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Annual Newsletter

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"This Time It's Different"

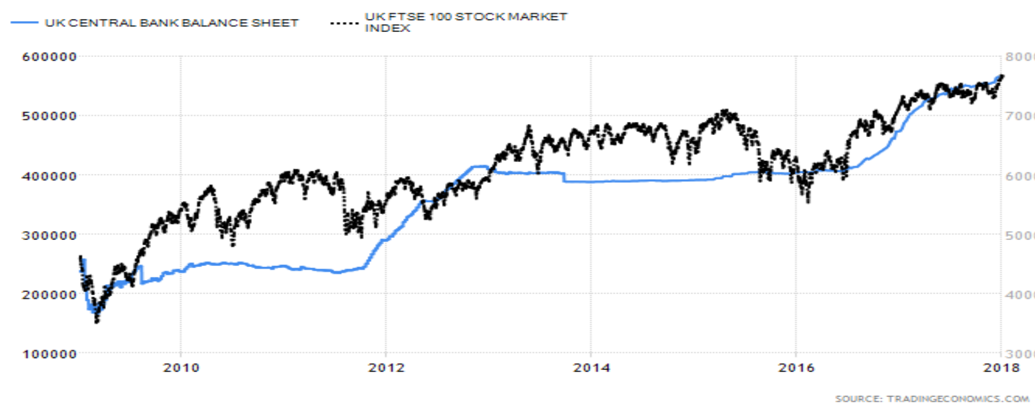
As you will know we have over the last few years remained cautious; looking back at the early days of the Financial Crisis in the period 2009-2010 we should certainly have been willing to take on more risk - but that's easy to say with hindsight.

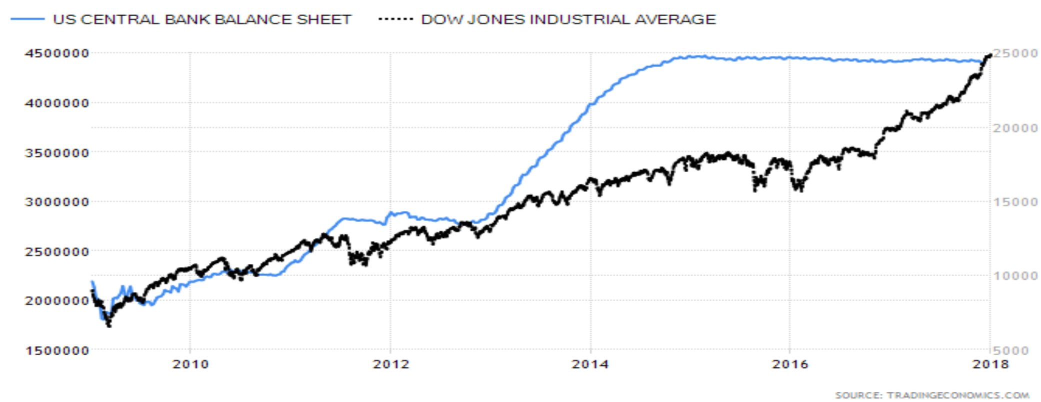
Within our annual and half-yearly updates, we try to provide forward looking information; these are not predictions but our view of market conditions and how we ultimately see things developing.

At present we may well be entering the "This Time It's Different" stage - often referred to as the four most dangerous words in investment! We also see many of the historical indicators that we look at moving from amber to red.

To understand the current climate, it's important to consider the anatomy of how it has been created and why the stakes are higher than ever.

The driver of Stock Market returns has been the giant Quantitative Easing program undertaken by Central Banks; the following two graphs show how the UK and US printed money and the Stock Market (rather than the Economy) followed.



