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Courtville Partners Investment Outlook – October 2018

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

- Returns from global markets have been mixed this year – strong in the US, but anaemic from most other asset classes.
- Why have US bond yields been rising? Loose US fiscal policy (and thus a growing budget deficit) is beginning to seem both the most likely and the most worrying explanation.
- Higher import tariffs will only exacerbate this problem. The Trump Administration's populist trade policies seem set to have financial consequences that are not yet fully discounted by markets.
- The risk of a new global liquidity crunch is rising.
- In our view, one of the unintended consequences of a decade of quantitative easing (QE) has been to spawn populism and endanger the very future of capitalism.
- Our asset allocations remain very defensive. We are overweight cash and commercial property but remain underweight fixed income. Within equities, we think Europe, Japan and Emerging Markets offer better long-term value than the US. The UK is not expensive; but we struggle to see how the Brexit negotiations, whatever the outcome, can be positive for the UK equity market on a year's view.

American exceptionalism continues – at least as far as stock markets are concerned (and arguably in other areas too). The major US share indices all show fat gains for the year-to-date: S&P 500 up 9%, Russell 2000 (i.e. mid-cap shares) up 11% and NASDAQ up 16%. By contrast, very few of the world's other major equity markets are in positive territory; and the FT World ex-US equities benchmark is down 3% in 2018 (and a chunky 9% below its year-to-date high). Particular brickbats go to China and Emerging Markets, both of which meet the criterion for a bear market (being more than 20% below their 2018 highs). Aside from oil, commodity prices have also been in the doldrums (e.g. copper and gold down 15% and 8%, respectively). Fixed income investments too have failed to offer any respite: the Barclays Global TR Index is down 2% so far this year. And the most watched bond yield in the world (the 10-year US Treasury bond) has risen 65 basis points since January and now seems well established above the psychologically important level of 3%. Only a month or two ago many pundits were predicting that the 10-year yield would see 2.5% before 3.5%. Not many of them are saying it now. We are going to examine in more detail the reasons for this, which will require us to reflect on what is going on at the very heart of the global financial system.

Why has the yield on the 10-year US Treasury bond risen so far, so fast? And what might it portend? We share the view of Gavekal Research, who put forward three plausible explanations. First, it is possible that investors have become more optimistic about economic growth, either in the US or globally. But there is little evidence from recent macroeconomic data to support this view. If anything, consensus expectations for growth are being trimmed. Second, inflation may be looming larger in bond investors' thoughts. After all, wage growth in the US is running at its fastest rate since 2009 (almost 3% in August) – the product in part of an unemployment rate that is now below 4% (a level last seen 18 years ago). Is the infamous Phillips curve (i.e. the causal relationship between unemployment and inflation) reasserting itself? Is the "Goldilocks" era of strong economic growth and subdued inflation at an end? We have been wary of the risk of resurgent inflation for a long time; and, although not ready to say "We told you so", we remain distinctly

anxious on this score. The third possible explanation for the jump in US bond yields lies in the sheer laxity of US fiscal policy. President Trump's tax cuts may have boosted economic activity. But are investors now beginning to worry that this near-term fillip has been bought at the expense of medium-term fiscal responsibility? It seems quite likely, especially since higher yields have been accompanied by a *weaker* US dollar. (One would expect to see the dollar *strengthen* if higher yields were a response to accelerating economic growth.)

Naturally enough, the investment implications of each of those explanations tend to be quite distinct. But, out of the three, it is the third possibility – namely, that investors are beginning to fret over America's bigger budget deficits and rising public-sector debt – that should induce the most nervousness. As Gavekal Research's analysts are keen to remind us, it is not as if the present state of the US government's finances is particularly healthy. The stock of public-sector debt has already risen from roughly 65% of GDP when Obama took office in early 2009 to 110% by 2016 and is on track to reach 117% by 2023 (according to the IMF). Simple mathematics dictate that a 1% rise in interest rates adds $200bn p.a. to the Federal Government's interest bill – equivalent to 5% of annual government spending. In the near term, it seems a reasonable bet that the US budget deficit will continue to deteriorate, almost certainly causing a weaker dollar in the process, while inflation continues to tick upwards. But this is not a sustainable path in the medium or longer term. So what might happen to change the course of US fiscal policy? Perhaps the government will rein in its spending on either welfare or the military – or both. (Together with interest on the national debt, these two items account for almost all the Federal Government's spending.) Cuts in welfare would be well received by bond investors and would surely drive the dollar higher. By contrast, reduced spending on the military would bring geopolitical angst to Europe and Japan. But neither scenario seems probable for now. Instead, it seems more likely that taxes will rise, especially if the Democrats do well in the forthcoming mid-term elections. Such an outcome, however, would hardly be propitious for consumer spending, company profits or stock markets.

