



Market Musings

April 2016

“ Canute, the greatest and most powerful monarch of his time, sovereign of Denmark and Norway as well as of England, could not fail of meeting with adulation from his courtiers; a tribute which is paid even to the meanest and weakest princes.

Some of his flatterers breaking out one day in admiration of his grandeur exclaimed that everything was possible for him: Upon which the monarch ordered his chair to be set on the sea-shore while the tide was rising, and as the waves approached, he commanded them to retire and to obey the voice who was lord of the ocean. When the sea still advanced towards him and began to wash him with its billows, he turned to his courtiers and observed that every creature in the universe was impotent, and that power resided with one Being alone, in whose hands were all the elements of nature. ”

History of England, David Hume, 1754-61

Veritas
Investment Management

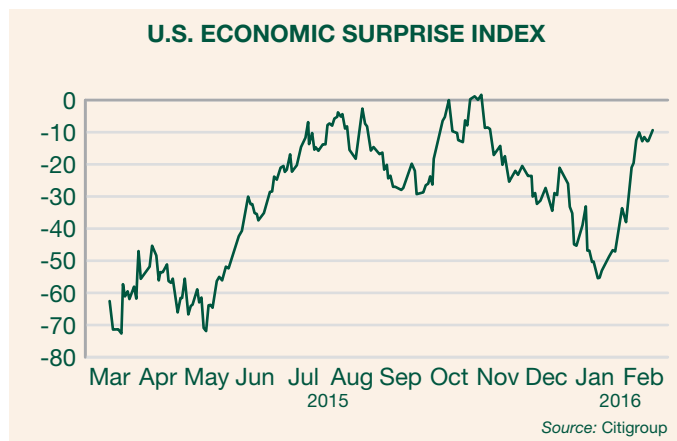
REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

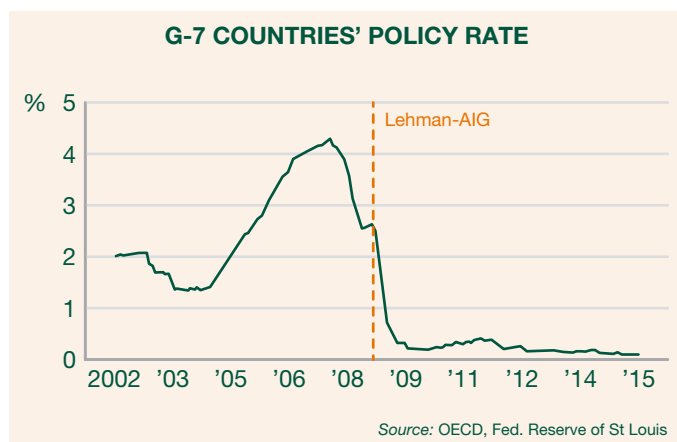
Forward? Backwards? Sideways?
Which way is the global economy travelling?

In the United States, GDP growth of 2-2½% is on track for 2016, driven by a healthy labour market and stronger consumption, supported by lower petrol prices.



Core inflation is accelerating. The Federal Reserve’s (“the Fed’s”) favourite Core Personal Consumer Expenditure Price Index rose by 1.7% p.a. in February, approaching their 2% target. As the slump in oil prices works through, inflation will ratchet up further.

James Bullard, President of the Fed of St. Louis, stated in a speech in Frankfurt on 18th March that “the FOMC’s goals have been met”: labour markets are close to normal and inflation net of the oil price is reasonably close to target. “Yet the FOMC’s policy settings remain extreme”, he added: after seven years the policy rate remains 3% below the long-run level and the balance sheet more than \$3.5 trillion larger than its pre-crisis level.



Janet Yellen, Chair of the Fed, nonetheless remains dovish. She considers there is still slack in the labour market and is mindful that raising rates will strengthen the dollar further, dampening exports and disrupting emerging economies. However, with jobs growth running at twice the growth rate of the labour force, she may soon be forced to agree with her more hawkish colleagues.

Jump start

In the United States therefore, quantitative easing would appear to have successfully tided the economy over from the credit crisis to renewed growth. In contrast, the central banks of both the Eurozone and Japan are finding that their expansionary policies are *not* jump-starting their economies.

