# Courtville Partners – Investment Outlook, April 2020

**Summary of the key points in this quarter's Investment Outlook**

- Many investors, including us, have been humbled by Mr Market.
- We suspect that the worst of the Covid-19 newsflow is yet to come and that stock market lows will be re-tested.
- Two major themes:
  - The long-term transfer of economic hegemony from the US to China will accelerate as a direct consequence of the pandemic.
  - Governments have promised fiscal intervention on an unprecedented scale. The money-printing involved may well mark the end of the disinflationary era.
- These will both have major implications for long-term asset allocation.
- At the risk of being early, we favour inflation hedges: inflation-linked bonds, gold, real estate and some equities (tilted away from the West to Greater Asia). Western government debt is already expensive and risks becoming toxic if we are right about inflation.

We didn't see it coming – or, rather, we did see CV-19 coming (from the direction of Hubei Province), just like everyone else. What we didn't foresee was the willingness of governments around the world, but especially in the West, to shut down their economies and lock up their citizens – at minimal notice and on the basis of almost no reliable data. This is the precautionary principle writ larger than ever before in human history. Our lack of foresight, combined with precipitous falls in stock markets, has left us feeling humbled by Mr Market, not for the first time in our careers. Global equities hit an all-time peak as recently as 12th February (how long ago that seems already), since when they have fallen 20% (having been down more than 30% ten days ago). Terrible as that sounds, it is a long way short – so far – of the declines seen in both 2007/08 (-50%) and 2000/01 (-48%). In both those cases, it took roughly three years to recover the losses. Arguably this recession is likely to be even more severe than that which followed the Great Financial Crisis. So a shallow bear market seems optimistic, even if economic recovery after the pandemic is swift.

The Courtville Partners model portfolio has fallen 15% year-to-date, though it is down a less awful 7% over the last 12 months (a reminder of how strongly markets performed last year). When the crisis hit, the portfolio was too heavily weighted towards equities (and UK equities in particular) and didn't hold enough government bonds (which have fulfilled their usual knee-jerk role of safe havens). On the other hand, our aversion to sterling and a longstanding liking for both gold and (relatively high levels of) cash have cushioned the blow a little.

We have all heard the throwaway line about the 19th century belonging to the British Empire, the 20th to the United States and the 21st to Asia (to China in particular). That this generalisation is commonplace does not make it wrong. In the present era, the difference between the growth rates of the American and the Chinese economies over many years, past and future, makes it almost inevitable that China will establish its undisputed economic hegemony in due course. But did any of us imagine that the mantle would be passed not gradually over the next decade or two, but quite abruptly in the space of just a few months (or however long lockdown lasts in the West)? No, we did not. But that's what is happening – on our screens, in real time, right before our eyes. It may still only be in second or third gear owing to the collapse of demand in export markets, but China's economic engine has already restarted. Meanwhile, Western economies have been put into *de facto* hibernation, but at the biblical cost of government intervention that almost guarantees toxic results further down the road. This may be how the centuries-old Judaeo-Christian worldview – and the individual's primacy over the collective – gives way to the Confucian preference for the common good and unquestioning respect for authority. Mr Xi and his fellow members of the Politburo will scarcely be able to believe their luck.

So much for politics. We fear that another baton is possibly being passed as we watch – from the essentially disinflationary environment of the last 30 or so years to a new reality in which Western governments commit themselves to borrowing and printing money on a scale never seen before (with the exception in some cases of the Second World War). It is hard to see how we will now escape a resurgence of inflation. Yes, the boy cried "Wolf!" (i.e. the economist cried "Inflation!") in the wake of the 2007-08 financial crisis, arguing that quantitative easing was bound to drive up prices. In the end, most central bank money-printing stayed within the banking system in the form of excess reserves. By contrast, the policy measures on the table this time will inject cash directly into the broader measures of money (e.g. the US Government's decision to send $1200 direct to every American). We seem to be close to widespread acceptance of a policy that until recently enjoyed little credibility, namely Universal Basic Income. Cynics may argue that such acceptance does not reveal so much a genuine Damascene conversion by governments, but rather an opportunistic grab for intellectual justification, however thin, of desperate fiscal measures. Whether the cynics are right or not, we may well be standing at the dawn of a new era of Modern Monetary Theory (a variation of the mythical Magic Money Tree) – a theory rubbished by us and every other level-headed economic commentator.

