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Courtville Partners – Investment Outlook, October 2021

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

- Stick or twist on Asia-Pacific – above all China?
- Government interference in the economy has been disrupting China's stock market all summer. But we don't subscribe to the hyperbole that China is now uninvestable.
- Growth in China (and Asia generally) may be slower than in the recent past; but valuations remain attractive. We stick with our overweight position in Greater Asia, including China, versus the US and Europe.
- We remain sceptical that the current inflationary surge will prove as "transitory" as the consensus seems to believe. If we are right, most types of fixed income are dangerous.
- Even so, bond yields have room to rise before equities look expensive by comparison.
- If capital returns from most asset classes turn out to be lower over the next decade, dividends may once again be the investor's best friend.

Within the weird world of financial services, the business model of Courtville Partners remains unusual – above all in our policy of charging a flat fee for asset allocation advice. Percentages are the enemies of fairness, we believe; and they create the perverse incentive to accumulate assets. Our firm's advice is tailored to each client's individual circumstances. We have nothing resembling a cookie-cutter. Nevertheless, the starting point in every case is our broad view of the world's financial markets, which we express through a "central-case" Model Portfolio, published here each quarter. Since inception, this portfolio has outperformed its benchmark (the FTSE Russell Private Investor Balanced Index) by a little over 8%.

For now, our Model Portfolio arguably exhibits only two major asset allocation choices: overweight equities versus bonds – and, within equities, overweight Asia versus the US and Europe. The first of these choices (equities over bonds) has stood us in good stead this year; but our preference for Asia has been costly, above all because of events in China. The broad Shanghai Composite Index may have risen nearly 3% this year. But the MSCI China A Index, which tracks only those shares available to foreign investors, is flat on the year; and the region's MSCI Asia ex-Japan Index is down 4% year-to-date and 15% below its February high. Given China's many upheavals, financial and regulatory, should we reconsider our faith in Greater Asia's stock markets as a source of equity-friendly growth? Or should we accept that China is at best "a market for sappers" (beware the next landmine) and at worst an impossible place to invest, at least for foreigners? While we're at it, will China remain a bastion of monetary rectitude in a world of zero-interest-rate profligacy?

Disruptions to China's stock market have been piling up all summer, many of them stemming from abrupt changes in government policy. Internet giants have had their wings clipped (Alibaba, Baidu, Tencent, etc.); videogame and online education companies have been crushed; electricity supplies have been curtailed; bitcoin has been made illegal tender; and the Evergrande property empire is likely to be buried beneath a $300bn mountain of its own making. Meanwhile, President Xi has a new favourite phrase, "common prosperity". It sounds mildly sinister to us; but even his critics must acknowledge its wonderful ambiguity.

To the extent that there is any consensus over how to interpret the Chinese government's actions, there is general agreement that Beijing is determined to rebalance the country's economy in ways that lead to materially greater self-sufficiency. You can see their point of view: China imports about

$23bn of oil a month, most of it along sea-lanes patrolled by the US Navy; it also imports $30bn of semiconductors every month (yes, more than oil by value); and it has to rely on the US dollar to settle much of its international trade, especially in energy. China is already the world's second-largest economy; but its leaders make no secret of their ambition to overtake the US. In order to do so, China aims to eliminate strategic vulnerabilities – and at the same time to avoid (what it sees as) the West's mistakes, including de-industrialisation, excessive consumerism and reliance on imports of crucial resources. It is not long since the Trump administration humbled Huawei by banning semiconductor exports to China. We can imagine how this went down in the Politburo.

For investors, the question is whether they can sensibly ignore what will soon be the world's largest economy, even if it is for now only 4% of global indices (i.e. about the same as the UK). Our hunch is that China's economic growth is likely to be lower and lumpier as a result of the pharaonic rebalancing of the economy, but is unlikely to evaporate altogether.

In the near term, the bankrupt property developer Evergrande is making everyone nervous. Could the group's $300bn of liabilities bring down the Chinese banking system? Could this be China's "Lehman moment"? No – not even close. For a start, the US Treasury was trying to *save* Lehman (and did save plenty of others, from AIG to Merrill Lynch to Wachovia). By contrast, Beijing wants to *collapse* Evergrande – in what one analyst called a "controlled explosion". The government is keen to reduce the economy's dependence on property and construction (together some 29% of GDP); and it will ensure the private sector bears much of the pain. In the West, losses may be socialised, even as gains are privatised; but in China – so the message goes – losses will definitely be privatised *pour encourager les autres*. It turns out that markets are pretty sanguine about all this. Chinese government bonds have comfortably outperformed their US equivalents since August; and the renminbi has been stronger than most major currencies all year.

Newsflash: we are living in a world of shortages. The semiconductor supply crunch (Investment Outlook, April 2021) continues to blight manufacturing the world over; and energy prices – above all natural gas – have gone beserk in response to a toxic mix of geopolitics (yes, you, President Putin) and shrunken capital expenditure. The last proper energy crunch dates back to 2007 when oil flirted with $180/barrel. Vast amounts of capital rode out to meet that particular supply-side challenge. Much of it was devoted to fracking in the US, only to be wiped out when oil and gas prices later tumbled (no doubt to the Kremlin's delight). No one can expect a similar capital spending splurge this time in the face of the take-no-prisoners green agenda. (Enormous amounts of capital have already been deployed in renewable energy too; and very little of it has yielded an acceptable return. But that is another story.) For now at least, oil and gas producers seem likely to keep capital spending tight – and, as a result, should go on generating prodigious cash flows. It may be ironic, but it is not accidental that commodities have stormed the stock market charts this year.

