WALKERCRIPS
STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

STRATEGY 2015 - PART IV

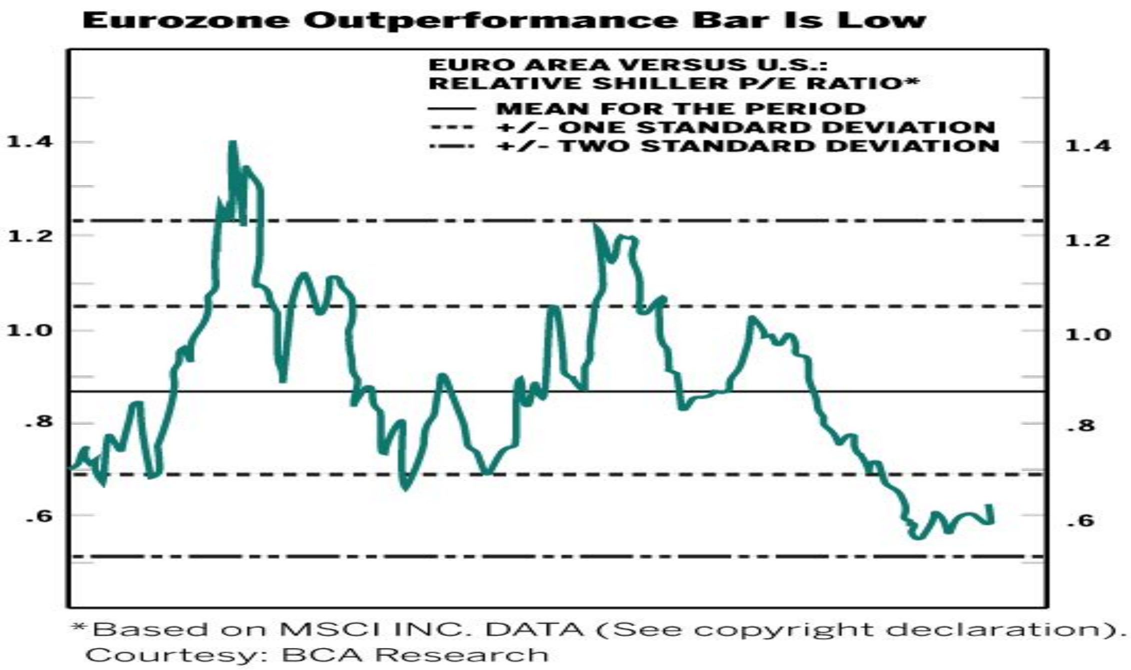
17 February 2015

1) Europe
2) Risk

Europe Equities

Having been to another of BCA Research's (Bank Credit Analyst to you and me) very useful breakfast (aaargh, the time) strategy sessions, I recently changed my Strategy 2015 Part II rather sniffy view of Europe. Only, I hasten to add, as regards equity investment currently. The European currency remains, well, Euromess. I have re-entered an Italy tracker for clients and self. (For fun – not for clients, too hairy, have made a small 'play' in an Athens tracker, market down over 80%.)

The European economy, notably Germany and Spain, was fast beginning to crawl off the floor anyway. But, if maintained, the currency and oil price decline should add about 1.5% to GDP growth, a significant number compared with not much more than schnix previously expected. Further, the fiscal policy depressant is ending. More important, forecasts of corporate profits, having declined remorselessly year by year since 2011, are now finally being raised. Psychologically Europe has been unpopular – a state of affairs that always attracts my interest. If lots of people agree with you in this business it is likely that you are wrong. Better to be the investment outcast at the 19th Hole. Being an only child, I have no problem with this sort of thing. Lastly, on valuation, the numbers are reasonable, if not overwhelming. Certainly *viz-a-viz* the Shiller PER - about 16 (Italy 8.5, Greece 3.4) versus US 26.



Caveat. Given the current absurd financial environment risks are so high that an "all bets are off" situation could (and likely will) occur at some stage. Trading skills are at a very high premium currently. Buy and hold medium term. Generally speaking, - dangerous. Though there are exceptions. Interestingly, fund managers have been selling out of UK equities, bar nine months, for over a decade. This is surely bullish (*source: FT 24/02*).

