



Investment Report N°52

Our aim is to protect investors' capital and to increase its value year on year.

2016 - A year of two halves

"(Re: Late in the hand play) Keep trump if you're setting up an outside suit, run trump if you have nothing left to set up!"

Robert S Todd, Adventures in Bridge

Forewarned is forearmed, or so they say, but prior knowledge of the political outcomes in 2016 would have been worse than useless to investors. Traders might understandably give a great deal for tomorrow's news but knowing the outcome of the UK referendum in June or the US presidential election in November would not necessarily have provided much investment insight (perhaps with the exception of the sterling weakness which followed the Brexit vote). The weaker pound was kind to those with international assets and proved to be a helpful tailwind to performance.

Both of these dramatic political events were expected to knock markets spectacularly off course with forecasts of imminent recession by many. These occurrences, which should have raised 'risk premia', failed to do so. Instead, the tide of liquidity and continued low (even negative) interest rates lifted all boats. By the end of the year the riskiest assets – emerging market and distressed debt, cyclical and financial stocks – had all performed strongly.

Investors experienced contrasting extremes in 2016 which began with a collapse of equity markets, allegedly the worst start to the year since 1932. The Federal Reserve's first interest rate rise in nine years, China's attempt to manage its currency lower and a fall in the oil price to a new low of \$27 all contributed to

investor unease. Stock markets swooned and bonds rallied in anticipation of a slowing global economy. Investors looked ahead to the prospect of a divisive Brexit vote in June and an equally invidious US presidential election outcome with trepidation. Bond yields reached historic lows.

From August, these factors reversed. Bond yields rose sharply in anticipation of reflationary policies. The political shocks were perversely interpreted positively rather than unsettling markets. By the end of the year, investors used the surprise Trump election win as a vessel into which to pour their continued optimism. The Italian referendum, feared as a potential catalyst for the collapse of the Italian banking system, passed without leaving a trace. Mr Renzi's defenestration by the electorate was taken in the market's stride.

Amid the extreme volatility, Troy's funds made steady progress with characteristically and reassuringly low volatility. A solid first half was somewhat offset (at least on a relative basis) by the market euphoria in the second half of the year. This year has started on a more positive trajectory than last; a lot of good news is already discounted by the market.

Trumped

The rise of populist politics in 2016 has placed austerity in abeyance. Government debt is at record levels but deficit targets are now being torn up. The election of Donald Trump is being interpreted as a game-changer – a shift away from the erstwhile post-financial-crisis consensus. The appointment of Theresa May



as Prime Minister without a personal mandate after the UK referendum appears less dramatic but there are some similarities. Mrs May took the opportunity in her maiden speech as leader to criticise the Bank of England at the Conservative Party annual conference. Mrs May, like Trump, pilloried monetary policy for increasing inequality. Following the populist call to arms, fiscal easing, hitherto constrained by the need to reduce deficits via austerity, is now back on the table. While the president-elect's policies look more radical, with tax cuts combined with infrastructure spending, there is a palpable change of direction. Will it be enough?

Since the financial crisis politicians have delegated economic policy, putting their faith in central bankers. The consequences have been uneven and unrewarding, except for those with assets. The success in steadying the economic ship in 2009 led to an over-reliance on monetary policy. The desire to conduct further unorthodox monetary experiments is now waning. Brexit and Trump are evidence that, with the backing of the electorate, politicians are taking back the reins.

There is a risk of overpromising and under-delivering. The paradox of some of Donald Trump's policies is that they may exacerbate inequality rather than reduce it. Certainly, the beneficiaries of income tax cuts are likely to be high earners with a low propensity to spend. Protectionism, a reversal of globalisation that we have discussed in previous reports, is unlikely to improve the outlook for world growth. A contraction in global trade began a couple of years ago and today's tendency to introduce further trade barriers will extend the well-established trend.

Rather Ronald than Donald

One positive narrative is that Donald Trump has many similarities with Ronald Reagan whose presidency enjoyed strong economic growth and stock market buoyancy in the 1980s. Reagan ignored the budget deficit and embraced the teachings of Arthur Laffer who advocated that lower taxes would lead to higher revenues for the Inland Revenue Service. We can see the appeal of this view but we are sceptical. Certainly from an investment standpoint, the Trump/Reagan comparison is flawed. Critically, Ronald Reagan began his presidency in 1981 with very different metrics: a low debt-to-GDP ratio, 10-year Treasury yields at 14% and stock market valuations at secular lows (see *Figure 1*). Reagan embraced market forces and was in favour of free trade. He also inherited an economic mess in the midst of a double-dip recession. President Trump enters the White House seven years into an economic upturn and almost eight years into a bull market in stocks.

