cannon asset management

newsletter

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Summary

The normalisation of US interest rates is at last under way. (Though the Fed's members' consensus forecast of 0.346% for their own rate was exceeded by the actual 0.5% rate. Keep this in mind about these people.)

This is a decisive signal for investors, with significant implications for both assets and investment strategies as the Fed continues with its rate rises – the first rise is not a killer, further increases will be. Capital preservation is not yet the primary concern, but it is much more important as some asset prices have already shown. Bonds and some equities shall be vulnerable: volatility - sometimes individually, sometimes whole markets – will place emphasis on "stock picking" and less conventional strategies in a more complex environment. Should a bear market develop, capital preservation will become paramount.

As we have been indicating for some time, interest rates in the US and the UK are too low and need to rise. The path to rates which are 1-2% higher and how to navigate markets during this process is crucial. Higher rates should extend the current growth cycle in the US and UK, leading eventually to higher equity values. However, the easy money has been made following 2008 and greater discrimination is required in the future. Active management may now produce more benefits and guard against market euphoria.

We expect markets to oscillate between complacency, despondency and eventually enthusiasm with consequent impacts on asset prices. In the US, company earnings are likely to grow by only 5% per year, providing little support for markets. Prominent investors' opinions will be conflicting at times, sowing confusion. The breadth of impacts from interest rate rises will be extensive and complicated – indeed they have been already. Some assets face valuation concerns yet for others there is irrational indifference. Recent price falls of emerging market bonds versus developed market bonds are an example.

Last quarter's market correction of most assets apart from government bonds ended with a recovery. Equities rose to beyond their long term fair values and rose again after the first Fed rate rise. Equity valuations are not yet in "bubble territory", economic indicators are currently good and stimulative policies around the world are in place. Weak commodity prices probably reflect past excess investment rather than falling global demand, particularly for energy. However, rising interest rates in 2016 may spark further corrections despite supportive policies, cheap commodities and reasonably good economic prospects which underpin profits.

While recessions and bear markets will occur in the future, they are not likely in the near term but a correction is. For conservative investments, any market crisis may impact capital values but will probably pass with little long term impact to business models.

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. Initially, rates rises may be positive for equities as they were in December.

Markets

Fixed Interest

The massive liquidity injections by the Eurozone and Japan are constraining their neighbour's monetary policies. It is difficult to raise rates or stimulate economies against these large economies' weakening currencies and QE driven money supply growth.

We continue to think US growth & interest rates rises will affect most countries irrespective of their local circumstances. The Euro area economic momentum is improving despite significant unresolved problems. Short term US and UK rates should rise during the next 12 months.

Oil and commodity price weakness continues, causing concerns over economic growth in emerging markets, particularly in China. As year-on-year price falls move out of the annual headline CPI figures of developed economies, inflation could increase rapidly to core CPI levels which are quite stable. Global growth forecasts continue to soften, but remain positive.

Short Rates

Currently US interest rates should be 2.49% higher (2.61% last quarter) based on long term inflation, real return and unemployment inputs. The Fed Open Market Committee mean forecasts fell again: 2015 – 0.42% (0.566%); 2016 – 1.49% (1.75%) and 2017 3.00% (3.00%).

Our estimates of UK short rates indicate that they remain too low, by about 3.30% (2.70%). European rates are about 0.05% (0.05%) too high for about 9% unemployment assuming no price inflation. However, for non-core Euro countries rates are about 3.25% too high (3.66%, a massive 2.74% improvement in four quarters).

Markets are still pricing US & UK short rates to rise significantly on a 2-5 year time frame. Europe and Japan remain challenged and their rises should be delayed.

Longer Rates

Developed countries' 10 year bond yields remained above their lows of last year. Longer term rates of 4-5% on 10 year US Treasuries (vs 3% for short rates in 2017) should eventually be expected. Their current yield is 2.24% compared to 2.97% in December 2013, but this is well up from their lows.

Credit & Emerging Markets

Investment grade corporate bonds are better value than government bonds. Improving economies and profits make defaults less likely but emerging market bonds corrected due to Chinese growth worries. The collapse of US high yield (i.e. junk) bonds was focused on the worst quality bonds, led to a rout in all grades and improved investment grade interest rate spreads over government bonds.

Bond Themes & Ideas

We expect more US rate rises in 2016, particularly if there is no evidence it will damage the US recovery. Short dated bond yields will rise as a result. The UK may tighten in 2016.

