GUARDIAN CAPITAL

Reflections & Insight

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“Surprises are foolish things. The pleasure is not enhanced, and the inconvenience is often considerable.” Jane Austen – Emma

It is tempting to think that there have been times in the past when certainty prevailed. An investor simply held a wholesome mix of equities and bonds and put his or her feet up as dividends rolled in and capital growth took care of the future. Looking back at these reviews over the last dozen years, though, it is uncertainty which has prevailed. It has never been clear exactly what is going on, and it has been possible to drown in the noise while not even hearing the signal.

The noise at the moment is deafening. The tsunami of economic data is parsed ad infinitum for nuggets, yet a single set of data either adds to the current wisdom or subtracts from it, but in each case, only marginally. Add to the economic hodgepodge the political posturing which, for once, weighs heavily on asset prices, and you have a veritable cacophony of white noise. In the background, and barely discernible, are some of the longer-term factors which should be driving what investors do. This quarter, we will look at some of these secular issues and consider what they might mean to a sensible investor with a long horizon.

Monetary Matters

The front of the shop window is dominated by monetary policy. As we have written before, at the end of 2018, it was a truth universally acknowledged that interest rates were going up almost everywhere (maybe not Japan): a happy corollary of faster and more robust economic activity. Unfortunately for those who were positioned for this universal truth, the first half of 2019 has been a complete refutation of that earlier belief. Now, we see a new cycle of easier monetary policy developing, where growth has stalled, and inflation is still inexplicably subdued. The reality is that, whatever the economic data show, and they are mixed, the global economy is not robust enough to cope with a normalization of interest rates – there is still too much debt around. For this reason, the monetary environment is likely to remain reasonably supportive of risk assets (like equities). This contention has been strengthened by the recent appointment of Christine Lagarde as Head of the European Central Bank, who is very likely to continue the accommodative policies of her predecessor.

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While a recession is out there somewhere, the most recent policy actions in the US and China probably defer any reckoning for a couple more years.

Fiscal Affairs

You probably remember the days when investors fretted about 'budget deficits'. Well, no more. The US can run gargantuan deficits without upsetting the markets. Of course, not everyone is the US, and some countries have to 'play nice' with the bond markets, but the broad intent of controlling public spending and containing public borrowing is gradually being abandoned. Countries like Germany stick to their knitting, but most are being forced to take a more stimulative stance by concerns over populism and other forms of voter discontent. This means that the austerity which accompanied the Great Financial Crisis of 2008 is on its last legs and, at the moment, markets seem to be relaxed about greater levels of borrowing by governments. This may not continue indefinitely, of course, but the example of Japan shows that it can have long legs, particularly when the dominant players in the market are domestic. Usually, a combination of faster growth accompanied by higher inflation is the natural regulator, but that seems a distant prospect in most countries. There is also a new economic theory doing the rounds (it's called Modern Monetary Theory, or MMT). Stripped to its basics, this asserts that a government which controls its own currency has no natural limit on what it can spend unless inflation starts to spark. That way, a mix of public and private sector can be stimulated to use the excess capacity of an economy by keeping interest rates at or close to zero. You may not be surprised to find that this is a policy which appeals to politicians, as it subordinates the independence of a central bank to the wishes of the political class. Without going into too much detail, suffice it to say that MMT adds to the evidence that austerity is being throttled.

Trade

One thing on which all economists agree is that free trade is a good thing. This is why there is so much wringing of hands about the dispute between China and the US. The markets worry when it seems to be getting worse, and celebrate when there has been some sort of breakthrough. In reality, the dispute is about domestic US politics and a visceral worry that the US is ceding its hegemonic power to China. Its second-order cause is a sense of injustice that China has 'stolen' US intellectual property over the years. The second cause is probably fixable – even if superficially, the first is probably not. China already produces 4.7 million scientist graduates a year, compared to 600,000 in the US. It filed more patents than the rest of the world combined in 2017. It will soon be the largest economy in the world, as it has been for 20 out of the last 22 centuries. The US is going to have to get used to dealing with another superpower which does not share its liberal values and plays a very long game. This need not be a fraught process, but the drumbeat on either side is not encouraging. The US President needs movement on the trade agenda ahead of the 2020 election, so the likelihood of something happening in the middle of next year must be rated as high, even if what will no doubt be billed as 'the greatest ever trade deal' has no substance.

