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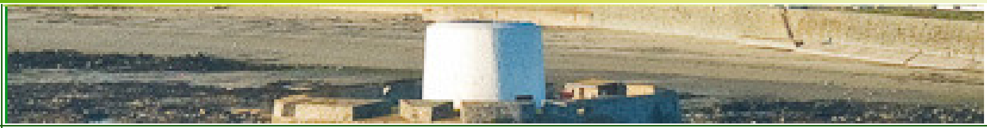
newsletter



July 2015

Summary

This quarter has seen a bond correction from last year's exuberance. European bond markets suffered badly, which appears to contradict the massive ECB interventions. Signs of recovery and a transient lower oil price are probably to blame. The Greek debt crisis sparked falls in Italian, Spanish and Portuguese bonds. However, all major OECD government bonds are participating in the correction.

Greece remains an immediate to medium term concern with no long term solution in sight. For conservative investments, the immediate crisis will probably pass with little long term impact.

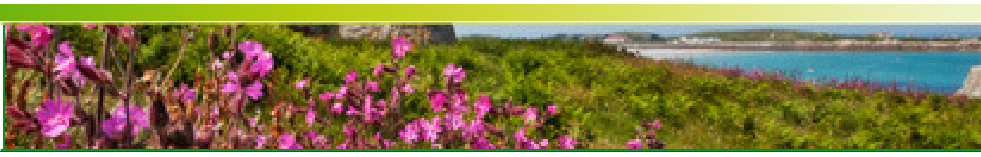
Further tightening in the US is on hold until the Federal Reserve raises rates, which is expected later this year. US Growth appears to be returning to pre crisis norms of 3-3.5% per year and the Fed members expect interest rates of 3.0% in 2017. A mid cycle slow down is likely and should unsettle markets at some point. In other countries growth and inflation may be advancing, threatening bond and equity values. Large issuance of corporate bonds is crowding out government bonds.

Equity markets also suffered from volatility, though they have generally remained in positive territory for the year. We remain of the view equity markets are in a bull market supported by economic growth, despite the current consolidation. Market breadth indicators predicted a retreat and Greek concerns were a major catalyst.

Euro quantitative easing (QE) appears poorly targeted, favouring banks over the broader economy. Fortunately signs of growth continue and domestic German consumption seems to be forging ahead. Our concern is that credit growth (borrowing) is not attractive for companies and individuals. Britain's election requires changes with the EU in the next 2 years which may spur EU reforms. The Conservative's victory in the UK is good news, economically at least.

Japan needs reform and further measures to lift growth above 1.5% per year. Asian markets are wobbling due to uncertain Chinese growth. China is easing monetary policy but still needs to tame dependence on rampant credit growth.

We continue to 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. US short term rates may rise in the next 9 months and in the next 12 months for the UK.



Markets

Fixed Interest

Most countries' long term interest rates fell during 2014, due to low inflation and low economic growth. These are now reversing with improving growth, stronger oil prices and very large corporate bond issuance. We continue to think the US recovery will affect most countries irrespective of their local circumstances. The Euro area seems to be in recovery but Greece could still disrupt progress and shock weaker Euro zone nations' bonds, if the ECB does not act decisively. US and UK short term rates should rise during the next 12 months, provided the Eurozone does not experience shocks.

Short Rates

Currently US interest rates should be 2.10% higher (reversing last quarter's change) based on long term inflation, real return and unemployment inputs. The Fed Open Market Committee which sets rates, reduced its mean forecasts in June: 2015 – 0.625% (0.566%), 2016 – 1.875% (1.750%) and 2017 3.125% (3.000%).

Our estimates of UK short rates indicate that they remain too low, by about 2.55% (0.25% improvement). European rates are about 0.20% too high (an improvement of 0.25%) for about 9% unemployment assuming no price inflation. However, for non-core Euro countries rates are about 4.45% too high (0.45% improvement, 1.55% in two quarters).

Markets are pricing 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 risen from their lows last year. Notable drivers are oil prices which have risen and European growth that has improved. Longer term rates of 4-5% on 10 year US Treasuries should be expected. Their current yield is 2.43% compared to 2.97% in December 2013, but this is well up from their lows. Weaker Euro zone government bond yields have risen strongly too. Quantitative easing seems to have had limited impact.

Credit & Emerging Markets

Investment grade corporate bonds are better value than government bonds. High yield bond yields remain above investment grade. Improving economies and profits make defaults less likely, but this is mostly reflected in yields.

Bond Themes & Ideas

Deflation is receding but is not yet history 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 last seen in American during the 1930's.

Loan demand is poor and deleveraging incomplete. Eurozone bank stress tests are finished for now but QE will benefit banks rather than other bond investors, limiting the impact on the economy. Greece is in dire financial straits and may set an ominous precedent for the Eurozone. Anti Euro and anti EU political parties continue to strengthen across the union.

We expect US rate rises in 2015, either in September or later in the year, particularly if there is no evidence it will damage 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 2-3 years. The UK may also tighten in 2015.

Equities

Broadly speaking equities are above fair value on long term measures (CAPE) and only Emerging Market equities look undervalued on a 7 year view. Markets reached new highs and all time highs during the quarter in some case. A catalyst for the correction was bond weakness and Greek debt concerns.

