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Investment Report Nº 51

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

Election Fever

"Life is full of choices but you never get any!"
Charlie Brown*

Stock markets have been rather serene following the initial post-Brexit induced falls. With US and UK equity markets flirting with all-time highs, the myopic attentions of investors have reverted back to corporate earnings (which remain weak) and valuations (which remain high). This apparent calm may soon be broken by further political uncertainty.

The western world is characterised by rising political anger, epitomised by the outcome of the UK referendum in June and now, Trump has trumped Brexit. But there remain plenty more invidious choices to be made including Italy's in its Constitutional referendum next month or France and Germany in their 2017 elections. We hold the view, expressed in our last report (Nº 50), that political outcomes are likely to offer investors asymmetric risks, skewed to the downside.

We are often asked how we are positioned for a particular eventuality or specific event. Back in July, following the UK referendum, we said that, as a matter of principle, we do not position our portfolios for binary events. Rather, we seek to construct funds that are resilient to a wide variety of possible outcomes.

The Perils of Relativity

Troy's funds have, to date in 2016, mainly enjoyed a fair wind. This has been a function of currency tailwinds (from sterling depreciation) and a further re-rating of many of our favoured holdings, while corporate performance has, for the most part, been consistent with our expectations. Our concern remains that the re-ratings of stocks are not necessarily gains derived from skill and can prove ephemeral. Re-ratings arrive slowly and leave quickly, while investor memories are short. Over a cycle, 15 times earnings can gradually become 20 times with a belief (or hope) that current valuations will never revert to previous levels. High valuations can be justified by high growth but growth is currently lacking. Anchoring on prevailing valuations is dangerously tempting. One comment from an analyst makes the point better than we can: "*Though on an absolute basis PG [Procter & Gamble] appears currently expensive (at 21.6x next year's earnings it is in the 99th percentile of its long-term trading range), we actually find its valuation relatively attractive at present.*" We find such an attempt at reassurance unnerving rather than comforting. We have seen it before and while some may find comfort in relativity, we prefer to stick to absolutes.

A rising tide has lifted many, if not all, boats this year. This is why it is all the more important to view returns over a full cycle and not a single year. In this extended cycle, which began in 2009, it is critical to maintain awareness of downside risks that have been obscured by the illusion of stability.

No U turn

Monetary policy is still the tool of choice, but it isn't working. David Cameron's six years in power coincided with a remarkable period of stability for interest rates: consistently 0.5% without a single move. Back in 2013, the newly

appointed Governor of the Bank of England provided 'forward guidance', offering emollient words to nervous investors that interest rates would not rise until unemployment was below 7%. Today unemployment is 4.9%. Despite plenty of indications to the contrary, the first base rate move since 2009 was a cut to 0.25%, a new 322-year low.

This decision was combined with the reintroduction of quantitative easing (QE) after four years of absence in the UK. The further £70bn of bond purchases (including £10bn of corporate bonds) will be added to the £375bn of new money created during the Bank's first programme. QE was introduced in 2009, with the indication by Sir John Gieve, Deputy Governor for Financial Stability, that it would be a temporary emergency measure which would be reversed. Seven years on, QE is looking ever more permanent, notwithstanding its apparent lack of success.

Unintended Consequence

There is one financial consequence of record low rates, which has come into sharp relief following the recent fall in gilt yields since the Brexit decision. Defined benefit pension deficits keep rising as asset prices fail to keep up with rising liabilities. Egregious management has made British Home Stores the current poster child for the developing pensions crisis. Hymans Robertson estimate that the BHS deficit rose from £571m in April to £717m by the beginning of August, following the Bank of England's base rate cut. While businessman-bashing makes great copy for Fleet Street, it is also a microcosm of what is occurring in the pension sector. Defined benefit schemes have deferred addressing their deficits in full with increased contributions in the hope that bond yields will rise and alleviate the liabilities. This is the financial equivalent of pouring too little water into a bath with the plug out. Moves in yields this year will see many deficits balloon. According to Lane Clark & Peacock, the combined deficit for FTSE 100 companies had increased from £25bn in July 2015 to £63bn by August 2016, after rising by £17bn between July and August 2016 alone. This pressure may have abated in recent weeks with the recent back-up in 10 year gilt yields to over 1%. However, the challenge has been building in recent years with the UK corporate pension shortfall now estimated at £1tn (50% of GDP).

