cannon asset management

newsletter

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Summary

We had two markets corrections in the final quarter of 2014 but we remain of the view equity markets are not over valued and are in a bull market supported by economic growth. Adding to central bank support are falling oil prices which act as a “tax cut” for most economies. Equity market corrections were up to 11% during the quarter for major markets but mostly were within the range we expected given our views above.

Tightening in the US continues as previously mention and will do so for at least a year. Elsewhere disappointing growth and falling energy costs has led to weak inflation supporting good quality bonds. High yield bond markets corrected during the past quarter.

Sanctions in combination with weak energy prices are provoking a full blown economic crisis in Russia however it is a modest sized economy. Uncertain second round impacts (e.g. falling Yuan bonds of Russian issuers, hitting Hong Kong owners) and irrational actions from Russia are likely. German exports are suffering but Europe is benefiting from lower energy costs. Sanctions will need to be renewed by Europe in May.

European growth is deteriorating due to poor Euro zone policies which are pressuring individual countries’ finances. Even lower energy prices are worsening deflation! The ECB intends to stimulate economic growth on significantly, but the details needs to be seen and a weaker Euro is expected as a consequence. Vocal opponents to current policies are now appearing in mainstream politics, raising political risk to bonds. Britain is seeing some slowing of its growth and a general election leaves uncertainty for investors as the UK’s economy strengthens.

On 3 November the Bank of Japan renewed quantitative easing but tax increases are offsetting these policies. Asian markets are wobbling due to uncertain Chinese growth. China is moderating money policy, but still needs to tame rampant credit growth.

US growth has surprised, being stronger than expected. We continue to believe growth may continue until 2018 and we have a long term target of 4-5% for the US Treasury 10 year bond. Corporate bonds and high yield bonds remain vulnerable to inflation, earnings disappointments or M&A activity. Short term rates may rise in the next 9 months, both in the US and UK.

Markets

Fixed Interest

Most countries’ long term interest rates have fallen over the past six months, due to low inflation and low economic growth. However, we continue to think US recovery will affect most countries irrespective of their local circumstances. If stimulus for the Euro area disappoints there could be a shock to weaker Euro zone nations’ bonds, particularly with strengthening deflation. Developed markets’ short term rates may not rise until the end of the year, however lower energy costs could bring this forward.

Short Rates

Currently US interest rates should be 2.07% higher based on long term inflation, real return and unemployment inputs. It is possible that these input estimates are too high, not reflecting weak tax revenues and low labour participation rates.

Our estimates of UK short rates indicate that they remain too low, by about 3.0%, European rates are about 0.7% too high for about 9% unemployment assuming no price inflation. However, for non-core Euro countries rates are about 6% too high.

It is now clear that markets expect US short rates to rise significantly on a 2-5 year time frame, however Europe and Japan remain challenged and their rises could be delayed.

Longer Rates

Developed countries' 10 year bond yields have fallen further from their lows last year due to low inflation and growth. Longer term rates of 4-5% on 10 year US Treasuries should be expected. Their current yield is 2.125% compared to 2.97% in December 2013. Weaker Euro zone government bonds have rallied strongly despite worse debts, high unemployment and poor improvement in deficits due to deflationary pressures. Modest anti-deflation measures could cause a further rally in the short term. However should stimulus or ECB actions disappoint markets then expect corrections.

Credit & Emerging Markets

Investment grade corporate bonds are better value than other types, particularly government, index linked and high yield bonds. High yield bond rates have sunk, but yields remain above investment grade. Improving economies and profits make defaults less likely, but this is mostly reflected in yields.

Emerging markets have rallied following last year's correction. Central banks and new governments have reset the prospects for these bonds but concerns about US dollar strength on debt remains. Bonds issued by soundly financed countries with good trade positions and foreign exchange reserves are safest.

Bond Themes & Ideas

Deflation is still building in Europe. The misguided austerity and monetary policies of the Eurozone continue to damage the continent and individual countries, in some cases on a scale seen in American during the 1930's.

Loan demand is poor and shrinking levels of bank lending within the Eurozone (due to bank stress tests) is not yet complete, so this process will continue. At last Germany is being affected and policies may change at the margin as a result. However this will take significantly more radical measures from the ECB and EU, to which Germany will object. Vocal opponents to current policies are now appearing in mainstream politics in France, Italy and Spain. Even in Germany anti Euro and anti EU parties have achieved over 10% in two state elections. However, Italy remains the greatest beneficiary of either leaving the Euro or a change in policies.

