Market Musings

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"The longer you look back, the farther you can look forward."

Winston Churchill, speech, 1944

Veritas Investment Management

REAL RETURN INVESTING

Meg Woods
Investment Partner

Buoyed by central bank quantitative easing, a characteristic of the nine year bull market that started in 2009 has been a dearth of volatility. That changed in 2018.

It started in February when the US equity market suffered one of the swiftest 10% corrections in history. After a benign summer, 'volmageddon' returned in the fourth quarter when the S&P500 Index saw another 10% drawdown, a 7% rip, a 6% drawdown, a 6% rip, a 16% drawdown and a closing 7% rip. This in a year when earnings per share grew by 16.5% and are forecast to grow a further 11% in 2019.

What is happening?

Certainly moves by the Federal Reserve ('the Fed') to end quantitative easing contributed. However, markets are increasingly dominated by derivatives – initially options on underlying equities, then on market indices, and now derivatives on derivatives. For example, an inverse VIX strategy shorts or sells the volatility index and makes money when markets are calm. This strategy was shredded in 2018…

'Big Data' has given rise to algorithmic trading, when strategies are executed by computer programmes.

Derivatives, algorithms, high frequency traders, exchange traded funds and passive investing strategies create destabilising price dynamics by amplifying investors' trading patterns. Too many are structured similarly, producing 'computer herding' when robo-programmes react to small signals in the same way, creating a cumulatively large impact. Machines don't whisper!

Normalising money

The sharp swings in markets stand in contrast to a mild economic backdrop.

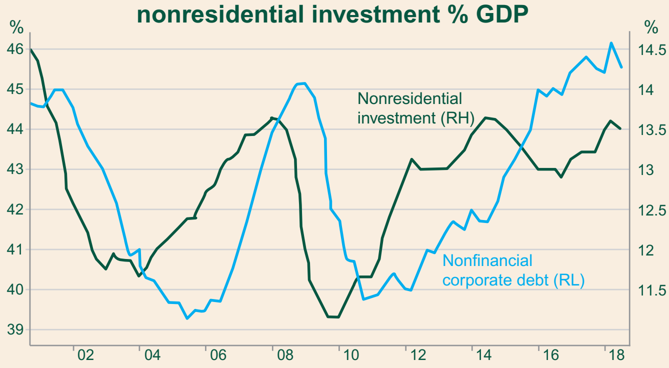
The US economy has, entirely predictably, started to moderate after the sugar rush of $1.5 trillion in tax cuts a year ago. GDP is nonetheless forecast to grow at a respectable 2.4% in 2019 after 3.2% last year. The unemployment rate at 3.7% is the lowest since 1969 and wage gains accelerated to 3.2% year-on-year to November 2018. Consumer spending is buoyant and consumer credit quality pristine – which belies concerns of a recession.

Inflation, as measured by the Fed's favourite index, the Core PCE deflator, remains well behaved, rising by 1.9% in the year to November. The Fed with its dual mandate of prices and employment dutifully hiked the Fed Funds rate for the ninth time since 2015 to 2.25-2.5%. The real rate is just into positive territory at 0.35-0.6% (at last!).

This increase in the cost of money as part of the effort to normalise monetary policy is welcome. Non-financial corporate debt stands at almost 46% of GDP, close to the highest since World War II. Alarms have been ringing in the leveraged loan market. These are loans to already highly indebted companies that are then packaged into collateralised loan obligations and sold to investors. Their attraction in an income-starved world is their higher yield, reflecting the risk, plus the rate is floating, offering protection in a rising interest rate environment. Demand has been so strong that protections have been watered down to levels that are worryingly thin. However, default rates remain a paltry 2.4%.

What is disappointing however, is that non-residential investment has not risen in tandem with debt as a % of GDP. Rather, along with tax cuts, debt appears to have been deployed predominantly in share buybacks but also in dividends.

Nonfinancial corporate debt & nonresidential investment % GDP



Source: BEA, Bloomberg

Dented credibility

Growth in the €urozone is similarly decelerating – but without the excuse of tax cuts washing through. Industrial activity in Germany, which accounts for one-third of the Union's output, has fallen for three consecutive months, mostly on the back of the diesel auto emissions scandal. France has been hit by the havoc wreaked by the *gilet jaune* protesters. President Macron's U-turn on raising fuel taxes and his generous new spending measures will take the fiscal deficit to 3.5% of GDP, denting the credibility of Brussels' 3% rule – not helpful to efforts to bring the new Italian government's spending into line. Anti-establishment, nationalist parties are expected to make disruptive gains in the May €uropean elections.

The Japanese and Chinese economies are feeling the chill of Trump's trade war. Japan's GDP shrank by an annualised 2.5% in the September 2018 quarter, and the People's Bank of China is cutting bank reserve ratios to support growth.

