Market Musings

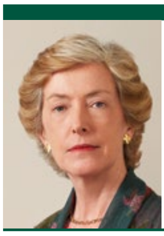
July 2015

“ I haven’t failed. I’ve just found 10,000 ways that don’t work. ”

Thomas A. Edison, inventor, holder of 1,093 patents

Veritas
Investment Management

REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

Grexit … or Grin … or Grimbo?

Greece exit … or in … or in limbo?

Prime Minister Tsipras appears to share Thomas Edison's determination not to admit failure, as per our front cover quote. The situation is a sad failure of democracy… in the home of democracy. The GDP of Greece is the same size as that of Dusseldorf; Germany could easily absorb the problem if she wanted to. The issues are rather those of principle and culture.

Brussels' drawing a line in the sand is a positive for the €uro, not a negative.

The principle of facing the fall-out from the credit crisis and dealing with it as a recipe for longer term progress has been established clearly elsewhere. The United States tackled the excess leverage in its private sector head on. Bad debts were written off, house prices tumbled, people lost their homes – but now the household debt service burden has fallen sharply, banks are again strongly capitalised and the housing market is recovering. There is positive momentum in the labour market, which, together with the declines in energy prices, is

U.S.A. UNFILLED JOB OPENINGS

Source: Bureau of Labour Statistics, UBS

generating consumer-led growth. Fiscal policy is no longer a drag, business cash flows are robust and fears of deflation have receded.

However, the strength in the labour market may result in wage pressures, and Janet Yellen, Chair of the Federal Reserve ('the Fed'), is preparing markets for the first interest rate rise in 11 years.

Top or tail?

Does a Fed interest rate hike signal the top of the equity bull market?

Certainly valuations are full after six years of strong price rises – but not excessive.

GLOBAL PROSPECTIVE P/E RATIO

Source: BoA, Merrill Lynch

Indeed, much of the backdrop for equities remains constructive.

The Fed is mooting a one-quarter of one percent rate rise. This is not large!

Historically it has been the third or fourth Fed rate rise that has reined markets in. The first increase has been benign, signalling economic growth that is positive for company profits; only the third or fourth rise starts to restrain growth – which becomes a headwind for equities.

Such a tiny rate rise reflects the fact that the current upswing has been the weakest post World War II. However, that has kept inflation subdued and the excesses that could halt the recovery at bay. A rise in rates is to be welcomed as confirmation the upturn is underway. It will be the first (small) step in the return to normalcy.

In the €urozone too, business and consumer borrowing is improving. The Composite Purchasing Managers' Index is at a 4-year high. German unemployment has fallen to near post reunification lows, enabling IG Metall, the country's largest union and a bellwether for others, to extract a 3.4% annual pay rise for its workers.

On the other side of the globe, Prime Minister Abe, in his quest for Japan's economy to beat deflation and join the global growth train, is tackling reform on a number of fronts. He has now turned his attention to the corporate sector, heavily shackled by cronyism and cross-shareholdings, not shareholder friendly. On 1st June Abe introduced a new corporate governance code. As a result, Japanese fund managers are now encouraged to challenge company management over poor returns, unprecedented in the Confucian culture of acquiescence!

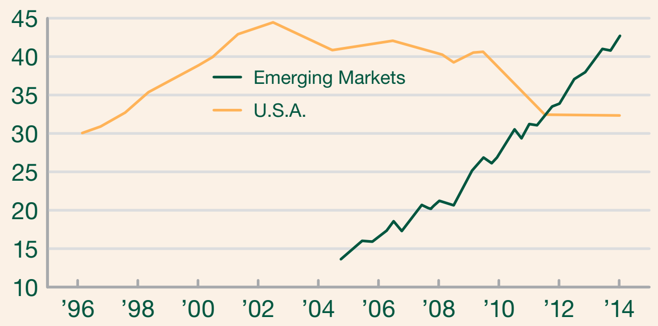
The Bank of Japan, to be supportive to the Prime Minister, has kept the monetary taps on full. As a result the ¥en has fallen to its most competitive real level since 1973. This is designed to boost exports – but has also produced a tourism boom. Beijing real estate agents are even organising fortnightly tours to Tokyo and Osaka, escorting 40 Chinese at a time on 3-day property shopping trips!

