GUARDCAP

# Reflections & Insight

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> "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way."
>
> *Charles Dickens – A Tale of Two Cities*

We can all sympathize with this. Given the knowledge the human race has acquired, it sometimes shows a lack of wisdom that is breathtaking. The cacophony of political noise around the world is drowning out rational thinking, whether about global trade policy, climate change, inequality or the future of the global economy. This doesn't mean that rational thinking is not happening, just that those who drive policy are choosing for narrow ends to stick it on the substitutes' bench.

Escaping the noise is a bit like wading through treacle, but the purpose of these reviews is to attempt to free at least one foot from the goo.

We have previously commented that a focus on individual economic data is pointless, offering a sugar high or a hangover, depending on the data and your disposition. Panning out a bit, we can observe that global economic activity is a bit sluggish. In the US, there is a natural reset as the stimulus from Trump's tax cuts fades, and this has had a bearing on a lot of recent data, as comparisons are difficult. Consumer spending is still a reasonably bright spot, but there are early signs of a slowing trend here too. In Europe, the most important economy (Germany) looks as if it may well have entered a technical recession in the third quarter of this year. The rest of the Eurozone is having what outgoing ECB Governor Draghi described as a 'pronounced sag.' The UK is in its own particular hell, while Japan faces a tax hike in its VAT rate against a soggy backdrop. China, well aware of the slowdown induced by the trade conflict, has announced up to 100 individual measures to mitigate the problem. None of these is anything like the bazooka mobilised in past crises, still, they add up to a significant stimulus that has propped up growth ahead of the 70th anniversary of the founding of the Peoples' Republic of China.

## Monetary Policy

All in all, then, a bit of a curate's egg, that is partly good and partly bad. Against this backdrop, it is hardly surprising that monetary policy has remained supportive. The likelihood of significant interest rate rises in the developed world has disappeared into the distance. Vast swathes of Government bonds trade at negative rates and inflation, with one or two notable exceptions, is very subdued. The markets have positioned themselves for long-term growth to be rather anemic and the environment to be quite disinflationary. Nevertheless, there are few signs of recession on a co-ordinated global basis. Countries like the UK or Germany face local difficulties, albeit exacerbated by global developments, but on balance, global growth looks likely to come in around 3% for 2019, down from a forecast of 4% at the start of the year.

Monetary policy, though, has reached the limits of what it can be expected to achieve. If interest rates at zero do not cause animal spirits to soar, the outside observer might conclude that there is something unusual afoot. Interest rates drop during a conventional economic slowdown to the point where borrowers see the returns on new investment opportunities exceeding the cost of that borrowing, and the cycle starts up again. Why is that not happening? There have been reports that mortgage rates in Denmark are negative, for example. That can only mean that potential borrowers have concluded that real estate prices are going to fall and thus that borrowing to finance such a purchase is illogical. What is unusual is that this behaviour is not accompanied by a significant economic slowdown. Magnified throughout the system, potential borrowers see little growth, the risk of price declines, regulatory creep, and disruption. The discussion around board tables is 'let's wait and see – we aren't missing a lot by hanging on and not building that new plant/shopping mall/call centre' – and that is what draws the claws from the monetary tiger.

## Fiscal Measures

Although the risks of a global recession appear limited for now, this economic cycle is long in the tooth. There is an aphorism that economic expansions do not die of old age – they need a withdrawal of liquidity (i.e. higher interest rates). Maybe. The most dangerous words in the financial world are 'This time, it's different-.' Although usually true, the problem is that we have never been in these circumstances before, so it will be a brave pundit who asserts with confidence that a particular outcome is a given. The evidence is that it has become increasingly difficult to translate monetary policy into economic growth. Each time Central banks have sloshed more cash around it has had a smaller and smaller effect on the real economy. What happens instead is that the creation of liquidity has supported asset prices, exaggerating the inequality a growing economy is supposed to offset.

In these circumstances, it is perhaps not surprising that fiscal measures are under consideration. We have already had the Trump tax package; the ending of austerity has been trumpeted elsewhere; and even in the last holdout of fiscal rectitude, the German political mood music is shifting towards some form of stimulus. Germany will probably wait until a recession is confirmed before acting, and even then, the action may be a little feeble, but this would be a sea change, which might shift bonds lower (interest rates higher) and point towards a more growth-oriented world. That, in turn, might revive those Keynesian animal spirits. For now, that looks quite a long shot, given the prevailing winds of caution.

## The Global Landscape

This review has not commented much on the UK, partly because nobody there seems to know what is going on. What is happening is not funny, though. A minority government is attempting to deliver some form of BREXIT against the wishes of the majority in Parliament. It has tried some jiggery-pokery to push its policies through, but these antics have been judged unconstitutional. Nevertheless, it would be foolhardy to think that Britain might not fall out of the EU by accident, or because the whole of Europe is fed up with the Brits. Without a deal, there will likely will be significant economic disruption, which will affect the whole of Europe. Optimists believe that the removal of uncertainty implied by any form of BREXIT will revive UK investment, but unfortunately, simply leaving the EU solves nothing without a framework for a future trading relationship with Britain's major trading partner, and those discussions have not even started. The likelihood is that the poisonous public discourse will not dissipate in the short run. There is also a significant risk of a rupture of the Union, with Scotland seeking a second referendum on independence. It almost goes without saying that UK asset prices (including sterling) reflect a pretty poor outcome, but it may still be too early to jump aboard.

Looking at the year ahead, apart from BREXIT, the global landscape will be dominated by the congressional investigation into Trump and the pyrotechnics surrounding the 2020 election. In China, the protests in Hong Kong are unsettling for the premier financial centre in Asia and the trade war complicates the picture even further. In the Middle East, the game of cat and mouse with Iran risks serious consequences for regional peace and the oil price. We are likely to see interest rates and inflation stay very low, and a lot of talk (and some action) to provide fiscal stimulus. All of this reflects a real worry on the part of policymakers globally that the economy is not robust enough to weather a significant slowdown or recession without triggering a financial panic. These considerations add up, perhaps counter-intuitively, to an environment that is still positive for equity markets, although the prospects for high return seem quite limited.

## Sustainable Business

Uncertainty tends to favour companies with sustainable business models and high quality, as expressed through balance sheet strength. In recent years, these are the companies that have been the market leaders, and as a group, many of these stocks are quite expensive. Because of this, investors are ready to jump into companies that are more economically sensitive whenever signs of strength appear, but the risks are that this strength will remain elusive and that

these leaps will be false dawns, to mix the metaphor horribly. Bonds remain expensive and could be adversely affected should the appetite for fiscal easing gain momentum. Emerging Markets offer growth, but are an investment area where a broad approach makes less sense than it used to, as some countries are caught up in the trade war or geopolitical tension. Fortunately, the corpus of interesting companies in this region has multiplied, and offers opportunities at reasonable valuations.

Uncertainty also forces us back to the basic principles of investment:

- Stay diversified, by country, by sector, by currency and by asset type
- When looking at companies, invest in those with understandable business models which have stood the test of time
- Avoid companies which are price takers or subject to government interference
- Demand a premium for illiquidity
- Have realistic expectations
- Keep a cool head

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