The end of US central bank bond purchases has occurred, with no panic over bond prices but focus has now shifted to interest rates. We expect rate rises in 2015, probably after the second quarter of the year, particularly if there is no evidence it is damaging the US recovery. Short dated bond yields will rise as a result.

Currently markets expect short term rates to match those of 5-10 year maturities within 2-5 years. The UK may also tighten in 2015, following statements by the Governor of the Bank of England.

Equities

Broadly speaking equities are about fair value and only Emerging Market equities look undervalued on 5 to 10 year views. The quarter has been lively, with two substantial corrections in equity markets, one continuing from September until mid October and another in December but markets rallied and regained lost ground both times.

Markets may go higher on improved cyclical profits underpinned by economic recovery, increased dividend yields, share buy backs from historically low levels, increased debt to enhance equity returns, increased M&A activity and reduced pension liabilities due to bond and equity market gains.

Enduring gains will depend upon rising earnings rather than the expansion of the price earnings (PE) multiples of recent year. But markets could move to over-valuation through further expansion of current PE multiples. Earnings growth may be emerging as the new driver for US returns but a strengthening dollar will favour domestic activities over multinationals.

Whilst there has been a correction in smaller companies' values, they remain more expensive than large companies. US high quality stocks are better value than other types, but prospective returns remain below both Emerging Markets and the 6.5% long term real return of US equities. International equities continue to offer better value than their US counterparts.

Emerging Markets remain better value due to sell offs since May 2013. GMO's estimates edged up to 3.5% in real returns at end of November 2014, on a 7 year view.

US Equities

Government deficits should improve, wages are growing, US household net worth is rising, housing is in a second year of recovery and debt servicing costs remain low. The cyclical side of the US economy remains in recovery but quality & growth stocks are yet to really perform.

UK Equities

UK equities are cheap but are less attractive to US corporate head offices for overseas tax benefits. The potential for a Labour led government in 2015 is worrying investors. The March budget forecast about a 6.6% government deficit and little improvement in government debt for years. This is despite much improved growth, unemployment, retail sales and consumer & business confidence. Domestic growth is strong but based mostly on higher consumer debt and may be disturbed by politics.

European Equities

There are initial signs of deflation being addressed by policy makers. Provided Europe regains growth, it remains relatively cheap compared to the US. Multinationals are most attractive. However, the Euro and government finances could disrupt this view, possibly making domestic firms preferred.

Japan Equities

The markets rose in November following further Bank of Japan stimulus measures, which have devalued the Yen, benefited equities and may help the economy. Gross debt remains high relative to GDP which could cause significant problems.

Emerging Markets Equities

These represent best value, particularly in China. The flash rally in China quickly corrected, so while the timing of an equity recovery is unclear, it may now have bottomed. FTSE EM index is now on 10.8 times next year's earnings.

Economic Outlook

Estimates of growth have been increased since our last newsletter, except for the UK which was downgraded. Global growth of 3.3% this year and 3.8% for 2015 is expected. Next year the US should see 2.3-3.1%, UK 2.7%, Eurozone 1.1-1.3% and Emerging Markets 5.0%. (Sources, IMF, OECD)

US data is becoming unambiguously robust despite some fundamental weakness of the economy and government finances. The last quarter's growth managed 4.2% per year equivalent. The Federal Reserve is removing $1trn in new money supply but Japan intends to provide $0.75trn and Europe a further €1trn ($1.25trn). The net impact should be positive for the world, provided it is actually supplied. Equally import however, is spending (demand) recovery. Oil price falls should help in that regard, in effect acting like a tax cut.

China (the largest source of global growth) is facing the collapse of over-extended property speculation as part of its adjustment to a more mature economy. But Europe and Japan are the global laggards which may have the biggest impact on global growth. Higher US interest rates will place stress on economies with USD debt.

China lowered interest rates based on worries about its economic correction but remains a concern as it tries to rein in lending, increase domestic consumption and introduce market forces to domestic debt markets. The country risks a significant economic shock from property lending in particular, though many activities are vulnerable. At the end of November, the central bank relaxed monetary policy due to a slowing economy and housing price falls. The next 12 months are promising to be eventful.

There have been some notable positive developments in Europe. Actions to reduce deflation pressures include negative interest rates announced by the ECB and the EU has softened its position on the French and Italian budget deficits.

The ECB has also announced substantial quantitative easing of €1tn, presumably due to deteriorating German growth. But as is typical this is yet to be implemented. While the scale is enough to meet the credit requirements for the Euro area's private sector, public sector deficits and their funding remain a concern.

