Market Musings

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"There are decades where nothing happens, and there are weeks where decades happen."

Vladimir Ilyich Lenin, 1917

Veritas Investment Management

REAL RETURN INVESTING

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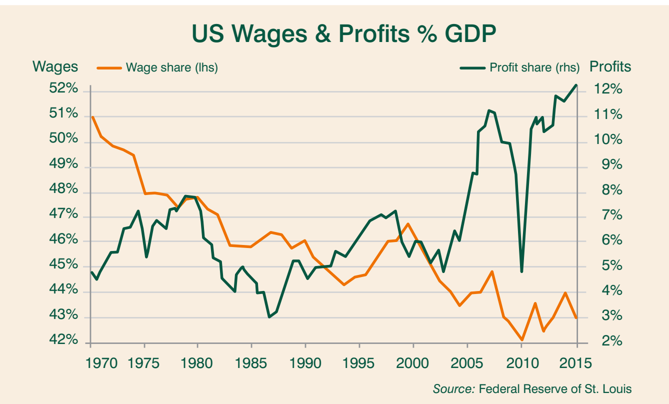
The light is slowly dawning at the U.S. Federal Reserve ("the Fed").

Janet Yellen, Fed Chairperson, speaking to the National Association of Business Economics on 29th September, conceded that the Fed "may have misjudged… the fundamental forces driving inflation".

Prior to this speech, she had steadfastly adhered to the traditional Phillips Curve economic model which decrees that once unemployment falls below a certain level, wages will accelerate, closely followed by inflation. Her trouble has been that, despite the unemployment rate heading steadily down towards 4.0%, well below the level at which the Phillips Curve alleges wage growth should kick in, it hasn't. Pay levels – and core inflation – have remained muted due to such factors as the disruption of technology, e-commerce and the many retiring baby boomers being replaced by younger workers on more modest wages. The entry of China and other emerging markets into the world economy didn't just make goods cheaper, it also swelled the global labour force, helped by connectivity. However, this is not reflected in the Fed's Phillips Curve for the USA.

"The odds that (inflation) could turn out to be noticeably different (to the targeted 2%) are considerable", Yellen admitted. However, mindful that "persistently easy monetary policy might eventually lead to increased leverage with adverse implications for financial stability", she believes that the case for further gradual upward adjustments in the Fed funds rate and for starting very slowly to run off the bonds on the Fed's balance sheet remains intact.

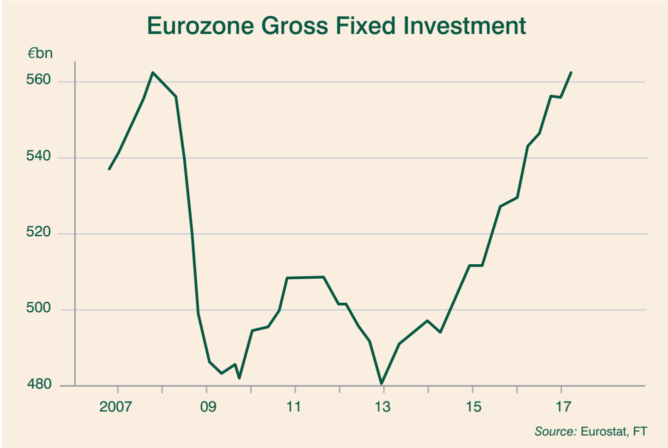
Another reason for continuing to raise rates is that low rates stimulate capital investment and technology-driven efficiency improvements. The more competitive capital is, the more it substitutes for labour. In their attempts to generate wage inflation with accommodative monetary policy, central banks are aiding wage *dis*inflation.



Source: Federal Reserve of St. Louis

Growing steadily

The Fed's econometric models might be in disarray, but the U.S. economy continues to grow steadily - as indeed, is the global economy. In September the OECD raised its forecasts for both 2017 and 2018, with global GDP projected to accelerate to 3.7% in 2018. Manufacturing in the U.S. grew in September at the fastest pace in 13 years on the back of improving exports and higher capital spending. In the €urozone, both domestic consumption and exports have been robust, and investment has regained pre-crisis levels.



Source: Eurostat, FT

The €uropean Central Bank is readying itself to join the Fed in tip-toeing towards policy normalisation by slowing its monthly bond buying programme further.

Japan too, is seeing a sharp and broad-based improvement in business sentiment: exports, underpinned by a weaker ¥en, and stronger domestic demand, supported by public investment, are buoying the mood amongst manufacturers. The Bank of Japan is however *not* joining the normalisation flotilla because Prime Minister Abe is planning another sales tax increase (if he wins the election), which would be a headwind to growth.