Signor Draghi, President of the European Central Bank (ECB), tiptoed into a negative interest rate policy (NIRP) in June 2014. The initial impact was positive. However, nearly two years on, investment, retail sales and consumer confidence remain weak across the bloc, prompting Signor Draghi to cut the ECB deposit rate again in March by a further 0.1% to a *negative* -0.4%. He also increased the monthly asset purchase programme and extended it to include corporate bonds.

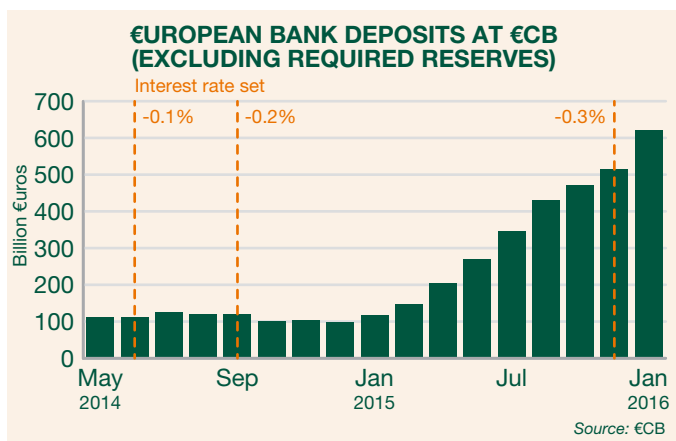
The Bank of Japan’s Governor Kuroda joined the NIRP club in January. His quantitative easing programme has been running at a mind-numbing 17% of GDP for the past 3 years! However, wages and consumer spending have remained muted. Indeed, in the latest Tankan survey of business conditions, manufacturing fell back sharply to June 2013 levels, while a persistent current account surplus has undone much of the initial weakness in the Yen.

Countries making up almost a *quarter* of the world’s GDP now have negative official interest rates!

NIRP is nonsense

NIRP, by taking interest rates to the extreme of negative levels, is of course designed to encourage borrowing in a world still struggling to recover from the ‘Great Recession’ of 2008.

However, NIRP is not achieving its objectives. Lending within the Eurozone has barely budged since the introduction of negative rates in June 2014. Actually, rather the opposite: deposits at the ECB by Eurozone banks in excess of required reserves have *jumped* an astonishing six-fold in that time.



The reason is that, far from encouraging banks to lend, NIRP discourages lending. Negative rates do lower company and consumer borrowing costs – but banks feel unable to

pass negative rates on to savers for fear of retail depositors withdrawing their money. The upshot is that bank margins, the difference between what they pay depositors and charge lenders, are crimped. Hence the ECB's introduction of TLTRO (Targeted Longer Term Refinancing Operations), *paying* banks 0.4% to lend to offset the squeeze on their margins of negative rates!

The new 'hot' product in Japan and Germany is safe deposit boxes... just in case commercial banks do decide to pass on negative rates...

There is also the issue of the adverse impact on confidence of NIRP. When the Fed increased rates, thereby expressing confidence in the US recovery, markets rose. When the Bank of Japan (BoJ) cut rates to negative levels in January, signalling official concern, markets fell. It is the BoJ that made a mistake, not the Fed.

Not only has NIRP not succeeded in boosting lending, it has had severe negative repercussions. It enables zombie companies that don't deserve to stay in business to continue operating. Following the inclusion of corporate bonds in the ECB's monthly asset purchase programme, companies are now *being paid* to borrow! Defaults will accelerate. The Japanese fiscal deficit is *shrinking* because investors are *paying* the government to borrow. Despite the U.S. Fed hiking its interest rate in December, Treasury yields have fallen as investors switch from the negative rate Euro and Yen bond markets to positive rate U.S. dollar markets.

NIRP punishes the good folks. It discourages savers and reduces pensioner incomes. A typical 35 year old must save three times as much to make the same retirement income when long term interest rates are at 2% as when they are at 5%. Thus low / negative interest rates mean that consumers saving for retirement must reduce spending... the opposite of what central banks intend.

