COURTVILLE PARTNERS

Courtville Partners – Investment Outlook, January 2019

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

- 2018 was a rotten year for investors. The value of almost every asset class fell.
- Cash was almost the only refuge for those seeking to preserve capital.
- Weaker sterling mitigated the impact of price falls for UK-based investors.
- Slower economic growth, lower earnings forecasts, a shortage of dollar liquidity, trade wars and Brexit are all likely to weigh heavily on sentiment over the next few months.
- Equity valuations in many regions are starting to look attractive relative to long-term averages, though they may well get cheaper still.
- Nevertheless, we would be surprised if by the end of 2019 we had not encouraged our clients to use some of their cash to buy more equities.
- In the short term, a switch to looser monetary policy in either the US or China (or both) is the most likely catalyst to boost flagging markets.

"Dog" has long been a slang term for a poor financial investment. Even if you didn't know already, you can probably guess which sign of the Chinese zodiac governed 2018, which was a year of near-universal pain for investors. Among all publicly traded asset classes, very few generated positive returns. All the world's major stock markets ended the year lower than they began it – in some cases much lower (e.g. China -25% and Emerging Markets -17%, both in dollar terms). Overall, world equities sank 11% through the year and now stand 17% below their intra-year peak. Indeed, several market indices are now into "bear market" territory (conventionally defined as a fall of 20% or more from a peak). Bonds, gold and property have done less badly, but still mostly show year-on-year declines.

A saving grace for UK-based investors is that returns in sterling terms were flattered by renewed currency weakness. Global equities, for example, were down 6% in sterling (rather than down 11% in dollars); and global bonds actually rose almost 5% (rather than falling 1%). The fillip from a weak pound is illusory, however, since the underlying message is one of alarm about the UK's economy (and, yes, its politics).

We have been mostly cautious about the prospects for markets – equities and bonds – for several quarters, while making no claim to be able to predict the timing of a major setback in markets. That is why we have advised keeping relatively large cash balances both to protect portfolios and to provide the wherewithal to profit from eventual price falls. So far, so good. After such a dismal 2018, do we think that investors should do some shopping in the new year sales? In short, no – at least not yet. Valuation, absolute and relative, helps put investments in context; but it never produces unequivocal signals to buy (or sell). Notoriously, assets of all kinds can remain expensive (or cheap) for long periods before eventually readjusting to historic norms. With that proviso, we note that equities in particular look decent value for money almost everywhere when judged against long-run averages. The valuation case for the US stock market, which admittedly accounts for a whopping 50% of global market capitalisation, seems less compelling. But then it had long been among the most expensive markets.

Another way of looking at the same issue is to add corporate earnings growth worldwide in 2018 (roughly 20%) to the stock market decline (almost 10%) to arrive at a de-rating of global equities of around 30% – which is quite chunky by any standards. The potential fly in the valuation ointment is the resilience of corporate earnings, forecasts for which have been sagging in response to slower macroeconomic growth (itself the result of trade tensions, rising interest rates, worries about banks and so on). Our hunch is that the de-rating is not over yet. Bear in mind that stock market corrections have historically tended to be both bigger and longer than we have yet seen in this cycle: a peak-to-trough fall of 40% over 18 months in 1973-74, 25% over nine months in 1990, 47% over 30 months in 2000-02 and 50% over 18 months in 2007-09. So far this time markets have dropped "only" 15% over 10 months. Nevertheless, we would be surprised if we got to the end of 2019 without having encouraged our clients to use some of their cash to buy more equities (probably at lower prices than are on offer now).

Like everyone else, we are keeping a weather-eye on the US treasury bond yield curve – because an inversion of the difference (or "spread") between 2-year and 10-year yields has over many cycles been a harbinger of recession in the US. This spread is still positive, though only to the tune of 17 basis points (i.e. 0.17%), compared with, say, 50 basis points at the end of 2017. If this number turns negative, it would be an almost surefire sign that the longest economic expansion in US history is over. The effects of a US recession would quickly ripple across the world. Meanwhile consider just this single dashboard warning light: some $3trn of US corporate bonds is currently rated just one notch about "junk" bond status. Scary stuff. Much of this debt has been issued by energy companies, which are already feeling the painful effects of the slump in oil prices (Brent crude has plunged 35% since October).

