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INVESTMENT OUTLOOK

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Markets were relatively calm in the third quarter, as despite the dire warnings of some commentators the Brexit shock did not cause a collapse. However the problem remains that there is little economic and profit growth in the world. Over the last ten years US GDP growth has averaged just 1.4% compared to 3.4% in the preceding fifty years. Over the same period S&P 500 profits have averaged only 4% compound growth even with the enormous assistance of much lower interest rates. The gargantuan stimulus by the Federal Reserve and other Central Banks has resulted in a lethargic performance, and increasingly the efficacy of their measures is being questioned. If zero interest rates have not kick started economic activity why should negative rates work much better? How will Central Bankers get out of the rabbit hole they have gone down? Another way of looking at this is Stan Druckenmiller's question: 'Interest rates are at the lowest level since the Federal Reserve was founded in 1913. Is the economy really in its worst state since then?'

There is little doubt that the defining feature of the current environment is the low and negative yields in the bond market. 30th September marks the 35th anniversary of the previous peak in yields. On 30th September 1981 the US 10-year bond yield reached 15.8%. In early July it had fallen to a measly 1.35%. Even this is higher than in many other countries. Perhaps a third of Developed Market sovereign bonds are destroying capital through negative yields. The consequences of this are profound for banks, insurers and pension funds. For example, low yields mean that people need to save more for their pensions. A pension pot used to be built by saving a third of the final pot with the other two thirds accumulating 'unearned' over a long working life. In a zero rate environment the whole pot has to be saved because there are now no low risk returns available. Viewed another way to provide yourself with 70% of your gross income for twenty five years of retirement when interest rates are zero, requires setting aside 45% of gross income every year for nearly forty years. Worse the corporate bond market has also moved into negative interest rate territory. In September two Europeans companies, Henkel and Sanofi, each issued €1.5bn of debt for three and five year maturity carrying a negative interest rate of 5 basis points. Such yields make saving hopeless. Furthermore the companies issuing this debt have no urgent financing needs. They have strong balance sheets and cash flows.

Eight years after Lehmans' collapse, quantitative easing is at a peak and central bank action is dominating markets, causing prices to part company with fundamentals. As the availability of yield in the bond market dries up many investors have been driven elsewhere to find the income they require. These bond refugees have bought the equity market which is not their natural home, but they have concentrated on the equity of companies with bond like characteristics, in particular with reliable and predictable cashflows. Such companies' share prices have been driven ever higher while their earnings growth has been only moderate, as an illustration since 2010 Unilever's share price has doubled while the earnings have risen only about 15%. Similarly Nestle's earnings are little changed over this period. Many consumer staples and utility companies have exhibited this pattern. Moreover this new class of shareholder who is primarily interested in yield is pressuring companies to change their behaviour. When the dividend becomes the most important criteria there is more pressure on managements to increase it. The combination of cheap debt and a rising dividend stream being rewarded gives an incentive to managements to borrow in order to boost the dividend. An example of this would be Royal Dutch Shell whose 7% yield is enticing to yield starved investors, but where the debt has risen from $15bn ten years ago to $90bn today, in a company facing a world where its basic products of oil and gas are at much lower prices. As growth remains challenging companies have been paying a high proportion of their earnings out as dividends so one risk is if growth now turns down then they will be forced to reduce their distributions, and a major support of the market will evaporate. Of more concern cash flow looks likely to be under more pressure. Governments are becoming more aggressive on tax, witness the surprisingly high back charge that the EU has made on Apple. Wages are rising as well, in particular there is a trend to the implementation of more minimum wages which few politicians will feel able to resist. The combination of flat revenues and rising costs is a poisonous one for corporate profits. Given their high ratings the bond proxy stocks will need a lot of growth for many years to work from here. This looks hard to achieve. However there remains the possibility that these stocks could have a spectacular blow off. If the bond market continues to rise and the US yield curve follows that of the Swiss where yields are negative out to fifty years maturity, then what price will be paid for any positive income yielding asset?

While the dust settles following the Brexit vote, change is in the air in politics. It is increasingly clear that Brexit was a rejection of the Establishment who are seen to have failed to deliver. This trend is a global one, witness the success of Donald Trump against the establishment figure of Hillary Clinton, and the plummeting approval ratings of Angela Merkel in Germany. The problem stems from resentment of the stagnant economic environment (often expressed as anti-immigration), while low interest rates and QE have driven up asset prices. These high asset prices are benefiting fewer people and creating a burgeoning class of angry voters who feel excluded. Electorates are demanding change and this will force politicians to act, and frame policies that generate growth. This is the significance of Trump. Whether he wins or not this unlikely candidate has changed the debate. As a natural borrower he is likely to demand a surge of fiscal spending, which may be hard to contain if the economy remains sluggish. Even if he doesn't win he has probably changed the debate sufficiently that much more emphasis will be put on fiscal measures. These are inherently more inflationary which could spell trouble for bond markets. Historically fiscal spending has led to lower PE ratios.

Where are the opportunities? It is worth remembering that many equity markets are lower than they were in 2000, yet 2000 was a fabulous buying opportunity. As the technology bubble peaked it left behind hundreds of companies that had been ignored by investors and represented excellent value. The bifurcation in the market is not as great today as then, but the momentum trade in yield stocks and consumer staples and has left behind pockets of value. This trend has been exacerbated by a shift from active to passive investment. Many investors have turned to index funds. Index tracking money is blind and does not buy earnings. The stampede into ETFs is similar to the mutual fund buying craze from 1995 to 2000. These trends are self-reinforcing as subscriptions drive more buying of the same assets. As a result companies that have no dividend or have more cyclical earnings cycles have been ignored by investors. As growth stocks have been pushed up by the momentum trade their overvaluation relative to value shares has become extreme. This has created an opportunity in value shares. Another promising area are the sectors that would benefit from increased fiscal spending such as infrastructure. The unfortunate rise in global tensions give opportunities for defence and security related stocks. Emerging Markets have de-rated drastically over the past five years and attractive values are appearing, particularly in Asia. Some caution is warranted here because these emerging markets are dominated by overseas money, and any problem in world markets always leads to some of this money being re-patriated. For the very brave bank shares are looking cheap. Deutsche Bank has well-advertised problems and banks have faced serious headwinds from low interest rates and an onslaught of regulations. But they will not all go bust and they are not all rotten to the core, and many European banks have suffered share price declines of 95% or so. Then there is gold. Gold’s role as the ultimate safe haven remains. In a world where the monetary base has been expanded several times gold, where annual production grows less than 1% a year, becomes more valuable. All these areas give opportunities for the stock picker but given the current uncertainties it does not seem to be a time to be embracing too much risk.

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