Investment review

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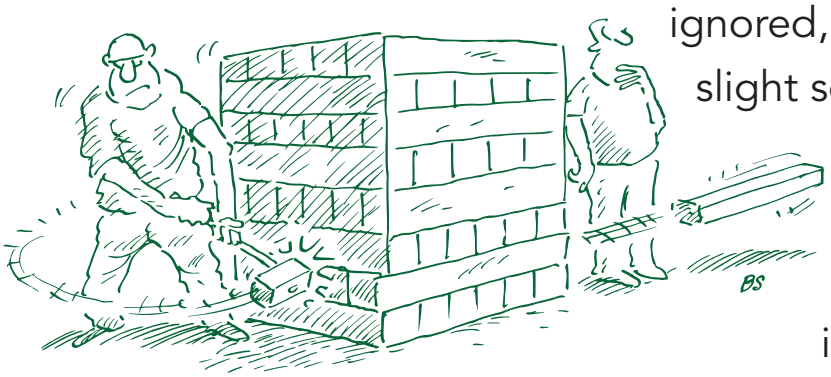
There's a childhood game, whose name changes each generation – currently called Jenga. It starts as a wall of wooden bricks, and successive players remove individual pieces until the loser takes one out, and down falls the edifice. Its drama comes from the fact that a seemingly parenthetic brick proves, on occasion, to be supporting the whole thing; whilst the removal of a brick which seems to be playing just that role, when removed, creates a yet more precarious wall, still standing. The markets have felt like that for a long time. Whatever has been thrown at them has either been ignored, or has produced a slight setback which creates a buying opportunity. How should one value a world market which is impervious to debt higher than 2008, to valuations which show extremes on every recognised 'measure of value', trade wars between the two biggest world economies, a series of crises in the EU of which Brexit is probably only the third most serious, unstable world leaders, and sluggish, slowing growth which seems unresponsive to the oxygen mask of central bank medication? Since it is generally accepted that the dynamic of market movement is essentially a discounting mechanism, it is reasonable to assume that each element of this litany of the apocalypse is already in the price – it needs something else to bring it down.



How wise is it, then, to bet against a continuation of this market, which, in the clichéd language of the trader, climbs a wall of worry? The trade-off is clear: in the short term, it's almost madness to believe that with every poison already in the mix, that there could be another malign factor whose sudden appearance has the power to torpedo the market. On a different timescale, every week which passes increases debt levels, reinforces the valuation of those assets which have been the beneficiaries thus far, notably the momentum stocks amongst equities, and fixed interest stocks (especially those with long maturities) in the bond market. A further factor needs careful consideration – would a market setback cause, *ipso facto,* a fall in the real-world economy? It didn't in 1987 and 2000, it did in 1929 and 2008, and it's hard to tell in the largest market fall of all, the bear market of 1972-75.

The darker side of this phenomenon is that it risks a violent and amplified reaction – the seventh gin makes tomorrow a more sorrowful place than the fourth. It is always the case that the delayed correction of disequilibrium is problematic. Perhaps the best way of seeing this is to reconsider the work of 19th century Swedish economist, Knut Wicksell, which we quoted a decade ago when interest rates were reduced almost to nothing; since then, we have become accustomed to zero rates but it's worth reminding oneself that this experiment (for that is what it is) has not been tried before. Wicksell's insight was that any society is made up of people who want to borrow money, and people who wish to lend it. There is, at least in theory, an interest rate at which both borrowers and lenders are prepared to deal, an equilibrium which he called the 'natural rate' of interest. It might be assessed intuitively, and if

actual rates are higher than the natural rate, then would-be borrowers would hold off from doing so, or even put their cash balances to work at the high rate; if they are set too low, then even a lender might be tempted to borrow more money. That's how it was when money was bounded by the scarcity of gold sovereigns; that's not the situation any more. Banks can create money, first with the help of trees (paper money), and now with the push of a button on the screen. As Wicksell himself noted, there is no equilibrium in a pure credit economy, and so, by way of absurd exaggeration, he said that if interest rates ever go to zero and stayed there, then asset prices would rise towards infinity. That's what seems to be happening, and it's a brave investor who imagines that the experiment ends well, even if it is helping the FAANGs, the disruptors of the modern world, to capture new markets with cheap borrowings. It is also helping companies to buy back shares on the New York Stock Exchange: the cost of borrowing being less – much less – than the extra earnings of same-again profits divided among a smaller number of shares, post-buyback. Witness Microsoft, the largest public company on earth, using two thirds of its remaining net cash ($40 billion[1]) to buy back its own stock, at an all-time high.

