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Courtville Partners – Investment Outlook, April 2023

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

- Policy error has been the defining feature of the last 25 years in the West.
- Recession, soft landing or no landing? The jury is still out.
- Our view is that inflation is likely to remain sticky; and that would mean interest rates that are higher for longer...
- ...which is why we are happy to keep cash levels unusually high and to wait until (at least) the second half of the year to buy more equities.
- But we shouldn't be too cute. Equities have generated handsome real returns over the long term (6-7% p.a.). Sheltering in cash for too long is a recipe for penury.

Our quarterly Investment Outlooks don't feature subtitles in the American style; but, if they did, this one might be called "Investment Outlook: The Era of Egregious Errors". It becomes steadily harder not to see policy error as the defining feature of the last 25 years. In the late 1990s Alan Greenspan, then Chairman of the Federal Reserve, over-indulged investors' animal spirits, a misjudgment that contributed heavily to the dot.com boom-and-bust. In 2003 the US Government unleashed 19 years of death and destruction in the Middle East and Afghanistan. At the same time, though we didn't yet know it, weak banking supervision was paving the way for the Great Financial Crisis of 2007-08 (on which subject "The Big Short" may never be bettered).

More recently, governments around the world locked up their populations for months and put their economies into cardiac arrest: evidence-free policy at its most extreme. Central bankers then made things much worse by spraying economies with biblical amounts of newly printed money, while choosing to ignore how this would interact with broken supply-chains. Even so, perfectly respectable people, including the Chairman of the Federal Reserve, insisted well past the point of decency that the ensuing inflation was "transitory". Yeah, right.

But the most serious mistake of all (for now, at least) was the ultra-low interest rate policy that the world's major central banks pursued for almost 15 years. The "emergency" monetary intervention of 2008 soon took on an apparently permanent aspect. Central banks and politicians quickly became hooked on easy money, notwithstanding the gross distortions to economic behaviour and yawning wealth inequality. Their consciences must have told them that one day it would all end in tears. What persuaded the central bankers in particular to abandon all rigour, monetary and intellectual? We may never know – because none of them is likely to confess.

A quarter-century of policy mistakes comes to mind now because investors face one crucial question: what will the Federal Reserve do next? Will it continue its mission to squeeze inflation – and inflationary expectations – out of the US economy by putting up interest rates further still? Or has Powell been spooked by the slew of regional bank failures? He may argue that Silicon Valley Bank et al. were brought down by management incompetence (or recklessness or greed), not by higher interest rates *per se*. Yet, as we've suggested before, all banking – and especially central banking – is in essence a confidence trick. And once confidence has been lost, it is hard to re-establish, especially when it concerns the security of customers' deposits.

Powell under-estimated the incoming inflation tsunami for much of 2021. Can he now afford to compromise in the Fed's campaign to restore its inflation-busting credentials? Our hunch is that he has come too far to give up now and that he will press on with further interest rate rises – or at the very least won't cut rates. (Arguably Jay Powell is channelling his inner Mark Zuckerberg: he

moves fast and he break things. This rate-hiking cycle has been the steepest since 1980 – and now things are starting to break.) We assume that more bank failures are likely as a result, courtesy of the law of averages (why would the management of SVB have been uniquely bad?). Bear in mind, though, that more than 500 US banks have failed since 2009, i.e. these are not unusual events and the system mostly copes well. Eyebrows may rise when Treasury Secretary Yellen *implies* (and it was no more than that) that *all* US bank deposits are now guaranteed by the federal government, not just the first $250,000. Everyone knows that this would be an uncashable cheque. Perhaps for a moment she reverted to the confidence-trickery of her previous job as Fed Chairman: suggest that something is possible precisely in order to stop it happening.

Europe has banking headaches of its own, but of a different kind. The demise of Credit Suisse came after at least a decade of mismanagement and failed strategic re-boots; and it would be hard to blame it on higher interest rates. Without wishing to tempt fate, we see CS's extinction as a special case rather than as a harbinger of systemic weakness in European banks, most of which are far better capitalised than they were going into the GFC in 2008. The collapse of CS did, however, offer at least one salutary lesson: always read the prospectus. The holders of $17bn of so-called "co-co" (contingent-convertible) or "AT1" (additional tier 1) bonds saw their investments wiped out even though some value was salvaged for CS shareholders. This is not how it usually works: when a company fails, the common equity is normally written off before debt. Yet in this case the prospectus states clearly that the AT1 bonds of CS may be written down to zero if the "public sector" makes "an irrevocable commitment of extraordinary support" to the bank. Besides, the most recent issue of CS AT1 perpetual bonds ($1.6bn in 2022) carried a coupon of 9.75%, which was surely a warning in itself.

On a more constructive note... Stuart Kirk is a name that may ring a few bells. He was in charge of Responsible Investing at HSBC Asset Management – until last July. That was when he argued in an investor presentation that central banks were guilty of exaggerating the likely financial impact of climate change. A video of his speech raced round the online globe. Having been publicly disowned by HSBC's high priests, he had to resign. From his new perch as an FT columnist, he has continued to lob stones into the millpond of investment orthodoxy.

In a recent column Kirk highlights the basic, but counter-intuitive, truth that understanding companies – and their merits, relative and absolute – is not important for long-term investors. Over the long term the stock market winners are very few (and aggregate stock market returns are surprisingly stable). Citing Bessembinder et al., Kirk points out that from 1926 until 2016 *all* the net stock market wealth in the US was created by just 4% of all 26,000 listed stocks. No one can reasonably expect to identify those golden-egg stocks in advance. These days we may wonder what ChatGPT and AI in general could mean for various sectors of the economy (and therefore for companies); but, in truth, we have no idea – and neither does anyone else.