Contrary to the prevailing view, the President of the United States is not omnipotent. Whether he can hold back the powerful forces of deflation, be they from demographics, debt, technology or globalisation, remains to be seen. A resurgent US dollar, resulting from rising protectionism, will not help. For the moment, markets seem to be giving Trump the benefit of the doubt.

Treasury conundrum

The anticipation of reflation and the subsequent rise of US 10-year Treasury yields from a low of 1.3% to a recent high of 2.6% have raised questions as to whether the 35-year bull market in bonds is over. The bull market began after 35 years of post-war reflation. The symmetry of a 70-year cycle may



appeal to some but it offers us no certainty in forecasting. Nevertheless, the direction of Treasury yields is critical; it has defined investment practice since the early 1980s. The 10-year Treasury bond yield peaked at 15.8% in 1981, just after Ronald Reagan had entered the White House (see *Figure 2*). The ongoing fall in the cost of capital has influenced almost all investment practitioners. Only those close to retirement will have experienced an environment other than that of continuously falling yields. Just as it took those now over 60 time to realise that yields could fall, it may take time for today's under-60s to get used to the idea that yields can rise.

At Troy we are circumspect and open-minded about the future outlook for bonds, accepting that we may be at a tipping point. The velocity of money, half of the inflation equation and defined as the frequency with which money changes hands within a specific period of time, is at an all-time low in the United States. If Trump's policies succeed in boosting economic growth, a small pick-up in velocity could be very inflationary. The alternative view which should not be ruled out is that inflationary pressures subside, overwhelmed by incalculable forces of deflation. This occurred in 2011 and there is some likelihood that it may be repeated. A third possibility is that planned infrastructure spending and tax cuts struggle to gain traction at first. In this instance, a return to faster nominal GDP growth, accompanied by higher interest rates, is not achieved in the near term. Meanwhile, the status quo of lower inflation and interest rates persists for a while longer before yielding to an inflationary conclusion. None of these outcomes is far-fetched, making predictions for the coming year and beyond especially difficult.

The reason this is so important is that the prices of all assets, whether equities, credit or property, are, to a greater or lesser extent, influenced by the cost of borrowing. The primary justification for a re-rating in equities, since the lows of 2009, has centred on the sustained, low level of interest rates. This has encouraged company management, faced with low growth, to increase debt levels.

Rather than becoming more debt-averse following the financial crisis, corporates have significantly increased leverage levels as funding costs have fallen. In the US, debt levels have doubled since 2008 with the weighted-average company's net debt to EBITDA (earnings before interest, tax, depreciation and amortisation) increasing from 1x to almost 2x today. The weighted-average net debt to EBITDA for companies in the FTSE All Share has increased from 1.1x in 2008 to over 2.6x today (Source: FactSet/SocGen). Balance sheet strength is once again no longer seen as a virtue or a necessity. This means that highly leveraged companies are now particularly vulnerable to a rising cost of capital.

Can you have your cake and eat it?

As investors seeking to preserve the real value of capital, we should be careful what we wish for in light of recent widespread acceptance of the reflation story. Populism in the past has led to problematically high levels of inflation.

There are some valuation-insensitive investors who suggest that equities are a great hedge against rising inflation and rising bond yields. In the very long term, equities can protect against the ravages of inflation as companies' turnover follows rising prices. However, this also assumes that the cost of labour rises in line with those prices if margins are to be



sustained. With margins at cyclical highs and the threat of populism looming, labour is likely to hold sway over capital, leading to falls in corporate profitability.

Sharp rises in government bond yields, driven by a surge in inflation expectations (particularly in the form of stagflation where growth is elusive), have been disastrous for equity investors in the past. The 1987 crash was triggered by this, as was the dreadful UK equity market fall of over 70% (over 80% in real terms) in the mid-1970s. It is true that stocks ultimately rallied from the lows of 1974 but the assumption that equities today are a win/win asset class, benefiting from falling long-term interest rates as well as insulating us from inflation, is naïve at best and misleading at worst. Ironically, the best outcome for equity investors is probably more of the same: weak economic growth with corporate profitability sustained and the cost of capital remaining low.

Another dash for trash

Markets are taking a great deal on trust. Since bond yields troughed in the summer, rotation has been less about bonds into equities and more about a savage change of leadership within equity markets in anticipation of reflation. Manic Mr Market has turned his view on a sixpence. Depression and deflation in the spring turned to inflation and growth by the autumn. 2015's losers of industrial mining, oil and bank sectors have become today's winners. Much of this has been driven by short covering and momentum buying. There is certainly little evidence of any material pick-up in earnings, rather a lack of further falls – the

so-called second derivative. Investors seem to have been hasty in embracing Trumpflation.

