields exist because of regulation that makes banks and pension funds buy government bonds to satisfy liquidity and liability rules that were put in place following the 2008 crisis. The unforeseen effect has been to wrench many other assets' prices away from where their fundamentals suggest they should be.

There has been much questioning of the ability of active investment management to outperform indices. This has been stimulated by Warren Buffett who recommended buying index funds despite never having deviated from an active approach himself, and despite his performance having failed to beat the S&P index in four out of the past five years. Indexation has worked in the US recently but it doesn't work everywhere. The Japanese index, for example, is still far below the peak levels of 1989 while plenty of managers have made good returns. An index always looks safe, but its constituent parts may be far from safe. When indices get overvalued the only way to beat them is to overweight the minority of companies that are the leaders of the bubble. The scariest stocks become the ones that it is most necessary to own. Because of this holders of ETFs are often unaware of how much risk they are taking. They are fully invested, or over-invested, in the most overvalued stocks. In the early 1970's in the US the market crowded into the companies with the most reliable earnings, the so-called nifty-fifty. The companies delivered respectable earnings while the index halved, and some of the companies declined 75%. There has been a stampede into passive products which have been chasing performance or yield, and blindly overweighting expensive shares and underweighting cheap ones. The cheaper the company gets the more it is ignored. This crowding into perceived safety paradoxically makes safe areas more risky. It has been driven by the very low interest rates and low growth in the world. If the global economy is improving then we may be at an inflection point, and this argues that there will be a rotation from bond substitute stocks to cyclical stocks. In this scenario indexed portfolios may suffer. Moreover the historically low interest rate environment has kept alive companies that in a normal cycle would have failed. Companies with excessive leverage prospered instead of dying. Indeed the better quality companies were at a relative disadvantage because they could not take market share in the Darwinian process. Despite the exceptional monetary policy support 34% of the Russell 2000 companies were loss making in 2016. As interest rates rise these companies' fundamental problems will be harder to ignore. The time for active stock picking suddenly offers the best prospects for ten years.

The opportunities in equities are increasingly outside the US. After eight years of rising prices Wall Street is becoming fully priced. One analysis forecasts that if US GDP grows 2-3% for the next twenty years, inflation runs at 3%, corporate profit margins revert to 7.6% compared to their current 11.5%, and PE ratios decline to 14-15 times from the current level of 21-22 times then the S&P could be flat over the next twenty years. One cannot ignore the US because of the extraordinary American ability to produce value for shareholders but care is required. Europe, Japan and Emerging markets' recoveries have lagged and as these economies start to do better their markets should pick up. Japan shows a clear case for investment. The export sector is strong, there is decent domestic growth, companies have a far stronger focus on profits and margins, have healthy share buy backs and rising dividends. Japanese companies are increasing returns on equity and earnings are growing steadily. Europe is wrestling with the problems thrown up by the common market and the immigration crisis, but the economies are starting to pick up. Germany has the lowest unemployment on record with the rate now 6% having fallen from 11% in 2011.

As global growth revives the more depressed earnings in Europe can catch up with those of the US. Politics can spoil the party but the indications have been better on this front. Emerging Markets are more complex. They have de-rated over the last five years and some good values have emerged. On top of that there is a more constructive environment with the upturn in global industrial activity generating more demand, and a slight weakening of the dollar easing the monetary pressure. Of most importance is that there is a lot of evidence that many companies have changed their approach and are paying attention to capital discipline and returns on equity rather than just pursuing market share. However the dark cloud sitting over Emerging Markets is the dizzying debt build up in China's banking system since 2009. Their banking system now has assets of $33tn, double that of the US. 64% of bank deposits are owned by just 1% of the population so wealth is not spread widely. As everywhere else careful stock selection, rather than an indexed approach, is necessary.

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