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Courtville Partners – Investment Outlook, October 2019

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

- Most asset classes have had a bumper 2019 so far: the MSCI World Equities index is up 16%, led by the US, China and (surprisingly) the Eurozone. Party time? Not really.
- Over the last 12 months equity returns have been much more subdued: the same global index is up a meagre 1%. As so often, it depends where you start your graph.
- Meanwhile, will Germany heed the departing Mario Draghi's plea? "It's high time for fiscal policy to take charge. Governments with fiscal space should act in an effective and timely manner."
- If Germany's government was to give any serious sign of loosening its fiscal straitjacket, then investors should dive into Eurozone stock markets with enthusiasm.
- Overall, we remain happier to own equities than bonds. Equities at current levels routinely yield much more than bonds. We are living in an upside-down world.
- The global stock of government bonds with negative yields has now grown to $17trn. Only if you think there is a "greater fool" (who may very well be a central banker) would you buy a bond that is otherwise bound to lose you money in nominal terms.
- For the first time in a very long time the UK is starting to look interesting. Yes the immediate outlook is dire, but is largely discounted. There is value in both UK equities and sterling.

According to literary legend, F. Scott Fitzgerald once said to Ernest Hemingway, "Let me tell you about the very rich. They are different from you and me." Hemingway is reputed to have shot back: "Yes, they have more money." Although economics and literature are not natural bedfellows, we might nowadays re-cast the writers' exchange thus: "Germany is different from other countries. Yes, it has more fiscal firepower."

If you have read our previous Investment Outlooks, you will know that we don't count ourselves as fans of the Eurozone – its stock markets, its currency and certainly not its central bankers. We have even gone as far as to identify Eurozone banks as the most likely source of the next serious financial crisis. That might still be true. But something may be stirring on the Continent. In mid-September, Mario Draghi signed off as President of the European Central Bank; and even we must admit that he did so in spectacular style (to the extent that central banking can ever be considered a spectacle). Draghi's package of measures included a 0.1% cut in the deposit rate to minus 0.5%, with a promise not to raise it until the Bank's 2% inflation target is hit; another big helping hand for the Eurozone's beleaguered banks via special funding operations; and a promise to buy €20bn of assets every month "for as long as necessary". Having unveiled all these monetary measures, Draghi warned that they would not be enough by themselves to pull the Eurozone's economy out of its slump. "It's high time for fiscal policy to take charge," he declared. "Governments with fiscal space should act in an effective and timely manner." He could only have been clearer if he'd added "Are you listening, Berlin?"

What does the ECB's latest package mean in practice? The pledge to buy €240bn of assets p.a. until further notice gives the ECB easily enough capacity to absorb *all* the debt issued by Eurozone governments in aggregate (and then some). In addition, the ECB also undertakes to roll over the €16bn of debt already on its balance sheet as this stock matures. The bottom line is that yields on government bonds across the Eurozone will not be allowed to rise for many years, barring a major

change of policy. Given currently rock-bottom (or even negative) yields across the region, this will allow Eurozone governments to fund their budget deficits for free (at worst) for years ahead.

For a country such as Italy, where the budget deficit is made up entirely of interest costs, this is radical stuff. But for Eurozone countries in general Draghi has at a stroke created room for fiscal stimulus on a pharaonic scale. And the country with the most room is – you've guessed it – Germany. Since the crisis of 2008, the German constitution has required the government to balance its federal budget across the economic cycle – a requirement known and lauded in Germany as "*schwarze Null*" (or "black zero"). The combination of no budget deficit at all and the sheer size of the German economy generates some mind-boggling numbers: running a budget deficit equivalent to just 1% of GDP, say, would imply extra federal spending of about €35bn. Germany's government debt has fallen from 82% of GDP in 2010 to 61% last year, thanks to the "black zero" policy. The extra spending headroom could easily be multiples of €35bn. Pick almost any number you like.

So has so-called Super Mario bowed out with a genius plan to revive the Eurozone's economy? Can it be that simple? Probably not. The blockage in the system is Germany's political and constitutional veto on applying Keynesian demand management. Could the Bundestag overturn the veto? It seems unlikely given the two-thirds majority needed in both houses. Could a government already under fierce political pressure from the Greens dress up extra spending as being necessary to save the planet? Possibly. Or will inertia prevail until the next crisis? Probably. The brutal truth is that for now at least Germany remains wedded to both its fiscal conservatism and to its blind faith in exports as the main motor of economic growth. If, however, Germany's government gave any sign of loosening its fiscal straitjacket, then investors should be alive to the opportunity that this would bring – and should dive into Eurozone stock markets with enthusiasm. It is too early to say that this moment has arrived; but we are keeping a weather eye out for it.

Meanwhile the main worry for investors in the 84% of the world that isn't the Eurozone has been fear of an economic slowdown, exacerbated by a host of factors (the US/China trade stand-off, tensions between Saudi and Iran, Brexit – and so on). There is a good argument to be made, however, that what economic slowdown there has been is largely a German phenomenon. Forecasts for global economic growth have been slipping for most of this year; but forecasts for German growth have been slashed. This makes sense: weaker demand for German-made cars and engineering goods generally has hit that export-addicted economy hard. In the US, by contrast, there are few, if any, data to suggest that a scary downturn is imminent. And now that the Federal Reserve has started cutting interest rates again, it becomes quite easy to imagine growth in the US picking up markedly in a few months' time. We might also choose to factor in the looming presidential election, which may serve as an incentive to dial down the trade war rhetoric. All this should be good for equities, other things being equal. Even if the result of the Fed's rate cuts proves to be an acceleration in inflation rather than in real economic growth, the damage to equities ought not to be serious. For bonds, though, faster inflation would surely be disastrous.