Markets expect short term rates to match those of 5-10 year maturities within 2-3 years. If this happens, current 5 year bonds could keep their current value as they become short dated thought the passing of time. Newer, replacement 5 year bonds yields should rise however.

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 in Europe is poor, but improving. 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 remains in dire financial straits and may spark more ill will. Spain is the latest country to evidence anti-Euro and anti-EU political party strength, following December's election. Prejudices about Mid East refugees will further this trend in Europe and improving economies will moderate it.

Equities

Markets reached new highs and all-time highs in some cases during the second quarter, followed by lows for the year during the third quarter. Broadly speaking equities are above fair value on long term measures (CAPE) and only Emerging Market equities look undervalued on a 7 year view. US high quality and international large capitalisation stocks are better value than other categories but prospective returns remain below both Emerging Markets and the 6.5% long term real return of US equities.

Market drivers are changing but improved cyclical profits underpinned by economic recovery remain key, jostling with interest rate increases, market volatility and emerging market developments. Increased dividend yields, share buy backs from historically low levels, increased debt to enhance equity returns, increased M&A activity and corporate pension liabilities due to bond and equity market gains remain longer term influences on prices.

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. Strengthening dollar and sterling will favour domestic activities over multinationals in the US and UK respectively.

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 valuation levels.

UK Equities

The autumn budget statement eased austerity further, stretching out the balancing of government spending and moving towards more realistic plans. This was needed despite much improved growth, unemployment, retail sales and consumer & business confidence. Domestic growth is strong but based mostly on higher consumer debt. Mid-caps are still expensive.

European Equities

There are signs of deflation being addressed by policy makers. However, the Euro and government finances could improve, making domestic firms preferred over exporters. European equities still appear to be good value, certainly on a relative basis.

Japan Equities

Japanese companies are groaning with cash, holding the highest levels in the world. The Bank of Japan stimulus measures and mixed signs of some reflation success lifted markets earlier this year. Gross debt remains high relative to GDP which could cause significant problems. Japanese equities are among the cheapest of major markets.

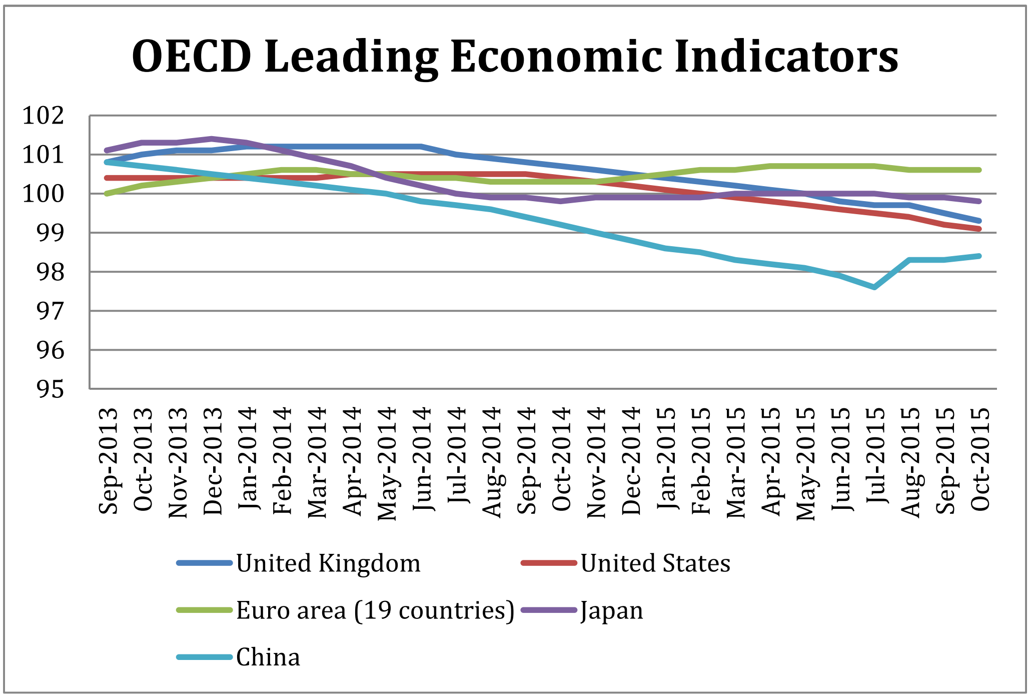
Emerging Markets Equities

These represent best value, but are volatile as seen in China. FTSE EM index is now on 10.94 times next year's earnings.