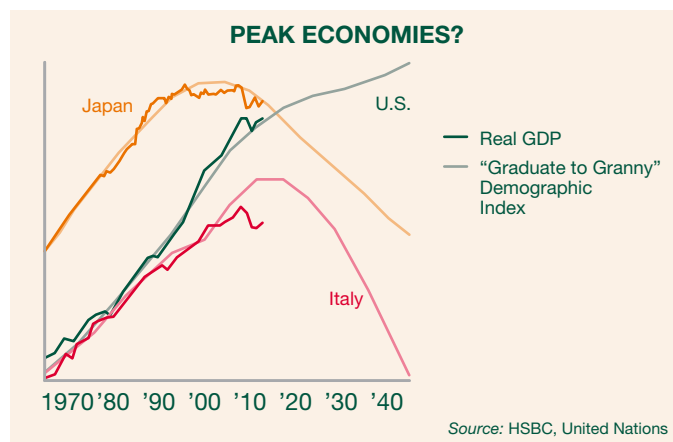
Companies assess projected pension liabilities using a discount rate based on the prevailing yield of investment grade corporate bonds. NIRP means that the amounts that companies must set aside to meet future obligations rises. Standard & Poors estimates that a 1% decline in the discount rate increases pension obligations by about 16%.

NIRP is negative. It is disruptive. The solution to too much debt is not more debt.

“Grad to granny”

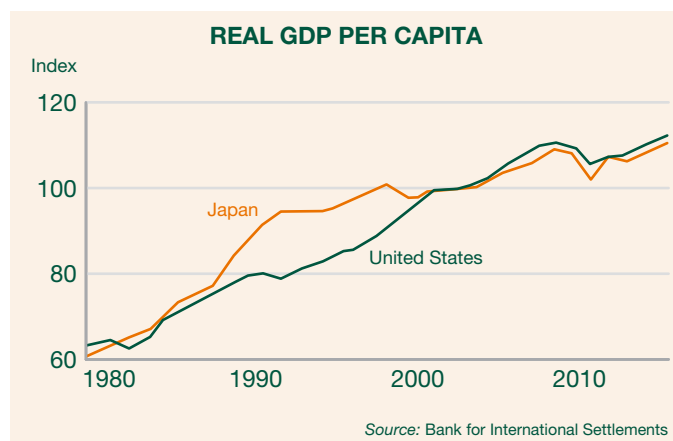
HSBC has cleverly devised demographic indices based on the ratio of graduates to grannies! These indices have a high correlation with a country's GDP and go a long way to explaining the divergent trends in the global economy at present.

The working age population peaked in Japan in the late 1990s and is topping out at present in the Eurozone. Of all the major countries, only the United States' demographic index continues to rise.



We asked the author (who is Swedish) what he attributed this to. “Well,” came the reply, “I think Americans have more fun in the bedroom than other nations...”

The true reflection of an individual's wellbeing is GDP *per capita* and a country's economic progress should be measured on this basis. Japan's economic performance since 1990 has been widely criticised – but the picture of two 'lost' decades of economic decline is qualified when demographics are factored in. Japan's real GDP *per capita* has in fact grown by a similar quantum as the U.S. since 1980.



Globally the fertility rate has halved to 2.5 babies per woman since 1950. There are now fewer wealth creators supporting the growing baby boomer retirement population. Lower growth is the new norm.

Central bankers need to learn from King Canute (front cover quote) that they are not able to reverse the tide. They cannot print babies!

Tectonic tailwinds

Investors face a challenging backdrop. Tectonic shifts are underway in the global economy as a result of technological innovation and ageing populations, exacerbated by prolonged monetary policy experimentation. Market volatility is inevitable.

At Veritas we are alert to the currents swirling around us. However, we are not deterred in our quest for real returns for our clients, ahead of inflation, on a five year view. We believe that our focus on established businesses run by proven management, financially sound companies with strong cash flows, a moat against competitors and the tailwind of a global growth theme, all at a sensible price, is particularly apposite in this climate.

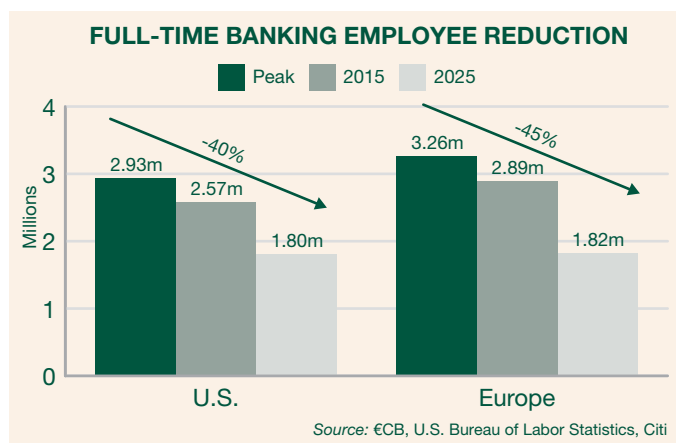
Our three high conviction themes, the pockets of growth that provide a tailwind to our companies, are:

