

Investment Outlook Update

2018 08

It is difficult to ignore the short term trends and volatility but I will give it a try.

In few other disciplines does luck or chance play a bigger part of the outcome than in investing. The shorter the time frame, the more chance plays a part in the outcome. The longer the time frame, the more fundamentals have time to be priced in and the more clearly patterns appear out of the information soup. This is a little at odds with quantitative techniques where short term forecasts face less uncertainty than longer term extrapolations. I do not know how to reconcile the two except to note that quantitative forecasting has a patchy track record.

The world is a less hospitable place then it was in the last 30 years. Before that we had the Cold War but since the fall of Communism, the world has come together and progressed through globalization and innovation. Since the Great Financial Crisis of 2008, globalization has retrenched as countries and people became less cooperative and more competitive. Trade has just been one front in which this new insularity has manifested. Immigration is another.

Debt and growth.

Orthodoxy regards long term growth rates as constant which implies that output levels grow exponentially, which is difficult to sustain. Technological innovations and demographic changes can fuel growth spurts but to expect constant growth rates absent exogenous perturbations places high stress on policy and efforts. One avenue to maintain growth rates is leverage. As returns on assets slow, returns

on equity or capital can be maintained by the application of leverage. The side effect is that at the global level, we only borrow from our own future output. Debt service and repayment can hinder growth in the future. Also, leverage represents increased risk to the economy and financial system.

As returns on investment slow, more debt is applied leading to increased risk. At some point a credit crunch occurs and the system deleverages quickly. A period of repair ensues. Not all parts of the economy are deleveraged, some parts actually increase leverage as debt costs are cut. Governments debt finance their bailouts substituting public for private debt. Total debt is likely to increase more than decrease.

As parts of the economy are made safer, they are also made less efficient. Banks and the shadow banking system after 2008 are a case in point. The relatively wastefulness reduces returns on investment. In this example, the regulation included limits on leverage which prevents the banks from reverting to pre-crisis levels of financial efficiency. In the trade war scenario, companies will be encouraged to build assets in the tax domicile of their customers resulting in wasteful duplication, which also reduces financial and operational efficiency. At some stage, the economy will seek to restore pre trade war efficiency by increasing leverage.

China

For the last decade China has recognized its dependence on exports as both a strength and a weakness and has explicitly sought to reduce that reliance. Exports as a percentage of GDP were 35% in 2006 but now count for less than 20% of GDP. Imports fell from 28% of GDP to 18% in the same period. The Chinese economy has become more domestically driven than before. A significant proportion of output is still investment driven which has also driven up debt levels.

China's growth in the past 20 years was helped by the cheap or free transfer of technology from the West as developed economy corporations sought low cost solutions to improve efficiency. This free transfer of IP is no longer available. China has recognized its dependence on Western tech and has not been complacent. According to the World Intellectual Property Organization, in 2017, China displaced Japan as the second largest filer of patents and was also the country with the highest growth in patents filed. Innovation in China may not yet be on par with the US but it is fast catching up and in certain areas, such as mobile payments, has surpassed it. Whereas China was seen as the factory of the West, an outsourced solution to developed countries, today China is a rich and balanced economy with a critical size of middle class consumers to power its growth domestically. China's technological advances have been sufficient to worry the US who now try to contain China's ascent. Constructive engagement would be more profitable, but it is human to compete. The trade competition from 2009 – 2016 was focused on manufacturing whereas the current trade spat is focused on intellectual property. In the short to medium term, companies' fortunes will be impacted by the trade war but the future will see the domestic demand well capable of supporting domestic business.

In China, policy is especially important. It is still debated whether China is a command economy outsourcing bits of its economy to the free market or if it is a free market economy bursting out of a command economy. The reforms enacted by the Communist Party do not add clarity. On the one hand China build's bridges with the international community even as it stifles dissent at home. China recognizes the importance of a reliable legal system, yet fears the challenge an independent judiciary could pose to the CCP. Expect pragmatic management of the legal system in which rule of law applies to all but the CCP, which is not very useful at the reach and scale of the party but gets progressively more useful as SOEs are

steadily privatized.

The same theme is visible in all policy in China. The PBOC wants to liberalize markets but fears the unreliable invisible hand of the market, and so constantly intervenes when markets threaten excessive volatility. The regulators want to regulate the shadow banking system but shrink when they choke the conduits of credit to the economy.

What this implies is a cyclical and trend reverting market valuation. (11X for SHCOMP and 8X for H Shares doesn't look too bad.)

US

The US remains the most vibrant large, developed economy in the world, driven by free markets and efficient policy (meddling) when the market fails. The handling of the 2008 financial crisis was a case in point. When the GSE's failed government stepped in to bail out the mortgage market and ensure continued functioning of markets. Critics are right to point to the abandoning of free market principles such as letting lame ducks die, but a pragmatic approach was taken and it has served better than the European or Asian solutions. The danger is that analgesics become staples and free market principles are never restored.