We are innately wary of companies with excessive debt levels and pension deficits are no different. UK companies with the largest deficits as a percentage of their market caps are GKN (45%), BAE (39%), BT Group (21%), G4S (17%) and International Airlines Group (9%)[#]. None of these companies are held in Troy's Funds.

The hope is that higher bond yields will bail out these liabilities. Our concern is that rising inflation may not be met with higher yields as short rates remain nailed to the floor. Low rates combined with higher inflation could be the worst of all possible worlds as liabilities rise with inflation but asset values fail to keep up.

Higher company contributions look inevitable over the next five years. These will result in lower dividends and fewer resources for companies to invest into their core businesses – in other words, there will be a transfer of wealth from owners and employees to the retired and future pensioners. Long-term and, in some cases, unquantifiable liabilities make these companies considerably less attractive to potential corporate acquirers.

Mismatched

Another area affected by low rates is insurance. Investor attention has generally been focused on the banking sector's inability to raise net interest margins in a low interest rate world but the threat to insurance earnings and solvency is, perhaps, less well understood. At Troy we like businesses that get 'heavier' (improve earnings, dividends and their competitive position) over five years. Much of the insurance sector does not qualify with some analysts forecasting company earnings to be down 60% over the next decade. Companies with asset/liability mismatching – life assurance in particular - are vulnerable to the fact that low rates disproportionately increase the present value of long-dated liabilities. The UK life assurance industry has endeavoured to diversify away - take Standard Life's shift to asset management for example. However, smaller and medium-sized European life companies, where governance is less robust and assets and liabilities less well matched, have substantial earnings headwinds. In the US, the life industry lobby may have succeeded in keeping the regulator at bay for now, buying time in the hope that rates recover. All the while, reinvestment yields continue to decline.

What is the relevance of this when Troy is unlikely to invest in this opaque sector? Few have forecast that rates would stay this low for so long. While much of the focus is on weak European banks (Deutsche Bank in particular), there is a risk that the next crisis emerges from the insurance sector.

It ain't necessarily so

If the dark side of monetary policy is affecting banks, pension funds and insurance, it is perhaps less surprising that the one-club QE strategy looks increasingly likely to be complemented by broader fiscal stimulus. This is likely to take the form of infrastructure spending financed by central bank money creation. The effects of this spending will however likely take longer to reach the wider economy. The longevity of projects such as HS2 railway line and Heathrow airport expansion mean any economic boost is back-end loaded. In the US, extra fiscal spending may be partially funded by the repatriation of corporate-held foreign cash on at a low tax rate. However the federal government has proven to be very slow in getting such a policy off the ground. As with the bank bailout decision in 2008, Congress needs a crisis to spur it into action.

While academics like Larry Summers give credence to fiscal spending, others are suggesting even greater policy extremism. According to fellow Harvard Professor, Kenneth Rogoff, the monetary policy options are not over. Far from it. In his latest book, *The Curse of Cash*, he suggests that governments should "start phasing out paper currency". This will have the benefits of discouraging tax evasion and crime. It would also clear a path for central banks to "invoke unfettered negative interest rate policy." Today Treasury bond yields cannot fall far below zero because savers have the option of holding paper currency. One only has to look at the circulation of high-denomination notes in Japan to see additional, unintended consequences of low rates (*see Figure 1*). Keeping cash under the mattress remains an option for now. Mr Rogoff's utopia of a cashless society, thereby facilitating an extension of monetary policy, is likely to take even longer than Larry Summers' much hoped for fiscal stimulus.

A lack of visibility

For all of the attention on the political circus, economic growth has remained very subdued. As has been the case for a number of years, initial New Year optimism has given way to resignation to another year of sub-par growth. As at the end of September, US GDP is up 1.5% year on year, below the 2.1% experienced since the previous trough in June 2009.

Considering the column inches on Fed Policy, interest rates may not rise in December leaving rates unchanged all year. This is completely at odds with the initial expectation of four quarter-point rises at the beginning of 2016. It would not surprise us if last December's rise to 0.5% is ultimately reversed in the next couple of years as growth fails to emerge. The best we can hope for seems to be a continued muddle through, i.e. low growth, full employment and corporate margins (now at or near record highs) resisting a reversion to the mean. What concerns us is that this outcome has already prevailed for some time.

