Market Musings

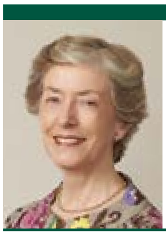
January 2017

“Not everything that counts can be counted, and not everything that can be counted, counts.”

Pippa Malmgren (US policy analyst), *“Professional Investor”,* 2016

Veritas
Investment Management

REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

If you had to answer the following question with a straightforward 'yes' or 'no', how would you respond?

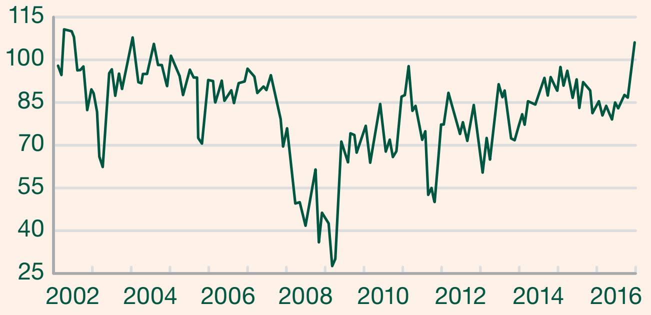
"Do you approve the text of the Constitutional Law concerning 'Provisions for overcoming equal bicameralism, reducing the number of Members of Parliament, limiting the operating costs of the institutions, the suppression of the CNEL and the revision of Title V of Part II of the Constitution' approved by Parliament and published in the Official Gazette no. 88 of 15 April 2016?"

This was the question posed on ballot papers in the Italian referendum in December! Little wonder that the answer was a resounding 'no'…

The €urozone economy is however doing rather better than its politicians, even recording higher aggregate growth in 2016 at +1.8% than either the US (+1.6%) or Japan (+0.7%)! Germany remains the Continent's growth engine, driven primarily by domestic demand, but momentum is accelerating across the region. Seven years after the credit crisis, the €urozone's aggregate unemployment rate is back in single digits.

Across the pond, the United States similarly ended 2016 on a strong note. The Conference Board's consumer confidence index hit its highest level in 13 years.

US CONFERENCE BOARD CONSUMER CONFIDENCE



Source: US Conference Board, GFC Economics

Manufacturing rose in December, boosted by buoyant export orders. Almost 2.2 million jobs were added last year, the sixth consecutive year of gains exceeding 2 million. Wages picked up in response.

Indeed, the Federal Reserve ("the Fed") is grappling with a new problem, the possibility of growth running faster than they had anticipated! At their December 2016 meeting, the Committee signalled that they may raise interest rates three times in 2017, rather than the two previously anticipated.

And the US economy may be even more robust than official figures indicate – due to inadequate recognition of the impact of technology and the shift from manufacturing to services.

The problem is particularly acute in services, where technology has produced an explosion in free services such as streamed entertainment, obviously not captured in GDP numbers. The cost of cloud computing has tumbled, reducing business costs and enabling widespread customisation to better match consumer preferences – again not reflected in GDP. The revolution in internet services from dial-up connections to broadband and ensuing increases in download bandwidth are not captured as growth by official statistics. The shift of sales from department stores to discount outlets is classified as a *reduction* in output.

Advances in healthcare are inadequately recorded, for example, robot-assisted keyhole surgery is passed over. Thanks to three-dimensional (3D) printing, prosthetics and implants can now be produced on-site and tailored to specific patient needs – at lower cost, so again a drag rather than a boost to growth. Products will often incorporate enhanced performance characteristics, such as cars now building GPS in as standard or digitising the sound system… without raising the vehicle's price.

Real GDP could conceivably even *decline* as more goods and services become available at either free or significantly reduced prices. As our front cover quote: *"not everything that counts can be counted, and not everything that can be counted, counts".*

There is consequently a growing divergence between real GDP and labour market data, with GDP lagging. Labour data is less susceptible to mismeasurement than GDP and hence a better reflection of true economic activity. And the labour market is robust, as detailed above. The US economy at present is in good shape, growing steadily, yet with modest inflation.

US CORE CONSUMPTION DEFLATOR (EX-FOOD & ENERGY)

% change year-on-year

Source: US Bureau of Economic Analysis, GFC Economics

Goldilocks shattered

And into this benign, 'Goldilocks' setting Donald Trump is charging with his 'America first' policies and wanting to unleash huge monetary and fiscal stimulus. He is shooting reforms from both hips – at Obamacare, at tax, at Dodd Frank, at immigration, at climate change, at trade agreements… even at vaccinating children, which he claims leads to autism.

Time will tell which campaign promises / threats Trump implements. *The Atlantic*, an American political journal, opined that "the press takes him literally, but not seriously; his supporters take him seriously, but not literally". He may well prove pragmatic. He is a business man, and has surrounded himself with corporate executives used to playing hardball to achieve change. Bridgewater Associates report that circa 60% of his cabinet appointees have corporate rather than political backgrounds, versus only 4% for Obama, 47% for George W. Bush, 18% for Clinton and 47% for Reagan.