Economic Outlook

Estimates of growth have decreased since our last newsletter, except for the Eurozone which was upgraded. Global growth of 3.0-3.3% (3.3-3.5%) this year and 3.6-3.8% (3.8%) for 2016 are expected. Next year the US should see 2.4-2.6% (2.2-2.8%), UK 2.2-2.3% (2.3-2.5%), Eurozone 1.7-1.9% (1.6-2.5%) and Emerging Markets 3.3-4.7% (4.7%). (Sources: IMF, OECD)

US data is sporadic with some weakness in Q1 and in government finances. Growth averaged over 2% and credit growth was over 7%. Employment rates, participation rates and wages are all improving. September saw US consumer confidence surprise at 103 vs the expected 96.9. 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 important however, is a spending (demand) recovery. Oil price remains a net benefit.



China (the largest source of global growth) is still dealing with its adjustment to a more mature economy, with long term growth officially lowered below 7% per year. Europe and Japan remain the global laggards which may have the biggest surprise impact on global growth. Higher US interest rates will place stress on economies with USD debt.

Resource suppliers are suffering due to the reduced demand from China, whether they are companies or countries. Asian inter-regional trade is falling, reflecting this slowdown. The oversupply of commodities is most evident in the prices of energy, iron ore and copper which are all dealing with over-investment and supplier wars. However, signs of supply adjusting to current demand are appearing and demand is increasing modestly.

China's transition to domestic demand and its anti-corruption drive are reducing global trade with China and delaying investments. Over 50% of China's GDP is in services now while manufacturing is under 45%, so the transition is going well. The OECD estimates that services are growing at 8.5% and manufacturing at circa 6% (and falling), so this transition should improve growth in China. However, many loss making companies need to reform and concerns remain about manufacturing activity, construction and international trade. Markets panicked about China's growth, commodity consumption, equity market losses and currency devaluation during the year, though China's economy has in fact been growing rapidly.

China is taking action to stimulate its economy by easing interest rates and capital adequacy requirements. Its LEI is picking up even as China tries to rein in lending, increase domestic consumption and introduce market forces to domestic debt markets. Housing prices have bottomed and are rising, with sales volume increasing. Further, China has begun to increase imports of raw materials (oil, iron ore and copper). However, the decline of the "old" Chinese economy is a threat to the Communist Party which may respond with a currency devaluation that could export deflation worldwide.

The ECB has again indicated that further market intervention and stimulus would be likely during global risk off behaviour of markets. This is in addition to the current program of €1tn of bond purchases. Other actions continue such as negative interest rates and the lenient EU position on the French and Italian budget deficits. Greek debt restructuring with IMF support remains unresolved prior to the March refinancing deadline.

While the scale of QE is enough to meet the credit requirements for the Euro area's private sector, it is biased to benefit banks. Public sector deficits and their funding remain a concern. Also political reactions continue – Portugal's left wing coalition has taken power and Spain's right wind parties are now a minority.

In the Eurozone, the periphery countries are improving and their economic sentiment is rising. Domestic demand is driving economic growth. Consumer and housing loans leapt during Q2 but business lending, particularly to small companies remain in decline.

On balance the prospect of a lost decade of growth similar to Japan appears to be receding. However, the incomplete nature of the monetary union remains and the German stance of a hard currency exchange system – not a common currency - has taken hold. For example, Eurozone deposit insurance appears unlikely. Long term this is a strategically flawed structure.

The UK now appears to be in a second stage of expansion: productivity is increasing. This is very good news, particularly with signs of rising wages. Wage costs are being offset by productivity, which should lead to continued low interest rates and domestic inflation. This will reduce the pressure for rate increases that choke growth, extending the business cycle. Tax revenues are showing signs of improvement but serious, sustained deficit reduction still weighs on the recovery.

Japan has now seen wage growth for the first time since 2007 and smaller companies are hiring in large numbers. Core CPI is at 0.8%, having been positive since 2013. The BoJ has targeted quantitative easing equal to 16% of GDP. Further VAT tax rises may eventually be possible, 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. Corporate cash balances remain bloated and pay outs are expected to rise.

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 expensive, placing stress on some countries. This is a more normal state of affairs compared to the past 6 years.

Themes & Ideas

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.

How Relevant is China to Developed Market Economies?

Exports to China are about 1% of US GDP (2014, source Bloomberg) and about 2% of German GDP (2014, source: Bloomberg). A decline of Chinese growth from 9% to 5% is trivial to both economies, despite popular perception. This example of a 4% drop would imply about 0.04% lower growth for the US and about 0.08% for Germany. For the UK, its exposure would be about 0.02%. Even if we double the results to imply a similar reduction for other emerging markets (as China is about half of emerging market growth), the results remain small.