Another powerful factor in market valuations, but largely unseen, is a change in the make-up of trades in the liquid markets. Work done by Michael Green at Thiel Macro suggests that when the passive share of market trading (the percentage owned by investors who own a balance of index-stocks) approaches half the total, then it's investment flows, not fundamentals, which drive the market. It's not the level, but the direction which matters: the point is that the

1 Microsoft press release, 18 Sep 2019

markets merely appear to behave (as they always have in the past) to the drumbeat of real events, but this is no longer the case. [Note to reader: momentum is outperforming value by a greater margin than has ever, historically, been the case.]

This raises the possibility that perhaps the stock market is not a discounting mechanism, after all. Could it be that the cocktail of problems, plain for all to see, is nevertheless out of sight of the stock market? Instead, its future performance will be determined by financial flows. If so, then the evolution of the political economy carries real danger. The markets look outward at the possibility of helicopter money, fiscal reflation and modern monetary theory – all interesting enough, but not the decisive factor in the hollowed-out market valuations.

What we are seeing is the financial establishment (central banks, governments) ensuring savers are penalised and borrowers are favoured. The oxygen mask works as an emergency support in a crisis, but promotes the distortions which might be expected if privilege is extended to one part of the market. One might expect that borrowings would grow faster than the economy. They have: France's non-financial private sector debt is more than twice the level of its economy (GDP). Add in the rest of its debt, and it's three times GDP. The 2008 crisis was triggered through debt default, and many 'safe' countries' debt levels have surged through those seen then (Netherlands now 333% versus 232% then, Singapore 283% versus 115% then, Ireland 302% versus 250% then, Canada 302% versus 222% then, US 250% versus 168% then[2]). It has

2 Russell Napier Strategy Report Q3 2019

concentrated wealth into the hands of the few; there is a backlash against a situation widely seen as unfair.

Certainly, the good times appear to be receding. There's unanimity of feeling in America (Democrats and Republicans alike) that China's free ride on trade is over; this suggests that the long term outlook for world trade should be adjusted down, and the same is likely true between Europe and the US. Closer to home, the political outlook in the UK is worrisome. Of course, the Conservative party may triumph in the coming election, or might it be a repeat of 1924 when in a three way fight, a Labour administration emerged for the first time.

If so, it might be time to consider what domestic taxation might look like.

One of the think tanks (Institute for Public Policy Research) has recently published some speculative ideas on how taxation might work under a Corbyn government. It is based on the idea that the person who earns their financial return without working should be taxed at the same rate as their working neighbour. This would mean the near-doubling of capital gains tax (levied with few exceptions), and an increase in the overall rate. (No mention was made as to income tax's sepulchral cousin, National Insurance, which could combine to make a heady top rate for the resident plutocrat). As ideas go, this one is pretty middle of the road. In Victorian times, earned income was taxed more highly than unearned, because the strong worked, while the weak needed unearned income. For most of the post war period, unearned income was regarded as less morally attractive, and suffered a further 15% surcharge. So,

treating them the same seems pretty reasonable? 'No', shout we all, because this brings capital gains into the income tax orbit! Well, shout back Labour, we're only doing what the Tories did in 1962… and what Nigel Lawson did in his 1988 budget, when he received a standing ovation.

Then there's Brexit. After Brexit, whether in or out, life will go on. The bulls will stop fighting, the china shop will need to be rebuilt. Our portfolios are constructed to be ambivalent as to the actual market outcome. (We live in a world where investors buy bonds for capital appreciation, and equities for income!)

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