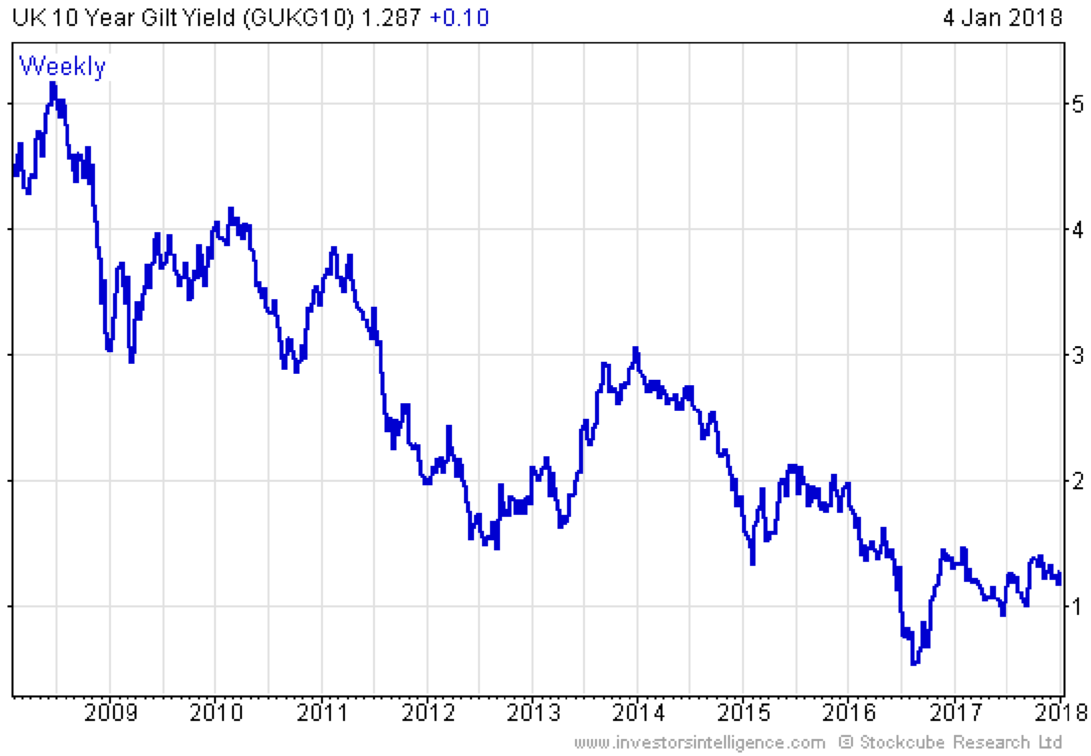


To achieve this Quantitative Easing interest rates were suppressed forcing them to ultra-low levels where savers would no longer be rewarded and would instead spend their money stimulating the Economy – again this appears to have failed to happen, instead they chased the yield from Gilts and then Equities pushing the prices of these assets ever higher and squeezing out any value.

The graph across shows the yield on 10 Year Gilts issued by the UK Government (falling yields equals rising prices for Bonds)

In 2009 you could buy 10 Year Gilts and receive a yield of over 5%; now the yield is 1.28% which after taking off the current rate of inflation of 3.9% means that you are locking in to a “real return” of -2.62%!

The negative real returns from cash and traditional safe-haven assets means that portfolios can no longer diversify risk as they once could; almost everything has increased in value and we see more and more investors looking at esoteric investment such as Tulips......



__Tulipmania (1634-1637__) was the first major financial bubble. Investors began to madly purchase tulips, pushing their prices to unprecedented highs; the average price of a single flower exceeded the annual income of a skilled worker. Tulips sold for over 4000 florins, the currency of the Netherlands at the time. As prices drastically collapsed over the course of a week, many tulip holders instantly went bankrupt. Tulipmania, reflects the general cycle of a bubble: investors lose track of rational expectations, psychological biases lead to a massive upswing in the price of an asset or sector, a positive-feedback cycle continues to inflate prices, investors realize that they are merely holding a tulip that they sold their houses for, prices collapse due to a massive sell off and many go bankrupt.

Sorry, I meant to say Bitcoin or other such Crypto Currencies, but more on that later! The lack of attention to risk levels is no more apparent than in the difference in yields between European High Yield Bonds and US Treasuries (Neil Woodford highlighted this in his blog). Attracted by the yield on European Junk Bonds and Mario Draghi's commitment to saving the Euro investors have piled in and are now effectively telling us that the US Government is about as likely to default on their obligations as European Companies with a low credit rating!

