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June

A Confluence of Factors

June's headlines have been dominated by the political narrative, especially a difficult G7 meeting and US trade war rhetoric.

June's market falls look like a continuation of the falls we saw in February and March. Markets peaked in January 2018 and have been ebbing and flowing since. Are we in the last throws of a 9 year bull market, measured from the financial crisis in 2008?

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Much of the above bull market was fake – as we repeated often in these reports. It was driven by the largest money experiment of all time, co-ordinated as it was by Central Banks across the globe. They set interest rates to nearly zero (negative in Europe), created money from thin air and used the money to buy shares and bonds, often from weak borrowers in the latter case. Other investors responded to low interest rates and bought assets too, which led to bubbles in property, shares and bonds, art and vintage cars.

The relationship between the Central Banks' balance sheet expansion and the US share market, just to take one example, can be seen in the following cleverly re-scaled chart.

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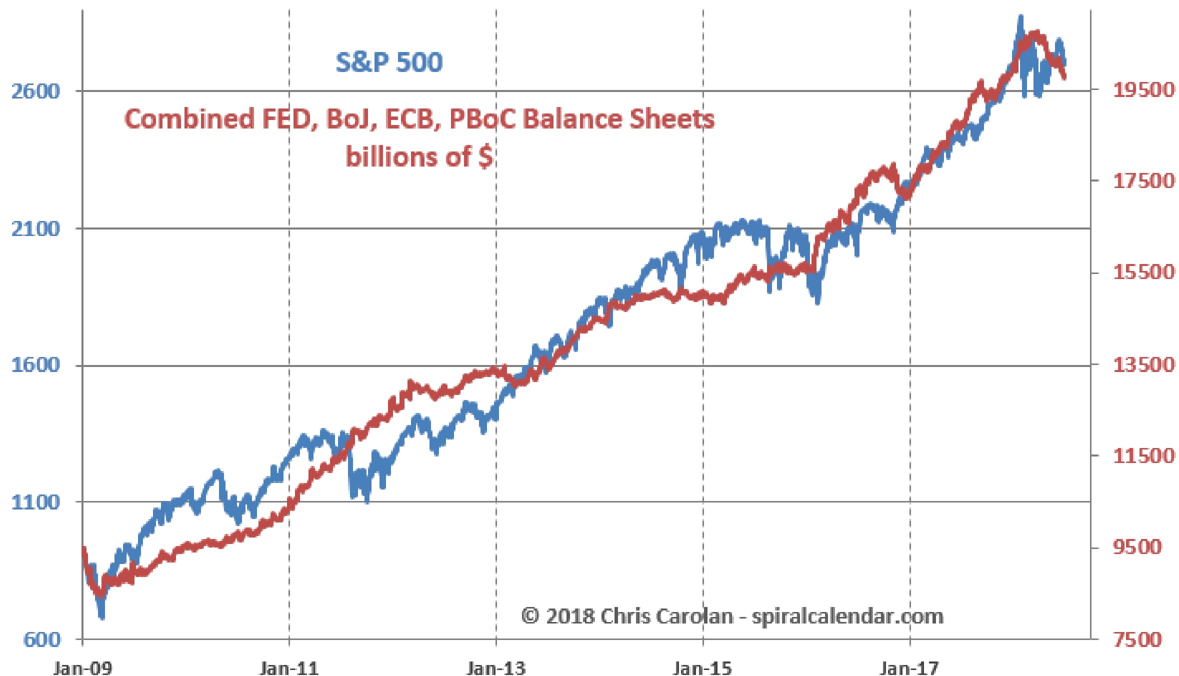
The rise in the US stock market alongside the expansion of Central Bank balance sheets (combined US, Japanese, European and Chinese).



When the price of something falls, more is demanded. When the price of money fell, more was borrowed. Businesses, individuals and governments went off on renewed borrowing sprees having pared back after the 2008 crash.

Last month we wrote about Italy where the government's debt combined with its additional commitment to the EU's clearing system are in excess of 160% of GDP. In China total debt to GDP stands at a neck-breaking 260%. We could feature any number of charts from other governments (including the US), or about corporate debt levels or individual borrowings and they would produce the same picture. The world is addicted to debt.