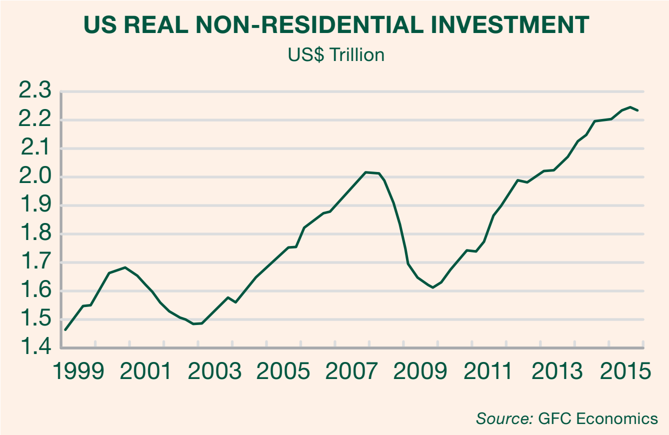
China is watching the new Administration with interest, ready to take advantage of the changing landscape. Beijing is offering to step into American shoes on the Trans Pacific Partnership trade agreement from which she had previously been excluded. Trump has threatened to renege on the Paris climate accord, which would open the door for China to lead. For the first time ever, the annual World Economic Forum gathering of the global elite in Davos is looking to welcome China's President, Xi Jinping.

One of Trump's leading reforms is expected to be tax. Significant reductions in both income and corporate tax rates are planned to be balanced by the withdrawal of permitted deductions in order to be revenue neutral. It is mooted that investment outlays be fully deducted in the year incurred rather than over time – a massive boost to capital intensive sectors. However, interest payments would no longer be tax deductible, hitting leveraged companies but putting debt on the same tax-footing as equity as a source of finance. A 'border adjustment tax' would tax imports but let exports go tax-free, seeking to bring jobs back to the USA – at the cost of higher prices, inflation and interest rates. Inter alia, a tax on oil imports would raise transport costs.

A tax holiday on unrepatriated foreign profits, currently untaxed, is mooted to encourage their return to the US and so stimulate investment. However, many companies have already borrowed against these profits to invest. Furthermore, when this was done in 2004, a sizeable proportion of the repatriations went to share buybacks and dividends, not investment.

The proposed tax changes are complex and the impact on different sectors would vary hugely. Until there is greater clarity on what will actually pass, firm conclusions on the implications for the companies in which we are invested for clients cannot be drawn. We do however anticipate that a number will benefit.

Trump has promised to scrap the Dodd-Frank Act of 2010, designed to prevent a recurrence of the credit crisis with rules for consumer protection and stiffer capital requirements for banks. For example, a minimum 20% down-payment is required on mortgages, and a borrower's financial resources must now be documented. The Act's aim is to stop bank lending being the primary driver of growth and it has been a resounding success. As discussed above, the economy is recovering steadily. Unemployment has more than halved from 10% in 2009 to 4.6% in December 2016, even as the household debt-to-GDP ratio has fallen from its peak of 99% in 2008 to 79.6% in 2016 and as real non-residential investment has surged.



The effective control of bank lending has produced a healthy, non-inflationary, sustainable economic recovery.

Trump however, being a property man, believes in debt. Repealing Dodd-Frank may be expected to unleash a long consumer boom. Some believe that Americans lost their appetite for debt in the credit crisis, but the two sectors not covered by Dodd-Frank – autos and student loans – have both witnessed significant rises in debt: student loans have exploded from 3.5% of GDP in 2006 to 7.3% by end-2015.

He is also proposing to unleash fiscal stimulus, even though the economy clearly does not require it.

Too hot

The question is whether Trumponomics induces over-heating.

Inflation is already ticking up cyclically around the world. Commodity prices, including oil, have moved up sharply off their lows, and manufacturers of appliances, furniture and chemical products all report mounting cost pressures. China is no longer a low-cost manufacturer exporting deflation: the minimum wage rose strongly again in 2016 and the producer price index accelerated to 5.5% year-on-year (yoy) in December. Consumer prices in Germany rose by 1.7% yoy in December, approaching the €uropean Central Bank's target of 2%, and in the UK the fall in sterling may be expected to take inflation above the Bank of England's 2% goal in 2017. In Singapore prices stopped falling in November for the first time in two years.

Coming on top of a global pick up in prices, a credit boom and fiscal stimulus in the United States could most certainly result in over-heating.