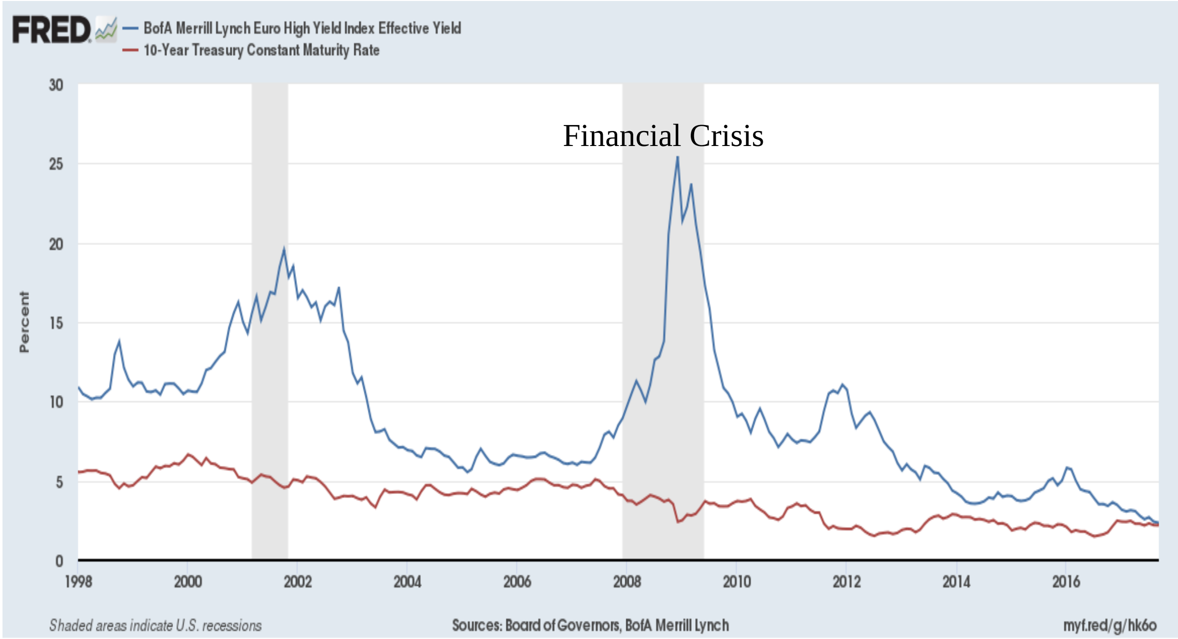
During the Financial Crisis US Treasuries yielded 2.2% as investors scrambled to buy Safe-Haven investments; on the other hand, European High Yield Debt could be bought with a yield of 25% given that most were viewed as likely to default.

Argentina provides a further example of the complacency that exists; it recently raised $2.75 billion by issuing a 100-year bond at 8%. In the current climate this may seem attractive, but buyer beware! In 2010 Argentinian 10 Year Debt was deemed one of the most risky around at a yield of over 20%; then factor in Argentina's Sovereign Debt Crisis record

- Default 1827
- Default 1890
- Provincial Defaults 1915
- Provincial Defaults 1930
- Default 1982
- Internal Default 1988-89
- Default 2001
- Debt Restructuring 2005-2016

Bearing in mind the above the chances of Argentina defaulting in the next 100 years on their debt seem pretty high.

A junk bond refers to high-yield or noninvestment-grade bonds. Junk bonds are fixed-income instruments that carry a credit rating of BB or lower by Standard & Poor's, or Ba or below by Moody's Investors Service. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.



The main reason for our focus on the Bond Market is its importance to the financial system – Business Insider recently reported that the value of Global Stock Markets is around $80 trillion, to put that into context the Institute of International Finance valued the 2016 Global Bond Market at $170 trillion. Problems in the Bond Market invariably transmit through to other asset classes and the fact that we appear to be at the peak of a 30-year bull market for Bonds should make us all pay attention.