QE Exit (QExit?)

The normalisation of rates in the first developed market economy since 2008 has started with the US rate rise. But what are the longer term implications?

Since 2007, $11trn of money supply was created with a further $1trn proposed from the ECB alone. While the US is tightening, the ECB and BoJ stand ready to loosen but capital has accumulated in capital markets over 7 years due to the explosive growth in money supply. Foreign reserves (e.g. US treasury bonds) are being sold to fund budgets in the likes of Saudi Arabia and China as they deal with economic stresses. On balance USD liquidity (but not other currencies) is falling and is likely to fall for years.

Bonds were the greatest beneficiary of US QE, both directly and via private buyers. This is now likely to reverse. Regulatory changes reduced the buffer of broker and investment bank buying, though pensions and insurance companies demand is higher and are required to hold more bonds. Without large cash balances prepared to buy bonds on weakness, then sharp but temporary price falls may occur. Inflation surprises or unanticipated rises of interest rates in the US could spark such market moves. In the past two years we have seen markets overwhelm central bank intervention in the short term, particularly with curtailed liquidity and few buyers.

This impact will be felt beyond bonds. Greater volatility will require risk budgets to be lowered, leading to selling pressure in the relevant assets but particularly in bonds. It is likely that equities will also be affected to a lesser degree, as they too will come under pressure as yields rise. This will decrease the benefits of diversification and lead to further assets sales. Under these circumstances shocks and falling liquidity will combine to present tactical price falls within a trend to lower valuations, particularly for bonds or their equity substitutes. In fact this may be taking place now.

This new environment will be characterised by higher finance costs (for everyone, including governments and companies) and lower liquidity starting with the dollar but influencing other currencies as economies normalise. This implies higher costs, tighter budgets and lower investments, particularly for those with high debt.

Portfolios should be less geared and must seek out more liquid and tactical strategies. Rising correlation and volatility of assets means risk will be lowered through lower net exposures, liquid investments or traditional asset allocations. Holding liquid products (futures, options and foreign currency) will be better, enabling switches to other assets or distressed investment opportunities. Taking profits will be important. Option strategies, selling into rallies, avoiding consensus or illiquid positions will be important.

Germany, Debt, Immigrants and Credibility

Germany faces very significant burdens of unfunded liabilities and infrastructure spending. The country’s unfunded liabilities are 400% of GDP and it has about €1tn of cost to exit its nuclear energy program alone. Commentators regularly mention the country’s crumbling and inadequate infrastructure. These liabilities drive the country’s obsession with austerity – it needs to save and avoid tax calls from Europe.

The well intentioned welcome to Middle East refugees supports an aging population at first glance, but studies by the IMF and others indicate that at best immigration has little economic benefit. Basically, immigrants must earn significantly more than average earnings (which is rare) to enhance the wealth of any country after settlement costs.

Unfortunately in modern service based economies, high paid unskilled jobs are rare. Even assuming good language skills of migrants, the net benefit is likely to be low. As most immigrants (circa 70%) are unskilled, above average immigrant wages are unlikely. One estimate is that 5 million such immigrants (6.25% of Germany’s population) would cost €38bn per year or about €1tn over 30 years – the same cost as nuclear decommissioning!

So, are ultra-low bond yields of Germany compatible with very large and growing government liabilities? If not where will the money come from - more austerity perhaps or looser money policy? Would looser money help Germany’s partners in the Euro as well?

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 disastrous (for some countries) 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.

At the moment, it has survived but 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 remain. 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.

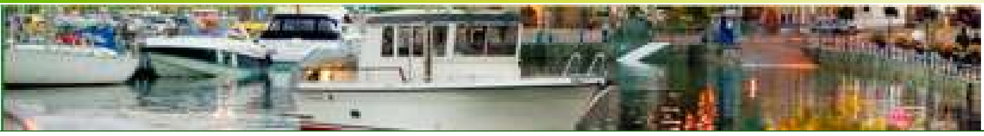
The Euro's fundamental problem is the "one size fits all" interest rates and economic policies applied to economies with different levels of productivity, wealth and labour market flexibility. It is worsened by the lack of Eurozone institutions to address the differences, such as fiscal transfers, a banking union and ultimately a single elected body representing the whole area rather than the national governments currently calling the shots. Domestic market policies are also a major source of instability.

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 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.)

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.

Contact Us



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