The trend is your friend, until it isn't. Momentum investing is not an approach we would ever embrace at Troy. Febrile risk-on markets have a tendency to be powerful and short-lived. Since the launch of the Trojan Fund in 2001, we have experienced a number of such rotations leading to relative (not absolute) short-term underperformance. These periods occurred in 2003, 2009 and 2013 and all lasted about six months. Stock market sentiment indicators are at bullish extremes. Acting upon the fear of losing out by chasing winners is an almost certain way to lock in poor future performance. On the contrary, we are hopeful that the rush to buy into reflation plays will leave some high quality businesses that we favour left behind.

Rising stock markets have not changed the fundamentals. Valuations remain very high and increasing debt has obfuscated the underlying fragility of markets. Interest rates have been so low for so long that the implications of a rising cost of capital are long forgotten.

Perhaps the new populism will succeed in rejuvenating the economy but for the past eight years below-average growth has been viewed positively by investors. Will the opposite hold true or can we really have our cake and eat it?

Sebastian Lyon

January 2017



Figure 1

Rather Ronald than Donald - more differences than similarities



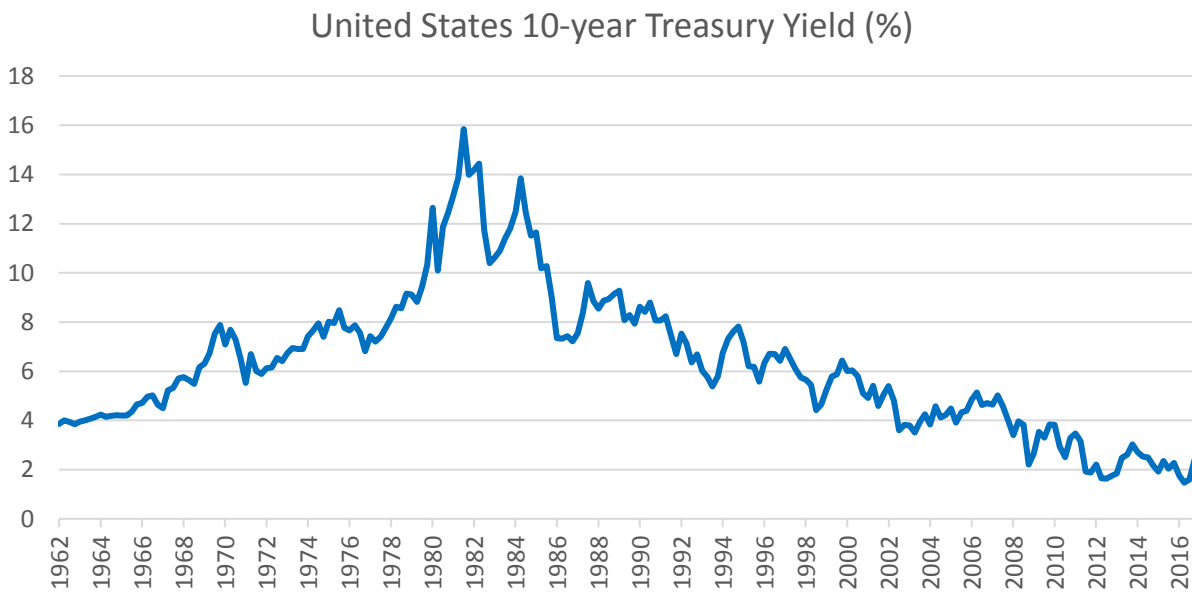
	December 1981	Now
US 10-Year Treasury Yield	14%	2.3%
Fed Funds Short Term Interest Rate	14.2%	0.7%
US Inflation – GDP Deflator	6.2%	1.3%*
US Total Public Debt/GDP	32.4%	105.7%**
US Personal Savings Rate	12.2%	5.5%
US Stock Market Cyclically-Adjusted Price/Earnings Ratio	7.8x	28.5x
Median Age of US Baby Boomer	26 years	61 years

*As at 30th September 2016
**As at 1st January 2016

Source: Bloomberg, US Census Bureau, Robert Shiller, Google Images. All data as at 17 January 2017 unless stated otherwise.

Figure 2

US 10-year treasury yield – Is this the end of a 35-year bull market?



Source: Bloomberg, 16 January 2017



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