As argued previously, a lost decade of growth similar to Japan remains a significant risk for Europe. With Germany's guidance, Europe is being required to reform markets and reduce spending in a poor growth environment. In Germany this produced a 1% growth rate, no productivity growth, falling wages net of inflation, high savings (i.e. reduced demand) and dependence upon exports for growth over the last 10 years.

Simultaneously, the Euro credit supply is falling due to stress tests and banks' reducing loans books to meet capital requirements. (About 35 major banks struggled or failed to pass capital requirements.). Additionally, individual countries continue to increase borrowing, often financed by domestic banks' purchases of government debt. (This squeezes the private sector funding, particularly for small and medium size business which create jobs.) Northern Europe remains wary of lending capital to weak, uncompetitive Southern economies except via central bank funding.

This low growth, low inflation policies imply that devaluation of the Euro must be the key source of demand but exports are in fact a small part of the economy. Exports within the Euro zone are between struggling economies, so that is a zero sum game. We remain pessimistic due to the above facts.

One hope for Europe is that the new banking framework will create a single banking system that could improve credit supply. However, this supposes that banks will lend across borders confident that their counterparty banks are not risky and without premium interest rates being passed on to weaker economies. It also assumes that borrowing will be taken up by the private sector – the opposite to what deflation produces.

The UK is looking better as time passes. Growth is the best in the OECD, it now has lower wage costs than Spain and employment is growing at a rapid rate. However wages are not improving and there are concerns about a serious short fall in the deficit reduction due to low levels of income tax revenues. Political uncertainty is a drag on investment particularly with a possible Labour led government from next May.

Japan's recovery is stumbling and the BoJ has announced quantitative easing equal to 16% of GDP, intended to devalue the Yen and stimulate inflation. Further VAT tax rises are planned, though prior increases poleaxed consumer spending, threating growth. The national pension scheme is reducing bonds from 60% to 35% of assets and raising equities from 24% to 50% of assets. However corporate cash surpluses continue, which are driving government deficits and low private sector spending.

Emerging markets will likely become more diverse in their prospects. Sound economies will prosper, but weak ones will suffer. A strengthening US dollar is making foreign debt servicing & repayment expensive, placing stress on some countries. This is a more normal state of affairs compared to the past 6 years.

Themes & Ideas

Little change - our views evolve, usually slowly as events unfold and we tend to follow a value philosophy which results in measured changes in portfolios. Here are some of our thoughts.

A Positive Oil Shock?

Oil's dramatic decline, like most things in life, will have winners and losers. Companies, countries and currencies will benefit or suffer to varying degrees, but broadly speaking the effect will stimulate most economies as expenditure on energy will fall and be spent or invested. Airlines for example will benefit at the expense of oil company profits. Producer nations such as Saudi Arabia will suffer but net consumers of energy such the UK, Europe, Japan and Europe will benefit.

The more interesting questions are the "second" round effects, which depend upon how long the lower prices last. If Saudi Arabia chooses to reduce production then oil prices will rise quickly and the effects will reverse. Examples of second round effects are lower core inflation due to lower energy costs spreading throughout the economy, falling investment in energy savings and impacts on investors' wealth (e.g. lower oil shares or bond defaults by some oil producers).

Lower prices will unsettle energy investment, particularly oil related ones but also natural gas and renewable sources – which is the stated objective of Saudi Arabia.

Even so current production levels can continue for years as pumping is cheap from existing wells (though not tar sands in Canada). Marginal production from frac wells (for oil and gas) declines at about 20-30% per year, meaning production will drop meaningfully after about 2 years. Also “stripper” wells produce will shut down quickly, taking out about 800,000 barrels per day in the US alone.

Major oil companies target projects with a budget for $80 per barrel, well below prices in the summer. Natural gas is a serious competitor for oil, where it can be substituted (usually not as a transportation fuel). One barrel of oil is roughly equivalent to 5800 cubic feet of natural gas. In Europe, natural gas usually sells for about $9 per thousand cubic feet, implying about $52 a barrel. In the US this figure is $23 and in Asia $70 (based on $12 per thousand cubic feet). These figures are useful references for sustainable prices.

The Europe and the Euro

The Euro is one of the great unresolved issues in world economics. It hangs over the region’s prospects & politics like a sword waiting to fall. The Euro was and is a political project, which the European “establishment” is clinging to in desperation.

It was supposed to lead to greater European integration, eventually full political, fiscal and banking union. It has been a disaster due to these unresolved issues, though they are not the root of its problems. It was also supposed to generate significant economic benefits, which are now totally overwhelmed by lost economic output in many countries. This in turn is discrediting the Euro and the whole governing class of the EU.