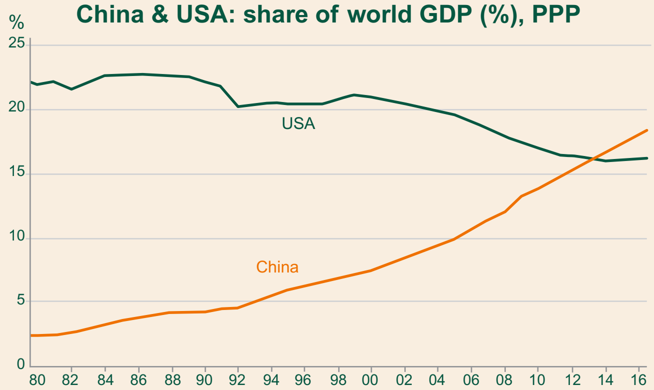
Big elephant

The big elephant in the room is indeed the trade spat between the United States and China, as its impact spreads around the global economy.

Is it just a spat?

Napoleon Bonaparte (1769-1821) is reported to have said: "Let China sleep. When she wakes, she will shake the world." The world has never seen anything like the rapid, tectonic shift in the global balance of power created by the rise of China. The US share of global economic output was 22% in 1980, but three decades of double digit growth in China reduced that to 16% in 2016. In contrast, China's share soared from 2% in 1980 to 18% in 2016 – and could reach 30% in 2040 if current trends continue.

China & USA: share of world GDP (%), PPP



Source: International Monetary Fund

When a rising power (China) threatens to displace a ruling power (the USA), the resulting structural stress makes a violent clash the rule, not the exception. It is dubbed the 'Thucydides Trap' by Graham Allison in his 'must read' book, *Destined for War*, based on the writings of the Greek historian of that name. Thucydides (460-395BC) documented Athens' challenge to the dominant power of the day, Sparta, which ended in the Peloponnese Wars.

Allison identifies 16 recurrences of the Thucydides Trap in the past 500 years.

One is Germany vs Britain. By 1871 Bismarck had consolidated the disparate Prussian states into a single nation. Germany's growing wealth and power fuelled its naval expansion, challenging the supremacy of the British Empire. Britain, declining economically relative to both the US and to Germany, was beset by anxieties; Germany was driven by ambition. "The heat of their rivalry… stoked an assassination in Sarajevo into a global conflagration", Allison observes.

Or take Japan's bombing of Pearl Harbour in 1941. In the preceding decade, Japan pushed China out of Taiwan, occupied Korea and invaded mainland China. Washington responded with sanctions to coerce Japan to stop - but Japan saw these as jeopardising its survival and threatened Washington with war five days before the "surprise" attack on Pearl Harbour. Washington dismissed the warning as inconceivable. Five days later, they regretted that.

Re-balancing

Now the world is in the grip of another contest. For seven decades since World War II, a rules-based framework led by Washington has defined the world order. Now an increasingly powerful China is challenging this.

China feels it has been cheated out of its rightful place by nations that were strong when it was weak. Its century of humiliation began in the first half of the 19th century when the Qing Dynasty came face-to-face with the power of an industrialising, imperial W. Europe. After the first Opium War, Hong Kong was ceded to Britain. In the second Opium War, the imperial Summer Palace in Beijing was burnt to the ground in 1860. From 1854 to 1941, US gunboats cruised China's inland rivers to protect American interests, rankling the Chinese. In the Boxer Rebellion (1899-1901), imperial powers looted China's cities. Some of the stolen art and porcelain is rumoured still to be held by the Metropolitan Museum in New York today, a festering wound.

Every high school student in China learns to feel the shame of this century of humiliation. "Never forget – and never again!" they are taught.

The man in charge of ensuring "never again" is President Xi Jinping, who grew up in Mao's Cultural Revolution. Mao had arrested his father and he was sent to the countryside to be "re-educated", shovelling dung and living in a cave. His older half-sister hung herself. He chose to survive by becoming 'redder than red'. He succeeded at the 10th attempt to become a member of the Communist Party – and rose to become Party chief in Zhejiang in 2002, overseeing spectacular economic growth and proving adept at identifying promising local entrepreneurs, including Jack Ma whose Alibaba is now a global titan that rivals Amazon. From there, a short hop to President in 2012, where he has waged a highly visible anticorruption campaign to masterful effect, ostensibly to 'cleanse' the Party but also in the process purging dozens of powerful rivals previously thought untouchable.

He is now President for life. He is a driven man… driven to make China great again. He is determined that China become a world leader in science, technology and innovation. His *One Belt, One Road* infrastructure project, whatever the flaws, underpins China's growth and projects power across several continents. The aim is for the American post-WWII position in Asia to become untenable. As Xi told Eurasian leaders in 2014: "It is for the people of Asia to run the affairs of Asia."

Fundamentally different Chinese and American values and traditions make a rapprochement between the two powers even more elusive. Confucian societies value authority, hierarchy, the subordination of individual rights. This contrasts

SPOTLIGHT

Practising what we preach

David Attenborough says climate change is humanity's "greatest threat in a thousand years". Estimates suggest cybercrime cost the global economy $600 billion in 2018 and employee apathy costs the UK economy alone £340 billion annually. Businesses around the world are facing a multitude of risks, from financial and regulatory to environmental and reputational.

