MARKET PERSPECTIVES

JANUARY 2018

THE LAST QUARTER...

- Equity markets continue to make progress, led by Asia; NASDAQ tops 7,000 for the first time.
- Japan's TOPIX index finally re-attains the level it last saw in 1991; the Nikkei 225 index rises 16 days in a row, breaking a 1961 record.
- Base rates rise in the UK for the first time in ten years; the FTSE100 reaches a new all-time high.
- Sterling ends the year up nearly 10% against the US dollar – but only up 1% on a trade-weighted basis given euro strength.
- Copper ends the year up over 30%.
- Oxford University issues a 2.5% 100-year bond.
- Volatility reaches an all-time low (using VIX index since 1990).

"All money is a matter of belief."

Adam Smith, *The wealth of Nations (1776).*

WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

Bond yields remain steadfastly low.

It seems extraordinary that, in the first year of synchronised global economic growth since the global financial crisis, bond yields should remain steadfastly at very low levels. Ten-year government bond yields in Japan and the Eurozone are still below 0.5%; in the UK, where the inflation rate has breached the Bank of England's target (RPI at 3.1%) and there is universal agreement that political risk is the highest it has been for decades, gilt yields are just 1.2%. In the US, ten-year treasuries closed 2017 yielding a slightly more respectable 2.4% – but that is still low in the context of c. 2.5% economic growth and inflation of 2.2%.

This is not warranted by fundamentals, and can only be accounted for by the flow of funds.

For a few years after 2008 the collapse in interest rates could be explained away by understandable risk aversion, a rational fear of deflation and the constant flow of funds brought about by quantitative easing, an increasing appetite for the use of index funds and bank regulation together with forced liability matching in the insurance and pension fund industries. How many of these explanations still hold water, ten years on from the crisis? The fact that equities are now performing well and appear to trade comfortably on relatively high valuations indicates that systemic risk aversion has dissipated – as does the increasing use of leverage around the world together with the recent outperformance of smaller companies and emerging markets. As to the fear of deflation: we have seen pockets of deflation emerge periodically in recent years but the danger of a 1930s-style downward spiral has receded and, in any case, no period of deflation in either the nineteenth or twentieth centuries resulted in bond yields falling this low – in which case even if the bond market is 'right' to predict an impending collapse, yields are still too low; thus a fear of deflation can no longer account for the present situation. Only the flow of funds argument still holds water because here the forces concerned are as strong as ever: firstly, regulation is increasing, and is supported by demographics (young people neither trust the equity markets nor, so we are often told, capitalism; old people want fixed income); secondly, index funds, whereby investors effectively lend money regardless of the quality of the credit or the prospective return, are becoming ever more fashionable.

'Safe assets' are actually rather risky in the long run.

An interesting piece of academic research was published last year which looked at investment returns on equities, property and bonds around the world since 1870*. Whilst much of the content of this paper was not new (e.g. the real return on equities tends to be c 6-7%), or is still open to debate (e.g. that the return on housing has been slightly better than the return on equities), one point was very striking: the return on safe assets (i.e. bills and bonds) has been, "very volatile over the long run…even more volatile than real risky returns." There have been long periods in the last 150 years when the decade return on these 'safe assets' has been materially negative. Perhaps not surprisingly these have followed periods of very strong returns: it really matters when you put money into supposed safe havens. Once they become overvalued, they are by definition vulnerable to price falls purely on valuation grounds, let alone what happens to the fundamentals in terms of default risk or the impact of high inflation. We therefore strongly believe that now is not the time to overweight the fixed interest asset class – although the diversification effect of fixed interest exposure is always likely to be worth having and there are, of course, invariably pockets of value to be found by active investors. It is worth noting that the yield spreads in excess of government bonds which are available on corporate credit are still quite respectable and should serve as a buffer in the event that bond yields rise modesty. In the US, the 2% spread which is available on BAA issues is in line with the average for the period since 1919. As an aside, an extra 2% from corporate credit on top of 2.5% from the 'risk-free' (i.e. government) rate is clearly more meaningful than 2% on top of 5%.

Investors who are excessively cautious.....

Being bearish about bonds is nothing new, as any regular reader of *Market Perspectives* can attest. Indeed most active managers one meets are of broadly the same view. Either we are wrong to be suspicious of the lowest bond yields in hundreds of years of history (and consequently the current state of affairs should be considered permanent), or those on the other side of this trade – i.e. passive investors and institutions who are effectively forced by governments and regulators through 'financial repression' to lend money at these ultra-low rates – will lose out.

