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Courtville Partners Investment Outlook – April 2017

Calm down, everyone. So far this year the world's media have continued to generate industrial quantities of hyperbole around Trump, Brexit and other lightning-rod issues. But financial markets have been mostly oblivious. Since December, global bonds have barely budged (especially the benchmark 10-year US Treasury yield, still stuck at around 2.5%); and most key exchange rates are not much different. Even the US Federal Reserve's latest 0.25% interest rate increase verged on non-event status. After all, it had been flagged for months. In the background, however, investors are still drinking and dancing at the stock market party that began all the way back in 2009. Global equities have risen an impressive 6% in 1Q17; and those in Emerging Markets (i.e. at the riskier end of the spectrum) have partied the hardest, jumping 12%. After so many years of strong returns, the obvious question still lurks: are equity investors dancing on a volcano?

Any consideration of equity markets in general must begin with the US. Many commentators are warning of danger ahead. They point to a cocktail of rising interest rates, slower corporate earnings growth, stretched valuations (combined with all-time highs on most indices) and a fading "Trump effect", as political reality collides with the President's previous rhetoric. In *relative* terms at least, we are more relaxed than some about the prospects for the US stock market – partly because we see the Fed's rate hikes as the classic problem of success and partly because the economic fundamentals (GDP growth and companies' profits above all) seem to us healthy enough. Moreover, the obvious alternatives in the Western Hemisphere are less attractive by comparison: the Brexit soap opera and unstable politics cast long shadows over the UK and Continental Europe, respectively. Not that we are gung-ho about equities as an asset class; and the continuing high level of cash in our model portfolio betrays *both* our suspicion that stock markets could hit turbulence at any time *and* our ambition to profit from any such bumps (by buying the same shares for less).

Several generations of investors have been brought up to take as gospel the notion that equities and bonds are inextricably linked (albeit with frequent time lags). Indeed, this belief is at the heart of the Capital Asset Pricing Model, which in turn has underpinned almost all modern portfolio theory. By now, however, years of extreme monetary policy across the globe have shaken this belief (and the underlying theories) almost to destruction. If there is such a thing as "the price of money", it is the cost at which the US Government is able to borrow money. But the Fed and other central banks have led us into a hall of mirrors with their quantitative easing and supermarket-sweep bond-buying – to the extent that no one can be sure any more what that benchmark price of money is. This in turn makes it very hard to price almost any type of asset with much confidence. Why do we bring this up? Because the way in which US 10-year Treasury yields have apparently stalled at about 2.5% has come as a bit of a surprise – and has left investors doubting whether the long-awaited "great rotation" out of (over-valued) government bonds into (better value) equities is ever going to happen. Our view? It may not matter – at least not as much as the consensus thinks – whether this rotation materialises or not. We do still see most government bonds as dreadfully overvalued; but we are happy to be invested in equities regardless of whether a tsunami of cash is heading stock markets' way from jittery bond investors.

Here's another important consideration in the bonds versus equities debate… Inflation. Suddenly it's everywhere. Ever since central bankers turned on the money-printing presses in response to the financial crisis of 2008, gloomsters have been prophesying the return of inflation. They have been

wrong, wrong and wrong again – until now. Inflation (using the CPI measure) is now running at 2.7% in the US and 2.3% in the UK. The Bank of England in particular dismisses the mini-surge in prices as the inevitable consequence of post-Brexit devaluation, but nothing more serious. It is hard to deny, however, that at the first sign of inflation worming itself into *expectations* (for prices and wages), the interest rate setters on the Monetary Policy Committee will overnight seem off the pace (or "behind the curve", as others put it). Most aspects of central banking – including the setting of interest rates – are a confidence trick. And once confidence among investors is lost, it is fiendishly hard to get back. Bond investors above all are allergic to inflation. By contrast, owning real assets (via equity stakes in real businesses) ought to be a decent hedge against inflation.

Even without the spectre of resurgent inflation, there is another big problem with the world's bond markets; and the sheer size of this problem poses a rumbling threat to all other asset classes. Janus Capital's legendary fixed income manager Bill Gross, whose views we have often cited, puts this most pertinent of questions: if a worldwide credit bubble helped cause the financial system's heart-attack in 2008, what should we make of the enormous credit creation that has taken place since then? In 2017 the global economy has created more credit relative to GDP than existed at the start of the 2008 crisis. Total credit in the US stands at 350% of annual GDP (and rising). In China that ratio has more than doubled in 10 years to almost 300% as $24trn of debt has been incurred. Over the same period the US and Europe have added $12trn each. These are impossibly big numbers, of course – impossible to comprehend. For sure, they serve as a reminder of why governments are so keen to keep a lid on their borrowing costs. But they are also evidence of a phenomenon that is unsustainable. When the music of economic growth eventually stops, bond markets may well scare all of us into retreating from the dancefloor.

Cash

Our overweight position in cash is both a sign that we expect trouble in stock markets at some stage and that we would like to have the wherewithal to profit from any such disruption (probably by buying more equities). History tells us that, when markets turn, they turn quickly. So holding a decent reserve of cash makes the portfolio more flexible and nimble.

Fixed income

No change here: we stick to our view that investors should stay underweight in bonds, most of which still look very overvalued. Within the overall fixed income asset class, we prefer index-linked bonds and emerging market debt.

Equities

We still recommend an overweight position in equities. Within the asset class, we reduce our exposure to the US and increase exposure to Asia-Pacific (including Japan) and emerging markets on valuation grounds. We are neutral on Continental Europe; and we stay underweight the UK, where Brexit worries are likely to be with us for a long time to come.

Alternative assets

Gold as an investment has been almost as good over the last quarter as it was bad in the last quarter of 2016. We like the metal's qualities as a hedge against both inflation and political uncertainty.

Property

Commercial property offers a decent yield and historically has been an asset that can protect against inflation.