If left unresolved, there are the possibilities of defaults on national debt, a lost decade of growth, a generation of vast unemployment and social ills, resentment between Euro zone members and political disintegration of the whole project. Currently, leaders of national governments in Europe are coming under threat from anti-EU parties, even in Germany, so change may yet occur though slowly.

The Euro’s fundamental problem is the “one size fits all” interest rates and economic policy applied to economies with different levels of productivity, wealth and labour market flexibility. It is worsened by the lack of Euro zone institutions to address the differences, such as fiscal transfers, a banking union and ultimately a single elected body representing the whole area rather than the national governments currently calling the shots.

In any event, completed or new institutions may not achieve change. There are examples of countries where regions have taken decades and even hundreds of years to align economically. The best example of this is Italy, where the north of the country has transferred wealth to the south ever since Italy came into being in 1861. In Germany, the former East Germany remains poorer than the West after 24 years together.

It is possible that the Euro will continue in its current incarnation, inflicting enormous damage on member states and their populations but there is also the possibility that it will change. Until there is change – which will require brave and enlightened national leaders - the costs of the Euro will continue to grind upwards in the form of social damage and lost growth. In any event, the deeper economic problems in many countries will endure, similar to Italy’s southern regions or Canada’s Maritime provinces. (I recommend Roger Bootle’s “The Trouble with Europe” for detail analysis.)

End of the Great Bond Bull Market

We are of the view that the great bull market in bonds since 1979 is probably now over. Rallies for government bonds will occur however if economic performance deteriorates, depending upon prevailing yields. This past year seems to have proven that view correct for now, but Greece hints at what might yet occur.

Deflationary stresses in Europe, China and Japan have prevailed this year resulting in gains for Euro zone bonds. US bonds rallied due to dollar strength and low inflation. We remain concerned that there could be a massive fall in government bond values due to increasing inflation or failing political support, particularly in Europe. This year Greek bonds fell about 30% from September to December on political concerns. Corporate bonds may be vulnerable depending upon the nature of any slowdown, earnings disappointments or takeovers.

Simply holding low yielding bonds is not our preferred strategy and we expect longer rates to eventually increase. In any case, short term rates should now increase toward longer rates as quantitative easing (QE) is stopped in the UK and US.

China, Debt & Growth

China has approximately 200% debt to GDP and its borrowing is expanding at twice the rate of economic growth. Mathematically, it is impossible for borrowing to grow at its current pace without the country's debt becoming unsustainable. Policy makers are re-balancing away from exports & investment to consumption from savings. They are trying to do so, in part through less government influence, less corruption and more market influence in banking & debt markets.

However, this adjustment carries large risks due to the quality of past lending - many loans are unlikely to be of good quality. Much lending was made in an overheated property market, for unwise public infrastructure or to loss making companies. Unwinding such lending is fraught with difficulty as we have seen in Western economies over the past six years. An added complication is the priority of the Communist party to remain in power based on rising standards of living. (The party members have enriched themselves from the current growth model. Turkeys voting for Christmas?) A reformed banking and welfare system could release significant savings for domestic consumption but a banking crisis would make matters worse. China's trump card is massive accumulated trade surpluses to relieve pressures in the short term – but this would mean significant US treasury sales!

Emerging Market Spending & Stock Values

Emerging market weakness is causing surprises in the performance of firms with heavy growth exposure to that part of the world. This may prove to be an excellent buying opportunity for this long term structural growth theme.

Global Re-Balancing

Large current account deficits exist between countries, where imports displace domestic goods or services. Over the longer term this cannot continue. Either competitiveness of importing countries must improve or their currency devalues to re-balance these trade relationships. As these trade balances correct, local sourcing is needed, presenting investment opportunities.

Large imbalances existed within the Euro area between Germany and Southern Europe. These imbalances are now correcting with the collapse of economic activity in the South. China remains in surplus with Europe and the US.

Improved government finances, lower unemployment and higher consumer spending should be seen in deficit countries with time. Surplus countries should experience the opposite effect, if domestic consumption does not replace export demand. Turkey, the Ukraine and South Africa are examples where currency devaluation is part of the correction process.

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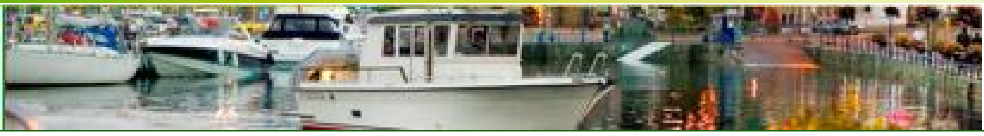

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