That pragmatism and wilful debasement of capitalism has seen the Fed bailing out the economy every time it slows too much, then taking away the punch bowl when the party starts to get too raucous. The trouble with this policy is that it seems that its not long after when the Fed has to come back with the painkillers.

The tax cuts have boosted the economy just as the Fed was raising interest rates. The fiscal boost will likely lengthen the cycle, however, the cycle is also expected to be

shallower. The experience of 2008 has led regulators and companies to be more circumspect. Corporate leverage has been falling since the crisis rising only briefly in 2015 before receding once again. The private sector is safer than it was before. Banks have also been required to deleverage and hold more capital against assets.

The Fed has been raising interest rates since December 2015 and is expected to continue from the current 2% to 3.5% over the next couple of years. It is possible that it will overshoot, if it wants to restore the rate to a level where cutting it becomes a meaningful stimulus. At the same time, the Fed is running down its holdings of treasuries and agency mortgages in an unwinding of QE. QE was an experimental therapy and its precise action is not fully understood. Its withdrawal represents a risk. Already the Fed's holdings of treasuries are distorting the yield curve.

Without a meaningful crisis or recession, it is likely the Fed will continue to raise rates. There is certainly a risk that the Fed could end up hiking for longer. While this argues for longer short rates, the way the Fed normalizes could suppress the long end of the curve. The increased issuance needed to fund the tax cuts could lead to higher yields from 2 – 5 years resulting in a humped yield curve. Given the levels of interest rates we are dealing with, rates are expected to stay low for a long time but their trajectory is very likely higher. After over 3 decades of falling rates it is difficult to contemplate a world of rising rates, especially if they rise slowly and over a few cycles. Such a market would not reward those who await a level at which to buy duration, and neither would it reward those buying and holding. There is a risk it might increase the term premium.

Since the last crisis valuations have risen steadily so that stocks are no longer cheap. On their own they look expensive but relative to treasuries they look less over-valued. That said, such a measure is sensitive to where treasury yields go.

Given where valuations stand today it is likely that at the very least, returns should moderate. The tax cuts will give corporate profits a boost and prolong the bull market but the reset in valuations while significant is mostly over. Further tax cuts could be on the way but these would translate into wider fiscal deficits. A bear market is unlikely given the robustness of corporate profitability and how gingerly the Fed is raising rates but with the S&P trading over 20X, it is difficult to see the double digit returns of 2016 and 2017 being repeated. A moderation to the mean is the most likely scenario.

USD: Recall Volcker's inflation management of the early 1980s where interest rates reached 20%. We are not saying this will happen again, inflation has been defeated by technology and demographics, but the USD strengthened enough to result in the Plaza Accord being agreed. This led to a sharp fall in the USD and a rise in JPY which probably resulted in Japan's multi decade depression. The current period is quite different in that we have low inflation and the US is the engine of growth of the global economy. While the Fed is raising rates it is nowhere close to the rates in the 1980s. At best we will get 4% Fed funds which is already a stretch. Global debt levels make it highly unlikely any central bank would venture further than 5-6% in the best of times. The trade war is, however, exerting upward pressure on the USD. It is unlikely that the strength will be of the sort to trigger another Plaza Accord but it may trigger soft management to weaken it at some point. In the meantime, a growth premium, higher rates and a more hawkish central bank together with trade retrenchment is likely to take the USD higher. Just not too high.

Europe

Europe's growth in 2017 was likely to be an outlier as a pause in deglobalization and a rebound in global trade lifted the

economies of a region highly dependent on international trade. With a resumption of the trade slump, whether by natural causes of reshoring, or by US protectionist policy, Europe's fortunes are likely to darken.

Europe is as innovative and its peoples are as dynamic and capable as those of any other region. A number of things disadvantage Europe. One is an unstable economic union which disadvantages some members and helps others. This is always the case with collectives but it is particularly acute in Europe. The central bank has to set one speed limit for a diverse region of economies not only in different phases but with different metabolisms. The lack of currencies causes certain factor markets to fail to clear. The payments system masks a de facto and covert funding of deficits which do not appear on current accounts.

Then there are the social and cultural aspects. America at least has a common language. Europe does not, although the ECB insists that its official communiques are in the language of a non-euro member on the brink of exiting the European Union.

With trade at over 80% of GDP, Europe has not weaned itself off exports and developed a domestic consumption base. Perhaps an ageing population will put a permanent damper on consumption. Immigration, importing demand, might be one answer but immigration is one of the most divisive topics in European politics. This summer it nearly toppled the German ruling coalition whose leader Angela Merkel opened doors to refugees some years ago. One of Italy's parties in the two party coalition campaigned on the anti-immigration ticket. Brexit was tangentially anti-immigration in some quarters. It is clear that the people are against unfettered immigration and freedom of movement (concepts that are related but not the same.) Their leaders are not and insist dogmatically on a concept that was acceptable decades ago when post war Europe needed to hold together.