If President Trump appears unfussed by a yawning budget deficit (and thus rising debt), he continues to be famously exercised by his country's external deficits (both the trade and current accounts), which – as Prof Tim Congdon argues in a recent piece – he sees as evidence that foreigners are somehow taking advantage of the US. Higher tariffs are a means to make foreign goods more expensive, leading Americans to buy fewer of them – which in turn will transform external deficits into surpluses. Ta-dah. If only it was that simple. In reality, US trade policy has many dimensions – and contains internal contradictions. Even if higher tariffs do reduce the external deficits, much looser fiscal policy makes a sharp increase in external borrowings almost inevitable. For although it is theoretically possible that the government's extra borrowing could be absorbed by the US private sector (rather than foreign investors), in practice the behaviour of American (and other nations') private sector investors has been stable over long periods of time. Much more probable is that the US government will have to continue selling large amounts of debt to foreigners, thus keeping the current account firmly in the red. In other words, loose US fiscal policy makes it a racing certainty that external deficits will endure, notwithstanding any impact from higher tariffs. What will the Administration do if this proves to be the case? Will it ramp up import tariffs ever further? Could this be one of the fears that are spooking bond markets?

However many contradictions there may be within US trade and fiscal policy, who could deny that the excess savings of the two mercantilist superpowers, China and Germany, are just as much of an obstacle to the world's financial harmony? Historically the US has been happy to act as the consumer-of-last-resort, generating "excess demand" to offset the "excess savings" of China and Germany in particular. No longer. "Create your own demand for your own goods" is what Washington seems to be saying these days. Meanwhile the Federal Reserve no longer feels obliged to act to correct any shortage of dollars in markets outside the US. This represents a change from

its historic approach – though it is undoubtedly consistent with the US government's use of the almighty dollar as an instrument of foreign policy. Against a backdrop of rising US interest rates, these are some of the factors that are feeding fears of an impending global liquidity crunch (i.e. a shortage of dollars).

As Prof Congdon puts it, "Big budget deficits and increased barriers to imports are the ugly twins of economic populism". Fine. But we see no mystery in the waves of populism that have crashed onto the political shores of many countries. The tenth anniversary of the collapse of Lehman Brothers in September 2008 – and the global financial meltdown of which it was a part – has been a pretext for endless press articles examining that near-death experience. How much of this commentary has made the connection between a decade (and counting) of quantitative easing and the surge in populist politics? Not much. Yet to us it is one of the few crystal-clear aspects of the present-day financial panorama. Ultra-low interest rates and their expansionary effect on net present values have brought even bigger wealth to those who were already wealthy, but have at the same time inflicted huge financial pain on anyone without a stock of real assets (which includes most of the world's population). How can anyone be surprised that this pain has spawned political anger (otherwise known as "populism")? After a decade of "emergency" monetary policy, courtesy of our central banks, it is not surprising – though it *is* hugely depressing – that so much political discussion nowadays is about wealth re-distribution, not wealth creation. Capitalism is the best system ever devised for pulling people out of poverty (and continues to do so at the rate of roughly 250,000 people every day); but it has been put in mortal danger by central bankers. Ironic, no?

What does all this mean for our asset allocation view? In short, not a great deal. We were already very defensively positioned and remain so. Our model portfolio has performed in line with its benchmark over the last quarter and has slightly underperformed year-to-date. We have been wrong to be underweight the US stock market, which has been the only major market to show significant gains in 2018. We have slightly increased our US weighting, although remain underweight overall for reasons outlined above; and we have further reduced our UK exposure. It is difficult to see how the Brexit negotiations can end well for either camp in terms of economic growth and investor confidence over the next year (or even two). A good deal of this is already in the price; but it is too soon to anticipate a recovery in UK asset prices even though valuations are less stretched than elsewhere.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	15	18.3
International Equities	46	39.7
Fixed Income	15	22.6
Alternatives	5	10.4
Commercial Property	4	0.6
Cash	15	8.4
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC
UK Equities		**15**	**-5**	
UK	VUKE LN	8	-3	0.09
UK	VMID LN	7	-2	0.10
International Equities		**46**	**+4**	
US	VUSA LN	10	+2	0.07
	XDPG LN	10	+4	0.30
Euro	VERX LN	9	-2	0.12
Japan	VJPN LN	7	0	0.19
Asia	VAPX LN	5	0	0.22
Emerging Markets	VFEM LN	5	0	0.25
Fixed Income		**15**	**0**	
Government Bonds				
UK	IGLS LN	3	0	0.20
US	IBTS LN	3	0	0.20
Index Linked Gilts	INXG LN	4	0	0.25
EM	JPEA LN	3	0	0.45
Corporate Bonds				
US	VCLT US	2	0	0.12
Alternatives		**5**	**0**	
Gold	PHAU LN	3	-2	0.39
Infrastructure	3IN	2	+2	1.48
Commercial Property		**4**	**0**	
Europe	IPRP LN	2	0	0.40
Asia	IFAS US	2	0	0.48
Cash	GBP	**15**	**+1**	
Total		**100**		**0.20%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
YTD	1.6%	3.0%	-1.4%
Last 12 months	4.3%	6.2%	-1.9%
Since inception(1/1/2015)	39.2%	35.9%	3.3%
CAGR	8.2%		