►On Target

Martin Spring's private newsletter on global strategy

January 13, 2018 No.223

Coming: First a Bubble, Then a Bust?

Here's hoping that 2018 will be as good a year for investors as 2017.

Last year was the best for many since 2009 and one of the best ever. In the case of one portfolio I've seen, the biggest individual-company holding, Tencent, saw its Hong Kong-listed share more than double in value. This Internet services giant, now Asia's biggest listed company and roughly the market size as Facebook, has a special interest for we South Africans -- our media group Naspers owns a third of its shares, presciently bought for peanuts back in 2001.

The portfolio's second largest single-company holding and the world's biggest bank, China's ICBC, even though bought and held for income, not capital gain, rose 35 per cent in value. The global fund in which the portfolio's holding is largest, Fundsmith Equity, delivered 34 per cent growth in dollar terms. Even stakes in assets held primarily to offset portfolio risk in equities – gold and German government bonds -- had good years.

Can investors do as well in 2018? What factors should shape your strategy?

The environment for global investors is excellent:

► For the first time in a dozen years, the major economies are synchronized. Most are growing relatively strongly and their rates of growth are speeding up. Morgan Stanley expects the world economy to expand 3.8 per cent this year, with the US delivering 2.5 per cent, the Eurozone 2.1 per cent, China 6.5 per cent, India 7.5 per cent.

Equity markets reflect this favourable business environment. Globally, corporate profit margins are high.

► Central banks have begun their retreat from easy-money policies, but are moving very cautiously. The US Federal Reserve has pencilled in three interest-rate increases this year, but only a quarter-point each. The European Central Bank's idea of tightening is to spend a little less each month on its continuing massive bond-buying programme. The Bank of England and the Bank of Canada have both started to edge up interest rates.

Overall, interest rates are still very low, credit is abundant, financial conditions have rarely been as easy.

In this issue: 2018, boom then bust ▫ Safety for your family ▫ Ben Graham's tips ▫ Buying a home abroad ▫ Japan's tax cuts ▫ China & the US

► The Republicans are boosting America's growth, as they have promised to do and as they must do if they're to hold off the Democrat threat in the November elections. Tax reform is about to come into effect. The bonfire of regulations is blazing away, with many scrapped and the number of new ones approved at the lowest level since 1994. Officials with free-market rather than socialist bias have been placed in command of federal agencies.

Businessmen seem certain to follow through on their greater optimism with heavier investment (this is going to be a "huge deal," says Scott Greenberg of the Tax Foundation).

► Things are looking good with China, the world's second biggest economy, which has perhaps the world's most competent governance. Beijing continues to maintain very high economic growth while closing down least-efficient excess capacity in industry and mining, tackling the massive pollution problem, and squeezing risky "shadow banking." Chinese bank stocks have been rallying in recent months in response to their improving asset quality.

Morgan Stanley says there's sustained growth in exports, consumption is supported by better wage growth, there's a healthier state of inventory in the property market, and improving profits in industry.

What are the risks in the global economy?

► War in Korea. Judging by the complete absence of panic on the Seoul and Tokyo stock exchanges, this is most unlikely. But sometimes major wars are triggered by accidents or misjudgements. Because they're so unexpected, consequences are correspondingly magnified.

► A crisis that starts in the bond markets. They are several times larger than global equity markets, and bloated by years of too-easy credit. If there is already a bubble in anything, apart from cryptocurrencies, it's in bonds. Yields are very low, sometimes even negative (investors accept a small loss of income as the price they're willing to pay for the security of their capital).

If central banks misjudge things – perhaps tightening too much, too fast – then investors could take fright and flee the bond markets. If they crash, panic will spread to markets in other investment assets, such as shares.

Assessing the long-tail risks

► An inflation explosion. Markets don't expect this because central banks have conspicuously failed to achieve the moderate inflation they believe would be ideal – prices rising about 2 per cent a year.

But the US is running out of spare skilled labour, with the unemployment rate to fall to 3½ per cent by year's end. Shortages are starting to drive up wages. If this combines with buoyant demand boosted by Trumponomics, and higher import prices due to a weaker dollar and protectionism, with a continuing lack of productivity growth, while the economy remains awash with cheap credit... a sharp pick-up in price rises could come as an unpleasant surprise.