We expect the companies in which we invest to consider all relevant risks and our investment process includes an assessment of any factor which could impact their long-term predictability and sustainability. It is crucial, therefore, that we continue to behave as a sustainable company ourselves. As Eleanor Roosevelt said: "It is not fair to ask of others what you are not willing to do yourself".

Celebrating our 25th anniversary earlier this year, we reflected on the efforts we have already made. For example, we have been a London Living Wage signatory since 2014, a commitment which covers both permanent employees and third–party contractors. Over the last year, we have doubled our efforts in relation to cyber security and our environmental footprint, not only because we believe it is the right thing to do, but because it makes business sense. In the never-ending battle against cybercrime, our more recent initiatives include appointing a Chief Technology Officer, increased management oversight and stepped up staff training amongst other (top secret!) measures.

All the energy we use in our offices is generated from renewable sources. We are carbon neutral, meaning we offset the impact of any carbon emissions we generate (for example, through travel) by contributing to a reforestation project in Uganda. All our printing is done on recycled, FSC-certified paper and we use local, fair trade suppliers wherever possible. The devastating impact of plastic has dominated press headlines this year and we have improved our recycling practices as a result. Now we are among the top three recyclers in our office building!

There is always more to be done and we will build on our existing work in 2019 and, hopefully, throughout our next 25 years.

Philippa Bliss, Assistant Investment Manager

with American beliefs in liberty, equality, democracy and individualism.

In a nuclear world, military conflict is improbable, but Chinese strategists anyway prefer a political and psychological approach. Sun Tzu in his book *The Art of War* declared that "the highest victory is to defeat the enemy without ever fighting". They plan to win by the accumulation of overwhelming advantages.

For example, cyberspace provides opportunities for disruptive technologies. China's recent historic landing on the dark side of the moon should be assessed in this context. Cyber-weapons can silently shut down military networks and critical civilian infrastructure such as power grids, hospitals, even parts of the financial system.

China will play the long game. Concessions in the short term should be seen as tactical and pragmatic, recognising that the two economies are so intertwined that anything precipitate risks the economic version of MAD (mutually assured destruction). The US is the largest market for Chinese exports, and China is America's largest creditor: Beijing selling down their Treasury holdings of over $1 trillion would cause financial turbulence. Virtually everything sold in the US, from iPhones to Boeing aircraft, is made with Chinese parts.

The current American administration has come into office determined to reverse the tide that has allowed China's economy to become larger than its own (PPP basis). However "DC has become an acronym for Dysfunctional Capital, founded on a poorly educated and attention-deficit-driven electorate, a sensationalist press and digital devices that degrade deliberation", opines Allison. The policy is to maintain the status quo – but history shows that that is not sustainable when the underlying economic balance of power has tilted so dramatically in China's favour. Rather the United States is likely to follow Europe down the road of declining influence.

The deepest aspiration of over a billion Chinese is to make their nation not only rich, but also powerful – so much so that other nations will have no choice but to recognise its interests and give it the respect they believe is their due. The sheer scale and ambition of this "China Dream" should disabuse any notion that the contest between China and the United States will subside naturally or soon.

Market agnostic

At Veritas, our quest for our clients is for real returns, ahead of inflation, both protecting and growing the purchasing power of their capital on a rolling five year view.

The global economy is moderating a little and monetary policy is inverting. The nine year bull market drew breath in 2018, an overdue and healthy correction, and valuations have retreated back below long term averages. We however remain firmly wedded to our philosophy of *not* trying to time markets. Few do it well consistently.

Over time, a company's share price will always reflect the underlying progress in earnings and free cash flows. We

S&P 500's forward P/E multiple

Source: FactSet, JP Morgan AM

therefore strive to ferret out predictable, sustainable companies, established businesses run by proven management, financially sound with robust and growing cash flows, a moat against competitors, all at a sensible price. We run focused portfolios, investing in some 25-40 equities.

We approach stock selection by identifying tectonic structural shifts. These trends forms the basis of our global growth themes, in turn a funnel to narrow the investable universe and focus on attractive sectors and stocks that are likely beneficiaries.

Our current high conviction themes are:

- online life
- demographic dynamics
- regulation, and
- all change: wire & re-wire.

The digital revolution is not all positive; we are aghast at its negative impact on the environment. Digital activity accounts for a full 2% of global CO_2 emissions! Global data centres together consume more power than all of the UK. Deleting 30 emails absorbs the same energy as a light bulb left on for 24 hours.

We approach this issue by further filtering companies by governance and social responsibility, including their environmental impact. Google, one of our longstanding investments through its parent, Alphabet, consumes as much electricity as San Francisco - but 100% of that is sourced from renewables.

Experian, also a core Veritas position, introduced an innovative cooling system in their Nottingham data centre, incorporating holes in the roof to allowed fresh air in, which is then filtered and blown across the floor to reduce energy cooling consumption – and costs. The project paid for itself in two years and is being rolled out to other centres.

These companies tick our 'environmentally responsible' box.

Meg Woods
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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