Risk – we have

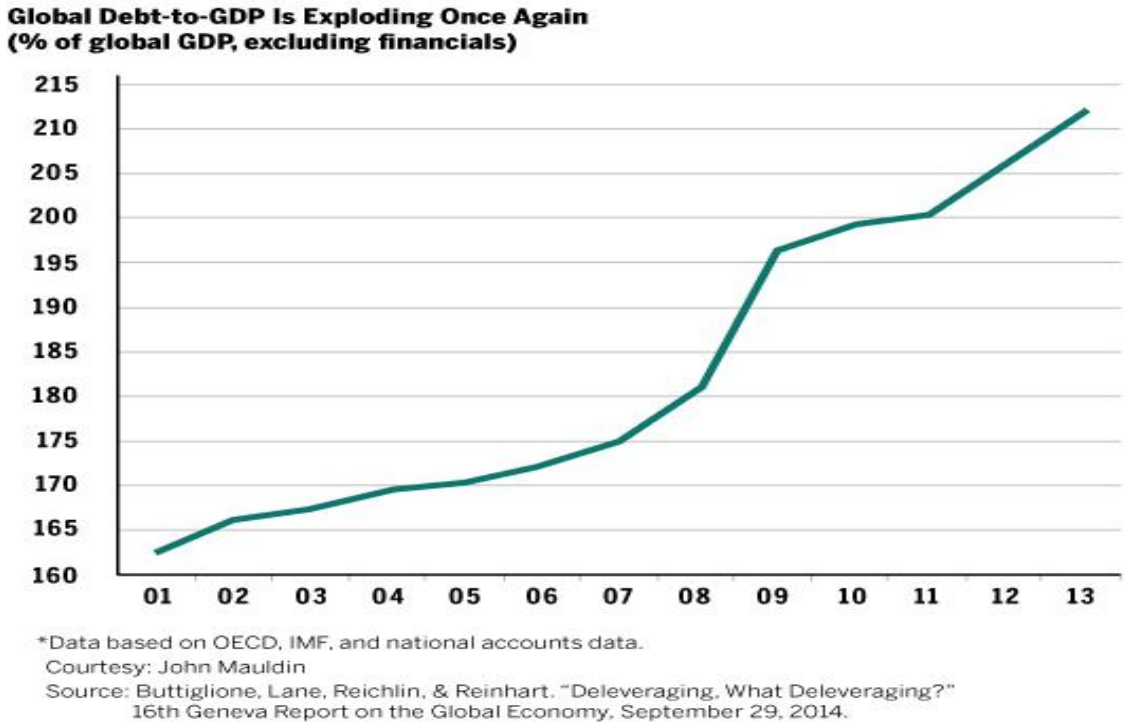
a) High risk; minimal potential return across very many asset classes.

1) The main item on this list, as readers know, is debt. None of the normal post crash clear-out has taken place. Worse, debt has actually increased and also relative to GDP. And disinflation makes the 'real' repayment burden remorselessly increase – though, temporarily, the rigged interest market takes the heat out of short term financing costs. This gives a false impression of everything being ok.

   Similar to, say, the UK housing market which, on valuations, near 4.5 x income, is hugely overpriced historically, but the minimal mortgage rate makes houses appear 'affordable'. (Well, to some people!)

   As for worldwide debt levels, McKinsey point out that, since the bursting of the credit bubble government debt has risen from \$37tn to \$58tn. This is a compound growth rate of 9% p.a. versus minimal GDP growth rates.

   Total debt has also ballooned.



2) In the US in 40 years a credit boom added $33 tn (2 x today's GDP) to spending. The world, let's face it, enjoys an almost out of control monetary expansion (want a drink, have one). This is truly unprecedented ('living financial history', as I described all this debt orgy **before** the crash). This has resulted in bubbles or heavy overvaluation in numerous asset classes: corporate bonds, government bonds, index-linked bonds, US equities, various housing markets, prime real estate worldwide, collectibles, for example.

   This is, of course, a personal view, but I don't see the hitch with the following logic.

3) Portfolio Management. Conventional wisdoms (actually an oxymoron) are **always** dangerous. Certainly in investment right now. In days of yore a middle risk portfolio might comprise, say, 40-50% government / corporate bonds; 20% US blue chips; 5% real estate; the balance local / world equities. Minimal cash.

   Actually, this is a lazy formula – but, appears in exam (spare me) papers. **Risk is obviously always a moving target**. For example, US blue chips (say, the Dow constituents) swing around from cheap valuation – say 5-7 PER to expensive 30-40 PER. No, US business value does not change, back and forth, by factors of 4 to 8! 'Risk' level swings accordingly.

   Obviously, as now, looking to Shiller PER, which is the best return 'predictor', US blue chips must be called more or less speculative. Emphatically not medium risk.

   Ditto government bonds of all sorts – often giving the lowest yield, in all history. As for indexed government bonds, the historic normal 'real' medium term top quality interest rate has been some 2½-3%. It is currently zero to actually negative (more or less unheard of). If this doesn't make these instruments high risk, what does?