The damage potential in these risks is enormous. But they're also what are called "long-tail" risks. They're very unlikely to happen. You can probably ignore them if you have some ultimate-safety measures baked into your family's moneycraft.

You will notice that the "risk" that concerns many investors isn't on my list – very high valuations. These measure risk as potential from which current values could fall. But they don't measure the potential of "lost opportunity" – the gains you could fail to make by not being invested.

My experience has been that one loses more from failing to be invested, or selling too soon, or failing to hold on to assets after their values have been clobbered (they always recover), than from failing to exit because of bearish fears.

It can be argued that valuations are dangerously high because central banks have foolishly pumped far too much money into the system, and made it clear that they will shield investors against a collapse. This has fostered the strategy of "buying the dips," so a necessary stabilizing of the markets through sharp falls to clear out leveraged speculation has been avoided.

On the other hand, the charts of major asset classes show no sign of bubbles. Prices have been rising, often in steady "staircase" patterns, for years. This suggests that there is still too much investor caution around for things to get out of hand.

Is this about to change?

One highly-respected commentator who thinks maybe so is Jeremy Grantham of the GMO fund management group. "We are currently showing signs of entering the blow-off or melt-up phase of this very long bull market."

He sees the recent acceleration in American share prices, a concentration of leadership in stocks, and growing media coverage of events such as Bitcoin's surge, as signs that we've entered the final phase of the bull market. There's a better than evens chance of a bubble within the next six months to two years, he argues.

Stock-market 'clawing its way steadily higher'

He advises investors to watch out for classical symptoms such as a mass-media focus on stock markets. When most TVs in lunchtime eateries are tuned to channels with "talking heads yammering about Amazon, Tencent and Bitcoin, and not Patriot [football] replays – just as late 1999 featured the latest in Pets.com [which proved to be one of the spectacular disasters of the Dot.com bubble] – we are probably down to the last few months," he says. "Brace yourself for a possible near-term melt-up... momentum increasing to a frenzy."

The strongest indication of a bull market developing into a bubble is price acceleration. Until very recently, the American stock market "could justifiably be described as clawing its way steadily higher. But just recently, say the last six months, we have been showing a modest acceleration – the base camp, perhaps for a final possible assault on the peak."

Grantham says no two bubbles are the same. They share many signs of investor euphoria, sometimes approaching the madness of crowds, "but the package of psychological and technical indicators has been different each time."

What to watch for... Are investors clearly getting carried away? Are prices accelerating? Is the market narrowing? Are valuations extreme?

What to expect… In the most moderate of classic stock-market bubbles, prices rose 60 per cent over the final 21 months. In other bubbles, price rises in their final phases were even greater.

What should you do?

Bubbles are times when great profits can be made, while exposing investors to greatest risk. For the moment, the markets aren't sending negative warning signals. On the contrary, they're generally looking good. It's time to stay fully invested, just watching out for trouble while accumulating gains.

Seeking Safety for Your Family

At a time when things, on the whole, have never looked better in the world, how strange it is that some people have such fears of a global catastrophe that they are taking out insurance for their families by moving to, or setting up arrangements to move to, what they perceive to be the safest place on Earth.

It reminds me of the American couple who in the Thirties, correctly anticipating the Second World War, actually moved to the safest place they could think of, a remote Pacific island. Its name… Iwo Jima.

Now some rather larger Pacific islands have become the destination of choice for wealthy families – New Zealand. The amount of land being acquired there by foreigners, mainly Americans, has increased dramatically in recent years. One big name is Peter Thiel, the billionaire founder of PayPal, who has bought a home on the edge of Lake Wanaka, a stretch of stunningly beautiful real estate down in the deep south of the south island.

"As the world gets crazier and crazier, our peaceful and beautiful little country just looks more attractive," says Ollie Wall, a property consultant. The inflow of foreign investors buying up New Zealand real estate has now motivated the new government to plan to stop them from buying existing homes – although, as in neighbouring Australia, they'll be free buy into new properties.

If you're nervous about the future, what ought you to do about it?