Populism

For those of us with a bus pass, most of our working lives have been passed against a backdrop of more or less centrist politics, more or less free-market economics, with bits of the world that weren't like that effectively off-limits. In many countries, we now have a populist movement which is probably gaining ground, although it is unlikely to have a smooth trajectory. The implications of this for investors are likely to mean more reckless public finances, a narrower focus on the national interest, with unfortunate implications for trade and immigration and a general coarsening of the polity, which could generate market volatility. In other populist experiments over the years (witness Argentina) unless checked, is a political system which can choke a wealthy country with corruption, nepotism and inflation. This is not a prediction but is a counterbalance to be borne in mind when thinking about the very long term.

Share Ownership

Investment theory says that owning a share is a claim on the future cash flows of a business; the share price is the discounted value of those cash flows. This is elegant, simple, and sadly no longer universally true. The internal dynamics of markets have changed radically over the recent decades, with the rise of passive investing, including ETF's and more recently the emergence of algorithmic and high-frequency traders. These actors now account for the lion's share of traded volume in the markets. The odd thing from an investor's perspective is that these are not investors. The average holding period of a stock in the S&P500 is just over seven months. That means that the ownership of a company typically changes nearly twice in a single year. The company behind that share is, of course, trying to follow a strategy which might take five or ten years to execute or to shepherd a brand which has taken decades to build. A good proportion of those who own shares at a given point are really only renting a set of financial characteristics for a brief period. They do not care what the underlying company does as long as its securities display the behaviour in certain market conditions that they have in the past. All this confuses the nature of ownership and stewardship. Furthermore, as many participants are simply looking to capture a trend by picking a set of instruments which encapsulate that trend, volatility is exacerbated when the herd changes its mind.

Regulation

The way the technology sector has evolved has led the market to display oligopolistic characteristics. This is an area so new that it is still little understood, but there is a growing recognition that the ability to disrupt (either other industries or political discourse) has to have some cost attached to it. Google's original premise was to 'do no harm' which looks hopelessly naïve today. The benefits of technology are clear; the downsides are still murky, and most users of technology do not understand how the companies make money. There is an irony that those who encourage transparency and disintermediation as ways to disrupt other industries are themselves very opaque and anti-competitive. This trend will roll, and the most likely outcome will be the break-up of companies, much greater protection of privacy, and possibly the fragmentation of the internet.

Climate Change

For most of us, this is the elephant in the room. We can discuss the points set out here until the cows come home, but if the science on climate change is correct, this is just rearranging the deck chairs. As an existential threat to our current way of life, we need to give this greater prominence in our policy making, but the mechanisms to do so remain depressingly limited.

So...

Where does all this leave us? Monetary and fiscal policy is likely to remain supportive of assets like equities, but greater political involvement in areas like trade is likely to bring about volatility. Longer-term threats to equity and bond markets lurk in populism and, to some degree, in the way in which market participants are changing. Regulation and climate change are factors we need to take into account. While none of these issues mandate significant changes in portfolio weightings today, they are all evidence of the degree of uncertainty out there and why vigilance matters.

In the shorter term, structural improvements in the corporate world suggest that the high margins which are so evident today may well continue, helped by lower taxes, better use of technology and low interest rates. Cyclically, these are supported by a slowdown in wage growth and improving productivity. Investors are generally underweight in equities, and Central Banks are entering a new easing phase. To be sure, some of the shorter-term economic data are mixed, but the broad measures which give us clues about the direction of markets are largely positive, albeit not showing the potential for huge returns.