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

Banking’s “Uber” Moment

One industry which is experiencing tectonic shifts as a result of online life and regulation is banking. Cyclical pressures include weak loan demand, crushed net interest margins in a low/negative interest rate world and deteriorating loan quality, especially in the energy sector. Structurally there is the regulatory burden of stepped-up compliance and higher capital requirements, both of which impair returns. And banking is being upended by fintech (financial technology).

The key fintech battlegrounds are lending and payments, lucrative activities for banks. Investment in fintech has exploded from \$1.8bn in 2010 to \$19bn in 2015, yet only about 1% of N. American consumer banking revenue has so far migrated to the new digital models. The tipping point of digital disruption has not yet been reached in either the U.S. or Europe – but cannot be far off. McKinsey projects that 60% of the profit from banks’ core businesses of deposit taking and lending could disappear as new players take over customer relationships. Anthony Jenkins, former CEO of Barclays, talks about banks’ ‘Uber’ moment and anticipates that the number of branches and employees may decline by as much as 50% in coming years given their high cost in the face of mobile banking.

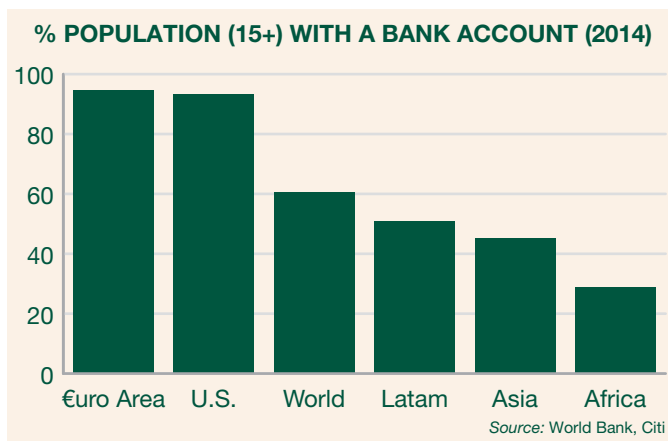


In addition to the loss of banking revenues to fintech competitors, there is enormous – and expensive – pressure to upgrade IT systems to adapt to increasing competition.

The other side of this coin however (no pun intended!) is the explosion in digital money, the migration from cash and

cheques to credit/debit cards and stored value instruments (such as the Oyster card for London public transport). Cards offer benefits to consumers and merchants alike, ranging from practicality, security, loyalty schemes and analytics. Almost all e-commerce transactions are done via a card, and as more transactions take place online, card companies will benefit: in the U.S. still less than 10% of transactions are online. Deutsche Bank’s CEO predicts the disappearance of physical cash within a decade.

In the emerging world, digital money is anticipated to have a far reaching impact. There are two billion unbanked or underbanked people in the world, primarily in Africa or Asia,



and mobile payments could help these folk to access basic financial services. Cash accounts for 25% of transactions in developed markets, but 75% in emerging markets. Digital or mobile money could revolutionise this – a tsunami for social inclusion.

MasterCard is a high quality, cash generative business. With its strong global brand recognition and international footprint, it is set to benefit from arguably one of the biggest structural shifts currently underway, cash to card migration. Global card payment volumes grew in double digits for the 21st consecutive quarter in 4Q2015.

In South Africa and Nigeria, MasterCard is working with the governments to enable social security benefits to be paid via a biometric prepaid debit card. Elsewhere salaries are being loaded directly onto prepaid cards.

MasterCard places huge emphasis on anti-fraud technology. Users will this summer be offered “selfie pay”, the option to snap selfies or scan finger prints to validate their identity in lieu of a pin or password. MasterCard is even testing a wearable device that would authenticate a card transaction from the user’s heartbeat!

The share is in our view fairly valued, not cheap, but this is a multi-year structural growth story and a worthy addition, where appropriate to the mandate, to client portfolios.

Meg Woods
11th April, 2016