This Goldilocks background of growth with muted inflation is feeding through to equity markets, where returns on equity are rising and earnings per share are being lifted for all regions of the world.

Technology v society

The disruption of technology goes further than the Fed's economic models. It is bringing a pace of change that, combined with climate change and globalisation, is not matched in societal structures.

Consider marketing in the luxury retail space. In the past brand value was built through exclusivity, limited availability, select store location and the media. Now new brands are born on-line with the consumer looking for expertise and buying into people. Charlotte Tilbury is an example, a British make-up artist who has developed a cult beauty and skincare brand. Where exclusive stores on, say, Bond Street might intimidate some, customers can now go on-line for designer fashion from the convenience of their homes, in their slippers, at an hour of their choosing. But websites must be an experience, they must engage the consumer and tug at his/her emotions to succeed.

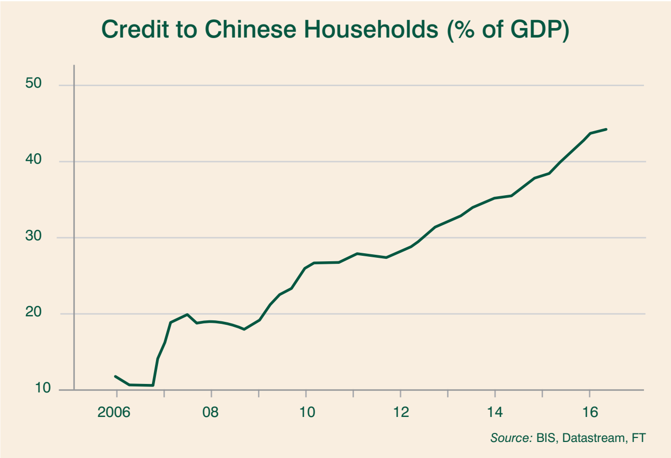
Social media is now the most effective way of reaching the consumer. Google Maps tracks every move of every person online, and adverts can be finely targeted to niche consumer groups, such as women between 25 and 40 who shop at Harrods or Selfridges. Retailers sign up bloggers, called affiliates, to circulate to followers photographs of themselves in a new outfit, or to comment (favourably, of course) on a recently launched product… in return for a cut of resultant sales. Affiliates are the new influencers, not glossy magazines; their circulation is tumbling.

These changes have huge implications for jobs and skill sets. Physical technologies evolve at the pace of science – fast, and accelerating – while societal structures – employment, education, social safety nets, regulation - evolve far more slowly. This mismatch is at the centre of much of the turmoil in society and hence politics, the growing pains of adjusting.

China in the lead

The one country whose government *does* however seem to be getting the governance of change right is China.

It has been a cornerstone of Beijing's policy to identify priority industries and nurture them. In the Noughties, Chinese innovation meant copycats and counterfeits. Now, encouraged by the government, the country is spouting an audacious, talented and globally-minded generation of entrepreneurs, embracing super-computing through to gene editing. And they have significant advantages over their counterparts in other countries. Because the economy is so large, a new business can attain huge scale just by succeeding at home, where language and culture are homogenous – unlike in Europe. The physical infrastructure – roads, rail, wireless broadband – is new, unlike America. The Chinese consumer, deprived of consumer goods and luxuries for many years, is now venturesome and eager to embrace technology. Mobile and internet penetration is high, enabling start-ups to reach a vast market cheaply. The consumer finance market was opened up three years ago and pent-up demand has been huge.



The benefits of immigration, the quest for fresh discoveries, the desire for education, the recognition of the benefits of stability, purpose and enterprise are all flourishing in China at the very time that they are being maligned or ignored in the U.S. by Donald Trump. Beijing is expanding a programme that allows qualified foreign graduates to obtain work and residency permits. It is building thousands of new schools. Trump wants to restore the manufacturing jobs of the 1950s, but Beijing is installing millions of robots on assembly lines and educating workers to rise up the value-added ladder.

The last 25 years was about who could make things cheapest; the next 25 will be about who can make things smartest. China has 40% of the world's trained artificial intelligence scientists.

The success of Beijing's approach is perhaps evident in the 7.3% rise in disposable incomes in the first half of 2017, ahead of GDP growth of 6.9%.

Today's political upheavals in Washington, London and Catalonia leave many Chinese wondering whether their long-held predictions about the eventual collapse of democracy are coming true.

Power parts

Should investors fret that the world's major central banks are declaring last orders on the quantitiative easing punchbowl?

At Veritas, our quest for our clients is for real returns, ahead of inflation, both protecting and growing the purchasing power of their capital.

