Courtville Partners – Investment Outlook, July 2019

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

- Markets – and therefore investors – are between a rock and a hard place: equities are not especially cheap by historic standards, but bonds are very expensive indeed.
- The consensus believes inflation to be dead. We don't – and there are signs that it may make a comeback. If it does, the value of longer-dated bonds will plummet.
- We prefer equities to bonds, not least because equities are claims on real assets.
- We are, however, wary of European stock markets. A full-blown recession in the Eurozone strikes us as the most plausible trigger for the global economy's next big crisis.
- History suggests that the EU's policy response will too little too late – even if its institutions had the standard monetary weapons with which to fight recession (which they don't).
- It is possible that von der Leyen and Largarde bring greater pragmatism to Eurozone policy. But the EU's institutional structures militate against it. The euro remains an orphan.

There is always someone worse off than you. If you invest in UK risk assets and are worried about what a no-deal Brexit on 31st October might do to the value of your portfolio, you might spare a thought for your counterparts in the Eurozone. The propensity of the EU's institutions to pursue precisely the wrong policies must drive Eurozone investors to distraction.

- No growth to speak of in the Italian economy this century? The European Commission orders Rome to cut spending and raise taxes.
- Falling fiscal surpluses in Germany? The government sees this as cue for lower investment spending.
- Eurozone economic growth petering out? The ECB suspends its bond-buying programme.
- Rising risk of a credit crunch? Banking supervisors instruct banks to raise capital and boost loan loss provisions.

In sum, is it any wonder that the Eurozone has been in recession for roughly half the decade since the Great Financial Crisis of 2008? No, it is not. Think of the turbocharged growth that the US has enjoyed over the same period – and weep. And let's not even mention the world's emerging economies, which have been growing faster still.

Time and again, when the macroeconomic facts have called for *counter*-cyclical action, the Eurozone's monetary and fiscal authorities have instead doled out foul-tasting *pro*-cyclical medicine. It would be funny – in a sick joke kind of way – if only it wasn't so serious. And why is it serious? Because full-blown recession in Europe looks like the most plausible trigger for the global economy's next major crisis. Routinely perverse policy response, plus never-sorted weakness in the banking system, is a potentially toxic combination for the Eurozone – and, via interbank contagion, for the rest of the world.

It gets worse. Even if the Eurozone authorities saw the light and for once met recession with a counter-cyclical response, the policy headroom at their disposal is more limited than it has ever been. In previous recessions, the ECB has cut official interest rates by an average 300 basis points (i.e. 3%). With benchmark rates already at 0% (where they have been for over three years), the "historically average" response will not be an option. Conventional monetary policy is exhausted before the next recession even begins. No wonder there is so much interest in *unconventional* monetary policy – especially, but not only, on the left of the political spectrum. A tentative consensus is coalescing around the likely need in the not-too-distant future to coordinate both fiscal and monetary policy in order to jump-start economies. But that presents a huge problem for the Eurozone – which is *not* a single country, does *not* have a single government and lacks a money-printing central bank. We can only wish Christine Lagarde good luck with this poisoned chalice. Even in parts of the world where these structural impediments don't apply (the US or the UK, say), the adoption of twin-track monetary/fiscal policy of an unconventional kind would be fraught with difficulty. As we argued in April, Modern Monetary Theory – aka the Magic Money Tree – is fundamentally flawed, not least in its failure to understand what money actually is.

It is becoming the fashion to argue for lower exposure to equities – mainly because so far this year they have returned a lavish 16% (in dollar terms), compared with just 5% for global bonds. Once more defying the many sceptics, US equities have led the way among major markets, racking up gains of 18%. This has come about despite the steady shift to an inverted yield curve (i.e. short-term interest rates higher than longer-term rates), which has been accepted as a reliable harbinger of recession since Warren Buffett was in short trousers. But, as with any graph, it depends when you start. In fact, global equities are broadly unchanged over the last 18 months. Meanwhile corporate earnings have continued to rise – which means that equities are better value than they were, *ceteris paribus*. Most government bonds, however, remain wildly overvalued in our view. Indeed, Charles Gave of Gavekal Research has been poking fun at the consensus view. We live in a generally deflationary world, says the consensus; and the biggest risk to portfolios lies in a "growth shock" (perhaps a sharp slowdown in China, say, or suddenly weaker demand from US consumers). Therefore, the thinking goes, investors should continue to pay up for growth wherever they can find it (hence the bubble in technology stocks); but they can and should hedge the attendant risk by owning expensive government bonds. As Mr Gave points out succinctly: when was it ever sensible to hedge one overvalued asset with another overvalued asset? Quite.