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Riding the Tiger

There is a major problem with pursuing a debt driven policy of economic expansion. Friederich von Hayek described the problem as being akin to riding on the back of a tiger ie there is no elegant way to dismount. If you step down, the tiger will turn and bite you but if you stay on its back it will buck with increasing vigour until you are hurled off anyway, at which point it will also turn and bite you. In the case of debt, to keep the growth going you need to issue more debt. The moment you stop doing this, you face a collapse in the bubbles which the debt policy created.

No Central Banker wishes to be at the helm when a debt bubble bursts, but if they are going to be in that position, they will try to lay as much blame with their predecessor as possible. And for the blame to be credible, ideally the bubble should relatively soon after taking up the new appointment.

In February 2018 the US Federal Reserve had a new head – Jay Powell – as a replacement to Janet Yellen. He has moved quickly to shrink the Federal Reserve’s balance sheet (in what has become known as quantitative tightening QT) and raise interest rates. He has indicated that he is not afraid to pop bubbles if need be. This has been taken as meaning that he will continue to raise US interest rates, perhaps more quickly than people have forecast.

The following chart shows the combined Central Banks’ balance sheets for the Federal Reserve, Bank of England, ECB, Bank of Japan (and Switzerland and Sweden). It shows the growth since 2008 and quite recent shrinkage, coming mainly from the US light blue portion. This is the QT referred to above. The shrinkage is projected to accelerate. Mario Draghi of the ECB (dark blue) has said the he too will commence shrinking his balance sheet.

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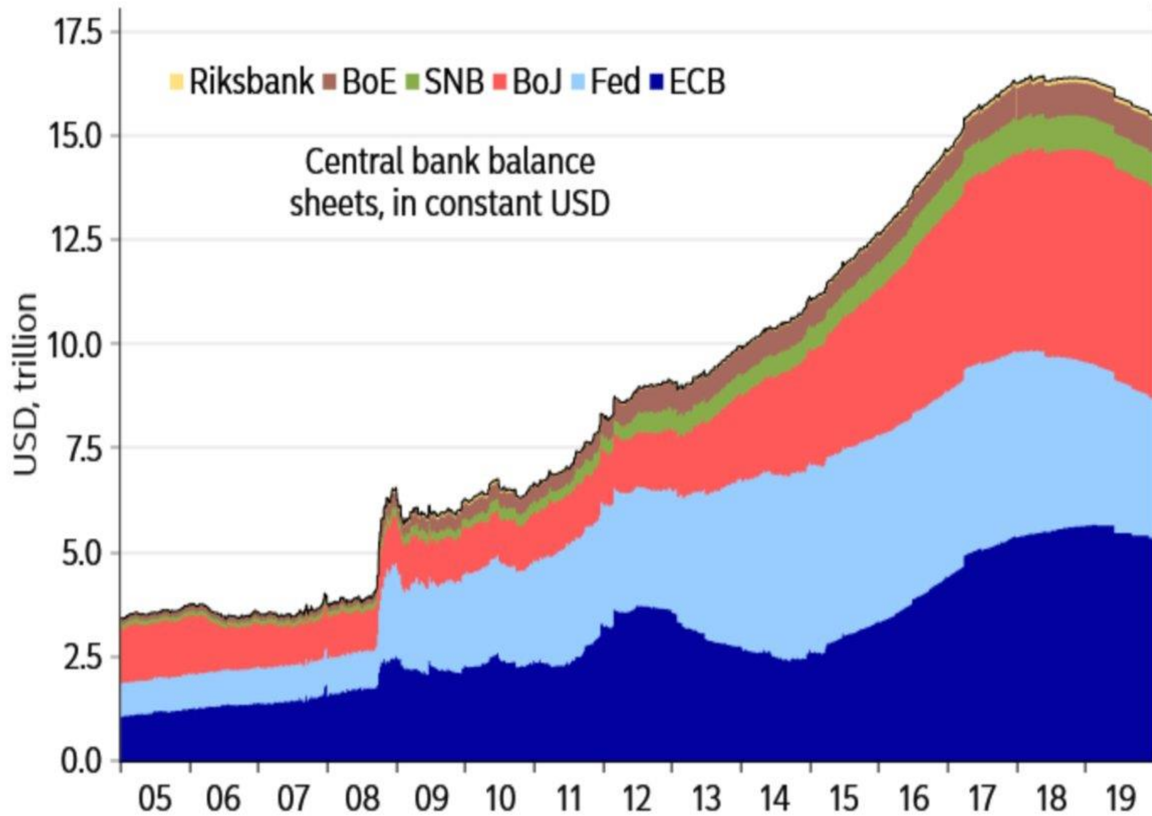