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 years. But markets could move to over-valuation through further expansion of current PE multiples and QE. A strengthening dollar will favour US domestic activities over multinationals.

There have been short lived corrections in smaller companies' values, but 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, but European markets are looking expensive.

Emerging Markets remain better value and GMO's estimates 3.0% real returns as of May this year, 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. Equities are relatively expensive but are not at record levels.

UK Equities

The May election result reduced political uncertainty. The March budget forecast about a 5% government deficit (6.6% last year) and optimistic improvement in government debt requiring 4% reduction in spending. This is despite much improved growth, unemployment, retail sales and consumer & business confidence. Domestic growth is strong but based mostly on higher consumer debt.

European Equities

There are signs of deflation being addressed by policy makers. However, the Euro and government finances could upset plans, possibly making domestic firms preferred over exporters.

Japan Equities

Bank of Japan stimulus measures and mixed signs of some reflation success have lifted markets this year. Gross debt remains high relative to GDP which could cause significant problems. Japanese equities are among the cheapest of major markets.

Emerging Markets Equities

These represent best value, but are volatile as seen in China. FTSE EM index is now on 11.82 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 3.5% this year and 3.8% for 2016 is expected. Next year the US should see 2.2-2.8%, UK 2.3-2.5%, Eurozone 1.6-2.5% and Emerging Markets 4.7%. (Sources: IMF, OECD)

US data is sporadically robust despite some weakness in Q1 and in government finances. Growth averaged over 2%, credit growth was over 7%, employment rates, participation rates and wages are all improving. The Federal Reserve has removed $1trn of QE but Japan intends to provide $0.75trn and Europe a further $1.25trn (€1trn). The net impact should be positive for the world, provided it is actually supplied. Equally import however, is spending (demand) recovery. Oil price remains a net benefit compared to last year.

China (the largest source of global growth) is still dealing with its adjustment to a more mature economy, with long term growth officially lowered to 7% per year. Europe and Japan remain 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 eased interest rates based on worries about its economic correction 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.

There have been some notable positive developments in Europe. Actions to reduce deflation pressures include negative interest rates and QE announced by the ECB. The EU has softened its position on the French and Italian budget deficits but Greece remains a basket case that could damage Eurozone credibility & bond markets.

The ECB announced substantial quantitative easing of over €1tn due to developing deflation. 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. The bond purchases will benefit banks rather than other holders of bonds, limiting the impact on the economy. Additionally banks can borrow at 0.05% for 4 years, profiting from buying bonds with loans – re-building their balance sheets. A weaker Euro may result, if borrowings or cash from bond sales are invested abroad.

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. Only now is Germany starting to prosper.

Simultaneously, the Euro credit supply is weak due to stress tests and banks' reducing loans books to meet their capital requirements. Individual countries continue to increase borrowing, often financed by domestic banks' purchases of government debt. Northern Europe remains wary of lending capital to weak, uncompetitive Southern economies except via central bank funding.

These low growth and low inflation policies imply that devaluation of the Euro must be the key source of demand but Eurozone exports are in fact a small part of the economy. By contrast exports within the Eurozone are between struggling economies are huge but are a zero sum game. We remain sceptical 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 of what deflation produces. However, we may now be turning that corner.

The UK continues to progress. Growth, employment and the first signs of wage improvements are evident. Tax revenues are showing signs of improvement but serious, sustained deficit reduction weighs on the recovery. Some political uncertainty has been removed but continued membership of the EU is not assured.

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.

Greek Default & Euro shambles

Similar to other Euro sceptics (Euro not EU sceptics) we have consistently highlighted the structural flaws of the Euro – please see below. While Greece brought much of it original problems upon itself, the past five years have seen a series of very poor decisions imposed on the country in a haphazard and inflexible manner by a range of creditors.

We are now witnessing a decisive moment for the EU and the Euro due to Greece's bankruptcy. In summary, Greece but particularly the Eurozone member states are not prepared to compromise enough to revive the Greek economy. Greece has an unsustainable level of debt and requires economic reform but austerity will not improve a depression. Currently the most likely out come further years of pain and economic decline with eventual default. Alternatively, is an immediate default by Greece and very limited economic reforms.

Long term, all events are bad for the Euro and the EU. Membership of either is not a protection for bond holders, so weaker member states will see their funding costs rise. Longer term, the EU, ECB, Euro member states and IMF have be discredited. Their policies have enabled the crisis to develop, worsened Greece's predicament and undermined support for European institutions. The IMF in particular has supported the Euro over its membership's interests.

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 Eurozone 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. QE is the first sign of this. The costs of the Euro will continue to grind upwards in the form of social damage and lost growth if the program is not successful. 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. However Euro QE could derail our view as market forces are mitigated.

Deflationary stresses in Europe, China and Japan prevailed last year resulting in gains for bonds. Also, 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. Last 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 move toward longer rates as quantitative easing (QE) is stopped in the UK and US.

China, Debt & Growth

China has approximately 282% debt to GDP and its borrowing is expanding at twice the rate of economic growth. (The US has 269% and Germany 258% by comparison). 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. (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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