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Courtville Partners Investment Outlook – April 2018

If any of us knew how long the world economy's current expansion was going to last, we might feel more confident about forecasting prospective returns on all sorts of asset classes, not just equities and bonds. We don't know, of course. But might we be asking ourselves the wrong question? Human beings exhibit a physiological tendency to think in terms of time (and its passage). Not even economists are immune, which is why we are regularly being told that the current economic upswing that began in late 2009 is already among the longest-lasting in recorded history – and that the same goes for stock markets. There is, however, a plausible case to be made for looking at the relationship between economic activity (as measured by GDP growth) and the aggregate capacity of the world's economies. By this measure – which is independent of time – the current cycle may be no more than middle-aged rather than approaching the end of its life. On one level, this is not so surprising: many economies took longer than usual to get into their stride in the wake of the 2007-08 meltdown.

Having admitted that we don't know where we are in this cycle or how long it has to run, we can nevertheless see that forecasts of macroeconomic growth – and its corollary, corporate profits growth – remain mostly undented. Indeed, the consensus for earnings growth in the US this year has even been accelerating, helped by US tax reform, and now stands at 15% or more. It is a similar picture across most of the world's stock markets: companies' profits are still growing almost everywhere. Other things being equal, such a robust outlook for earnings goes some way towards alleviating worries about the absolute valuation of equities.

If the macroeconomic prognosis is so rosy, why have stock markets been struggling? Over the last quarter the obvious culprit has been a sharp rise in US treasury bond yields (up 50bp to 2.85% at the 10-year maturity) – itself a response to simmering worries about inflation and the strong hints from the Federal Reserve's new Chairman that there are likely to be four interest rate rises in 2018. The ensuing 10% across-the-board falls in stock markets in late January and early February had a "fire practice" feel to them, not least because most other asset classes did not echo the alarm; and equity indices quickly recouped more than half their losses. More recently, the US stock market has taken another tumble as investors have been forced to confront the self-evident truth that Facebook's customers are *not* the 2 billion people who use the service. The net effect of all this has been to leave the levels of the US stock market essentially unchanged over the last six months.
Meanwhile the UK stock market is actually down 5% over the last year. All this feels rather counterintuitive amid the orgy of back-slapping over strong 2017 investment performance – and leaves investors wondering whether equities as an asset class are simply worn out after their nine-year ascent or are just "resting" while central banks switch their monetary policies from loose to not-so-loose.

We subscribe to the "resting" view; and we still prefer equities over bonds on a medium- to long-term view for the reasons we have rehearsed in previous Investment Outlooks. Even after the recent rise in yields, government bonds still seem to us heavily overvalued by comparison with most asset classes, especially if our hunch about the return of inflation proves correct (against which scenario equities should offer insulation, being claims on real assets). But hasn't the long-awaited bear market in bonds already begun? Well, if it has, investors would be hard pushed to tell judging from the trailing 12-month performance of major bond indices. The Barclays Global Aggregate Bond Index, which is expressed in US dollars, is still up a healthy 7% from a year ago,

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for example. No, we think the worst is still very much ahead for fixed income investors. Does this mean that trouble-by-association lies in store for stock markets? Quite possibly. Indeed, we expect to see more "fire practices" before long. Some observers argue, however, that US stock market history shows that equities can stomach rising bond yields at least until these reach the 5% mark; and we are still a long way from that.

We have developed a habit – a tic, even – of listing some of the things that may worry investors – from unstable geopolitics to resurgent inflation to spookily low volatility. Naturally, the Trump administration's imposition of tariffs on imported steel and aluminium is a new item on our list. On balance, we are inclined to play down this particular threat. First, the associated political haggling still has much further to run (viz., proposed exemptions for "friends"). Second, the impact of tariffs on world trade has historically been modest – probably because tariffs are just one of many factors that influence trade. Other new entries in our "worry charts" include the increasingly tense stand-off between Israel and Iran-in-Syria (not something you read much about) and the US Government's investigation into China's alleged theft of intellectual property (as a possible prelude to punitive action of some kind). And we cannot ignore the burgeoning controversy around "big data" (and the giant companies that exploit it, most notably the so-called FAANGs (Facebook, Apple, Amazon, Netflix and Google). From an investment perspective, the most serious charge against these companies is that their near-monopolies are bad for competition and therefore bad for consumers. The companies' critics argue that the FAANGs' supra-normal returns may be *prima facie* evidence of discriminatory pricing. The seriousness of this charge stems from the fact that US antitrust legislation is very much rooted in the effect that a company's activity has – or may have – on market prices.