Not an engine

Unusually, developing countries are not this time the engine of the global growth train. Indeed, the World Bank recently proclaimed the emerging world to be experiencing a structural slowdown. A decline in import demand resulted in emerging markets actually subtracting from world trade growth in the first quarter of 2015 for the first time since 2009.

Most of these countries did not use the bonanza of globalisation to build diverse economies. For years, weak productivity was masked by low interest rates, American quantitative easing and high commodity prices. These props have now been kicked away. Brazil for example, is facing chronic deficits, high inflation and an over-valued currency.

PRIVATE SECTOR DEBT AS % OF GLOBAL GDP



Source: BCA Research

Nestlé's Chief Executive does not expect his industry to see double digit economic growth in emerging markets again, and is cutting its workforce in, for example, Africa.

The dependable boost that the global economy has derived from the youthful dynamism of its developing countries for well over a decade has recently become an outright drag.

The Communist Party's party

China, like Japan, is on the reform path. The government's objective is both to re-balance the economy away from exports to consumption, and to allocate savings more efficiently and boost productivity. Corporate red tape has been cut, resulting in a boom in the registration of private firms. Local governments are receiving a higher proportion of central tax revenues in order to reduce their reliance on land sales revenues and so stabilise the property market.

Financial reform is underway too, including the liberalisation of foreign exchange markets. The renminbi has become the main currency for payments between China and the rest of the Asia Pacific region, tripling over the past three years to outstrip the ¥en and U.S. dollar. Foreign investors' holdings of Chinese domestic 'dim sum' bonds increased by 68% in 2014 on the previous year as the yields are higher than those in the U.S., Japan or Europe – and the currency is perceived as safe. Chinese buyers topped Canada's to rank as the biggest foreign purchasers of U.S. homes by sales in the year to March.

The renminbi seems on an inexorable march towards becoming a global currency, even to the point of being considered for inclusion in October as a reserve currency alongside the U.S. dollar in the International Monetary Fund's Special Drawings Rights. Acceptance would be a powerful boost to China's geopolitical ambitions and global recognition of its rise in status. The very stringent requirements would serve as a quality assurance to global users.

However, not all is rosy in Beijing's garden of reform. The government has supported equity investment to wean particularly state-owned companies off borrowing. The 'Shanghai-Hong Kong Stock Connect', launched last November, enables investors in each country to invest directly in the other's stock market. The upshot has been a stock market boom greater even than the U.S. tech bubble of 1999/2000, with the Shanghai Composite Index up 2½ times in the twelve months to 12th June. There are currently more than 90 million individual investors in China – surpassing the Communist Party's membership of 87.8 million at end-2014!

Now it is individual investors that need weaning off debt: they have borrowed $335 billion to finance their speculation.

MARGIN DEBT ON CHINA'S EXCHANGES AS % OF MARKET CAP

Source: BCA Research

The bubble had to burst, and the Shanghai index is down by 30% at the time of writing, erasing value greater than France's entire market capitalisation. The Authorities are pulling out all stops to stabilise the market. Interest rates and reserve requirements have been cut, margin lending loosened, new issues suspended. Homes are now acceptable collateral for borrowing to buy stocks – a move that smacks of desperation and is dangerous.

At a time when President Xi's team should be strengthening China's financial system, they are making it more fragile. This will unquestionably tarnish Beijing's efforts to establish the renminbi as an official reserve currency.

Open door policy?

It's not just Chinese stock investors that are on a steep learning curve as their country develops. As VietJet Air flight 175 prepared to leave Hanoi for Ho Chi Minh City a few weeks ago, a 43 year old passenger opened the emergency exit door because he wanted to go to the toilet! A farmer from a small village, he activated the aircraft's evacuation slide, causing a chain reaction of flight delays and costing VietJet Air $30,000.

