Psigma
Investment Management

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View from Psigma
VALUATION COMMENTARY

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The first six months of 2019 has seen strong gains in the price of nearly all asset classes, something that very few people were expecting at the start of this year, in a complete reversal of the losses experienced by investors in 2018. Last year it was as hard to find a positively returning asset class as it had been in decades, whilst this year 95% of asset classes have gained so far. "The economy must be doing great" and "companies must be generating excellent growth in profits" would be an investor's natural reaction to such exuberance in asset prices, but that is currently not the case.

The global economy now appears to be as weak as it has been in 10 years and growth in corporate profitability is broadly stagnating across the world. The change from abject pessimism to unbridled optimism has rather been triggered by the fact that seemingly interest rates around the world are not going up for a very long time and central banks have capitulated on any thoughts of tightening policy and are instead once again purely focussing on loosening monetary policy instead.

The Global Economy Slows

At the start of this year, we forecast that the global economy was going to slow considerably in 2019 and into 2020, as the effects of the monetary stimuli put in place across the world after the UK's decision to leave the European Union and the industrial recession of 2015 waned. Our expectation was also that global growth would surely moderate due to a slowdown in the omnipotent US economy, as the "sugar high" of the "Trump Tax Cuts" of late 2017 wore off and the US economy was weighed down by the anaemic rates of economic growth of regions like Europe. We also felt that analysts and economists were underestimating the negative effects of the "trade wars" that had been ignited between the US and China, as well as a general warming-up of global geopolitical tensions, which when combined with an increasingly suspect growth trajectory in China, would act as a brake on world trade growth.

All these forecasts have proven correct so far, with our other view that, despite a decline in broad economic activity, the world would not fall into a recession looking more questionable as we stand here today. The global economy is still growing, but quite obviously growth rates have fallen towards levels that we see as "long term growth trend rates" of around 2.5% in real terms. Such growth rates are about 1% lower than where they have been over the last decade and our own forecasts are lower than the wider consensus.

Why Growth Rates Will Remain Subdued

Hopefully we are wrong in expecting lower rates of growth in the future, not least as generating high rates of investment returns is far easier when you have the tailwind of strong economic growth, such as that which the world enjoyed in the 1980s and the 1990s. Indeed, after a slump in recent months, there is the possibility that the global economy does pick up in the second half of the year, not least as consumption remains steady, supported by low rates of unemployment and reasonable wage price growth. However, our approach at Psigma has also been one of "realism over optimism" and in the longer term our own forecasts are lower due to the combination of high levels of debt and poor demographic trends that the mature world suffers from.

Again, Europe is currently a good guide for how the global economy will look as populations age and the debt piles accumulated over the last few decades act as an anchor upon potential growth rates. Certainly, there will continue to be a positive impact on global growth from the emerging world, but that will only provide a reduced impulse by comparison to the past, as the biggest beast in the emerging world, namely China, also starts to slow, again as its economic engine splutters under the weight of a "greying" population and heavy debt loads.

Whilst our forecasts might sound cautious, we would rather be surprised on the upside and, as we will go on to write later, it does not mean that there are not attractive investment opportunities; it is just that they are harder to find and the approach that one could have pursued over the last few decades of simply buying anything and watching it go up in price are probably over.

Central Banks Ride to the Rescue

As we see it, the predominant factor driving positive performance of various asset classes in the first half of this year were the actions of central bankers. Indeed, we have just seen one of the biggest "volte-faces" in the US Federal Reserve's (Fed) history over the last 10 months, from a time when the Fed was guiding markets towards three interest rate hikes in 2019 to current market expectations of three cuts before the year is out, starting with the first move lower in July. We have long been talking against the consensus in expecting the Fed to be forced to cut rates, due to the slowdown we were forecasting in the US economy. However, despite our view we are surprised by how quickly the Fed has capitulated from their previous forecasts, not least as they have made themselves look stupid with their persistently erroneous forecasts.

At the same time, the European Central Bank (ECB) which tried to stop their extraordinary monetary easing programme, found that the European economy was so weak and financial markets were so reliant upon their supportive actions, that after a matter of weeks they were forced to promise yet more easing. The impact upon markets has been huge and the distortions we are now witnessing are like nothing ever seen before in history. In very simple terms, the lowering and the maintenance of interest rates at close to 0%, or in the case of Europe and Japan in negative territory, forces investors to move money out of the bank and sell lower risk assets and take more risk to achieve the sorts of returns they are hoping for.

This gives us a great deal of concern about the outlook for a range of different fixed interest investment, but fortunately our investment approach allows us to simply avoid the extreme pockets of overvaluation, something that passive investment approaches don't.

Distortions Everywhere

The effects of the central bankers have been extraordinary. It is fair to say if we had predicted 10 years ago what is now in evidence in monetary policy and financial markets we would have been laughed out of the room. Many of the more extreme examples are to be found in Europe, where the authorities there have fought hard to hide the grave economic and financial situation that faces the continent.

The ECB has set their main interest rate at -0.40% to try and force savers to take money out of the bank and buy risky investments. To find a positive yield in "safe" German government bonds you need to buy a bond that is over 30 years in duration, otherwise you must pay the German government to look after your money for you (the current yield on a 10-year Bund is -0.40%). At least that's better than lending money to either the Swiss or the Danish governments as locking your money up for any period will not get you a positive return.

Other fixed interest investments' yields have been pulled down as the "reference yield" on government bonds has plummeted, such as German mortgage-backed securities where effectively investors must pay homeowners to lend money to them for their mortgages. If you think this sounds ridiculous then maybe move to Denmark and buy a property, as the banks there will pay you to take out a mortgage. Whilst I am sure this financial alchemy will sound absurd to most of you, the important factor for us is trying to value assets that in this "la-la land" world of manipulated valuations and recognise that we need to think differently as to how we have in the past.

Attractive Investments Remain on Offer

A combination of "full" valuations, investor complacency, economic uncertainty and heightened geopolitical risks is an environment in which we are struggling to find lots of good new investment ideas (and that's without even mentioning what might happen with UK politics and our economy in the coming years!). Indeed, the most recent decisions across our portfolios have been to take profits where we felt either that valuations had become full or where prices had moved too far, too quickly. This has led the cash weightings across our portfolios to drift higher, something we are comfortable with, recognising that our strategies will have some protection if recent market trends reverse and that we have some "dry powder" to use as and when opportunities start to present themselves again, as they surely will in the future.

The good news is there are still a broad selection of investments where we have high levels of confidence with a diversified portfolio, such as Japanese equities, investments in healthcare companies, UK corporate bonds, niche fixed interest markets (such as asset backed securities and Asian corporate debt), gold mining shares and various commodities. In addition, while admittedly our new idea generation is lower than it was a few years ago, we are currently exploring exciting new opportunities in specialist credit markets and we are attracted to the long-term growth potential of sectors like environmentally-friendly energy sources, which are likely to be represented in our portfolios in the coming months.

Conclusion

Our current view is that the best of 2019's returns are likely to have come already this year and now is a time for patience, caution and ensuring that one is prepared to expect the unexpected. We will continue to operate with an "open mind" as to what the future might bring and are prepared to shift total portfolio risk both higher and lower as we have done regularly over the last few years. We promise to keep you updated as to how our views might shift in the period ahead.

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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

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