Equity Risk

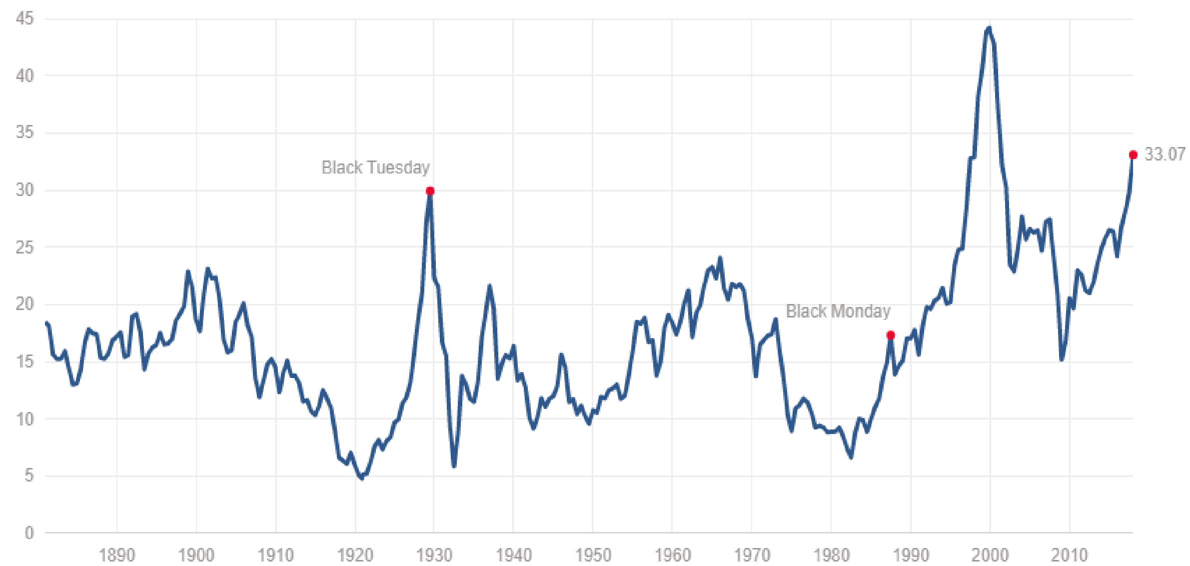
We touched briefly at the start of this document on how Central Bank largesse had driven Stock Markets since the Financial Crisis; this in part is true but it was also helped by a strong recovery in corporate profits and valuation levels that had reached multi-year lows in 2008/2009.

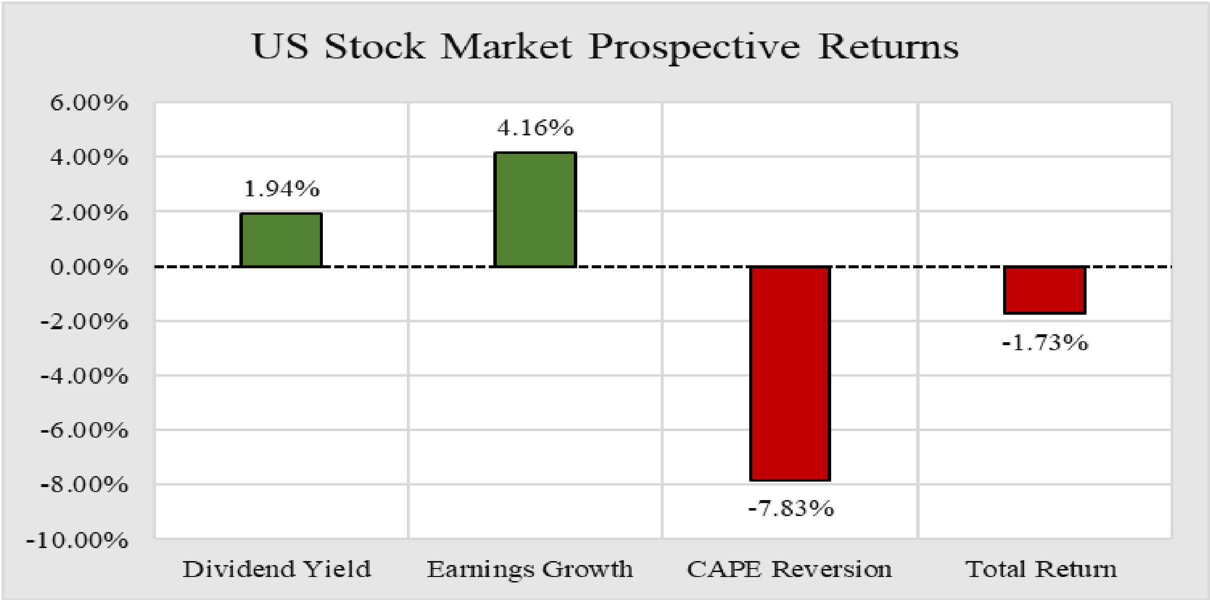
The US Cyclically Adjusted Price Earnings (CAPE) ratio is good example of this. The price earnings or PE ratio, is simply the current share price divided by the earnings per share. The CAPE ratio adjusts the earnings for inflation and uses an average of 10 years to iron out short term business cycle fluctuations.