Our valuation-based antipathy to bonds of almost all kinds has led us to miss out on the gains that have accrued from the renewed fall in yields this year. The investment convention is that falling long bond yields are a warning of decelerating growth; and the inversion of the US treasury bond yield curve earlier this year was cited by many as a harbinger of a US recession. But there is little sign yet of recession in the US. So what is going on with bond yields? And does any of it matter? In its shortest form, our view is that bond yields for now have lost whatever predictive power they may have once had. The near-halving over 12 months of the yield on 10-year US treasuries to 1.65% and the collapse in 10-year German bund yields from 0.50% to minus 0.60% (to take

two big examples) are signs only of investors' gathering belief that central banks will keep yields suppressed for years to come. Besides, if bond yields did mean anything, why would 10-year Greek bonds yield less than 10-year US treasuries? This is clearly madness; and it cannot end well.

What has been going on in markets? On the face of it, most asset classes have had a bumper year so far: the MSCI World Equities index is up 16%, led by the US, China and (surprisingly) the Eurozone. Other assets have done well too: global bonds up 6%, gold up 14% and commercial property (MSCI World REIT Index) up 24%. Party time. Looked at over the last 12 months, however (thus taking in the slump of late 2018), equity returns in particular have been much more subdued: the MSCI World Equities is up a meagre 1%, which is some way adrift of the 6% return from global bonds over the same period. As usual, it depends where you start your graph.

Despite bonds outperforming equities over the last 12 months, we are still happier to own equities than bonds. Equities at current levels routinely yield much more than bonds. Compared to most of the post-War period, we live in an upside-down world in which investors resort to buying equities for income and bonds for… Well, barring a re-run of the 1930s, we don't really understand why any investor would buy most government bonds nowadays (unless that buyer is a central bank with no interest in fundamentals or valuation). But that hasn't stopped the stock of government bonds with negative yields growing to $17trn. That is a lot of bonds guaranteeing capital losses for anyone holding them to maturity. Only if you think there is a "greater fool" (who may very well be a central banker) would you buy a bond that is bound to lose you money in nominal terms. Crazy.

So fixed income looks to us like a bubble; and it is too soon to buy Eurozone equities. Is there value to be found anywhere? Surprisingly, given the current chaos, the UK assets are starting to look interesting. Yes the UK is gripped by a political and constitutional crisis; it may yet have to cope with the fall-out from a no-deal Brexit; and, to cap it all, it faces the mortal danger of being broken on the wheel of a Marxist government. Yet all of this is known – and therefore largely discounted. Can it get worse? Of course. Corbyn might actually win a General Election. Both UK equities (and sterling) have already done much worse than other developed markets over the last three years. UK equities now trade on a forward P/E of 12x and a yield of nearly 5%, which is both a 30% discount to other developed markets and is close to the bottom of the 30-year range. Stock markets discount expected events. What if a post-Brexit economic shock is not as bad as currently discounted and Corbyn doesn't win the election? There is a case for thinking that UK asset valuations are already discounting a disastrous scenario. In other words, the bad news may be in the prices of both the FT All Share Index and the pound sterling

Finally, a quick reminder of a favourite Courtville bug bear: high fees. "Wealth Management is going to cost you 3-4% of your assets in year one (set-up costs) and upwards of 2% on an annual basis. That sounds shocking. It is." So wrote Merryn Somerset Webb in the Financial Times last week. As so often, she is bang on the money. At Courtville we do our level best to ensure that our investment advice is thoughtful, logical, rational and appropriate – but of course we cannot promise that it is infallible. In the same article Merryn suggests that only wealth managers with serious economies of scale have much of a hope of getting total costs below 2% p.a., which is arguably evidence that wealth management is not yet a fully disrupted industry. We disagree. Fees are the *only* thing that any investor can control; and we can promise that with our approach total fees for any reasonably sized portfolio will come in much lower than the 2% p.a. figure cited in Merryn's article.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	21	18.3
International Equities	46	39.7
Fixed Income	12	22.6
Alternatives	9	10.4
Commercial Property	4	0.6
Cash	8	8.4
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC
UK Equities		**21**	**1**	
UK	VUKE LN	10	+1	0.09
UK	VMID LN	11	0	0.10
International Equities		**46**	**+4**	
US	VUSA LN	8	+2	0.07
	XDPG LN	11	0	0.30
Euro	VERX LN	6	+2	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		**12**	**-3**	
Government Bonds				
UK	IGLS LN	3	-1	0.20
US	IBTS LN	3	0	0.20
Index Linked Gilts	INXG LN	2	-1	0.25
EM	JPEA LN	2	-1	0.40
Corporate Bonds				
US	CORP LN	2	0	0.12
Alternatives		**9**	**+1**	
Gold	PHAU LN	3	0	0.25
Infrastructure	3IN	3	+1	1.48
Agribusiness	SPAG LN	1.5	+0.5	0.55
Water	IH20 LN	1.5	+0.5	0.65
Commercial Property		**4**	**0**	
Europe	IPRP LN	2.0	0	0.40
Asia	IFAS US	2.0	0	0.48
Cash	GBP	**8**	**-3**	
Total		**100**		**0.23%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2019 YTD	13.0%	12.7%	0.3%
Since inception(1/1/2015)	46.4%	44.5%	1.9%
CAGR	8.4%		

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