...will bear a large opportunity cost.

It is tempting for active investors to feel dispirited by the continued lack of mean reversion in bond land – to lament that it has been wrong to be underweight the asset class because yields have continued to stay low. However, it is important to realise that the loss of value when real yields are negative (i.e. when inflation is higher than bond yields) is material over time, and the opportunity cost when virtually all other asset classes are appreciating is both massive and, in all likelihood, irrecoverable. Bond prices may or may not crash (possibly not if the flow of funds into the asset class is so solid); but even if they don't collapse, it seems inevitable that they will nevertheless prove to be a poor investment over anything other than the short term.

* www.macrohistory.net/data

OUTLOOK FOR EQUITY MARKETS

Equity investors should not be smug. A correction in bond markets will affect equity valuations. Moreover, in the long term ultra-low bond yields are bound to have resulted in misallocation of capital across a potentially broad spectrum. This happens when unviable or excessively risky projects that would not otherwise proceed manage to secure financing which then all unravel, generating big losses in the next downturn. On the other hand, diligent investors and well managed companies will benefit from being able to borrow at very low rates, so the present state of affairs is not all bad for the system as a whole. It is important to remember that there are beneficiaries from the aforementioned transfer of wealth away from those who are prepared to lend money at ridiculously low rates.

Equity investors will be affected whatever happens to bond yields.

It is for this reason that we pay particular attention to the way companies that we invest in allocate their capital and finance their operations. As such, a key input to our investment process is cash return on invested capital (CROIC). A strong balance sheet is also important because many apparently good business models, when conditions change unexpectedly, ultimately turn out to have been flattered by gearing – by which time it is often too late for the company to adapt or for investors to sell out at a reasonable price. The attributes that we consider in evaluating whether a high CROIC is likely to be sustainable and worth investing in are: 1) a sustainable competitive advantage, 2) opportunities to grow future cashflow and 3) a value-enhancing management strategy; finally, we require an attractive valuation in relation to the opportunity and risk. All of this together leads us to overweight good quality long-term compounders like Microsoft, Visa, Philips, British American Tobacco etc., and to favour sectors like technology and healthcare in preference to banks and commodities, where returns are inherently unstable and excessively dependent on the external environment.

We must be disciplined about the type of company we invest in...

This *modus operandi* has worked well for us, especially over the last year or so. However, there are times when the opportunities that arise from changes in the outlook for industry sectors warrant a re-examination of companies that we have previously avoided. Looking at the oil sector, for example, EOG Resources has been our favoured holding because its business model has been founded upon the application of innovative technology in the shale fields of the Permian Basin. This enables the company to be a very low cost operator which can add value even when the oil price is under pressure in a way that deep water operators like BP and Royal Dutch Shell cannot. However, all that said, we have to be cognisant that not only has the oil price recovered materially over the last few months, but companies in that sector which we would have excluded from a 'best ideas' list previously could become eligible once again on the back of a change in their own fundamentals. Shell, for example, has successfully bedded down its acquisition of BG and de-geared its balance sheet; it is now a leading player in the growing (and 'greener') natural gas and LNG market.

... whilst retaining an open mind when the metrics change.

Banks have also been a recent topic of discussion. As things stand, our somewhat limited exposure to this sector has primarily been through US Bancorp (the second largest regional bank in the US, with the highest return on equity in the sector) and Danske Bank (high capital ratio and good cash returns to shareholders). During the middle of 2017 it was a little painful for our relative performance not to be exposed to more names in this sector – especially the lower quality European banks like Deutsche Bank, which saw a major recovery in their share prices, albeit from depressed levels. Just as we have done in the oil sector, we re-examined our thesis and came to the firm conclusion that the risk inherent in these low quality banks remains high and that their failure to meet our fundamental investment criteria means that we should continue to avoid them. That does not, of course, preclude us from tactically increasing our exposure to high quality banks, or indeed other financials.

Financials are difficult to call.

Investors should be prepared to pay up for quality. It is true that companies with highly dependable earnings (e.g. consumer staples) are looking expensive, and some 'dead cert' long-term growth stocks like Tesla etc. look overvalued. However, given continued economic growth combined with low inflation it is possible that these high valuations turn out to be justifiable; we are certainly not observing the same degree of excess as we did in 2000. However, the bond markets are a different matter because the premium valuation accorded to the supposed safety of government paper has gone way beyond what is justified by both the fundamentals and historical analysis. Perhaps the reason that so many people are buying bitcoin* is that doom-mongers regard it as an alternative to untrustworthy / overvalued cash / government paper, whereas speculators see more excitement in this new 'edgy' cryptocurrency than they do in an old-fashioned equity bull market that happens to come with surprisingly low volatility. We continue to feel that it is right to be overweight equities in spite of high valuations because the fundamentals are supportive given synchronised global economic growth and consequent earnings upgrades. Furthermore, the speculative excesses that are traditionally found in the closing stages of a bull market seem, for the moment, to be confined to new types of currency.