Inflation in a deflationary world

Whether it is the price of petrol, Marmite or Microsoft Office software, UK core inflation is likely to rise in 2017 and 2018. In a previously deflationary environment this seems paradoxical. It may prove temporary, as it was when the RPI rose to +5.6% in September 2011, only for deflationary forces to prevail. Should sterling weakness become sustained, inflation could become more endemic. Interest rates did not move up five years ago, and we would expect the MPC to argue again that inflationary pressures will prove short-lived. With short rates staying low, conventional bond yields may not rise by much. In 2011 10 year gilt yields were 2.3%. Today they are half that. The result will be negative real interest rates. Here lies the reason for our preference for index-linked gilts and US TIPS.

Higher inflation is also a threat to ever higher earnings multiples on stocks. We have warned in the past of the fallacy that inflation is good for stock markets. There is a risk to margins as input prices rise. With stretched valuations, future profits will be worth less at today's values.

In a world where steering a course between inflation and deflation becomes harder, not just for central bankers but for investors as well, forecasting the next few years is extremely difficult. Navigating febrile, volatile and illiquid markets is likely to become more challenging as investors are forced to cope with political and economic extremism. There is still good reason to hold inflation protection.

Please see Special Report No.3, by my colleague Charlotte Yonge, for why we favour holding index-linked bonds.

Sebastian Lyon November 2016

*Source: Charles M Schulz, Charlie Brown's Little Book of Wisdom
#Source: RBC Capital Markets, Estimate as at 30.6.16

Japanese cash under the mattress

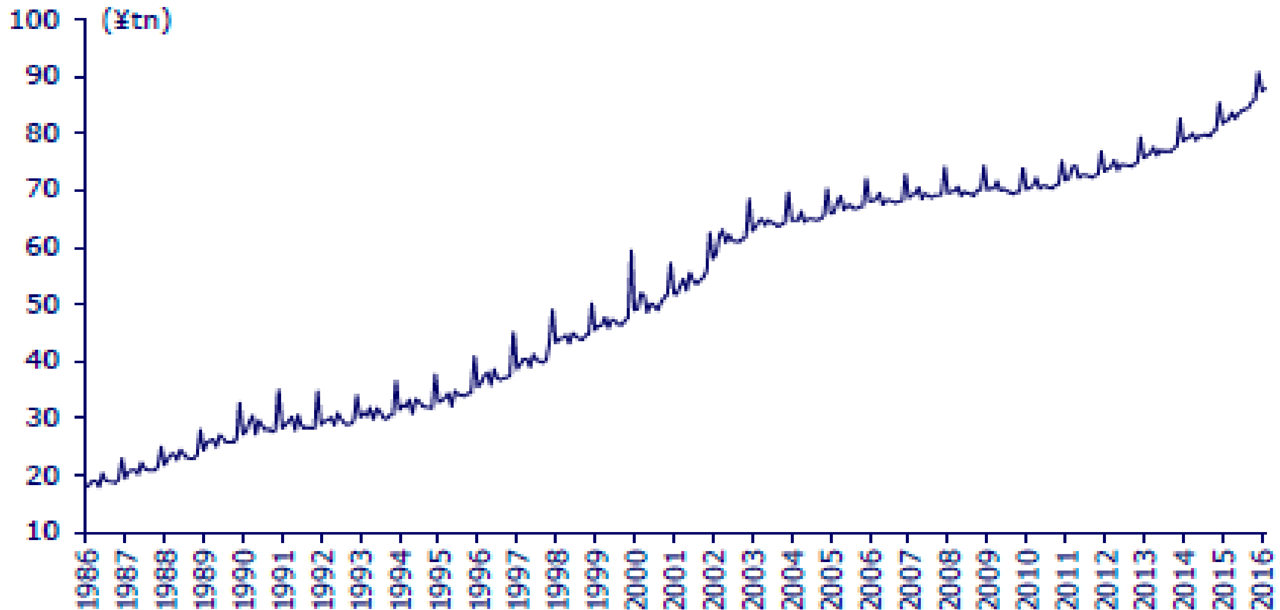

Figure 1 *Source: CLSA, Bank of Japan, 31 March 2016*

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