Trump may however be let off the hook by secular forces that are pulling in the opposite direction. Technology is driving costs down in many industries, enabling companies to absorb input cost increases. For example, cloud computing offers significant economies of scale in data storage and, through 'machine intelligence', productive analysis of consumption patterns. Supply chains are being optimised using algorithms: UPS use artificial intelligence (AI) to optimise driver routes, even using real time traffic data to avoid congestion. Ports have introduced automated cargo handling. Amazon is using robots and tablets to train new recruits, reducing training time from six weeks to two days. Walmart uses predictive sales software to plan staff rotas.

Toyota has greatly raised the efficacy of its advertising expenditure. Using AI, their digital boards along expressways in Japan detect the model of car approaching to estimate the driver's wealth, and switch ads appropriately…

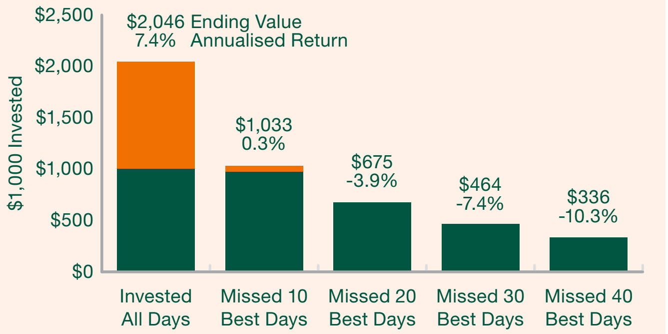
A pivotal question for investors at present is the extent to which emerging cyclical inflation will be dissipated by secular disinflation. It's an open question, but cyclical pressures will probably dominate in the short term, prodding interest rates higher, as anticipated by the Fed.

However Trump plays out, it is anticipated that he will ignite animal spirits. A pro-business USA with its rule of law, political stability, property rights protections and a much reduced corporate tax rate would be an attractive environment for companies.

Time to book profits?

As ever at Veritas, we are alert to the economic backdrop and context within which we are investing for clients. However, we remain firmly wedded to our philosophy of *not* trying to time markets. Few do it well consistently – and the chart below lucidly testifies to the futility of it.

OPPORTUNITY COSTS OF MISSING MARKET PERFORMANCE
S&P 500 INDEX, DAILY, 10 YEARS ENDING 30TH JUNE 2016



Source: CFA Institute Magazine Dec 2016, Hillsdale Investment Management

This does not deter us in our quest for real returns for our clients, ahead of inflation. Over time, a company's share price will always reflect the underlying progress in earnings and cash flows, and we focus on long term wealth creation by companies. We ferret out established businesses run by proven management, financially sound companies with strong and growing cash flows, a moat against competitors, all at a sensible price.

We use global growth themes as a funnel to help narrow the investable universe and identify attractive sectors. Our current three high conviction themes are:

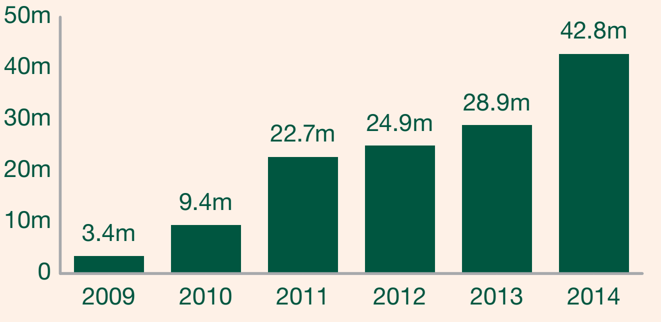
- online life,
- demographic dynamics, and
- regulation.

As regulation raises reporting and financial obligations for global businesses, it is rare to find companies that are well-positioned to benefit from both the shifting regulatory landscape and from digitalisation. Experian is however one such company.

Best known for running consumer credit checks, Experian holds credit information on more than 740 million consumers and 70 million businesses worldwide, a unique data repository which is second to none. It sells the data as well as proprietary software and analytical tools to assist customers utilise the information in, for example, lending decisions or reducing fraud. Experian is as much an identity company as a credit bureau, and the combination of identity data with credit data is a key differentiator versus other 'Big Data' players such as Google.

The group is extremely well placed in terms of structural growth, benefiting from mega trends that are immune from the business cycle, including identity theft, fraud, data security and rising regulation. A PricewaterhouseCoopers survey found that the compound annual growth rate of detected security incidents between 2009 and 2014 was a mind-blowing +66%, and in 2015 was running at an average of 117,339 attacks per day!

TOTAL NUMBER OF DETECTED INCIDENTS



Source: PricewaterhouseCoopers, Julius Baer

Meg Woods,
12th January, 2017

VERITAS INVESTMENT MANAGEMENT LLP 90 Long Acre, London WC2E 9RA. Tel +44 (0) 20 3740 8350
VERITAS INVESTMENT MANAGEMENT AG Genferstrasse 21, 8002 Zürich, Switzerland. Tel +41 (0) 44 206 2660 www.veritasinvestment.co.uk