Fortunately it doesn't matter: the market will decide for us, being made up of the collective wisdom of *all* investors, updated continuously. This is an excellent reason to invest principally via low-cost (or "passive") vehicles. For the most part, we shouldn't waste our money on someone else's attempts to identify the winning 4% before they've won. Most actively managed funds are condemned to underperform their benchmarks and market indices.

At the risk of over-simplification, the asset allocation choice now facing investors hangs on the near-binary debate over whether there will or won't be a US recession this year. Bulls have it that both inflation and interest rates have peaked, while China's re-opening is helping to stimulate

global demand. And so – ta-dah! – a soft-ish landing beckons for the economy. Bears, by contrast, argue that the current stagflation (the toxic mix of inflation and sluggish growth) will morph inevitably into recession. After all, recession in the US has always followed a collapse in consumer confidence to the levels seen recently; and only once has recession been avoided (in 1952) after a bout of double-digit inflation. To the extent that market prices express investors' collective views, risk assets (including equities) seem to be mostly in the bullish camp, while recent falls in bond yields speak of fears of recession and/or further bank failures. One of them is wrong.

Our view is that inflation – and above all wage inflation – is likely to remain sticky and to persist at levels well above the 2% target. Either central banks will "keep calm and carry on hiking", as one wag put it – or they will bottle it and settle for structurally higher inflation (3-5%, say). Neither outcome is obviously encouraging for risk assets in the near term. That's why we are still happy to keep cash levels unusually high (at 10%). We expect to get a chance to buy equities at lower prices. But we shouldn't be too cute: we believe firmly that staying substantially invested in real assets (i.e. equities) is the best recipe for long-term growth in wealth. The real return on equities has been in the region of 6-7% p.a. over the last 100 years – a period that took in two world wars, several other major conflicts, the Great Depression, the Great Financial Crisis, regular bouts of inflation and at least three huge stock market bubbles.

We are keeping the asset allocation in our Model Portfolio broadly unchanged this quarter. In January we said that we expected to reduce cash and increase exposure to equities in the second half of 2023; and this is still the case. For now, however, we are keeping levels of both cash and gold well above benchmark weights. As a cross-check, the observable equity risk premium in many stock markets, above all in the US, looks low by historical standards, which ought to encourage prudence. (The equity risk premium is a measure of the relative value between equities and bonds. Crudely speaking, it indicates the extra reward on offer to equity investors – defined as the excess of the earnings yield over the risk-free yield offered by 10-year government bonds.)

After a lacklustre 2022, our perennially favourite hedge against a loss of confidence, gold, had a good first quarter, appreciating 8% (in dollars). If nothing else, gold – and its relative performance against US treasury bonds – is a barometer of the degree to which investors fear persistently higher inflation: outperformance by gold against long bonds betrays fear of inflation, whereas the reverse suggests an expectation of lower inflation (or even deflation).

The Japanese stock market continues to intrigue us. Valuations remain attractive, especially against earnings (P/E 12.5x) and book values (P/BV 1.3x); and even the Yen seems to have found a measure of stability after two years of precipitous declines against the dollar. We still await the formal abandonment of the Bank of Japan's policy of "yield curve control" that has kept government bond yields suppressed for years; but it may come as soon as April or June. Meanwhile, a couple of other developments offer encouragement. First, in January Prime Minister Kishida proposed a major expansion of the country's individual savings account scheme. The government's high-level priority seems to be to promote greater private investment in domestic equities in response to the challenges posed by dismal demographics. Second, the Tokyo Stock Exchange has suggested that companies whose shares trade at less than book value (about half of them) should do something about it. Share buybacks would be an obvious ploy. The TSE's admonition carries no legal weight; but Japanese business culture often pays heed to perceptions of collective duty. We remain overweight Japan.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	8	14.7
International Equities	51	46.3
Fixed Income	18	21.3
Alternatives	12	10.1
Commercial Property	1	0.2
Cash	10	7.4
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**8**	**0**	
UK	VUKE LN	6	0	0.09
UK	VMID LN	2	0	0.10
International Equities		**51**	**0**	
Global	IWQU LN	6	2	0.30
US	VUSA LN	15	0	0.07
	XDPG LN	11	-2	0.09
	IUVD LN	3	0	0.20
Euro	VERX LN	1	0	0.12
	EGRG LN	2	0	0.29
Japan	VJPN LN	4	0	0.19
Asia ex-Japan	VAPX LN	3	0	0.22
China	IASH LN	2	0	0.40
Emerging Markets ex China	VFEM LN	4	0	0.25
Fixed Income		**18**	**0**	
Government Bonds				
UK Inflation Linked	INXG LN	2	0	0.25
UK	IGLT LN	4	0	0.07
US	IDTM LN	8	0	0.17
China	CNYB NA	2	0	0.35
Corporate Bonds				
US	CORP LN	2	0	0.20
Alternatives		**12**	**0**	
Gold	PHAU LN	5	0	0.39
Commodities	NRGW LN	1	0	0.30
Infrastructure	INFR LN	2	0	0.65
Water	IH20 LN	2	0	0.65
Carbon Allowances	CARB LN	2	0	0.35
Commercial Property		**1**	**0**	
Global	IWDP LN	1	0	0.59
Cash	XSTR LN	**10**	**0**	0.15
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2023	3.0%	2.8%	0.2%
Since inception(1/1/2015)	77.5%	68.4%	9.1%
CAGR	7.4%	6.7%	0.7%

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