Over time, a company's share price will always reflect the underlying progress in earnings and free 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 remain firmly wedded to our philosophy of *not* trying to time markets. Few do it well consistently. Rather our focus is on long term, secular, tectonic patterns. These form the basis of our global growth themes, in turn 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.

Our themes of regulation and online life are playing out now in power generation.

In the quest to reduce emissions to meet regulatory standards, research into wind energy has halved costs since 2009, mainly driven by larger blades on the turbines. Greater efficiency on solar panels has boosted load factors and costs have tumbled by a huge 70%! Further significant reductions are anticipated and, for the first time, renewable capacity commissioned in 2016 nearly matched that for coal and natural gas.

In the auto sector, also searching for the holy grail of reducing emissions, the improving performance and falling costs of electric vehicles (EVs) is attracting much attention. Interestingly, Henry Ford's wife Clara chose to drive an electric car. Combustion engines were noisy, dirty and required hand-cranking to start; her 1914 Detroit Electric moved away instantly, was nearly silent, could exceed 20 mph and had a range of 80 miles on a single charge. However, her husband's mass production techniques soon cut the price of a Model T to $500, one-seventh of Mrs Ford's car. The Detroit Electric was discontinued in 1939.

Now however, electric cars are cruising back. Tesla's new Model 3 reaches 140 mph and has a range of 300 miles. EVs lack mechanical complexity: GM's Chevrolet Bolt has just 3 moving parts compared with 133 in a four cylinder internal combustion engine, which materially reduces maintenance costs. The challenge of setting up charging infrastructures and managing the new demands on the power grid have yet to be resolved, but a fundamental shift is underway.

Electrification is only one megatrend in the sector. As cars evolve into smartphones on wheels, online life soars to new heights. Car sharing and ride-hailing apps are nibbling away at car ownership, which is morphing into 'transport as a service'. ADAS (Advanced Driving Assistance Systems) are rapidly making inroads, heading towards fully driverless cars. Multimedia and entertainment systems are being adopted on the back of enhanced connectivity.

All of which is made possible only through the might of a little microchip called a 'power semiconductor' which regulates electric current. All appliances through which power is fed require a power semiconductor, ranging from smartphones and kitchen appliances to industrial machinery and electricity generators. In electric vehicles, power semiconductors convert alternating current (AC) from the national grid to direct current (DC) to charge the battery, then back again to AC to propel the motor.

We have consequently introduced into portfolios (where appropriate to the mandate) a holding in Infineon, which was spun out of Siemens in 1999. It is now the global leader in power semiconductors, built on a long tradition of supplying quality components to the German auto and industrial sectors, and with a deep understanding of the design requirements.

It is perfectly positioned to benefit from the geometric growth in renewable energy, electric and hybrid vehicles, Advanced Driver Assistance and Driverless car systems, and the adoption of more multimedia and entertainment systems in connected vehicles.

Meg Woods
10th October, 2017

SPOTLIGHT

TACKLING AIR POLLUTION

Globally, air pollution has risen to shocking levels. Environmental regulations are being strengthened to tackle this, which is increasing the need for equipment to monitor air quality. As a world-leading supplier of such equipment, Thermo Fisher Scientific is helping solve a global health problem.

News stories warning that we face *Airpocalypse* because of escalating air pollution have been making headlines for years, and the associated long-term health issues have reached critical levels. The World Health Organisation (WHO) estimates that 92% of the world's population lives in places where air pollution exceeds safe limits and air pollution is responsible for over 6.5m premature deaths worldwide per year.

What can be done? Authorities are addressing the problem through a combination of stricter environmental regulations and more accurate monitoring. In China alone, more than 600 cities now monitor their air quality, a critical step toward cleaner air.

When we first discussed Thermo Fisher in *Market Musings* in October 2016, we highlighted the company's mission to make the world healthier, cleaner and safer, and it is living up to this. Although this was not the primary reason for our investment in the group, Thermo is working with governments and private companies, from China and India to Europe and the US, providing them with cutting edge analytical equipment to monitor air quality accurately to help ensure regulations are met.

Are tougher regulations and better monitoring having an impact? Early indications show that they are. The American Association for the Advancement of Science estimates that every dollar spent on improving air quality brings a $4-30 benefit to health impact, while the air quality in Beijing has steadily improved over the last four years despite the rise in the number of people and cars.

There is still some way to go. A recent WHO report noted that the average air particle reading in Beijing is seven times higher than the recommended level and throughout Asia it is higher in 99.4% of cities. We consequently believe the demand for Thermo's environmental testing products will continue for many years.

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