VietJet estimates that at least 30% of the 10 million passengers it will handle this year will be first time fliers.

Confused diversity

What is an investor to make of this diverse, rather confused backdrop?

At Veritas we do not forecast markets, something which is extremely difficult to do well consistently. Rather we focus on certain principles. Governments do not generate new wealth. Financial engineering (derivatives) does not generate new wealth. Zero sum games (portfolio insurance) do not generate new wealth. Only companies generate new wealth. Security analysis is about ferreting out wealth generating companies.

Our analysis focuses on established companies with proven management, financially sound, a moat around the business and the tailwind of a global growth theme.

We distinguish between volatility, which arises out of the short term ups and downs of the market, and risk, which is the long term loss of capital and inability to meet long term obligations. Short term volatility can result in mis-pricing which affords the long term investor entry opportunities.

Our core themes at present are 'structural growth' and 'scarcity'. We remain especially excited by our structural growth sub-themes of technology and healthcare – well worn perhaps, but still with considerable steam. Some examples to illustrate.

In 2014 a 3D printer made an electric car, the Strati, in 44 hours with just 40 parts. This has huge implications for the automobile industry, as does Google's driverless car.

Today people have more computing power in their smartphones than was available to NASA at the time of the first moon landing.

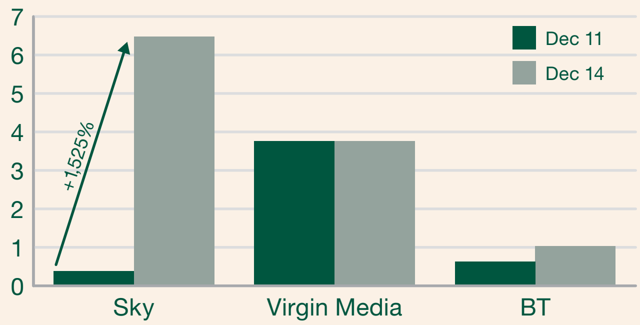
Thank to technology, the life expectancy of humans is increasing by five months every year. A female born today has a life expectancy of 100 years. This has significant ramifications not just for the healthcare sector, but also for pensions and investment structures.

'Next generation' sequencing, done at high speed and low cost, enables genetic information to be extracted from biological samples to address an array of health problems. If a nasty medical condition can be caught before it happens, it is much cheaper to deal with than treating the consequences after it has developed. This will be a powerful way for healthcare systems to cut costs. The '100,000 Genomes Project' in the UK aims to sequence 100,000 NHS patients by 2017.

Reach for the Sky

A company that has embraced technological innovation in connectivity to produce a win-win scenario is Sky, the UK's leading home entertainment and communications provider. In the triple play market of television, broadband and telephony, Sky is reaping the benefits of offering its customers a wide range of content on multiple platforms. It now has over 7 million customers with set-top boxes connected to the internet, and an array of apps which allow them to watch

3 YEAR CONNECTED BOX GROWTH FOR SKY, VIRGIN MEDIA AND BT (MN)



Source: Goldman Sachs

linear television, use a personal video recorder, access catch-up services, download movies or watch content on the go, either by downloading or by streaming. Since it has embraced connectivity, churn has reduced to levels last seen in 2005, customer satisfaction levels have improved and television subscriber additions are running at their highest since 2006.

Sky's ownership of unique content is a formidable moat. Its strength in sport is well known. It has built a competitive advantage in entertainment with contracts such as those with Paramount and Fox. Sky is also an example of Big Data, as its connected base provides it with a feedback loop to adjust price on content that is most in demand, create content in popular areas and segment its customer base effectively.

Advertising can be personalised. Based both on their own customer database as well as profiler experts such as Experian, Sky AdSmart enables different adverts to be shown to different households watching the same programme. This is hugely beneficial and financially attractive to the advertiser.

We view Sky as a wealth generating company.

Meg Woods
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