Consider also China's targets of peak carbon output by 2030 and carbon neutrality by 2060. Against this policy backdrop, will the world's oil producers be encouraged to drill new wells? Possibly not – in which case will hydrocarbon prices stay higher for longer? And what about all those energy-intensive industries – steel, aluminium, petrochemicals, etc. – in which China has long provided excess capacity? What is their future if Beijing is serious about curbing pollution and rebalancing towards higher-added-value industries? There is, after all, much room for improvement: 23 of the world's 25 most heavily polluting cities are in China, not that Greta Thunberg talks about this much. Do we see here the spectre of structurally higher inflation for the rest of the world?

Labour too is in short supply in many sectors in many countries. A dearth of lorry drivers is playing havoc with logistics in the UK, above all in petrol distribution. Of rather greater concern for the global economy should be the secular reduction in China's labour force. Having grown by 10-15 million p.a. from 1980 to 2010, the Chinese population of working age is now destined to *fall* by 5-10 million each year from here until the middle of the century. If the former was deflationary for the world's economy, will the latter prove inflationary? A declining workforce also undercuts arguments in favour of growth-at-all-costs for China. The threat of social instability through unemployment (or under-employment) is reduced when several million young Chinese are no longer leaving their villages for cities every year.

Even as inflation continues to climb almost everywhere, are we wrong to worry so much about it? As far as we can tell (from broker surveys and the like), the consensus view among investors is rather more relaxed and tends more towards the Federal Reserve's preferred adjective, "transitory". FT columnist Merryn Somerset Webb recently pointed the finger at central bankers who are keen to adopt all sorts of priorities unconnected to their core inflation-targeting and employment mandates. Predictably, climate change is chief among these, closely followed by wealth inequality (even though central banks' own zero-interest rate policies have done more to widen wealth gaps than any other factor). Mission creep aplenty, then – and possibly eyes off the ball. Given the scale of the threat from common-or-garden price inflation, you might think that central bankers already had enough on their plates without assuming extra duties.

Where does this leave financial markets? Global equities ground to something of a halt in the third quarter. Within this, Japan was a modest star, rising almost 5%, while the rest of Asia fell 7% (China retreated 5%). Government bond yields have begun to show ominous signs of heading north, though index-linked issues have outperformed other fixed income bonds. Looking ahead, it feels as though the post-vaccine economic charge is fading; and the next few months could be altogether trickier. If investors decide that central banks are running out of excuses not to raise interest rates, bond markets could get messy quite quickly. Although not the ideal recipe for equities, higher bond yields are not automatically poisonous: 10-year US treasury bond yields could rise another 100bp or so before equities lose their relatively-good-value tag. Besides, as we never tire of saying, equities represent claims on *real* corporate assets, tangible and intangible. They protect investors over the long term against inflation's destruction of *nominal* assets.

We were recently reminded that even during the US stock market horror-show of 1929-54 investors made an average real return of 4% p.a. Amazing, but true. Most of this return came in the form of dividends. Even during the boom of the last 50 years, roughly a third of stock market returns have come from dividends; and at times of relatively high valuations (as is the case now) dividends are likely to represent a bigger share of future total returns. Corporate pay-out ratios are particularly low by historic standards in Continental Europe, which has persuaded us to add a Eurozone dividend factor ETF to the Model Portfolio (EGRG – WisdomTree Eurozone Quality Dividend Growth).

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	15	16.7
International Equities	51	47.0
Fixed Income	11	20.4
Alternatives	14	9.7
Commercial Property	2	0.3
Cash	7	5.9
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**15**	**0**	
UK	VUKE LN	8	0	0.09
UK	VMID LN	7	0	0.10
International Equities		**51**	**3**	
US	VUSA LN	14	2	0.07
	XDPG LN	10	0	0.09
Euro	VERX LN	4	-1	0.12
	EGRG LN	3	3	0.29
Japan	VJPN LN	5	0	0.19
Asia	VAPX LN	6	0	0.22
China	IASH LN	4	-1	0.40
Emerging Markets ex China	VFEM LN	5	0	0.25
Fixed Income		**11**	**-1**	
Government Bonds				
Inflation Linked	INXG LN	4	0	0.25
Inflation Linked	TIP5 LN	2	0	0.1
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	2	-1	0.20
Alternatives		**14**	**-1**	
Gold	PHAU LN	5	0	0.39
Commodities	BCCU LN	3	0	0.35
Infrastructure	INFR LN	3	-1	0.65
Water	IH20 LN	3	0	0.65
Commercial Property		**2**	**0**	
Global	IWDP LN	2	0	0.59
Cash	GBP	**7**	**-1**	
Total		100		**0.21%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2021	8.6%	8.0%	0.6%
Since inception(1/1/2015)	77.1%	68.8%	8.3%
CAGR	7.7%	7.0%	0.7%

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