The graph across shows, the CAPE ratio has only been higher once before in the Tech Boom and currently US investors are paying over 33x earnings for shares. Our interest in the US is driven by the fact that data is readily available for over 100 years and that most other Global Stock Markets tend to follow the direction of US equities. The availability of data also allows for construction of a model for prospective returns based on three components that drive the valuation of shares: -

1. The dividend yield;
2. Growth in earnings;
3. Reversion of the CAPE to its average.

Using the above; currently we estimate that returns from US Equities will be -1.74% per annum for the next 7 years made up from dividend yields plus earnings growth plus reversion to mean by the CAPE (that will have a negative impact).





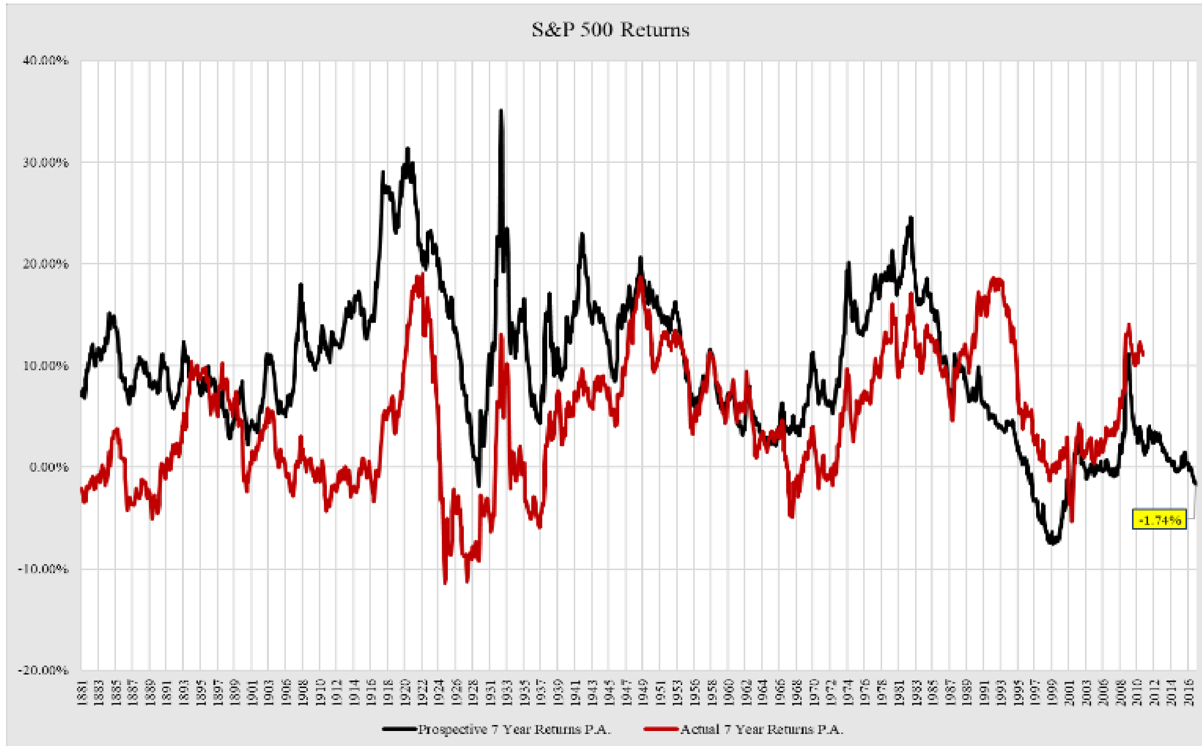
The graph below shows how this simple calculation can create a pretty effective model for under an over valuation of the US equity market and the prospective seven-year returns (black) compared to the actual seven-year returns (red).

