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INVESTMENT POLICY NOTES

NOTZ STUCKI INVESTMENT MEETING OCTOBER 11TH 2016

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Unusually the meeting was accompanied by no charts. Charles Gave gave a bleak tour d'horizon of how he sees the world and investment landscape. About every seventy years the world seems to undergo a fundamental change of direction after a long period of relative calm. The 1780's and the French Revolution until the battle of Waterloo was one of these periods in Europe. A hundred years later the period from 1880 to 1920 saw even greater upheaval. We are currently living through another such period. Since 1990 the world has seen the Soviet Union collapse and China's rise. 2016 is seeing dramatic political unrest with the possibility that the EU will break up, and the US take a turn to more trade protection.

Whatever the outcome of the US election we are probably seeing the end of the Pax Americana which has dominated since 1945. During this period a large part of the world came under American protection. Trump is challenging this, and recent Presidents have been more successful in creating wars than establishing peace, and Obama has been much more disengaged in projecting American power. If America withdraws from its protective role in defence this has major implications. In Europe defence budgets could rise by up to 5% of GDP to replace what America has provided, and this would necessitate tax rises. Alternatively Germany could make an alliance with Russia to protect the eastern border, an event which would cause serious concern among the other eastern European countries. In Asia, China has been pushing hard to become the local hegemon. As a result the Philippines have overtly moved towards China. Indonesia may be next. The post-1945 world is coming under immense pressure. In financial markets there are equally disturbing issues. Negative interest rates make any sort of rational decision making impossible. The effects are feeding into politics. Low or negative interest rates are attacks on the poor for the benefit of the rich. They have led to almost no growth, huge asset price inflation, and lots of leverage. This is totally socially unacceptable. The poorer sections of society are revolting through the ballot box, most obviously in the UK Referendum. A series of elections are coming in Europe where voters can express their anger in Italy, Holland, France and Germany. Each election has the potential to break the euro, so managing an already unstable situation will be even more difficult.

For investors more volatility is likely. However it is important not to confuse volatility with risk. Investors need to own companies with strong cashflows and no debt, such as L'Oréal and Air Liquide. The huge strains on public finances mean companies that have a dependence on the state will be massacred. They are a value trap. European bonds are now to be completely avoided. Trillions of these bonds have been printed for social distributions. Economically these promises cannot be repaid in real terms so they will either default or the currency of the country devalue. This is a colossal problem for Germany who are the owner of many of these bonds either through the ECB or through their domestic financial system. If the euro does collapse they will have to issue a vast amount of bunds to sort things out. The one interesting bond market in Europe is Russia. It yields 8% and there is no budget deficit. The most interesting currency is sterling which following a major correction looks significantly undervalued and should appreciate 15% over the next couple of years if it returns to purchasing power parity. The US faces its own election in a month. Perhaps the biggest risk from this for markets is the dollar. There have been substantial borrowings of dollars (about $10 trillion) from overseas and if these were covered then the dollar would rise sharply and equities suffer. In particular if Trump wins and pushes through his promise to create a fiscal surplus then that would pull a lot of liquidity out of the system, and this could trigger a big bear market. But the US is full of excellent companies. Some are expensive but the market still offers opportunities for the stock picker. Asian debt offers respectable returns, especially in comparison to the West and Japan. India and Indonesia offer yields of 7% and the Philippines 6%. Moreover the necessity for Asian savings to go abroad is lessening as local bond markets develop and the RMB starts to become a viable alternative to the dollar. India is a leading example of a country where protectionist barriers are coming down, and services and banking are gaining traction. These markets are relatively immature but they will develop in the next few years.

It is not an easy time for investors, and made considerably more complex by the unusually strong influence of political factors. The potential for policy error or failure is high. To cope with this environment the best approach seems to be a mix of companies with strong balance sheets that are producing some sales growth, combined with bonds that have some yield, most of which are in Asia.