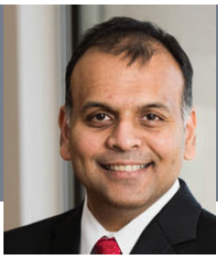
From the desk of Amit Lodha



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Finding humour in the markets

Greece can now borrow money cheaper than Trump's America, leaderless people's movements are raging in countries as far as apart as Chile and Hong Kong, there is no resolution yet to Brexit as we hurtle toward another election, trade war Tweets and impeachment hearings are all you read in the press, Elizabeth Warren is rising fast in the democratic polls, and yet the market continues to march higher – even making new highs. If nothing else, the market gods seem to have rediscovered their sense of humour!

While there is much to worry about (which we cover in greater detail below), tactically, I find it tough to be too negative. Here are a few reasons why:

- Trump may be a lot of things, but he knows that if he needs to get re-elected, the US cannot go into a recession in 2020. There is a lot that can still be done to 'juice' the economy (constant pressuring of the Federal Reserve (Fed), a minor trade war resolution, payroll tax cuts, fiscal stimulus for infrastructure build, and so on).
- While 2021 estimates seem too high, we seem to have passed the worst of the earnings downgrade cycle for FY2019/2020 and, as the recent earnings season has shown us, cyclical stocks are no longer going down on bad news, and some are actually going up on bad news. (If stocks don't behave the way consensus expects them to behave on bad news – take notice.) As one of our US portfolio managers commented on Caterpillar earnings (ticker: CAT): 'CAT did not behave like a DOG post results!'
- The Fed and the European Central Bank (ECB) have decisively shifted from quantitative tightening to quantitative easing. Broad liquidity and money supply growth has rebounded in most parts of the world and especially in China it has stabilised – when things go from bad to less bad, good things happen in markets!
- Lead indicators (OECD, for example) seem to have bottomed out, and while there is no steep re-acceleration, at least things are not getting worse.
- Employment in the US remains at pretty high levels and whilst company indicators would suggest that we are already in the midst of an industrial recession, given the strength in the US consumer, it is tough to imagine we are in the midst of a broad-based US recession, as some commentators have suggested.
- While there is no hard data to back this (yet), when we look at industrial orders (machine tool order series), companies (like investors) have gotten so defensive (run down their inventories) that even the smallest hint of positive sentiment could trigger a significant inventory re-stock (which tends to be a powerful driver of sales and margins) – see what has happened to Apple orders and supply chain as wait times for the iPhone 11 have been longer than everyone expected!
- Cyclical Japan, which can be thought of as the industrial heartbeat of the global economy, seems to have a pulse since September. (The same cannot still be said for Germany – yet.)
- And lastly, for all of the UK Parliament's attempts at reliving 'groundhog day' with reference to Brexit, with elections in December, a no-deal Brexit off the table, it feels like we are much closer to the resolution of uncertainty within the next six months – theoretically positive for sentiment both in the UK and Europe.
- While this is the tactical set-up which could continue to lead the market higher, it would require a rotation from defensives into cyclicals and value versus growth. We have had a number of false starts to this and all the ducks need to line up (including the ever-important yield curve!), but it does feel like, with the round of coordinated global easing since January 2019, the central banks have succeeded once again in administering more morphine to the patient and grabbing a temporary victory from the jaws of certain financial Armageddon.

However, in spite of all of the above, the structural concerns are very much alive.

- Central bank financial terrorism remains alive and well, with over 25% of government bonds in negative yield territor – this is clearly where the bubble lies and what is currently playing havoc with any analyst's earnings and discounted cash flow models. (The difference between a 2% risk-free discount rate and 5% rate for a given stream of cash flows is about 50% on any stock price.)
- Given the incentive structure, corporate leverage has continued to rise even higher, with buybacks (at least in the US) continuing to fuel the equity markets.

