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Martin Spring's private newsletter on global strategy

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## Red October: Welcome Break or Ominous Signal?

The past few weeks have been hard ones for share investors, with sharply falling prices across the board. Can we expect further weakness? Is there reason to fear something much worse -- a global plunge into a depression?

The recent bear market has occurred against a background of good news about the American economy. Its growth has been strong, almost phenomenally so (hitting an annual growth rate of 4 per cent), thanks to a combination of tax reform and the tail-end effects of stretched-out recovery from the Great Recession. Unemployment has transmuted into labour shortage, worker earnings are growing strongly, and corporate earnings are at record levels.

So what has driven investor pessimism?

One reason is growing belief that the Federal Reserve will stick to its guns about raising interest rates despite the way it's angering President Trump, and may even get tougher. Abundance of nearly-free credit has been a force driving up share prices for years. Withdrawing "the punchbowl," as a former Fed chairman famously said, dismays investors and, it seems, politicians too.

A second reason is recognition that the golden days of company profits surging ahead 20 per cent or so a year are over. A buoyant economy means rising costs of labour, materials and credit. This year tax reform delivered a one-off boost. It won't be repeated next year, when corporate earnings growth is expected to roughly halve to about 10 per cent.

A third reason is that China, the world's second biggest economy, has been slowing down, and there's renewed fear that its heavily-indebted businesses will implode.

Then there's the impact of Trump's aggressive trade policy. There's widespread recognition that much of it is posturing to provide largely fake political victories and that the president won't allow policy to progress as far as a "trade war." Nevertheless, there will be some negative consequences as companies adjust to deal short-term with tariff increases and long-term with adapting their global supply chains.

Stock markets are always more about what they expect to happen rather than what already has. In America, the engine of global markets, investors turned cautious in the autumn, that's why it was "Red October."

However, there are good reasons not to be too pessimistic about the future.

**In this issue:** Stock-market outlook □ Risks in FANGs □ Contrarian investing rules □ Elites □ Electronics □ Electric cars □ Climate change □ Street anger fuelled by cash

There are no signs yet of imminent recession. Morgan Stanley says: "Consumer confidence remains high and spending on services remains healthy." There's no significant weakness yet in "early-cycle" industries such as advertising or casinos.

We can expect the Fed to err on the side of caution in raising interest rates. Future earnings growth of around 10 per cent sounds fine to me. And nearly all commentaries about Trumpian policies are infested with emotion and ignore positive outcomes.

The fundamentals of the world economy remain sound. The US remains the world leader in the new technologies that drive much of the growth. China, we're told, is "slowing down"… but to an incredible 6.2 per cent a year. India is doing even better. Europe, despite its crazy politics, doesn't seem to face any credible major threats to its prosperity and abundant welfare systems.

All of which suggests that what the markets have been experiencing is nothing more than a major correction.

Sentiment has been shocked by the speed and dimensions of the trend reversal. Those with lots of cash will hold back and not recommit till they see positive news. This suggests the probability that markets will soon stop falling, but they're not likely to bounce back strongly for a while, and to trade in a range for some months to come.

But what if I'm wrong with my relative optimism? What if the current stock-market weakness is not merely a correction, a pause for consolidation after years of excitement, but an ominous signal of something much worse to come?

*The Economist* recently ran a speculative report on the subject of The Next Recession. Its big fear is that governments won't be up to the job of taking swift action to deploy the many policy tools available to underpin economic growth and to drive recovery.

The traditional stimulus policy of easing credit won't be available because interest rates are already too low, while going to the extreme of negative ones – charging interest on bank deposits or bonds -- is (probably correctly) viewed as too dangerous.

## How to combat the next crisis

However, there's nothing to prevent central banks from reversing course on "quantitative tightening" and reverting to, or introducing, massive buying of bonds, even of equities, as has been happening in Japan, with "printed" money. The radical policy of quantitative easing, implemented as a response to the 2008 financial crisis, did work. It stopped recession plunging into depression.

Trouble is, it's been a political failure. The consequence of an abundance of nearly-free credit has been to make elites richer than ever. Easy-money has been combined with poisonous policies of fiscal austerity that imposed the costs of fighting recession on the individuals, businesses and countries least able to bear them. Political stability has been destroyed by inflating the power of populism.