Equities are a better home for capital than either bonds or bitcoin.

* For more information on bitcoin please see the Waverton Insights page www.waverton.co.uk/media-centre/insights

TOTAL RETURN INDICES TO 31ST DECEMBER 2017

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	2.0%	1.6%	0.3%	2.0%
Citigroup World Govt Bond Index	0.2%	-1.2%	-2.2%	-1.8%
MSCI United Kingdom All Cap Index	5.0%	7.4%	8.7%	13.1%
MSCI United Kingdom Index	4.9%	6.8%	7.6%	11.7%
MSCI AC World Index	4.9%	6.8%	7.2%	13.2%
MSCI AC World (ex UK) Index	4.9%	6.8%	7.2%	13.3%
MSCI AC World (ex US) Index	4.1%	7.0%	9.0%	16.2%
US Dow Jones Industrial Average	10.0%	12.5%	12.6%	17.0%
S&P Composite Index	5.8%	7.0%	6.2%	11.3%
MSCI Europe (ex UK) Index	0.1%	3.6%	8.1%	15.8%
Tokyo TOPIX Index	7.7%	9.0%	11.1%	15.6%
MSCI AC Asia Pacific ex Japan Index	7.0%	9.8%	12.2%	25.1%
Waverton Growth Index	4.0%	5.4%	5.7%	10.5%
Waverton Growth UK Bias Index	4.0%	5.6%	6.1%	10.5%
Waverton Balanced Index	3.5%	4.6%	4.8%	8.9%
Waverton Balanced UK Bias Index	3.5%	4.7%	5.1%	8.9%
Waverton Cautious Index	2.9%	3.8%	3.9%	7.2%
Waverton Defensive Index	2.3%	3.0%	3.1%	5.7%
Return on Cash £ (1 month deposit rate)	0.0%	0.2%	0.2%	0.3%
Inflation - UK CPI	0.4%	1.2%	2.0%	2.6%
Gold Price (£963.56)	0.7%	0.7%	-3.4%	2.9%
£ vs US$	0.8%	4.1%	8.2%	9.5%
£ vs Euro	-0.7%	-1.1%	-3.6%	-3.8%
£ vs Yen	0.9%	4.4%	9.4%	5.7%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx $ Treasuries Index	0.1%	0.5%	1.7%	2.5%
Citigroup World Govt Bond Index	1.0%	2.9%	5.8%	7.5%
MSCI United Kingdom All Cap Index	5.8%	11.8%	17.6%	23.8%
MSCI United Kingdom Index	5.7%	11.2%	16.4%	22.3%
MSCI AC World Index	5.7%	11.2%	16.0%	24.0%
MSCI AC World (ex UK) Index	5.7%	11.2%	15.9%	24.1%
MSCI AC World (ex US) Index	5.0%	11.5%	17.9%	27.2%
US Dow Jones Industrial Average	11.0%	17.2%	21.8%	28.1%
S&P Composite Index	6.6%	11.4%	14.9%	21.8%
MSCI Europe (ex UK) Index	0.9%	7.9%	17.0%	26.8%
Tokyo TOPIX Index	8.6%	13.5%	20.2%	26.6%
MSCI AC Asia Pacific ex Japan Index	7.9%	14.3%	21.4%	37.0%
Waverton Growth Index	4.4%	8.6%	12.4%	18.4%
Waverton Balanced Index	3.6%	7.1%	10.4%	15.2%
Waverton Cautious Index	2.8%	5.6%	8.3%	12.1%
Waverton Defensive Index	2.2%	4.3%	6.5%	9.4%
Return on Cash $ (1 month deposit rate)	0.3%	0.6%	0.9%	1.1%
Inflation - US CPI	-0.1%	0.7%	1.2%	2.2%
Gold Price ($1303.46)	1.5%	4.8%	4.5%	12.6%
US$ vs £	-0.8%	-4.0%	-7.6%	-8.7%
US$ vs Euro	-1.5%	-5.0%	-10.9%	-12.2%
US$ vs Yen	0.1%	0.3%	1.1%	-3.4%

* All MSCI benchmarks are net of tax

Source: Thomson Reuters DataStream

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