We began with the question of how far this economic upswing has to run. So let us end by highlighting some of the things that might presage the next downturn, as and when it comes (and, *pace* Gordon Brown, it always does). An inverted yield curve (i.e. interest rates higher at the short end than the long) has been the harbinger-of-choice for every post-War recession in the US. But there is a view that the distorting effects of QE may create an exception next time. Instead, a broad range of macroeconomic indicators – unemployment, truck sales, money supply growth, new orders, stock market volatility and many other measures besides – helps to build a picture of how far away the next recession may be. For what this "basket" is worth, recession this year seems very unlikely. But a few of the individual predictors are suggesting that a downturn in 2019 is at least possible (though not probable). Once we see more of these warning lights flashing amber (or even red), we are likely to shift our asset allocation more towards credit (and away from equities). Not yet, though.

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In view of the outlook from here, how might investors best allocate their assets?

Cash

As we have already said, we expect more "fire practices" to test investors' nerves before long; and our hunch is that price falls may not be confined to equities next time. Given what we see as the continuing overvaluation of most government bonds, we are resisting the temptation to allocate even to the short end of the yield curve (i.e. bonds with maturities of less than five years). Yes, short-dated bonds are – by mathematical definition – less vulnerable to rising interest rates than longer-dated issues. But the running yields available to investors at the short end still offer a poor

risk/return equation in our view. Meanwhile, our off-the-clock 14% cash weighting continues to offer both portfolio protection and ammunition with which to profit from market setbacks.

Equities

We hold to our view that equities in general offer better prospects than bonds. At the same time we acknowledge that the unusual evolution and shape of the current economic upswing, now entering its tenth year, have made it harder than usual to feel confident about how much longer equities can continue their outperformance. Meanwhile, decent bottom-up data – and corporate earnings in particular – provide some comfort in most territories. We still prefer equities in Japan, Asia and Continental Europe over those in the US (where valuations remain high) and the UK (for which prospects are inextricably tied to the B-word).

Fixed income

The last quarter's rises in yields at the long end of many government bond markets is nowhere near enough to wean us off our view that most of these bonds are very overvalued in the wake of a decade of ridiculously easy monetary policy. Whether the inflation dragon really is ready to stir again has not become much clearer of late; but we still see a good chance that it will, bringing the risk of sharper interest rate rises than Mr Market is predicting. Therefore we are still heavily underweight in fixed income – and are likely to remain so until either bond yields have gone up a long way or (Heaven forbid) economic depression seems possible. What holdings we do have are mostly in either emerging market or inflation-linked bonds.

Alternative assets

We never tire of being told that gold has no place in any sensible investor's portfolio. It is gold's very immunity to government interference that attracts us – a currency that cannot be debased by sly politicians (of whom there is no obvious shortage). Besides, long-run historical evidence suggests a positive correlation between gold and extended periods of rising interest rates (which is what we expect from here).

Commercial property

Although only a small (1%) part of our model portfolio, we have removed our exposure to US commercial property. The ETF in question has shown greater correlation to US long bonds than we had hoped. Elsewhere in the world we still like the sector – in Continental Europe and Asia in particular, where growth prospects remain attractive.

Currency

We are long-term bears of sterling, even after being blindsided by its relative strength against the dollar in 2017. The UK's yawning twin deficits – on the current account and in government spending – would be enough to encourage a high exposure to non-sterling securities. The threat of a self-proclaimed Marxist in 11 Downing Street within the foreseeable future provides an extra incentive.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	18	32.5
International Equities	49	30
Fixed Income	9	17.5
Alternatives	5	10
Commercial Property	4	5
Cash	15	5
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC
UK Equities		**20**	**2**	
UK	VUKE LN	11	+1	0.09
UK	VMID LN	9	+1	0.10
International Equities		**46**	**-3**	
US	VUSA LN	6	0	0.07
	XDPG LN	6	0	0.30
Euro	VERX LN	14	-1	0.12
Japan	VJPN LN	7	-1	0.19
Asia	VAPX LN	5	-1	0.22
Emerging Markets	VFEM LN	8	0	0.25
Fixed Income		**11**	**2**	
Government Bonds				
UK	VGOV LN	2	+1	0.12
Index Linked Gilts	INXG LN	4	+1	0.25
EM	EMB US	3	0	0.40
Corporate Bonds				
US	VCLT US	2	0	0.12
Alternatives		**5**	**0**	
Gold	IAU US	3	-2	0.25
Infrastructure	3IN	2	+2	1.48
Commercial Property		**4**	**0**	
US	VNQ US	0	-1	0.10
Europe	IPRP LN	2	+1	0.40
Asia	IFAS US	2	0	0.48
Cash	GBP	**14**	**-1**	
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
YTD	-3.9%	-3.8%	0.0%
Last 12 months	1.7%	1.8%	-0.1%
Since inception(1/1/2015)	35.1%	26.9%	8.3%
CAGR	9.7%		