If you're looking for physical safety, I agree New Zealand would be an excellent choice. As would almost anywhere in the southern hemisphere – all potential foci of a major war are in Earth's northern half.

If physical safety is not your main concern, you may be more attracted to a stable, well-governed country providing a good environment for your family… assuming they'll let you settle. New Zealand is undoubtedly one such, but there are many others. Singapore, Ireland, Australia, Switzerland, for example.

If you are a retiree, or about to become one, other considerations may affect your choice of a destination such as a nice climate, low living costs, excellent medical services. My own choice, as you know, has been Chiangmai in Thailand. *International Living* has selected six Latin American countries headed by Mexico as the world's ten best, plus three in Europe (Spain, Portugal and Malta), but only one in the Asia-Pacific – Malaysia.

Wherever you live, a key element of your family's security will be adequate, safe financial resources – enough stable income to meet your regular needs, plus capital to meet periodic expenses and provide insurance against the unexpected.

Your required moneycraft should be based on several important principles:

► Diversity in geographical location. To some extent this will be limited by your background and the source of your wealth, but it's sensible to seek some international balance across North America, Europe, Asia and the country where you live.

► Diversity in asset classes. Your capital is probably focused on equities and/or property, but every portfolio should contain some gold and low-risk bonds, plus perhaps some alternative investments.

► Diversity in income. Your inflows will inevitably be concentrated in one currency determined by your background, but it's important not to be totally dependent on one currency, such as the US dollar. Some regular income should be sourced in others such as the euro, sterling, Asia-Pacific currencies.

No matter how clever you are at investment and other aspects of moneycraft, many of your choices will turn out to be wrong ones, and all of us are exposed to major unforeseen risks. In the same way that the three guiding rules for real estate investing are said to be location-location-location, the three you must follow for your family's financial security are diversity-diversity-diversity.

Avoiding Investors' Chief Hazards

Here are some useful tips for investors from the late Benjamin Graham, one of the alltime giants of the investment craft...

► If you are shopping for common stocks, choose them the way you would buy groceries, not the way you would buy perfume.

► Remember that obvious prospects for physical growth in a business do not translate into obvious profits for investors.

► And most businesses change in character and quality over the years, sometimes for the better, perhaps more often for the worse. The investor need not watch his company's performance like a hawk; but he should give it a good, hard look from time to time.

► Price fluctuations have only one significant meaning for the true investor -- they provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns, and to the operating results of his companies.

► The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense, because they alternately create low price levels at which he would be wise to buy, and high price

levels at which he certainly should refrain from buying and probably would be wise to sell.

► The risk of paying too high a price for good-quality stocks – while a real one – is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favourable business conditions. The purchasers view the current good earnings as equivalent to "earning power" and assume that prosperity is synonymous with safety.

► Even with a margin [of safety] in the investor's favour, an individual security may work out badly. The margin guarantees only that he has a better chance for profit than for loss – not that loss is impossible.

► To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks.

► Most of the time stocks are subject to irrational and excessive price fluctuations in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble … to give way to hope, fear and greed.

Taking Care When You Buy a Foreign Home

Here are some interesting tips from *International Investment* on buying property outside your own country:

► Never sign a contract that you don't understand, particularly if it's in a foreign language.

► Always seek specialist advice from independent lawyers, architects and surveyors (not ones recommended by the seller or his agent) before buying, and get an independent valuation.

► Make sure that you're not inheriting any debt linked to the property.

► Always take a "cooling off" period before committing yourself and paying a deposit.

► Try to arrange mortgage finance in principle before agreeing to purchase. Ensure that the contract gives you the right to recover your deposit if the deal falls through because you can't get finance.

► Arrange the mortgage in the currency you earn, unless offsetting rental income will be received from the property.

► Consider combining your resources with those of friends or family so you can afford a better property.

► Establish what will be the legal fees, taxes, insurance premiums and other costs that you'll have to meet in addition to the purchase price.

► Open a bank account in your chosen country and ensure you get the necessary certificates recording your importation of money.

► Set up standing orders on your local bank account to meet bills and taxes as they come due.

I would add to this list:

► Check carefully that the seller actually owns the property on offer!