There are many other reasons to expect a sharp and sustained rise in inflation. When it comes, the post-lockdown recovery is likely to be quick, which will have the effect *inter alia* of making governments' fiscal measures seem very pro-cyclical (i.e. the fiscal equivalent of pouring petrol on the flames). Bear in mind also that China, having been the great exporter of disinflation for several decades, probably exerts at best a neutral influence on global price levels nowadays (and may well begin to export inflation in due course as its economy shifts towards consumption). Meanwhile in the West the balance of power in the eternal struggle between Capital and Labour may well tilt in Labour's favour. Faith in extended global supply-chains has been rattled to the extent that surely companies will think twice before countering demands for higher pay with threats to export jobs to Asia in a post-Covid-19 world.

All in all, the current pandemic – and the accompanying supply shock – may just turn out to mark the dividing line between the disinflationary period of the last 30-40 years and the new age of revived inflation. If so, what are the financial consequences likely to be? And what might be the implications for investors' asset allocation?

Having decided to shut down their economies for weeks or even months, governments arguably had little choice but to follow up with promises of financial support for vast swathes of their economies. They were not wrong to make these promises. The alternatives would have been worse. The longer-run mistake lies in the collective determination of governments and central banks since 2007-08 to prevent companies going bust by keeping interest rates at or close to zero. As a direct result, capital has been misallocated on a huge scale for a long time. Legions of so-called "zombie" companies have been created, kept alive only because the cost of servicing their debts is so paltry. The capitalist imperative of "creative destruction" has been denied for the last dozen years; and, as one wag put it, capitalism without creative destruction (manifested in bankruptcy) is like Catholicism without Hell. The upshot is that a mountain of debt will now be piled upon the existing mountain of debt. Governments will act through central banks to keep interest rates ultra-low for fear of the balance sheet catastrophe that would be unleashed by higher rates. It may take time for inflation to begin to stir; but, once it does, savers risk remaining imprisoned within the cage of negative real interest rates for decades to come. Governments will have to issue gargantuan quantities of new debt to bankroll the promises they have made in order to keep their economies alive while in suspended animation. The only buyers of this debt will be central banks, as they have been for most of the last decade. The last few believers in the notion of central bank independence will surely have to admit that it has been abolished. There will be many losers, among whom savers in general (at least those who hold mostly cash), pension funds (many of which are likely to need rescuing by governments), insurance companies (unable to generate positive yields on their invested premiums) – and so on.

We believe that investors can draw some conclusions straightaway. Avoid the bonds issued by those Western governments that are already heavily indebted. Even if yields rise, inflation is likely to rise faster in due course. Reconsider inflation-linked bonds (that have been curiously out of favour of late). Even if through gritted teeth, accept that Chinese bonds are rapidly replacing US Treasury paper as the benchmark for fixed income investment. Own gold as insurance against the almost inevitable debasement of many countries' currencies. Consider certain types of real estate, above all for their inflation-hedging properties. Do not run away from equities as an asset class. On the contrary, be brave and embrace equities for what they are, namely stakes in real, tangible, productive entities, many of which will still be able to generate returns for their owners above the cost of their capital. That said, tilt equity portfolios away from the West towards Greater Asia.

What about timing? As we never tire of saying, no one can time markets. Nevertheless, we judge it too early to buy equities. Using a 20% peak-to-trough fall as the definition of a bear market, then among the 15 examples since 1945 (but also including the 1929-32 mega-bear market) there has only been one occasion (1982) on which the stock market did not re-test its initial low point within three months. The news of Covid-19-related deaths seems bound to worsen in many countries before it improves, above all the US. Governments are still acting on the basis of almost no reliable data (about infection levels or even mortality rates), which makes it impossible for them to take rational decisions or plot a path out of "lockdown". And, although stock markets are famously discounting mechanisms, most indices suggest to us a surprisingly high level of *sangfroid* (or perhaps complacency) among investors over the near-term outlook. Markets just haven't fallen that far compared with other (arguably less serious) crises.

Nor has there been much attention paid so far to governments' coercion of companies into abandoning dividend payments – or at last postponing them. In the UK banks have been the highest-profile targets of this on-the-hoof policy; but other sectors are likely to find themselves in the government's sights, especially if they make use of the Treasury's financial aid packages. We've been here before. Dividend controls were a feature of UK financial regulation for much of the 1950s, 1960s and 1970s. It remains to be seen how many other countries' governments pursue this approach. Other things being equal, dividend restrictions are not good news for stock markets. Although they may help reinforce companies' balance sheets at a time of stress, they short-circuit the basic equation on which equity valuations sit, namely that the value of a company's shares should correspond with the net present value of its future dividends.