In the next crisis a more effective way of stimulating economic growth would be fiscal stimulus – governments increasing their spending. Or they could try

more radical approaches such as giving money directly to individuals. This could be done in a way that forces citizens to spend what they receive rather than save it.

The very high level of public debt that results with such policies is often seen as a limit, but that is more a political restraint than a reality. Debt accumulated by one state agency (Treasury) to the credit of another (the central bank) can easily evaporate, be written off by passing a law. In the private sector, too, debt forgiveness can be pursued, as it was in the last Great Depression.

To some extent, countries can implement protectionist policies using tariffs or currency-rate warfare to promote exports and discourage imports. But their effectiveness is largely destroyed by trade partners' doing the same. As we saw in the 1930s, protectionism damages the global economy without solving the depression problem for individual nations – it took a world war to do that.

# Market Risks for FANGs and the Rest

Corporate earnings growth remains strong in the US, and also superior to what is seen elsewhere in the world. However, says CLSA investment banker Christopher Wood: "The obvious risk, apart from Fed tightening, is the impact to profit margins from rising costs. And labour is the largest cost for most companies. This is… why wage-related data remains critical to monitor."

Labour costs are rising – but not yet alarmingly. In the non-farm business sector by mid-year they were up at an annual rate of 2.2 per cent compared to 0.9 for the same period to mid-2017. Average hourly earnings and other wage-related data also continue to trend up, but also not yet alarmingly. In September earnings were ahead 2.8 per cent at an annual rate.

If that continues to rise, "it is likely to accelerate Fed tightening expectations… to the detriment of the stock market."

For FANG stocks – the Internet-based shares that have been leading the market – "the big risk is not rising costs but rather regulation… or technological disruption; both of which could potentially demolish these 'winner takes all' business models.

The risks are rising in America. There have been more highly-published data breaches at both Google and Facebook. "Perhaps most damaging of all, both companies are fast becoming 'uncool.'

They have largely escaped the constraints that encompass traditional media companies by arguing that they are not media companies. CLSA's Shaun Cochran says "all digital content platforms must shed the fantasy [that] they are not media companies and accept the responsibility this entails." The problem about this, Wood says, is that "the geeks running these companies have no competence in editorial matters, and never will have.

'The other obvious threat to the Silicon Valley 'scaleable' business's models and related network effects… is the decentralized model provided by blockchain technology."

## ‘Contrarian Investment Rules’ from a Master

Here’s some concentrated wisdom about how to invest from David Dreman, the fund manager, columnist and publisher of the *Journal of Behavioral Finance*…

► Respect the difficulty of working with a mass of information. Few of us can use it successfully. In-depth information does not translate into in-depth profits. Our limitations in processing complex information correctly prevent their successful use by most of us.

► Do not make an investment decision based on correlations. All correlations in the market, whether real or illusory, will shift and soon disappear.

► There are no highly predictable industries in which you can count on analysts’ forecasts. Relying on these estimates will lead to trouble. Analysts’ forecasts are usually optimistic. Make the appropriate downward adjustment to your earnings estimate.

► It is impossible, in a dynamic economy with constantly changing political, economic, industrial, and competitive conditions, to use the past accurately to estimate the future.

► Be realistic about the downside of an investment, recognizing our human tendency to be both overly optimistic and overly confident. Expect the worst to be much more severe than your initial projection.

► Take advantage of the high rate of analyst forecast error by simply investing in out-of-favour stocks.

► Positive and negative surprises affect “best” and “worst” stocks in a diametrically opposite manner. Surprises, as a group, improve the performance of out-of-favour stocks, while impairing the performance of favourites.

Positive ones result in major appreciation for out-of-favour stocks, while having minimal impact on favourites. Negative ones result in major drops in the price of favourites, while having virtually no impact on out-of-favour stocks. The effect of an earnings surprise continues for an extended period of time.

► Favoured stocks underperform the market, while out-of-favour companies outperform, but the reappraisal often happens slowly, even glacially.

► Buy solid companies currently out of market favour, as measured by four value lifelines, the contrarian strategies -- low price-to-earnings, low price-to-cash flow, low price-to-book value ratios, high yields.

► Don’t speculate on highly priced concept stocks to make above-average returns.

► Avoid unnecessary trading. The costs can significantly lower your returns over time. Low price-to-value strategies provide well-above-market returns for years, and are an excellent means of eliminating excessive transaction costs.