Trend growth in Europe is slow. The ECB deployed QE late and is now about to withdraw it just as the economy is slowing once again. Peripheral spreads are diverging. Populist Italy is challenging the logic of the Maastricht budget conditions. There is no fiscal latitude in Europe as there is in the US and China.

Monetary policy is the only analgesic available and the ECB is in a difficult position. The economy is slowing and it still hasn't normalized policy yet. Technical reasons force the ECB to cease QE but it is almost certain that a replacement accommodation policy will be found. In the meantime, wide ranging QE has propped up markets so that they do not appear particularly cheap (the Eurostoxx trades at 14X which is above its historical average.)

Japan

Japan is of cyclical interest due to a reformist government pursuing an aggressive program of reform. It is also at the forefront of gerontological economics and investing. Japan has a rapidly ageing population and a shrinking labour force. Despite policies to encourage economic immigration its unique culture is a barrier. Reforms to improve corporate governance and shareholder interests have improved financial efficiency of firms and boost returns on equity. Tax cuts have also delivered better growth to the economy. Japan is also trying to attract foreign capital and visitors to Japan. But there are reasons for caution.

Abenomics is 5 years old and the initial gains have been made. Fiscal tax and spend policies have had mixed success. Fiscal stimulus packages have boosted the economy only for consumption tax increases to slow it again. Japan's national debt is sizeable at over 2.5X GDP and strains the ability of the government to maintain such largesse. Monetary policy has

led to the BoJ becoming the de facto lender of last resort to the state, albeit through private sector intermediaries. With inflation well below target and slow growth it is doubtful if the BoJ will ever be able to back away from buying JGBs. In fact the central bank has taken to buying ETFs on the Japanese stock market.

That isn't to say that Japan is not a good place in which to invest, it just means that investors need to be more purposeful and target specific areas and stocks.

India

India has held promise for decades but failed to deliver. An inscrutable bureaucracy and countless red tape and process has tied India in knots. This ended when Prime Minister Rajendra Modi won India's first simple majority in the lower house in 3 decades which gave him sufficient freedom to pursue a reformist and commercial agenda. No hung parliament or coalition government would have approved the sudden demonetization of 2016 whereby the largest denominations of physical cash notes were voided. Or the implementation of a market unifying GST to replace a whole list of tariffs which were the lifeblood of corruption and rent extraction. Or the insolvency code now used to pursue an elite tier of deadbeat billionaires previously untouchable by the law.

The long term rewards for investing in India are significant. India has nearly as many people as China and with a younger population has a faster growing labour force. India's nominal output is about a fifth of China's. A partial catch up would reap serious gains. The reform agenda is packed, the most significant being the forced formalization of the informal economy (through demonetization and the Aadhaar (Unique ID number)), the new bankruptcy code, the recognition of non-performing loans and recapitalizing of banks and the single

market created by the implementation of GST.

There are risks to investing in India. The foremost is political risk for if Modi is unable to maintain power, the risk of India backsliding into viscous complexity would be substantial. Also, equity valuations, unfortunately, are quite lofty, at 20X. That the central bank (the RBI) which had cut rates from over 10% in 2003 to as low as 6.25% in 2018 has now raised rates twice in response to rising inflation in particular stemming from higher energy costs. A rising oil price is not just a tax on the economy but elicits a policy response.

US Treasuries

If you believe that inflation has bottomed and will rise, you would expect the yield curve to steepen. The Fed seems quite determined to raise short rates to at least 3.5%. Assuming a 1% difference between Fed funds and the 10 year, this would put the 10 year at 4.5%. The 30 year is being suppressed by a shortage caused by the Fed's existing holdings which account for 30% of the treasury market at most maturities except the long end where it is 56%. Given that the Fed will not sell bonds in its normalization this shortage should persist. To fund the tax cuts Treasury is issuing bills and notes from 2m to 5 years which will probably create a hump in the curve in the 2 – 5 year sector.

The long term outlook for oil

Demand growth for oil will almost certainly fall. According to a study by BP, oil demand will rise to 4.56 billion mt in 2020, a 13% increase of 2010. The growth rate to 2030 slows to 6.6%, peaking in 2035 and flattening from there. Global demand will likely be met by natural gas and renewables with growth

in renewables the most significant contributor. BP expects renewables to grow from 794 million mt in 2020 to 2.5 billion mt in 2040 or a CAGR of 6%, or from 17% of oil demand to 52% in 20 years. World Bank estimates an oil price of 70 USD which given peak demand circa 2035 is also likely peak price.

EIA projections indicate an oil price peaking at 70+ in 2018 and levelling off after that. OECD forecasts oil prices rising gradually but steadily after 2018. Formal studies' estimates of oil demonstrate high serial correlation indicating an unwillingness to make large adjustments in forecasts. Given the underinvestment in capacity and the speed at which existing reserves are being depleted, the oil price, currently in the mid 70s, is likely to accelerate into 2020. Peak demand is likely to come earlier than industry forecasts of 2030-2035 given the pace of investment and innovation in electrification of transportation. It could come as early as 10 years early by 2025.