It is hard to see Central Bank balance sheet changes not having just as much of an influence over markets on the way down as they had on the way up. Central Banks giveth and Central Banks taketh away. But although correct, this is unlikely to become the *official narrative* in the event that markets fall. Instead there will be any number of rival causes suggested ranging from the Russians/Chinese/Populists/OPEC or Iranians. In my view, these are sideshows as is the tit for tat US trade war with China and the EU which made many headlines this month.

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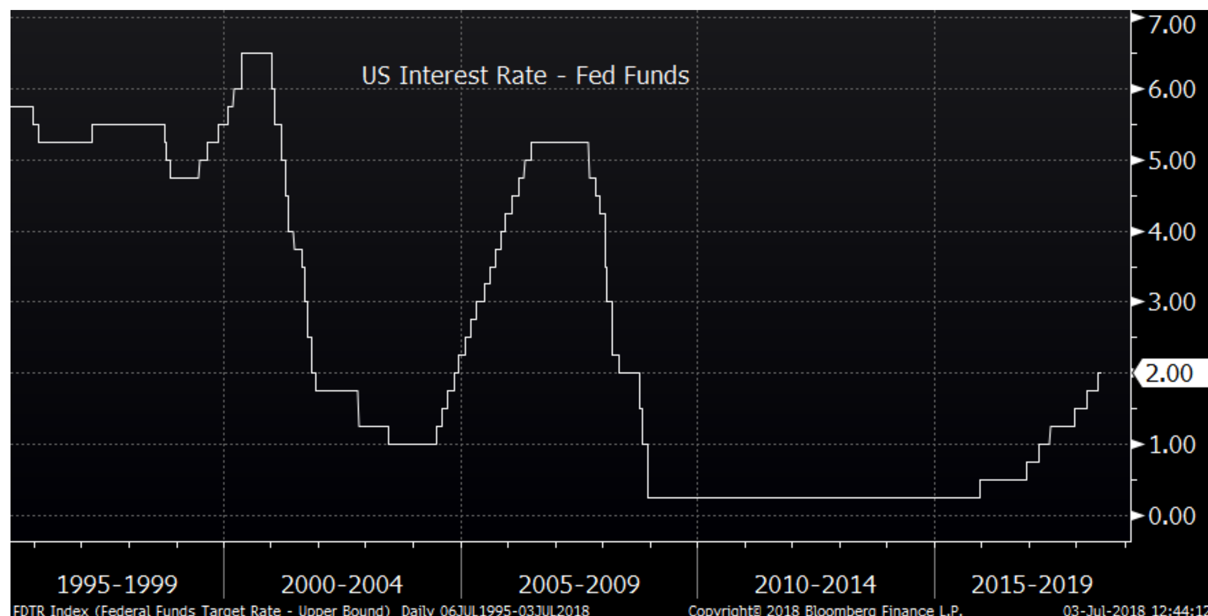
Risk Off Trades

The risk free rate of interest in the US is no longer zero.



As US interest rates rise, and with it also the value of the Dollar, investors are inclining to shed a little risk which is logical because they can earn a more once again through taking no risk. The trend can be self-reinforcing.

I comment on 2 risk-off trades below. One is happening already, the other not yet.

1)Emerging Markets

Investors in emerging markets have seen the Dollar value of their investments fall considerably since January. In past cycles, emerging markets have been a canary in the investment coalmine and have sometimes led where developed markets follow. When uncertainty rises investors prefer to return closer to home and exotic markets often suffer disproportionately.