4) As for corporate bonds, the risks appear even more terrifying than I have previously suggested.

   As you know, having held quite a lot for clients, I sold the lot (and all bonds) about two years ago.

   John Plender – always a good, sensible read – wrote in today's (18/02) FT that:

   1.
      a. The amount of 'junk' (non-investment grade) bonds globally has increased by some 700% (!) from 2000 to 2012 – direct result of the bizarre 'Rake's Progress' monetary policy, under which investors cannot get a decent return from 'quality' fixed interest investments. There was a $ trillion of this stuff around at end 2013. (Ed – and more now, to be sure.)

      b. In that period 'junk' rose from 4% to 18% of all corporates outstanding. 'Junk' can be decidedly lethal – typically 20-30% default in a sharp economic downturn. As for what you get for all this risk – give or take the lowest return in 'junk' history. Just think about it all.

      c. As for the 'quality' of the 'junk' (almost another oxymoron), you've guessed, it has plummeted as the desperate herd of investment lemmings rush towards the cliff. The percentage of 'callable' bond issues – whenever it suits, issuers may force you to sell back your bond; lose its yield, facing, thus, reinvestment risk - as well as 'covenant - lite', i.e. less protection for investors in the terms of the loan; both have shot up in prominence.

5)

a. So you suddenly want to get out. Join the queue fella. As the stash of this stuff (corporate bonds) has gone through the roof, the market absorbing capacity of the main banks has, as readers know, **decreased** by some 70 %.

b. Illustratively, in the US, apparently of over 41,000 corporate bonds, in issue as of June 2013, only 6,400 traded daily. In most main equity markets nearly every stock trades daily.

c. Yields on fixed interest in the main economies, as I have said, are often the lowest levels in history. The story doesn't end there. In various economies you now have to **pay** the government to lend it money. Again, just think about it.

d. As this goes to press Lebanon (Lebanon?!) has just raised its biggest loan ever at about 6.5 % for various dates. It has the third highest government debt to GDP of 'rated' (by rating firms) nations in the world. Now I've seen it all.

6)

a. As for pension funds, they are forced into loading up with fixed interest. They dare not step out of line by not doing what is considered the 'prudent' (no, don't laugh) post-crash approach. Understandably, the Trustees are fearful of being sued – common activity practiced nowadays, and increasingly resorted to by bad losers and assorted back coverers.

b. Worse, by the way that pensions liabilities are actuarially calculated, 'deficits' grow and grow as bond rates collapse. The knock-on to, say, corporates is that they have to shovel more and more money into the schemes, leaving less for dividends, investment and current wages. (The calculation – which arises out of a figure for the net present value of the liabilities, depends on the discount rate used to arrive at the net present value. The lower the discount rate the higher that number.) As if today's extreme interest rate circumstances substantially change the funds' abilities to pay their obligations years hence, obligations which, in fact, might be less than expected due to possibly lower inflation of wages and salaries. Go figure.

For this reason, unlike in the recent two previous crashes, this time around I have no large scale convincing alternative investment. Then I had stacks of bonds, indexed bonds and a little gold, which hugely protected portfolios, one or two of which actually crept up in value in the crashes.

It's tough, very tough. All I can – and do - do is trade (if you can't trade you are more or less dead in current circumstances) 'value', high yielding (largely), stocks and a little bit in countries like Europe / Japan (investment trusts / ETFs / i-shares, never unit trusts: hugely expensive). Plus a silver share tracker, currently on a trading basis, where I am now only one third in.

Otherwise, I am stuck with a heap of unrewarding, at the moment, but necessarily protective, cash / equivalent. But if the logic of the fundamentals so strongly indicate what I describe, you **must**, as always indeed, maintain discipline – and be patient.

So where are we?

1) Savers have been massacred. Risks have soared. Thank you QE *et al.*
2) The elephant in the room, the debt problem, has put on a few more tons.
3) The big Central Banks are actually buying more debt than than issued as a result of massive government spending.
4) Investors face horrible choices.
5) The on the ground economies remain weighed down – no surprise – by the debt mountain, thus impeding repayment ability.
6) One asset class after another has become more or less uninvestable by prudent investors.

Conclusion

The proverbial Martian arriving here would wonder whether he had either arrived in

a. a lunatic asylum or
b. Alice's Wonderland

Good luck.

Peter Bennett, BA Cantab, MBA Wharton

P.S. Per Barrons: "For a century and a half after the war of 1812, the Federal government only borrowed during wars and economic downturns. Good fiscal stewardship meant paying down debt after emergency borrowing, not simply borrowing more" Ed: in this period the US was becoming the greatest economy in the world.

P.P.S. Athens tracker just 'flipped' for modest turn.

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