► Buy only contrarian stocks because of their superior performance characteristics.

► Invest equally in 20 to 30 stocks, diversified among 15 or more industries (if your assets are of sufficient size).

► Buy the least expensive stocks within an industry, as determined by the four contrarian strategies already mentioned, regardless of how high or low the general price of the industry group.

► Sell a stock when its P/E ratio (or other contrarian indicator) approaches that of the overall market, regardless of how favourable prospects may appear. Replace it with another contrarian stock.

► Look beyond obvious similarities between a current investment situation and one that appears equivalent in the past. Consider other important factors that may result in a markedly different outcome.

► Don't be influenced by the short-term record of a money manager, broker, analyst or adviser, no matter how impressive; don't accept cursory economic or investment news without significant substantiation.

► Don't be seduced by recent rates of return for individual stocks or the market when they deviate sharply from past norms (the "case rate"). Long term returns of stocks (the "base rate") are far more likely to be established again. If returns are particularly high or low, they are likely to be abnormal.

► Don't expect the strategy you adopt will prove a quick success in the market; give it a reasonable time to work out.

► The push toward an average rate of return is a fundamental principle of competitive markets.

► It is far safer to project a continuation of the psychological reactions of investors than it is to project the visibility of the companies themselves.

► Political and financial crises lead investors to sell stocks. This is precisely the wrong reaction. Buy during a panic, don't sell. In a crisis, carefully analyze the reasons put forward to support lower stock prices – more often than not they will disintegrate under scrutiny.

► Diversify extensively. No matter how cheap a group of stocks looks, you never know for sure that you aren't getting a clinker. Use the value lifelines as already explained. In a crisis, these criteria get dramatically better as prices plummet, markedly improving your chances of a big score.

► Volatility is not risk. Avoid investment advice based on volatility.

► Small-cap investing: Buy companies that are strong financially (normally no more than 60 per cent debt in the capital structure for a manufacturing firm). Buy companies with increasing and well-protected dividends that also provide an above-market yield. Pick companies with above-average earnings growth rates.

Diversify widely, because small companies have far less liquidity. A good portfolio should contain about twice as many stocks as an equivalent large-cap one. Be patient.

Nothing works every year, but when smaller caps click, returns are often tremendous. Don't trade thin issues with large spreads unless you are almost certain you have a big winner.

► When making a trade in small, illiquid stocks, consider not only commissions, but also the bid/ask spread to see how large your total cost will be.

► Avoid small, fast-track mutual funds. The track often ends at the bottom of a cliff.

## The Elite Benefit Most from Abundant Easy Credit

One of the roots of the stunning rise of populists in global politics is the way elites tackled the financial crisis by imposing the costs of dealing with it on the masses – unemployment, personal bankruptcies, public spending cuts, destruction of small businesses – while themselves avoiding almost all the pain.

And adopting solutions that benefit themselves.

Creation of an abundance of nearly-free central bank credit has been key. The supposed intention was to stimulate economic recovery. But its most spectacular consequence has been to inflate the values of investment assets, making the elites much richer.

One of the less obvious ways this has been done is to channel much of that credit towards those who least need it – the elites whose incompetent governance caused the crisis and who used their power to escape almost entirely its negative consequences.

Peter Atwater of Financial Insights reports that the latest quarterly earnings reports from US banks and brokerages make it clear how the elite are feasting on the abundance of ultra-cheap credit. JP Morgan, for example, nine years ago was lending five times as much to its cardholders as to its private clients. Now it has lent almost as much to a small number of its elite customers as it has to its millions of cardholders.

"Where the availability of credit to Main Street has been limited, if not reduced, since the housing crisis a decade ago, for those on Easy Street it has never been better. Fuelled by low-cost debt, the wealthy have driven markets in real estate, watercraft, art and other collectibles to record prices."

In the stock market, investments are the ultimate luxury goods. Demand for them increases more than proportionally as income rises. "For the very wealthy, it does so dramatically. Net worth, like yacht length, is a measuring tool of status.

"The danger is that no one will want stocks at the bottom of the next crisis, just as no one will want big homes and big boats."

## Can China's Power in Electronics Grow Even Greater?

In global electronics, China is the dominant player, making for example more than half the world's mobile phones. It's the most important reason why China runs such a huge trade surplus with the US. It's a dominance that has come about through unfair Chinese practices such as forced transfer or even outright theft of intellectual property – the main reason why the Trump administration is raising tariffs on Chinese imports.