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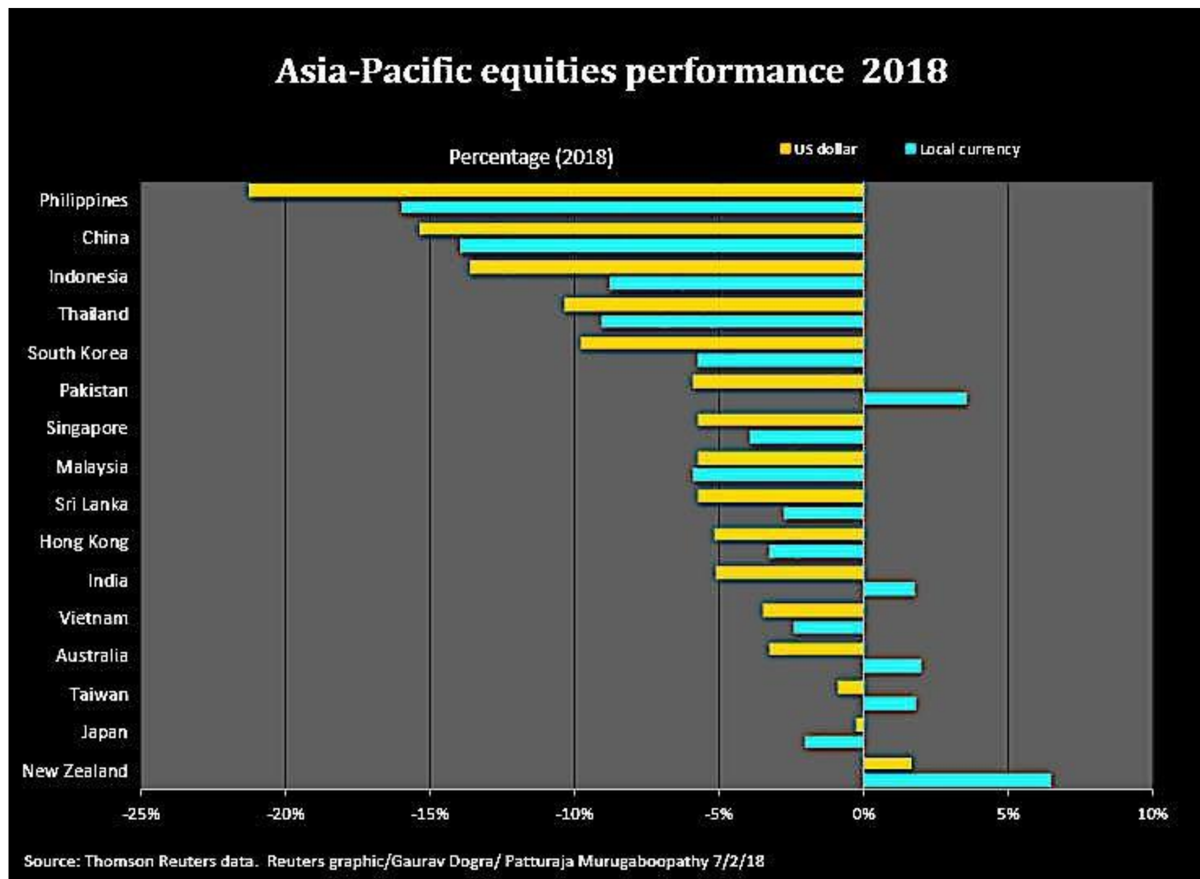
Asian Pacific Emerging Markets and Emerging Market Currencies have been weak since January



Brazilian, Argentinian and Mexican markets and currencies are performing similarly poorly.

2)Value Shares

This one is yet to happen. Over long periods, value stocks tend to perform better than growth stocks but in strong bull markets, for a while, growth stocks prevail. The end of the bull market usually coincides with the end of the outperformance of growth stocks.

Value stocks are ones with solid fundamentals, strong balance sheets, good cash flows, reliable profits and dividends. Growth stocks are companies sometimes without any of those things but which represent an exciting new aspect of our future lives. Growth stocks can be fantastically exciting as investments and they can rise many times over. But often the future which arrives is different from the one which was envisaged by growth stock investors and the sector collapses in disappointment and broken promises.

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The following chart from Schroders shows that value stocks usually do better than growth stocks (blue) when looking at 10 year rolling returns and when covering several cycles. Recently the value stocks have underperformed (red).

Figure 1: Value has nearly always outperformed growth - until recently

Past performance is not a guide to future performance and may not be repeated.

Based on monthly returns of the US Fama/French HML (High Minus Low) Factor. HML is the return on the "high" portfolio minus the return on the "low" portfolio, where book to market is used as the value metric. Source: Kenneth French's Data Library and Schroders. Data from 31 July 1926 to 29 December 2017.