Our view? As we have said before, equities are not especially cheap by historic standards. But bonds are very expensive indeed. That is why we continue to overweight equities in our Model Portfolio and to underweight bonds. Hang on, though: couldn't it be argued that the lofty valuations of both equities and bonds are sending signals that are inconsistent, perhaps even contradictory? Not necessarily. Instead, the two asset classes may simply be telling different stories – or even two sides of the same story. How so? Well, bond investors are naturally interested above all in the outlook for monetary policy (i.e. interest rates) and for inflation, which together influence bond prices more than all other factors; but they tend to be much less concerned with prospective economic growth – except insofar as it affects interest rates or inflation. Equity investors, by contrast, care deeply about the outlook for economic growth – because it is a major driver of corporate cash flows. As things stand, bond markets seem to be saying that short-term interest rates will remain low for years to come, regardless of growth, whereas equity markets are expressing investors' collective view that economic growth will also continue for many years – partly because interest rates are so low.

One of the other reasons we still opt for equities over bonds is that equities count as *real* assets. They represent a claim on the profits and cash flows of real companies. Bonds, on the other hand, are just IOUs, no matter how illustrious the issuer; and their returns to investors are strictly nominal, i.e. they take no account of inflation. (Yes, inflation-linked bonds are an exception; but they are relatively rare beasts.) To the extent that we can divine it, the overwhelming consensus appears to be that disinflation is here to stay in most parts of the world. Hardly anyone is talking, let alone worrying, about inflation for now. Sure, this has been the case for most of the decade since capitalism's cardiac arrest in 2008. We imagine that even ten years later central bankers around the world can't believe their luck. They have been able to print as much money as they like without stoking inflation, in the process tearing up macroeconomic orthodoxy. One might almost say that this time it really has been different (famously the most dangerous words in finance). But something is stirring out there. Have you seen the price of gold recently? It is well above $1400/ounce and is up 20% over the last 12 months. Could this be a canary in the coalmine? Defying valuations that were already in nosebleed territory, inflation-linked gilts are up a whopping 15% over the last 12 months. We see inflation as easily the biggest left-field risk for investors – and not just because so few investors have personal experience of investing in an inflationary environment. If nothing else, a US economy running at almost full tilt brings the obvious threat of an inflation spike if economic growth proves stronger than the legions of gloomsters are predicting. Its return may not be imminent; and in any case the timing is impossible to foresee. But one day – and it is only a matter of time – inflation will come roaring back like some hideous antediluvian monster. And at that point, with little warning and even less ceremony, longer-dated bonds will be vaporised.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	20%	18.2%
International Equities	43%	37.8%
Fixed Income	12%	22.9%
Alternatives	9%	11.7%
Commercial Property	4%	0.5%
Cash	12%	8.9%
Total	**100%**	**100%**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC
UK Equities		**20**	**0**	
UK	VUKE LN	9	0	0.09
UK	VMID LN	11	0	0.10
International Equities		**42**	**0**	
US	VUSA LN	6	0	0.07
	XDPG LN	11	0	0.30
Euro	VERX LN	4	0	0.12
Japan	VJPN LN	6	0	0.19
Asia	VAPX LN	6	0	0.22
Emerging Markets	VFEM LN	9	0	0.25
Fixed Income		**15**	**0**	
Government Bonds				
UK	IGLS LN	4	0	0.20
US	IBTS LN	3	0	0.20
Index Linked Gilts	INXG LN	3	0	0.25
EM	JPEA LN	3	0	0.40
Corporate Bonds				
US	CORP LN	2	0	0.12
Alternatives		**8**	**0**	
Gold	PHAU LN	3	0	0.25
Infrastructure	3IN	2	0	1.48
Agribusiness	SPAG LN	1.5	0	0.55
Water	IH20 LN	1.5	0	0.65
Commercial Property		**4**	**0**	
Europe	IPRP LN	2	0	0.40
Asia	IFAS US	2	0	0.48
Cash	GBP	**11**	**0**	
Total		**100**		**0.22%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2019 YTD	10.4%	10.0%	0.4%
Since inception(1/1/2015)	45.2%	42.8%	2.4%
CAGR	8.5%		