TOWN CLOSE
Financial Planning

ICM MINUTES
August 2019

future proofing your finances

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This document reflects the discussions held at the Town Close Financial Planning Investment Committee Meeting that took place on 13th August 2019

Macro Overview

This quarterly ICM was a catch up on the current economic and political picture. And confirming when/how future portfolio changes might arise.

As predicted in the May minutes there were no changes forthcoming to the portfolio.

We still await a significant drop in equities in order to buy them cheaply using the allocation to bonds each portfolio has. The chances of something like that happening have increased recently.

For those that are interested what follows is the sanitised transcription of the meeting:

"Lots of things have changed since last time. But the expected outcome has not.

Interest Rates

The really big difference between now and 6 months ago is that we expected to go from ultra-low interest rates to plain old low interest rates. That was true for a while.

In August 2016 10 year gilt yielded c0.6%, in Feb 2018 it was 1.7%. That's ultra-low to low. However, in the last few months yields have been driven lower and are now less than 0.6%.

It surprises us the extent to which the bond market has priced in lower interest rates. The 10 year yield in France is now negative. Even Spanish yields might become negative. The German yield is negative way beyond 10 years.

The best performing asset this year is not US equities, it's German 30 year bonds. This year you'd be sitting on a 30-40% gain YTD had you bought them. That's the extent to which interest rates have moved. And there are several reasons.

Japan is sustaining QE on a massive scale, their easing is both qualitative and quantitative. It looks like the Europeans are heading down the road of both quantitative and qualitative easing too. We were always sceptical that Europe's pronouncement that QE was over would come to pass.

It seems Europe are going down the Japan route, i.e. we can expect them to start buying corporate bonds and equities. That needs them to amend their rules, which isn't a problem for them having already dropped the rule that they wouldn't buy Government bonds that yielded less than the main policy interest rate. That change in policy drove yields lower.

Buying corporate bonds and equities made sense in Japan in terms of the three arrows of Abenomics. Europe would need a clear mandate for doing the same, they don't have that. But, logically, once you've bought as many Government and corporate bonds as you can, only equities are left, so it's not a big step.

The Reach for Yield

Another theme we see becoming more apparent is the sort of investments that are being heavily backed at the moment. Sober assessment is out the window. Simply comparing yields and the reach for yield is becoming more prevalent.
That's understandable to a degree. An investment manager can't recommend negative yielding Japanese bonds to a client and then charge them a portfolio management fee on top. They look for yield and ignore the increased risks associated with it.

Not being concerned with risk, focussing only on yield, is a big problem. There is no due diligence. This is anti-capitalism – capital is not going to the areas where it will be used most efficiently.

We only see the flaws in capitalism. As it is the dominant system we don't see the flaws in other systems because they are not being used and so the flaws are not manifested. Perversely this can make those other systems look more attractive.

But for now, the immediate upshot of this is that investors are allocating their capital to riskier and riskier areas, with little due diligence, with only yield in mind and at the first sign of trouble they sell out and that creates downward selling pressure.

Inflation

The UK is the one bright spot when it comes to inflation – it's the one place where there is some! Post-Brexit, we could be at 3% in 12-24 months. There is no inflation anywhere else (of consequence) in the world. Slightly excessive inflation would be 3%. High inflation is beyond that.

Why wasn't there inflation in the US when the economy was doing better? Who knows, but there's no sign of it suddenly coming back anywhere.

Interest rates are not going higher until inflation does. The bond market simply reflects where the market thinks inflation and therefore interest rates will be in the future. There is no bull market in bonds per se, it's simple mathematics.

Are the markets are predicting deflation?

Either the markets are definitely not afraid of inflation, or someone is interfering in the bond market. We know the central banks are interfering. Definitely in the short term markets (that's how they set the interest rate) and QE has had an effect in the longer term.

But the forward guidance element of central banks is overlooked.

This is where the central banks say what they are doing today and what they won't do in the future. That removes uncertainty. The ECB have said they won't move interest rates until they have backed out of QE, and in fact we're going further into QE.

From that we know interest rates aren't going up for 18 months. Forward guidance depresses the "term premium" and long term interest rates by taking away uncertainty.

So, the bond market doesn't see inflation anywhere (UK aside, but it's not huge, maybe peaking at 4% for a year after Brexit). This might support the equity market?

Not necessarily, the equity market should flourish if the economy is being productive. But if it's not being productive it won't. That returns us to the point above. In the credit markets we end up with non-productive loans which come about because covenants and due diligence go by the wayside in favour of yield at any cost. It's more about yield not risks involved and, in time, that will extend to the equity markets. Capital is now free and being misallocated.

In Denmark a bank is paying people to take a mortgage from them, it has a negative interest rate. They still make money because what they are paying their clients is less than they are being paid to take the money in the first place.

That might sound great, but what's the long term consequence? How productive is using capital in that way?

US/China Trade War

The US/China trade war isn't going away and there's little in the way of market pleasing pronouncements. It's effectively a "Cold War".

The US easily beat the USSR because of capitalism. The USSR couldn't attract US companies to invest in them. USSR technology kept up and was great but couldn't be produced in the volumes the US could manage. There was no partnership between the two countries.

Today, US firms are partnering up with a Chinese firm and taking their technology there. They find skilled labour at a lower cost allowing China to effectively "steal" that intellectual property.

However, in the long run China loses. It doesn't attract ideas from the rest of the world in the way the US does. The US just needs to starve China of US intellectual property (which is effectively made up of the world's intellectual property).

This becomes a generational issue, a Cold War, and the US will win albeit at some cost to the US economy. A cost the current administration is happy to pay.

In Summary

We thought interest rates would glide back, but ultra-low is back. And we thought some market pleasing US/China détente type announcements would have happened by now but they haven't. This leaves markets hyper sensitive.

Bad news used to mean good news in terms of more stimulus coming. That's not now the case it would seem.

For example, it's apparent that Draghi's big bazooka hasn't worked. But after you've pulled out your "Big Bazooka" what do you pull out next? Announcements need to surprise to move the markets and currently they are not surprising anyone.

Brexit

Very briefly, Brexit was of course discussed. The Pound and Euro are virtually at par, the 10 year UK gilt yield could go negative.

No-deal Brexit seems inevitable, the EU will not abandon the back stop, they have no ladder to climb down, and there's no fudge to be had. The UK is more or less ready, but it's a big project, there will be troubles ahead but no Armageddon."

Future changes

Our regional exposure is now, more or less static. The majority of holdings are cap weighted in a globally diverse portfolio – we're grabbing as much global growth as we can (the well-muscled rump).

That means that future portfolio changes will result from conversations around:

more or less equities and/or

more or less emerging markets and/or

more or less smaller companies.

There's plenty of flexibility, simplicity and low, low costs in this approach.

We took "the temperature" of the markets and found them to be neither too hot nor too cold.

And that was the meeting, the next will be in November and we might be slightly more expectant about announcing portfolio changes than we were in August.

Town Close