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Courtville Partners Investment Outlook – July 2018

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

- Is the recent weakness in bank shares an early signal of renewed distress in the global financial system?
- Are high Italian bond yields signalling renewed stress on the Euro? Potentially catastrophic for economic growth in the Eurozone?
- The stronger US dollar is painful for emerging markets. We remain firm believers in the long-term benefits of investing in EM economies, but reduce short-term exposure for tactical reasons.
- Central bankers should have normalised monetary policy sooner. In our view, 10 years of so-called emergency measures have short-circuited the capitalist system, widened wealth inequality and help foster the rise of populism, not to mention the dormant, discredited theories of Marxism.
- In short, we have become more cautious. We reduce the exposure to both European and EM equities in our model portfolio; and we increase the exposure to short-dated fixed income securities.

We now know that the world's stockmarkets were indeed "resting" back in 1Q18, which is what we suggested in our April Investment Outlook. The most recent quarter has seen major equity markets rebound convincingly, led by Wall Street (up 5%). Is all well, then, in the state of risk assets? No, it isn't. And there is one particular sub-sector of global stockmarkets that we want to highlight, namely the "SIFIs" (or "Systematically Important Financial Institutions"). As the term implies, SIFIs are mostly large banks or insurance companies, the financial health of which is likely to be considered by regulators and central banks as important for the good order of the overall global financial system. What is remarkable is that, while global equities have risen roughly 1% so far this year (in US$ total return terms), the share prices of some SIFIs have fallen by chunky percentages. Approximately $800bn (or 18%) has been wiped off the aggregate market value of the SIFIs since the late-January peak. But many individual SIFIs have fared much worse than this average; and the shares of 18 out of 40 are now officially in bear market territory (i.e. 20% or more below their 12-month peaks). Deutsche Bank, for example, is 44% below its 12-month high (in US$ terms); Nordea is down 29%; and ICBC (Industrial & Commercial Bank of China) is off 28%. Although many of the institutions on the list are European, it may be a mistake to see the savage markdowns as being only – or even predominantly – the result of Eurozone jitters in the wake of Italy's new populist government, Chancellor Merkel's political strife and so on. After all, the list includes names from China, Japan, Switzerland, Sweden and even the US.

So what is going on with the big beasts of the global financial system? Unfortunately, that is not clear. The recent strength of the US dollar seems to be creating pressure – and even stress – within the world's banking system. (Banks' willingness to lend to each other has been a keenly watched barometer of this since the tumultuous events of 2008/09 – and seems for now to be in decline.) Another factor may be the deterioration in corporate credit markets, where spreads have been rising in both the US and the Eurozone. Whatever the underlying reasons, the obvious question is how long central banks and other policymakers will wait before they feel obliged to respond. Historically the US Federal Reserve has been quicker to react to weakness

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among SIFIs than has the European Central Bank. On the other hand, the signs of weakness among SIFIs are concentrated this time (and for now) in the Eurozone. It is worth pointing out too that SIFI share price falls of 15-20% have typically been followed by 50-100bp declines in US 10-year Treasury bond yields - which makes intuitive sense if stresses within the banking system lead to softness in the wider (or "real") economy.

On a related subject we were struck by the argument of a recent report from Gavekal Research pointing out the extent to which Italy's public finances are back in a so-called "debt trap". From a purely mathematical perspective, the prevailing yield gap between German and Italian 10-year government bonds (0.4% plays 2.7%) implies a 20% devaluation of the Italian currency. Of course, devaluation is impossible within the single currency area, as Greece discovered a while ago. The risk (which is hardly new) is that this logical conflict will be played out via a new Euro crisis – with all the misery that this would imply for both European banks and growth in the Eurozone.

Another stand-out underperformer in 2Q18 has been emerging market equities (down over 5% is US$ terms). In contrast to the SIFIs, almost everyone thinks they know the main reason for this poor performance – namely US dollar strength, encouraged by the Fed's regular interest rate increases. At a simple level, a stronger dollar makes life harder for emerging economies in at least three ways. First, dollar-denominated imports become more expensive (which tends to push up inflation and thus domestic interest rates). Second, dollar-denominated debt, whether public- or private-sector, becomes more expensive in local currency terms to service and repay, which diverts resources away from investment and ultimately consumption. Third, higher rates of return on dollar bonds tend to lure money flows back to US assets and away from emerging markets. We are still firm believers in the long-run benefits of investing in emerging market economies. History has shown that the returns outweigh the risks (and periodic realities) of currency depreciation. Nevertheless, there are early signs that inflation is indeed pushing up in many of these markets (not helped by this year's spike in oil prices, of course).

