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INVESTMENT OUTLOOK

Q3 2017

Written by James Macpherson

“The reduction of interest rates below their natural levels has poisoned the river at its source, and nobody knows whether the water is fit to drink.” Jonathan Ruffer

The markets performed well in the second quarter propelled by the reassuring election result in France which drew a line under the populist victories in the major elections last year. As the year has progressed the shocks of Brexit and the Trump victory have been digested, and there is more clarity on what they may signify. Ironically after four decades of being a difficult member of the EU Britain may become a better European state when it leaves, being forced to accept compromises. The Brexit negotiations are likely to offer more noise than light in the next year, the process has been likened to negotiating a divorce with 27 spouses simultaneously, but despite the nationalist rhetoric both sides are incentivised to come to a sensible agreement, and Mrs May’s disastrous election campaign has weakened the hand of the hard Brexit camp. Meanwhile the more one watches the Trump administration the more it seems that the Barbarians are in the Castle. Mr Trump’s unpredictability and lack of Washington experience has affected his ability to push his reforms through. Thus far the anglo-saxon world has seemed powerless to translate the visceral voter anger into legislation.

As politics becomes less of a concern investors can worry again about QE-fattened markets. In 2008-09 the Federal Reserve adopted QE as a measure to fight the credit crunch as the financial crisis took hold. It was justified by the urgency of the situation, but as the intensity of the crisis receded Central Banks continued the policy as a deflation fighting tool. However much deflation is caused by the internet and globalisation, the effectiveness of QE in dealing with them is unclear. Instead QE has created a financial bubble. The mechanical buying of bond markets has led to a situation where bond yields don’t compensate for inflation. In some countries like Switzerland and Germany negative yields have been reached. While there is little sign of inflation now, bond markets are clearly vulnerable to any sign of reflation. Worse, endless QE and negative interest rates have sustained zombie companies and weak banks, starving new productivity-boosting firms of investment and preventing necessary restructuring. Pension funds are forced to chase yield where they can find it, and they encourage companies with high cash flows to pay high dividends rather than invest. This is creating significant distortions. It is hardly surprising that bonds are overpriced given that the ECB is buying 125% of net issuance. The nature of QE prevents price transparency, because it destroys the risk mechanism. The desperation for yield leads allowed Argentina to issue a bond in June with a 100 year maturity yielding less than 8%, despite Argentina being a serial defaulter. They were three times oversubscribed. At the same time Ivory Coast sold 16 year bonds with a 6.25% coupon despite a military uprising. It too was oversubscribed

How worrying is this? According to a study by Ned Davis Research, world non-financial debt has increased from $37.5 trillion in 2000 to $103.5 trillion in 2016, an almost three-fold rise. In the United States federal debt has more than tripled from $6 trillion in 2000 to $19 trillion today. In 2000, the total interest cost of servicing the federal debt was $360 billion, based on a blended interest rate on government bonds of 6%. Today, the blended interest rate is 2.1% and the total interest cost is $400 billion, $40 billion more on a debt burden three times the size in 2000. If interest rates on government securities rise 1%, the cost of debt service would increase almost $200 billion, offsetting most of the budget cuts being proposed by the Trump administration. Why have interest rates declined when debt has increased and economies are growing? Central bank interference in the U.S., continental Europe, the United Kingdom and Japan account for most of it. QE targeted bank lending but much of these funds found their way into financial assets, inflating price-earnings ratios and keeping interest rates low. This situation will only be resolved when a crisis forces it, but it represents a large balloon next to a pin.

The fashion for ‘passive’ products such as ETFs and index funds continues. This too is linked to QE. Several Central Banks have bought ETFs with the money they have printed. They have no regard for value as they buy assets mechanically based on the market capitalisation not the value of the stream of earnings that a company produces. Index investors are value-ignorant. So at the heart of the system there is another distortion. In fact there is no such thing as passive investing. When an index is created someone has to decide which stocks are selected. It is just a different form of active management. However, the herding into index funds has created a narrow market with just a few technology stocks driving the index. No-one doubts how impressive these companies are but it took years for investors to recover from the last technology stock boom in 2000. Companies like Microsoft, Intel and Cisco were at the forefront of that boom, and Microsoft’s stock price only regained its high last year, and Intel and Cisco still trade at only half the prices they reached in 2000. Their earnings grew steadily throughout. The current crop of leaders like Google, Facebook and Amazon may find that their very dominance is their Achilles heel. In the past companies with monopolistic characteristics usually get reined in by governments.

In the US growth is desperately needed to justify the market valuation. Since 2000 S&P earnings have compounded at 4% p.a. despite record operating margins and a benign interest rate backdrop. Stronger growth can probably only come from regulations being pushed back. In the last five years, for the first time ever, more businesses closed than were started in the US. Start-ups are important because this is where many of the new ideas come from. But with valuations stretched and operating margins at record highs it is starting to be difficult to see how the US can continue to outperform.

The mood in Europe is better. Businesses in Europe have more scope for cost cutting than those in the US. Macron won his victory on a reformist agenda so has a mandate for change. Assuming that Merkel wins the German election then real progress can start. The reality is that nothing really happens in Europe without Germany and France working together. Moreover Europe's markets have lagged. Since the start of 2000 the MSCI Europe Index is flat measured in US dollars. The catalyst to improve these returns could come from activist investors. European shareholder returns have always been relatively poor, but with yields from bond markets so low there is a need for pension and insurance funds to find returns elsewhere, and there are signs of pressure being put on businesses to improve returns for shareholders. Events at Euro Disney and Safran this year show active managers gaining traction. If institutional investors really exert pressure then there are substantial gains to be harvested. This process is already well underway in Japan where despite little economic growth profits are rising, and there is far greater attention to shareholders than before. Large parts of Japanese industry are still managed more for the benefit of employees than shareholders, but government pressure and a new generation of managers is forcing change. Japanese companies have grown used to operating in an economy where there has been almost no growth for twenty years. Any reflation is helpful to them. In a low growth world European and Japanese equities present the better opportunity due to their recent underperformance and their greater ability to restructure compared to American stocks. However investors must be aware that moves by Central Banks to withdraw liquidity and slowly raise interest rates will remove the strongest support the market has had for the last decade.

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www.notzstucki.com

www.nsfunds.com

NOTZ, STUCKI & CIE S.A.

Rue Saint Jean 98
1201 Geneva
Switzerland

+41 (0) 22 906 52 50
+41 (0) 22 738 72 87
geneva@notzstucki.com

NOTZ, STUCKI EUROPE S.A.

11, Boulevard de la Foire
1528 Luxembourg
Luxembourg

+352 (26) 27 11 1
+352 (26) 27 11 69
luxembourg@notzstucki.com

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