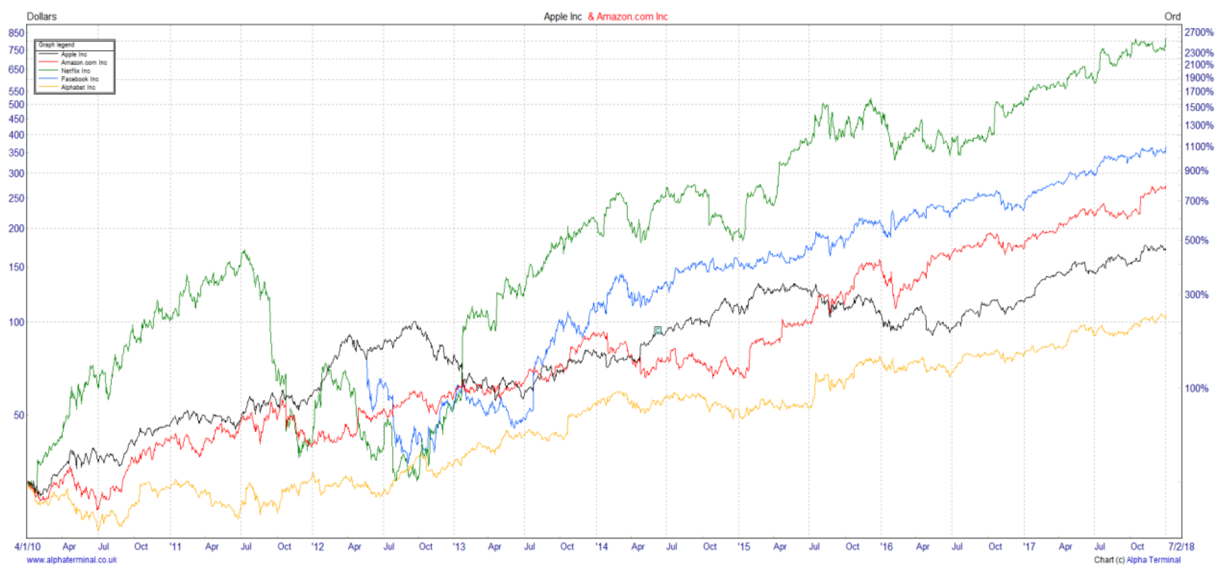
Add to this the fact that the US Equity Market is now dominated by Facebook, Amazon, Apple, Netflix and Google making up almost 11% of a US Stock Market that is dominated by Technology Stocks again. A recent article from CNBC highlights some of the risk.

Technology has the largest sway over the fortunes of the overall stock market that it's had since the tech bubble, and that's a concern to some strategists. The S&P technology sector is close to 23 percent of the market weight of the S&P 500, the highest percentage since the tech bubble, when the weighting peaked at 34 percent in March 2000, according to Howard Silverblatt, senior index analyst at S&P Dow Jones Indices.

But the Street's favorite stocks have outsized clout in the index. For instance, Silverblatt says the FANG names — Facebook, Amazon, Netflix and Google parent Alphabet — equal about 7 percent of the S&P 500. With Apple, they make up about 10.6 percent……An abrupt sell-off in the Nasdaq on Thursday highlighted the role big-cap tech has played in the market's gains, and raised concerns that the nature of the move was signaling a further sell-off ahead.

"As an investor, you have to be concerned when so many investors are on the same side of the canoe. It's an unusual market. One that appears to be defying gravity, but if there's any indication that things are turning around, there are a lot of weak hands holding tech," said Jack Ablin, CIO of BMO Private Bank.





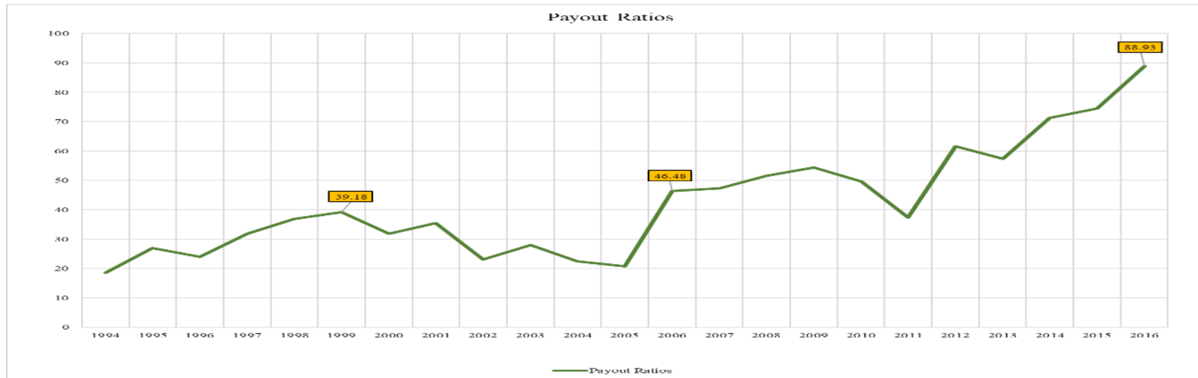
We can also see similar problems in the UK using the ten largest firms in the FTSE-100 based on Market Capitalisation, their Price Earnings (PE) ratio is now higher than in the Tech Boom back in 1990-2000.