► Also check that there is public access to the property (in Thailand buyers sometimes discover too late that the only access is across privately-owned land – in which case you need to establish what you're going to have to pay the landowner for access).

Taxes Are Being Cut in Japan, Too

The Japanese government has been frustrated by companies' failure to use their buoyant profits – they're currently sitting with cash reserves equivalent to more than a trillion dollars -- to spend more on paying more to their workers, which would stimulate consumer spending and boost economic growth.

Now it's taking action to penalize them for their tardiness. A tax reform package approved by the Cabinet will lower the effective corporate tax rate for big companies to 25 per cent if they raise wages by more than 3 per cent and expand investment. Small and mid-sized firms will only have to increase workers' pay by 1½ per cent to qualify for the tax break.

Companies' tax rate will be cut even more, to 20 per cent, if they invest in new technologies related to the Internet of Things.

These tax concessions will apply as from the next tax year running from April 1, and remain in place for three fiscal years.

However, companies' caution about increasing their operating costs is not the only reason Japanese incomes have been rising so sluggishly, despite business conditions for all enterprises now at their strongest since 1991.

Around the world, you can expect labour unions to push as hard as they can for higher pay for their members. But not in Japan. There, unions have decided to push for no more in the next annual round of wage negotiations than they did last year, despite record corporate profits and a developing shortage of workers. Labour leaders give priority to improving working conditions, such as ending extreme overtime, rather than higher pay.

There's Actually a Shortage of Shares

Some reasons why we're experiencing a wonderful bull market are well known: high corporate profits, abundant nearly-free credit, unattractive alternatives (globally, nearly $11 trillion worth of bonds are trading on negative yields).

A less-noticed driver has been shortage of stock.

Companies are taking shares off the market much faster than they're issuing new stock. Since the financial crisis, buybacks have been the biggest single source of demand for American equities. Goldman Sachs estimates firms repurchased about $570 billion of their own shares this year, will do even more this year.

Another factor is the growth of passive investing. Money is pouring into exchange-traded and index funds. It goes into equities, but increasingly investors are

reluctant to cash in. They're saving for the long term, for retirement, so they're buy-and-hold investors. Fewer shares are being recycled back into the market by funds.

Commentator Robin Wigglesworth warns that the scarcity theory does rest on uncertain foundations. If the stockmarket does suffer a severe setback, investors might decide to cash in. "But the overall, long-term trajectory is clear, and the 'black hole' of passive investing is likely to continue to soak up stocks for a long time to come."

Dodgy Logic About Renewables

California's governor, Jerry Brown, has been in Europe extolling the virtues of his state's aggressive policies hostile to fossil fuels, which include an order to utilities to raise renewables' share of energy supply to 50 per cent by 2030. He colourfully suggested that California is well on its way to "energy nirvana."

Well, not quite.

According to the latest report from the California Air Resources Board that he offered as evidence, in 2016 companies subject to the state's system designed to discourage carbon emissions did deliver a 5 per cent fall in their emissions.

However a researcher who closely examined the data discovered:

► The fall in emissions from electricity generation had nothing to do with the state's carbon-hostile policies, but wet and snowy winter weather that meant utilities had less need for carbon-fuelled power as much more hydro-electricity was available.

► Despite policies promoting the use of low- and zero-emission vehicles, greenhouse gas emissions actually increased because lower gasoline price encouraged people to drive more.

(The state's definition of "renewables" specifically excludes power produced by major dams – because carbonatics hate dams as well as coal mines).

China and America

Despite all Trump's protectionist talk, China, which accounts for almost half America's foreign trade deficits, is expanding – not reducing – its bilateral trade surplus. In the first ten months of 2017 it rose at an annual rate of 7 per cent, to $309 billion.

"The reality so far," says CLSA's Christopher Wood, "is that Trump has not really pursued the protectionist agenda on which he campaigned – save for one major policy. That was the decision taken last January not to sign up to the Trans-Pacific Partnership (TPP), a trade pact which had been negotiated over several years…

"The irony, of course, is that the decision was a huge positive for China.

"First, the [aborted] TPP was in essence the 'anyone but China' trade deal.