With more amber lights flashing across most asset classes, we feel it is prudent to tilt our model portfolio more in the direction of fixed income, but at the shorter-dated end, and away from equities. Our model portfolio has slightly underperformed the FTSE Russell Private Investor Balanced Index so far this year. We have been too cautious this year, especially with such a high allocation to cash while equities in general have continued to rise. If anything, however, we have become even more cautious over the last three months. We are reducing our exposure to European and Emerging Markets equities (for reasons set out above), slightly increasing our exposure to US equities and adding exposure to short-dated fixed income securities. This will lower the volatility of the model portfolio even further and should make it more defensive in the event of a new Euro crisis or increase in emerging market inflation. Although US equities continue to look pricey by long-run historical standards, very strong earnings growth from corporate America has helped to bring valuations down somewhat.

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We have long been exasperated by the behaviour of many of the world's central banks in the decade since the last global financial crisis. We see no justification – almost by definition – for "emergency" monetary policy that remains in place for 10 years (and counting). It is one thing to intervene to prevent, say, the failure of systemically important banks, which are both the

guardians of ordinary people's savings and the "gearboxes" of any modern economy; but it is quite another to maintain a zero-interest rate policy for a decade with all the attendant distortions. Standing here in mid-2018, we cannot be the only ones who wonder what weapons the Bank of England, for example, would be able to deploy to combat another major financial crisis. Conventional monetary stimulus would not be in the armoury, barring a series of shock interest rate rises in the next year or so. Well, we shall all find out in due course.

In the meantime, we do not think it an over-reaction to attribute to central banks much of the blame for the revival of the reputation – and baleful philosophy – of Karl Marx (born 200 years ago this year). Bit of a stretch? Not really. Many of Marx's criticisms of capitalism have proved quite risible (e.g. the labour theory of value, historical determinism, belief in dialectical materialism as a science and the timing of global revolution – to name a few). And his insistence that capitalism contained within it the seeds of its own destruction has been made to look foolish time and again by the sheer ingenuity, flexibility and unrelenting technological progress of the capitalist economic system.

Having said all this, Marx's insistence that the manipulative capitalist class somehow holds the proletariat in a state of unwitting subjugation (social media as the modern-day opiate of the people?) finds a sinister echo, we think, in the huge widening of wealth inequality that has been one of the toxic consequences of 10 years of ultra-low interest rates. "Emergency" monetary policy (including quantitative easing) has been directly responsible for preventing the winnowing of unproductive capacity on which capitalism crucially depends, however painful it may be. Quite simply, central banks have short-circuited the capitalist system. In our view, this is the single most potent reason why Marxism not only gets a hearing these days, but is warmly embraced by large sections of the population in the West. Given the incalculable human misery inflicted by the USSR's 70-year-long experiment with communism, Karl Marx's dogmas should be as extinct as the man himself. But they are not. We blame the central bankers.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	20	21
International Equities	42	41
Fixed Income	15	21
Alternatives	5	8
Commercial Property	4	1
Cash	14	8
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC
UK Equities		**20**	**0**	
UK	VUKE LN	11	0	0.09
UK	VMID LN	9	0	0.10
International Equities		**42**	**-4**	
US	VUSA LN	8	+2	0.07
	XDPG LN	6	0	0.30
Euro	VERX LN	11	-3	0.12
Japan	VJPN LN	7	0	0.19
Asia	VAPX LN	5	0	0.22
Emerging Markets	VFEM LN	5	-3	0.25
Fixed Income		**15**	**+4**	
Government Bonds				
UK	VGOV LN	0	-2	0.12
UK	IGLS LN	3	+3	0.20
Index Linked Gilts	INXG LN	4	0	0.25
US	IBTS LN	3	+3	0.20
EM	EMB US	3	0	0.40
Corporate Bonds				
US	VCLT US	2	0	0.12
Alternatives		**5**	**0**	
Gold	IAU US	3	0	0.25
Infrastructure	3IN	2	0	1.48
Commercial Property		**4**	**0**	
Europe	IPRP LN	2	0	0.40
Asia	IFAS US	2	0	0.48
Cash	GBP	**14**	**0**	
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
YTD	-0.2%	0.8%	-1.0%
Last 12 months	4.9%	6.1%	-1.2%
Since inception(1/1/2015)	36.6%	33.0%	3.6%
CAGR	8.8%		

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