Another way to look at the above is by comparing the performance of the S&P Value index to the S&P total market. It gives a similar picture to the last section of the above chart. It shows that value underperformed growth throughout the final years of the '90s before the latter crashed in the early 2000's with the break in the technology sector. Since the financial crash in 2008, growth has performed better once again, this time led by the FAANGs.

One sign of a possible market top is the sheer dominance of growth over value in the past 2 to 3 years. We might be in line to see a reversal of the kind we saw back in 2000?

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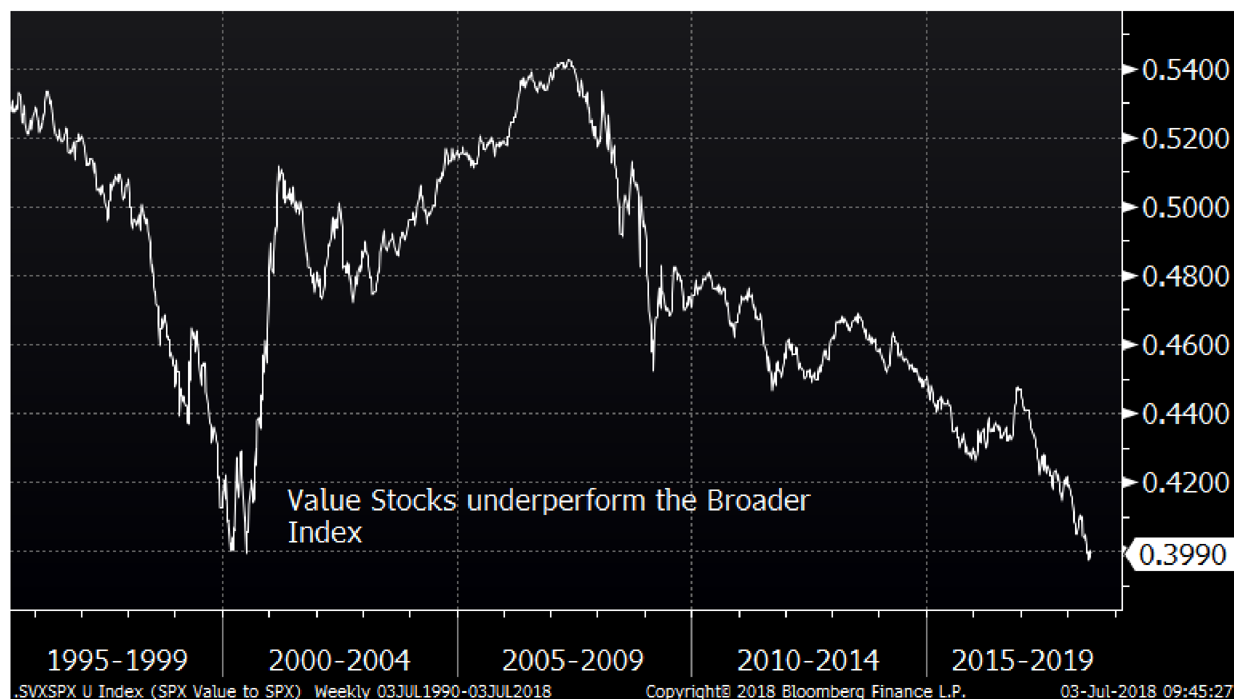

Our stock selection method should favour value shares which represent altogether safer companies. On the whole our companies have performed well but have still lagged behind the supercharged FAANGs.

Conclusion

Since 2008 investors have become dependent on Central Banks. They think the CBs are there to protect them ie that there is an implied put option on the market. They have become a little complacent as a result.

CBs are at the start of a new phase in which they are willing to try to wean investors off their dependency. They have warned that this is their plan and they have said they will put up with the tantrums, should they occur.

At the moment QT is for real; CB balance sheets are shrinking. US interest rates are rising. So it really does feel as though a different investing backdrop has been put into place in 2018. In an extreme case I suspect that the CBs would step in once again to rescue (although ammunition is low) but absent this case, the message they are sending is that they would like to extract themselves.

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US action is having an impact on markets throughout the world, particularly in the emerging economies but also in Europe. The US is swinging its weight politically; it could suit the new US political stance if its monetary policy caused the rest of the world to sweat a little.

Young investors have never known a time when they had to fend fully for themselves. The CBs have always had their backs. Increasingly the signals are that investors should re-learn independent thought. This could translate into more volatile times ahead.

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