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Courtville Partners Investment Outlook – December 2016

"May you live in interesting times" – Chinese curse (apocryphal)

If we think of all the ways in which the present investment landscape is "interesting", we can quickly compile an alarmingly long list. How's this for starters…? Donald Trump, protectionism, Brexit, the Italian referendum, forthcoming elections in France & Germany, surging oil prices, the return of Russian geopolitical aggression, Chinese banks' bad debts… Scared yet? Well, bond investors are – at least a little bit: 10-year government bond yields in the US have already risen from 1.5% to 2.5% since our September Investment Outlook. We have long been suspicious of the ultra-low yields available from government bonds for the last few years ("an Alice-in-Wonderland world" was how we put it three months ago); and we have warned that yields must rise sooner or later. We have been right so far, then; and we think there is more to come now that inflation shows signs of stirring (more on which later). Curiously, however, equity investors seem not to share the bond brigade's twitchiness and have remained mostly calm: the MSCI World Total Return Index has risen 5% since the US election and 8% so far this year. Are they rational to be relaxed?

The obvious problem facing the world's major economies – and, by extension, investors – is that "monetary policy has reached its effective limits". Who said that? It was the OECD, as it happens, just a few weeks ago, echoing our own long held view. Indeed, the effects of the extreme monetary policy in place across the developed world become ever more perverse. The solvency of banks and insurance companies is threatened (because of their inability to earn high enough nominal returns on their assets). Bank credit tends to become *more* expensive (because low rates squeeze banks' profitability). There is no incentive to invest to improve productivity (because "zombie" competitors' inefficient capacity is not shut down). And the balloon of financial market distortion continues to inflate as investors are pushed towards excessively risky investments in their desperate search for yield.

No central banker on earth would subscribe to this view, of course – at least not in public. Instead, the mantra from the Bank of England and the rest insists that, whatever the deleterious effects of the "emergency" monetary policy of the last eight years, the alternative would have been (and would still be) worse. But this argument denies the timeless virtues of a stitch in time. To put it in more ideological terms, the central bankers are denying one of the basic tenets of capitalism, namely that excess capacity must be threshed periodically from the system (once excessive investment has generated too much capacity). Yes, the threshing is painful, but does allow the economic system to be re-set – for both the suppliers and the users of capital. That has been the way for centuries. But today's generation of central banker believes that monetary policy, if taken to sufficiently extreme lengths, can postpone (or even abolish) the day of reckoning. Like the alchemists of old, they are deluding themselves.

For all the supposed independence of the world's major central banks, most of them are in a co-dependency pact with their governments. Ultra-low interest rates allow the politicians to go on borrowing more and more at nugatory nominal cost. Bill Gross has coined a new phrase to describe this phenomenon: "extend and pretend". Quite. But it will end badly one day when bond investors finally wake from their reverie and demand higher returns.

Investors in equities are – and always have been – in a different position from their bond counterparts, not least because their investments represent stakes in *real* assets (as distinct from the trust-based IOUs issued by governments). For now, at least two influences are likely to continue propping up stock

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markets: first, Trump has been making noises in favour of a looser fiscal policy (lower taxes, increased infrastructure spending, etc.). Second, there are more inflationary straws in the wind than for many years – e.g. the 20% jump in the oil price following OPEC's recent deal to curb output and the tight US labour market. Closer to our UK home, the collapse of sterling should prove beneficial to the economy on balance, but will stoke import prices and thus overall inflation. Other indicators are flashing the same inflationary warnings – among them money supply growth (the broad M4 measure of money in circulation is rising at almost 8% year-on-year, the fastest since 2008) and consumer credit (growing at over 10% p.a., the fastest for 13 years). Something is stirring, for sure.

Against this "interesting" backdrop, how should investors position themselves as 2016 gives way to 2017?

Cash:
We continue to keep a higher level of cash than most mainstream asset allocation models – both for the resilience this adds to a portfolio and the flexibility it provides in the event of a sizeable market setback.

Bonds:
Despite the recent increases in yields, we persist with a relatively low exposure to bonds; and we think that government bonds in aggregate are still very much in "bubble" territory. Early signs of resurgent inflation bring a new threat. With this in mind, we add a 4% weighting to index-linked bonds (i.e. government-issued bonds the yields on which are linked to inflation).

Equities:
Here we make our biggest asset allocation changes. We tilt our UK equity exposure away from mid-cap stocks towards large-cap (i.e. FTSE100 companies) since the latter tend to perform better in response to sterling weakness. Overall, though, we keep our underweight position in UK equities, believing that the drawn out Brexit saga will continue to cast a shadow of uncertainty. With political storm-clouds gathering – or, rather, intensifying – over the Eurozone, we trim our weighting in Continental European equities and reinvest the proceeds in emerging markets, which still offer the prospect of growth in an otherwise low-growth world. Our heavy US equity weighting is unchanged for now. For sure, interest rates are already on the rise in the US; but we see this on balance as a problem of (economic) success. We will keep a weather-eye on the new Administration's policy proposals. Will Trump's anti-globalisation rhetoric fade? (We suspect it will.) Will fiscal policy be loosened much? (We have no idea, though the bond market seems already to have decided that it will be, at least to some extent.) Stagflation – the combination of low growth and high inflation – is a risk.

Alternative assets:
Gold has been a terrible investment during the last quarter and has been overshadowed by the prospect of an increase in official US interest rates (which has now come to pass). Nevertheless, in an investment landscape that features so many identifiable risks and with inflation perhaps making a comeback, we keep faith with the incorruptible metal.

Property:
We make no changes to our property exposure, all of which is in the commercial sector (rather than residential).

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A final thought

The Nobel-winning behavioural economist Daniel Kahneman has been in the news recently. Michael Lewis (of "Liar's Poker" fame) has written a book about how Kahneman and his long-time collaborator Amos Tversky changed the way we think – or, rather, changed the way we think about the way we think. They did this mainly by identifying ways in which human reasoning goes "wrong", often through cognitive biases. It is hardly a surprise, therefore, that Kahneman had strong views on how people go about choosing their investments. Indeed, much of what is nowadays referred to as behavioural finance is based on his work. Given Courtville's approach to investing, it is worth repeating here Kahneman's view on investors' ability to outperform an index by picking individual shares: "The illusion of skill is deeply ingrained in the culture of the financial services industry. Facts that challenge basic assumptions – and thereby threaten people's livelihoods and self-esteem – are simply not absorbed… Large numbers of individuals in that world believe themselves to be among the chosen few who can do what they believe others cannot."

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