“Second, the decision to abandon the TPP signalled, from an Asian perspective, that America was withdrawing from the region, thereby opening the door wide for China to walk into.” China has a long-term plan to fill that vacuum – the massive One Belt One Road project.

The Stalin’s Bullet Strategy

Jeremy Grantham of fund managers GMO has evoked memories of the Soviet dictator to characterize a high-risk investment strategy.

One of Stalin’s management techniques was to set very tough targets for his officials, who knew that their success would earn them lavish rewards, while failure to meet the targets would earn them a bullet.

Suppose, Grantham says, you were a fund manager given the task of earning Stalin’s pension fund an average annual return of 4½ per cent in real terms over the next few years, but if you fail you’ll be shot. What would you do?

GMO is predicting negative returns over the next seven years in shares of American and international companies. Positive returns are forecast for only one equity asset class – emerging markets. Within that asset class, a value strategy should deliver an average annual return of 6.7 per cent. So that’s the one you’d follow, despite the risks.

Bullet avoided, success rewarded.

Chinese Shares

Soaring profits drove China’s infotech leaders such as Tencent and Alibaba to new highs last year, but some experts think it’s time to switch into other major companies that have long been neglected by investors.

One example is those that are starting to benefit from government-imposed pruning of over-capacity in the steel, coal, property and manufacturing sectors. In October, according to investment bank J P Morgan, the profits of state-owned enterprises were up almost 49 per cent compared to little more than 10 per cent for the rest of the corporate sector.

At time of writing the Hong Kong-listed shares of the world’s biggest bank, ICBC, were up 38 per cent over 12 months, Maanshan Iron & Steel 61 per cent, the coal giant China Shenhua 64 per cent, the largest life insurer Ping An 110 per cent.

Outlook for Australian Property

Although its economy has avoided recession for an amazing 26 years, Australia faces “continuing negative headwinds in terms of an overvalued residential property market, high household debt levels, and anaemic income growth,” says CLSA’s Christopher Wood.

Although house prices haven’t gone anywhere in Perth over the past decade because of the bad times in Western Australia’s mining sector, they continue to

rise from already-elevated levels in other major cities. They're up 72 per cent in Sydney since early 2012, 59 per cent in Melbourne.

The market has been driven by both foreign investors, mainly Chinese, and locals, who are great believers in property investment.

Banks continue to fuel the optimism with abundant credit. Mortgages account for 63 per cent of their total loans.

The ratio of household debt to disposable income is about to hit a new record of 200 per cent, compared to 105 per cent in the US, 122 per cent in Britain.

Tailpieces

Philippines: The good news continues. Tax reforms will mean that no one earning less than the equivalent of $5,000 a year will pay income tax. The underemployment rate is at a 14-year low. Remittance income sent home by Filippinos working overseas is heading for a new annual high of $28 billion, while business processing services are earning around $25 billion a year.

Tax reform gains: Although Congress has cut the US's corporate tax rate from 35 to 21 per cent, the actual benefit to shareholders will be rather less as companies use various means to avoid paying the statutory rate. The average effective rate of S&P 500 firms has been less 26 per cent. The cut is expected to boost earnings no more than 6 per cent.

Oil: American output of crude is expected to average 10 million barrels a day this year, up from 9.2 million last year, and an all-time record. Shale production is recovering in response to higher prices, and there's a continuing pick-up from Gulf of Mexico deep-water projects coming on stream.

Investing outside America: It's looks the better choice, says Sebastian Page, head of asset allocation at T Rowe Price. "Outside of the US you are earlier in the business cycle, you get cheaper valuations, you still have much more accommodative central banks… and you have fairly good momentum in terms of earnings growth and returns."

Being contrarian: What should you do if you don't believe all the current optimism from commentators? The *FT*'s Robin Wigglesworth says "the brave maverick would be bearish on… high-flying US tech shares and buy defensive stocks in healthcare, consumer staples, energy. Taking a broader view, iconoclasts would bet on the dollar regaining its vim, and favour government bonds over stocks."

Wise words: *If you think healthcare is expensive now, wait until you see what it costs when it's free!* P J O'Rourke.

Martin

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