



Investment Letter – Q3 2014

“Speculative bubbles do not end like a short story, novel, or play. There is no final denouement that brings all the strands of a narrative into an impressive final conclusion. In the real world, we never know when the story is over.” – Robert Shiller

We find ourselves writing our first investment report at the end of a deceptively benign quarter. Quantitative easing has provided cheap capital to global corporations and inflated equity prices around the world, while encouraging investors to take exuberant risk in fixed income by supplying cheap debt financing. And yet even with an abundant money supply, economic indicators across the world appear anaemic; China is unable to achieve 7% growth, and the Eurozone has slipped into Japan-style deflation.

Global markets have edged ever higher over the past months, seeming to dismiss deteriorating data and rising geopolitical tensions as inconsequential. As the gulf between market sentiment and economic reality has continued to widen, many have been quick to call a bubble. True, valuations are at historical peaks; there is little to no value remaining within fixed income assets, and investors, in their relentless search for yield, are taking considerable liquidity risk to receive little return. Many of the practices seen pre-2008 have returned with gusto: complex loan issuance is booming, and companies are bolstering share prices using debt to finance buybacks. We are not, however, convinced that this is a true bubble – at least, not of the Alan Greenspan “irrational exuberance” ilk. In fact, we have seen a degree of investor reticence in some markets which has caused many to miss out on the gains seen in the first half of this year. And at a fundamental level there is an absence of macroeconomic volatility, of which true bubbles are a considerable source.

The key at this point is to look ahead to the coming quarters, when we will see a divergence in central bank policy. The Fed looks set to end its quantitative easing programme in October and to raise rates next year, while the Bank of England has intimated that a rate rise is “getting closer”. In contrast, ECB president Mario Draghi made the surprise move of cutting interest rates in early September and unveiling an asset purchasing programme to combat deflation; the People’s Bank of China has injected liquidity into its faltering banking system, and the Bank of Japan is not averse to undertaking new easing measures to stimulate flagging growth following April’s rise in the consumption tax. What happens when the taps are turned off? Our biggest concern as we move into Q4 is the US. Currencies, up until now relatively stable because of quantitative easing, have already seen an increase in volatility. A strong dollar will weigh on the competitiveness of American firms at a point when their share prices are reaching less spectacular highs and corporate balance sheets are carrying peak levels of debt. Fundamentally, we believe that equity valuations are stretched, with the CAPE ratio (a measure of how expensive the US equity markets are) back at levels last seen in 2008. We expect China to struggle in the mid-term as it attempts to rotate from an economy fuelled by the supply of cheap credit towards one led by genuine consumer demand. The picture in the UK is better; however, we expect equity volatility, until now artificially suppressed by central bank policy, to return. In Europe we take the view that “bad news is good news”; disappointing data have encouraged the ECB to undertake easing measures, which should support asset prices over the short- to medium-term.

We are most positive about the long-term prospects for Japan’s economy. Consensus estimates remain conservative, despite the fact that return on equity (the amount of net income returned to shareholders) is at its highest level in 35 years and dividends paid by companies this year are at record highs. Further, a performance-based index, the Nikkei 400, has been introduced, which rewards the most profitable, shareholder-friendly companies with a place on its books. This will more than likely goad corporate executives, operating in Japan’s shame-based culture, into action. We believe the opportunity for outperformance over the long term is sizeable.

Nobel Laureate economist Robert Shiller was one of the first to warn market participants about a burgeoning bubble in technology stocks...in 1996, around 4 years before the bubble burst. Nowadays, he is a proponent of the inability of most investors to time the market. We are not looking to time a correction in overvalued assets. Instead, we are cautiously building equity positions and even more cautiously building positions in fixed income. With capital preservation as our primary investment objective, now is not the time to be a hero.

Fred Hervey
Chief Investment Officer