GUARDIAN CAPITAL

Reflections & Insight

OCTOBER 2018

'It will fluctuate'. The answer given by JP Morgan, founder of the eponymous bank, when asked what the stock market would do.

Of course, the original JP had not heard of quantitative easing, that elixir which has ironed so much 'fluctuation' out of the system. As we enter the eleventh year since the Great Financial Crisis (GFC), investors have become inured to the new normal of interest rates being lower than justified by cyclical or fiscal considerations, debt being desirable (because it's cheap) and growth and inflation being a bit subdued. It's been going on for so long that investors accept a historically unprecedented set of circumstances as quite usual.

As a saver or investor, it is hard to remember the time when a bank deposit and debt both carried a real rate of interest, when equity markets were volatile and central bankers didn't have to worry about saving the financial system. In previous reviews over the past decade, we have commented at length on the fact that there is so much liquidity in the system – on the flip side of very low interest rates, two things might happen. The first is that asset prices become inflated; the second that economic activity picks up. We can all agree that the first has happened – bond markets, equity markets and yield spreads all contain a valuation premium that suggests tolerance for risk. It would be hard to argue that if short-term rates were 5% that all asset prices would be at today's levels. Of course, you might well be regarded as a madman for suggesting that rates could be 5%, but in the eleventh year of a past recovery that would have been anything but unusual.

Economic activity has picked up as well, albeit in a rather anaemic fashion, except in the US where it has been subject to a large fiscal stimulus at a point in the cycle where that is probably unwise, and in any event creates a large increase in the government debt burden in the medium term. The fiscal stimulus has primarily been of benefit to asset owners and corporations rather than to the base that elected the current administration. Empirically, therefore, it looks as if the monetary experiment has benefited assets and not done much for the real economy. This combination has fertilized the soil in which populism has germinated.

Guardian Capital LP is providing this market commentary which was authored by GuardCap Asset Management Limited. GuardCap Asset Management Limited is a sub-advisor to, and an affiliate of, Guardian Capital LP.

There are a series of risky games of chicken being played in the geopolitical sphere. From developments in Iran, which are affecting the oil market, via BREXIT to North Korea and then to trade tensions, the world feels like a riskier place than it did a couple of years back. Markets occasionally sniff trouble, but the smell is carried off quickly on the wind. Economists, who never agree on anything, do agree (with the exception of the hawks in the Trump team) that a trade war is bad for everybody. The US president seems to believe that trade is a zero sum game and that the US trade deficit is inherently bad and in need of fixing. The reality is that the trade deficit is a mathematical identity which reflects the fact that the US consumes more than it produces. There are two ways to fix that – consume less or produce more – neither economically possible over anything other than the cosmically long term, and neither in the current policy mix.

> "... Picking a fight with allies [plays] well with the Trumpian base...

Picking a fight with allies and economic rivals alike may play well with the Trumpian base, but it takes little account of the fact that political considerations in China, for example, mean that a public climbdown is impossible. That is why we have seen concerted efforts to weaken the Chinese currency and to stimulate the domestic and services sectors of the Chinese economy. The authorities there are buying time and 'wiggle' room, should events get more heated. The likelihood is that the initial impact of a trade war hits China hard, but then spills over to US companies operating in that country and eventually to US consumers through higher prices, which are already visible in certain products.

One of the effects of these geopolitical spats, combined with the choreographed rises in US interest rates, is that the US dollar has been strong for most of this year. This has caused problems for many emerging markets, some of which have high dollar borrowings at both the sovereign and corporate level. Currencies and both bond and stock markets have suffered from a generalized sell-off which implies a heterogeneity across countries that is far from reality. Travails in Turkey or Argentina have little real world echo in Korea or India, but all are tarred with the same brush. This indiscriminate scapegoating has created an unusual opportunity in that emerging markets are now trading well below their long-term average rating and are at record lows in valuation terms compared with the developed world. When the dollar stabilizes or weakens, there will be an interesting opportunity in individual companies in many of these countries, even if not yet.

Elsewhere, BREXIT remains a nightmare, with no clear outcome yet in view. European economies are rumbling along adequately and the ECB will be exiting QE (Quantitative Easing) at the end of the year. Japan remains sluggish, but the stock market is quite well valued. Technology continues to disrupt incumbents across many industries and calls for greater regulation are gaining strength in many jurisdictions. These trends will take years to play out.

In developed world stock markets, the commentariat remains positive. The narrative runs like this: interest rates are lower than they should be, so there is plenty of cash around; because the recovery has been sub-par, there is little sign of inflation in wages, even if rising oil prices are a headache; tax reform in the US has given earnings a real boost; and higher earnings are leading to more capital investment which will in turn lead to improving productivity. Those investors who were active in the 1990's will remember the 'Goldilocks' economy, which was not too hot, not too cold, in fact just about right. A generation on, and here we are again. It is true that these conditions support equity prices, a contention reinforced by the pitiful returns on offer from other asset classes. Even high yield debt is trading at record low spreads to more respectable bonds.

> "It tops the cake with a debt-flavoured cherry...

There is a different story out there as well. This one starts with the length of the cycle – it is close to an all time record in duration – and wends its way through high valuations and extended profit margins to the shifting sands of geopolitics. It tops the cake with a debt-flavoured cherry – debt is now higher than it was before the GFC (albeit not in mortgage markets) and by many measures we are back to lax lending standards again.

Which of these tales you prefer will often be a matter of personality. This comes as a shock to many clients who believe investment practitioners deal in evidence and facts. The reality is that the mood of investors (which is known in the trade jargon as 'sentiment') has a large bearing on how things turn out. Because it is unknowable, all kinds of proxies have been developed to measure it. Most of them try to measure things like risk tolerance, and then pick up data about asset allocation to confirm or refute the hypothesis. At the moment, most such surveys tell us that investors are pretty relaxed and quite positive – in other words invested in narrative number one. It has generally been right to be positive on the returns available from risk assets – over the very long term, the real return from equities has been around 5% per annum, varying somewhat by the market chosen.

"... If you are looking after somebody else's assets, you do not want to stray too far from the herd.

There is another reason why things are as they are. It is to do with investor timescales. If you are looking after somebody else's assets, you do not want to stray too far from the herd. This is particularly marked in institutional behaviour. Performance can be measured minute by minute and while it shouldn't be the case, it is an unusual asset manager who is not aware of how his portfolio is faring on quite a short-term view. The best do nothing about the fluctuations of fortune, because they are following a lodestar, but many trim their sails to respond to changes in the wind.

The effect of this is that institutional investors are slow to change their strategic views, focusing on the narrower tactical perspective instead. The best are following a carefully calibrated stock selection process and will not change when the weather changes. Others, though, watch the herd and will be skittish when everyone else is skittish. This is why most stay at the party for too long, and when they do head for the exit get knocked down in the rush.

"... At times like this, when the sun is still shining...

Our position is that while it is easy to postulate that things look OK at the moment, we acknowledge that the risks have been growing. The underlying dynamics of asset prices depend on a complex interaction of the relative value of one asset class against another, tempered by sentiment and investor timescale. Individual investors do not have to please an investment committee and nor do they have to stay with the herd. At times like this, when the sun is still shining but dusk is approaching, a degree of caution is warranted.