The Americans are worried that China will soon strengthen its grip on the global industry, which it has made a priority target for development by 2025. Is that going to happen?

"The origin of China's dominance lay in cheap labour," *The Economist* reports. "In the early 2000s companies in all sorts of industries sent at least some manufacturing to China to stay competitive.

"Although much production has been automated since, electronics can be labour-intensive even today: components often need to be assembled by hand or taken from one machine to another. In recent years labour costs have gone up – by more than 60 per cent between 2012 and 2016, say some estimates. Vietnamese or Indian workers are far cheaper."

Nevertheless, China continues to offer major attractions:

► Places such as Huaqiangbei have an ecosystem of businesses able to provide everything from logistics to prototyping. "Although high-end components such as processors and memory chips must still be imported, most other things can be sourced locally." Henry Yeung, a Singaporean expert, says 'total production cost is still lower than elsewhere."

► When an ecosystem becomes large, the scale itself becomes a magnet. Shenzhen's, for example, pulls in more hardware makers the bigger it gets, "just as Silicon Valley's dense network of venture-capital funds, law firms and other service providers has attracted more and more start-ups."

► Although some firms have begun to shift their operations to combat rising labour costs or to reduce dependence on one country, in China's case the alternatives remain unattractive. "Vietnam's infrastructure is far worse; India's bureaucracy makes building a factory and hiring a few thousand people too onerous to bother with."

The threat to their supply chains posed by the Trump administration's anti-China measures have forced American electronics firms to consider shifting assembly and production of components to the US. But, Yeung asks, where would they find the people to do the badly-paid, repetitive jobs?

# Electric Cars: an Industry to Invest In?

Why are all the automotive giants ploughing ahead with massive capacity growth plans in electric cars in the aftermath of the diesel cheating scandals when they're unable to make any money out of them? asks Eoin Treacy.

"Is it blind faith in technology that is leading to the belief they will achieve profitability through scaling [up] production? Or does this mean that ultimately cars will be more expensive?

"Diesel is dirty, there is no getting around that fact. But the cars are reliable and last a lot longer than petrol cars. Meanwhile, the resale value of electric vehicles is terrible because of steep depreciation owing to the life cycle of batteries.

"Tesla might eventually go bankrupt, but the other auto manufacturers are not in a much better position. And at least Tesla already has a battery factory at its disposal.

"Meanwhile, companies like Ford are building the cars people actually want to buy, [such as] SUVs – and make good margins on them."

I largely concur, but have a slightly different view…

If every car company is going to flood the market with electric models, the market will be swamped, far in excess of demand, even allowing for ideology-driven

political stimulus. Competition will be so intense that there won't be enough income, let alone profit, for any one. As in the early days of the industry more than a century ago, most companies will go out of business, only a tiny handful will survive. And we don't know which ones.

That doesn't look to me like an industry I want to invest in now, especially when companies are planning to invest so much in a market with dubious prospects, when in any case current circumstances are so difficult.

## Climate Change: How Sound Is the Science?

Despite the media's excited focus on the latest report of the IPCC, it totally ignored one of the more significant disclosures about the "science" on which the scary warnings about global disaster are based. The leading data-set of world temperatures in the past, says Australian researcher John McLean, contains so many errors and inconsistencies as to be virtually useless.

For example…

► Large gaps where there is no data and instead averages were calculated from next to no information, such as estimates for temperatures over land in the Southern Hemisphere based on readings from one site in Indonesia.

► Sea measurements, supposedly from ships, but mistakenly logged up to 50 miles inland.

► A Caribbean island – St Kitts – where the temperature was recorded at 0 degrees C for a whole month (somewhat implausible for the tropics).

When there are such doubts about the validity of the "science," despite the herculean efforts of establishment media to promote it, it's not surprising that every poll shows that climate change and global warmings rank at the bottom of the public's list of concerns.

## Demonstrations: Anger Fuelled by Cash

For some time I've been aware that those street protests we see given such publicity on international news programmes are sometimes fake, or at least seriously misleading in portrayal of public anger, in that the participants are paid… they're mercenaries. Their anger can be fuelled by the prospect of tax-free cash, which it's claimed may be as much as $1,000 a day.

What I didn't realize is that in America, at least, arranging public protests by hired demonstrators has become a profitable business.