And that brings us to the subject of banks – large, systemically important banks, in particular. We observed in our July 2018 Investment Outlook that the share prices of many of the world's largest banks have been trying to tell us something. Those messages are now louder and more alarming: according to independent research house ASR, the share prices of 34 out of the 37 systemically important financial institutions (or "SIFIs" for short) meet the down-20%-or-more criterion for a "bear market" (measured in dollar terms from 12-month price peaks). As recently as June 2018, only 16 of the 37 SIFIs met the criterion. So whatever is going on has got much worse.

What *is* going on in the global banking system? Since the crisis of 2008, the world's central banks, led by the US Federal Reserve, have been flooding the global financial system with money (or "liquidity" as it is sometimes termed) by means of quantitative easing ("QE"). These money-printing programmes have mostly come to an end. Higher interest rates, especially in the US, mean that more dollars are needed to finance both the yawning US budget deficit and the mountain of corporate debt that has accumulated. This in turn has made it harder for banks everywhere to secure dollar funding. There has also been a widespread sell-off of corporate credit, to which all major banks are exposed – which is adding to investors' nervousness about the shares of banks. (For anyone looking for a single yardstick by which to measure that nervousness, here's one: the shares of the mighty Deutsche Bank are valued at a price/book value ratio of just 0.2x. In other words, investors in aggregate are saying that the equity of Deutsche Bank is worth only one-fifth of the figure last put on it by the bank's auditors.)

Talking of Europe, the European Central Bank's decision to stop buying bonds (i.e. to end its QE efforts) is pushing up corporate bond yields (and depressing bond prices and thus impairing banks' assets). For the grand panjandrums of the European Union, the main agenda item is definitely not Brexit – it's Italy. Three times in a decade external forces have spared the Italian economy its day of reckoning. But a recession now would cause the country's already parlous fiscal position to spiral quickly out of control – and would thus presumably set its populist government on a collision course with the Eurocrats. What Italy needs, *inter alia*, is a devaluation of its currency – an escape-valve denied to it by the vice-like grip of the single currency. The euro is a moral issue, given its deleterious effects on the employment prospects of several generations of young Southern Europeans. More pertinently for investors, the euro has from its inception – and by definition – been the bomb that would sooner or later explode beneath Europe's banking system. Time to take cover. This is just one reason why we are keeping our own investment powder dry.

Let's look on the bright side. We may now be seeing the formation of a coincidence of factors that will finally – 10 years after the global financial system's heart-attack – allow unproductive capacity to be winnowed from economies and asset prices to be re-set (which will make a change from having them rigged by central banks and their dangerous money-printing policies). Such a process is likely to be both risky and painful. But, as long as the inevitable challenge from neo-Marxists like Corbyn & Mélenchon can be repelled, it offers a chance of re-birth for Capitalism – the system that *every day* lifts more than 100,000 people out of extreme poverty across the world.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	17	18.3
International Equities	41	39.7
Fixed Income	17	22.6
Alternatives	8	10.4
Commercial Property	4	0.6
Cash	13	8.4
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC
UK Equities		**17**	**+2**	
UK	VUKE LN	8	+1	0.09
UK	VMID LN	9	+1	0.10
International Equities		**41**	**-5**	
US	VUSA LN	7	-3	0.07
	XDPG LN	8	-2	0.30
Euro	VERX LN	5	-4	0.12
Japan	VJPN LN	7	0	0.19
Asia	VAPX LN	6	+1	0.22
Emerging Markets	VFEM LN	8	+3	0.25
Fixed Income		**17**	**+1**	
Government Bonds				
UK	IGLS LN	4	+1	0.20
US	IBTS LN	5	+1	0.20
Index Linked Gilts	INXG LN	3	-1	0.25
EM	JPEA LN	3	0	0.40
Corporate Bonds				
US	CORP LN	2	0	0.12
Alternatives		**8**	**+3**	
Gold	PHAU LN	3	0	0.25
Infrastructure	3IN	2	0	1.48
Agribusiness	SPAG LN	1.5	+1.5	0.55
Water	IH20 LN	1.5	+1.5	0.65
Commercial Property		**4**	**0**	
Europe	IPRP LN	2	0	0.40
Asia	IFAS US	2	0	0.48
Cash	GBP	**13**	**-2**	
Total		**100**		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
Cal Year 2018	-3.7%	-2.9%	-0.8%
Since inception(1/1/2015)	30.1%	28.0%	2.1%
CAGR	6.8%		