Of all the things that have changed in the world in recent weeks, one of the biggest – from the narrow perspective of financial investment – is German fiscal policy. Six months ago we were arguing that the sheer scale of Germany's fiscal headroom made it far and away the most powerful potential game-changer within the Eurozone. The crucial word here is "potential": the country's "*Schwarze Null*" doctrine continues to represent a formidable obstacle to any loosening of the purse-strings. Now that several Southern European governments are struggling to bail out their economies with money they don't have, the political urge to tap into Germany's ultra-strong balance sheet is irresistible. France, Italy and Spain are lobbying hard for the issuance of "common debt instruments" that would be guaranteed by the Eurozone states collectively – which in the last resort always means Germany. The funds would be used to meet both the immediate costs of the pandemic and the inevitable economic reconstruction later on. But Germany is not budging. "Euro-bonds" – i.e. obligations issued and guaranteed by all Eurozone states – would require approval by a 67% majority in the Bundestag, whose members are well aware of German taxpayers' antipathy to the idea of paying for Southern European profligacy (as they see it). This impasse creates the risk of an existential threat to the single currency – perhaps even to the EU itself. After all, what is the point of nation states ceding all that sovereignty to Brussels if the EU offers no worthwhile help when the chips are really down? People all over Southern Europe are already asking themselves this question. Meanwhile, it makes the Eurozone almost uninvestible.

The changes to our Model Portfolio (see the table below) reflect both our short-term caution and the major new investment themes set out above. We already have a good idea of a sensible long-term asset allocation for the new world order, but intend to take our time gradually migrating the portfolio in this direction.

| Asset Classes | Courtville Partners Asset Allocation (%) | FTSE PI Balanced Index (%) |
|---|---|---|
| UK Equities | 22 | 18.8 |
| International Equities | 46 | 41.8 |
| Fixed Income | 9 | 21.4 |
| Alternatives | 10 | 10.1 |
| Commercial Property | 3 | 0.5 |
| Cash | 10 | 7.4 |
| **Total** | **100** | **100** |

| Courtville Partners Model Portfolio | ETF | Weight (%) | Changes this quarter | Weighted OMC |
|---|---|---|---|---|
| **UK Equities** | | **22** | **0** | |
| UK | VUKE LN | 11 | 0 | 0.09 |
| UK | VMID LN | 11 | 0 | 0.10 |
| **International Equities** | | **46** | **0** | |
| US | VUSA LN | 11 | +3 | 0.07 |
| | XDPG LN | 13 | +1 | 0.09 |
| Euro | VERX LN | 3 | -3 | 0.12 |
| Japan | VJPN LN | 6 | | 0.19 |
| Asia | VAPX LN | 5 | | 0.22 |
| China | IASH LN | 3 | +3 | 0.40 |
| Emerging Markets | VFEM LN | 5 | -4 | 0.25 |
| **Fixed Income** | | **9** | **-3** | |
| Government Bonds | | | | |
| UK | IGLS LN | 0 | -2 | |
| US | IBTS LN | 0 | -2 | |
| Index Linked Gilts | INXG LN | 4 | +1 | 0.25 |
| China | CNYB NA | 3 | +3 | 0.35 |
| EM | JPEA LN | 0 | -2 | |
| Corporate Bonds | | | | |
| US | CORP LN | 2 | -1 | 0.2 |
| **Alternatives** | | **10** | **+1** | |
| Gold | PHAU LN | 4 | +1 | 0.39 |
| Infrastructure | INFR LN | 4 | +1 | 0.65 |
| Agribusiness | SPAG LN | 0 | -1 | |
| Water | IH20 LN | 2 | | 0.65 |
| **Commercial Property** | | **3.0** | **0** | |
| US | IUSP LN | 1.0 | 0 | 0.40 |
| Europe | IPRP LN | 1.0 | | 0.40 |
| Asia | IFAS US | 1.0 | | 0.59 |
| **Cash** | GBP | **10.0** | **+2** | |
| **Total** | | **100** | | **18%** |

| Courtville Partners | Model Portfolio | FTSE PI Balanced Index | Relative performance |
|---|---|---|---|
| 2020 YTD | -14.7% | -10.3% | -4.4% |
| Since inception(1/1/2015) | 26.0% | 31.1% | -5.1% |
| CAGR since inception | 4.5% | 5.3% | -0.8% |

*The value of your investments can fall as well as rise, and you may not get back all the money you invested.*