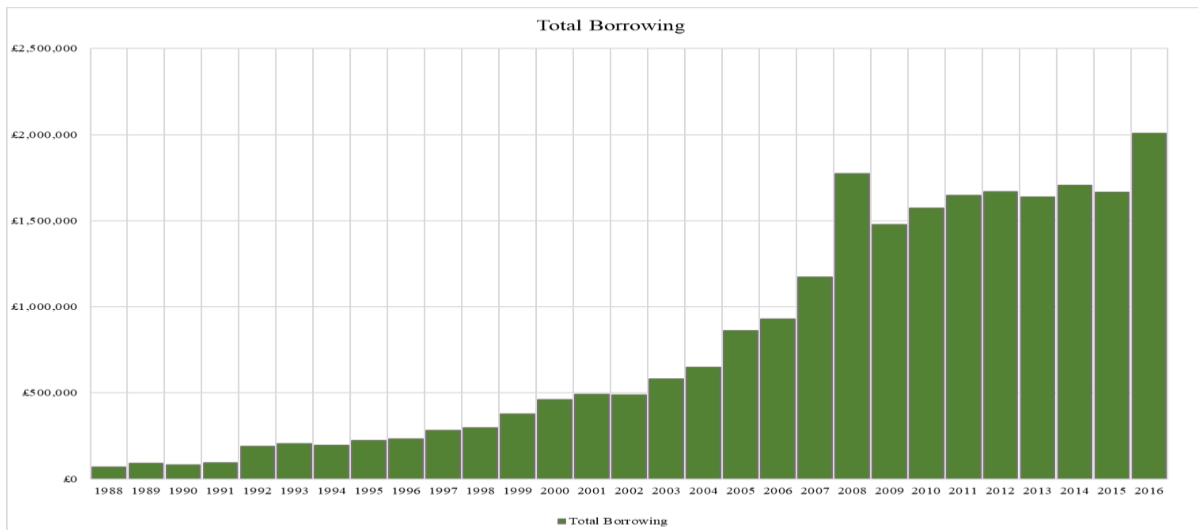
At the same time these firms are also paying out more and more of their earnings as dividends (the “payout ratio” shows the dividends per share divided by earnings per shares). The result is that this helps keep the share price high as investors are attracted to the income but long term there are implications.

Money that firms previously may have set aside to spend on capital expenditures or research & development has been paid out. If Company’s were feeling more positive they tend to spend cash on future projects to expand and grow their businesses.

Prior to the Financial Crisis firms these large firms paid out less than 40% of their earnings as dividends – today the median payout from the 10 firms is 88.93% of earnings. In recent years some have even gone past 100% - this means they are paying our more in dividends than they earned!

It may well be that to fund this dividend policy and sustain their share prices firms have been taking advantage of the low interest rates and cheap borrowing to help fund their dividend policy increasing the level of debt. The graph across shows the total borrowing from the ten companies included in the study. Even though interest rates are low this debt still needs to be serviced and a downturn in profits coupled with less of a cash buffer (spent on dividends) could signal hard times.





Earlier on we promised you some information on Bitcoin and if you were wondering about my reference to Tulips the graphs across hopefully show you why. Nearly four hundred years on from Tulip Mania we can't see how "This Time Its Different" and Bitcoin like Tulips is simply a medium for financial speculation and not fundamental analysis. I have also added some other famous financial bubbles!

In the scheme of things Bitcoin is not that important to the functioning of the overall financial system; but it is reflective of investor attitude and a race to "get rich quick". However, the bursting of such bubbles can be a trigger for changing sentiment and the start of a race to the exit doors across other asset classes. All this may leave you wondering if there is any good news and asking why we are still investing?

The fact is that Quantitative Easing and ultra-low Interest Rates may be here to stay in the next few years at least – after all the Central Banks can claim their actions averted financial disaster and they may well be willing to do it again. Our view is that at present there are not enough questions being asked to change investor sentiment and whilst the masses fell this way the music will continue to play, and risk assets may well perform for the moment. Therefore, with no clear end in sight to speculation we remain committed to the tried and tested holdings that provide boring consistency and focus on capital preservation.

Kind regards

Andrew