- And while we may get some temporary resolution on the trade war between China and the US, it is unlikely we are ever going back to how things were before Donald Trump started it all!
- Protests (inequality is increasing/capitalism is not working) around the world (Chile, London, Barcelona, Argentina, Lebanon, Hong Kong) are a sure-fire indicator that the current state of play is not working and needs to change!

Constructing portfolios to out-perform in this environment becomes ever more complex. Bond-like defensive equities feed off the circular logic of being cheap 'relative' to their negative yield government bond brethren, yet seem egregiously expensive on any historical absolute measure in a 'normal' world. Quality at reasonable value is an oxymoron!

On the other hand, cyclical equities seem cheap on current expected consensus earnings, but it is fair to say that in a deep recession, they also are about 20–40% over-valued on an absolute basis to their deepest drawdown price, and every investor needs to ask the question if he or she will have the emotional ability and patient capital (no pun intended) to hold them through that period.

The job description of an active equity investor is pretty simple – develop a view on markets/individual stocks to exploit an inefficiency, decide how to express that view (which stocks to buy/sell), and when.

So, here are my views:

- **I am not worried about Brexit.** With the elections, I think over the next year we will see some resolution around Brexit and, with uncertainty removed, this should augur well for UK and European equities (markets hate uncertainty more than anything else). In fact, if we did not have the non-zero risk of a Labour government, UK domestic stocks would be the biggest overweight in my portfolio!
- **I think there will be a trade deal.** Even if it is not **the** trade deal, Trump understands the election maths, especially in the swing states, and he would like to get re-elected. Watch the corn belt and the Midwest as these are bearing the brunt of the industrial recession and need things to turn around for people to be happy and vote for Trump again! A stimulus trade deal around agriculture/ethanol policies could all be in the works by the end of the first quarter.
- **Both of the above should be positive** for the cyclical end of equity markets (value and maybe cyclical value!). However, duration of ownership of these businesses depends on the economic cycle and the yield curve, and hence one needs to exercise great discipline around the valuations paid as well as not overstay one's welcome. After all, we are in the tenth year of this very shallow upcycle!
- **What I am really worried about is 'democracy' and capitalism.** As a student of history, it is clear that the world goes through cycles of wealth accumulation and redistribution, and it seems to me we are the end of accumulation and possibly at the start of redistribution. Higher taxes, more fiscal rather than monetary policy, protectionism and inflation are legitimate worries for the 2020s. Most of all, being a global investor, I worry about the risks to globalisation (see my note of July 2019, 'Is the end of globalisation the end of global investing?').
- **The Democratic party platform in the US (Warren/Sanders) and the Labour platform in the UK** both have some form of 'socialism/wealth redistribution' embedded in them. US markets overall currently reflect a very low probability of a Warren/Sanders regime. Paradoxically, however, if we enter a recession (fuelled by low business leader confidence), the chances of one of these candidates being in the White House becomes higher.
- **Let's be clear, If there is regime change in politics this time, that regime change is undoubtedly equity-markets negative.** As we get closer to election season, both in the UK and the US, I would expect daily gyrations to follow the polling numbers of the key candidates and to have significant implications for most equity market sectors (not only for healthcare/energy, as some market participants would have you believe).
- **The above uncertainty and current valuations** would suggest that the US should remain underweight in any global portfolio as we navigate 2020, given the risk of heightened political volatility. Technology companies, especially large-cap, will see risks of increased regulation as well as the likelihood that the tech world will be increasingly divided into China and non-China. The law of large numbers also looks like it is catching up on them. Invest accordingly!
- **Pockets of stability** where there is limited risk to current systems of governance or which can safely work with both the US and the Chinese systems (what we referenced as 'Switzerlands' in my July 'End of globalisation' note) may enjoy premium valuations – seek those out!
- **As ever, companies that are not impacted by significant government oversight and regulation** and which are in control of their own destiny, run by exceptional managers, and which are available at reasonable valuations would be the best place to be in all scenarios: that remains where we seek to spend most of our time to grow your capital.

Above everything else, be serious about humour – you will need it to navigate 2020!

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