One such is California-based Crowds on Demand, whose website promises "protests, rallies, flash mobs." But professor Edward Walker, who has written a book on paid protesting, says "there are hundreds of lobbying firms and public affairs firms that do this work."

President Donald Trump has claimed that protesters have been paid by billionaire far-left activist George Soros and others to disrupt conservative events. The *Los Angeles Times* confirms that such paid protesters "are real."

## Home Prices Rise in Line with Jobs Growth

Although the American residential property market is growing less strongly, the problem is not growth itself but the developing division within the market between winners and losers. The best performer, Denver, has prices 54 per cent higher than the pre-recession peak. Prices in the ten worst-performing cities are on average still 11 per cent below their pre-recession peaks.

The top cities rise because they are where the jobs are, Rana Faroohar reports. Yet house prices in those cities have risen much faster than wages. That has made it harder for middle-class people to live in such places.

"Much of the investment gains from housing in the past decade have flowed to the oldest, richest buyers. Younger people have an average of $30,000 in student loans and have come of age in a weak employment market. That makes it harder for them to get on the housing ladder than it was for past generations."

The labour share of income is at a post-war low, and it seems that those enjoying the biggest pay rises are billionaires.

## Investing in Infrastructure: Risks Start to Rise

In a world of ultra-low interest rates, infrastructure is an asset class that has become particularly attractive, especially to long-term institutional investors such as pension funds, because of seemingly reliable income flows from charges such as road tolls and airport fees, often underwritten by government support.

However, as political instability rises, it's become less certain that investors can rely on such support.

Some of the world's largest asset managers are finding this in Mexico City, where the fate of their investment in bonds issued to pay for a $13 billion new airport hangs in the balance. The newly-elected president, Lopez Obrador, has declared that he is abandoning the project, as the majority of his voters demanded.

The bonds are largely secured by taxes that passengers pay when flying into the existing airport. Obrador could scrap these by changing the law. Bond values have already fallen by a fifth because of the risk.

## Tailpieces

**The "Tropical Trump":** A disgraceful example of how ideological beliefs are increasingly corrupting mainstream media, even those whose focus on investment reporting and analysis demands that they always be emotion-free, was *The Economist*'s front-cover portrayal of Brazilian presidential candidate Jair Bolsonaro as "Latin America's latest menace."

In contrast to what? The candidate of a party who looted state companies and pension funds on a scale never seen before, whose leaders were massively corrupt, and who brought Brazil to its worst-ever recession, with sky-high unemployment and plunging living standards?

Given such a choice, it's hardly surprising whom voters preferred. They may have seen him as no better than the lesser of two evils -- although from what I've seen, Bolsonaro does have some good ideas. Judging by how investors reacted to his election, they clearly believe *The Economist* got it wrong.

**Inflation**: For years many have forecast its inevitable return… but it never does. Could it be about to happen at last?

Peter Tasker of Argus Research says we should take note of the political dynamics that are unfolding across much of the developed world – the rise of populism and the policies it has spawned by governments seeking to outflank it. "Tariffs and quotas on traded goods, higher minimum wages, heavy deficit spending on infrastructure… are potentially inflationary." The consensus view that the future is likely to be lowflation or noflation, on which so many investment portfolios are based, could be about to blow up.

**Hypocrisy:** China is busy trying to paint itself as the protector of global free trade, but this amounts to doublespeak as it has abused the system to boost its economy, writes a reader to *FullerTreacyMoney*.

It was allowed to do so by Western leaders "because of a mistaken belief that prosperity would breed liberalism. But that has failed to materialize. If anything, China's authoritarianism is becoming even more engrained."

**Japanese shares**: Their upside potential is huge. That's the view of the chief investment officer of one of the world's largest pension funds, Leo Lewis reports, after he saw a chart comparing the Tokyo and New York markets. Over five years to September the price to tangible book value ratios of the S&P 500 index rose from 10 to 28 times while the equivalent figure for the Topix went nowhere – stable at just 1.8 times.

**Renewables:** Although they're getting cheaper and more efficient, they're still generally uncompetitive compared to fossil fuels, despite being forced into the electricity distribution grid by government mandates and/or subsidies.

Latest evidence, from the University of Texas Energy Institute is that natural gas combined cycle is the cheapest source almost everywhere in the US.

**Singapore**: Prices of luxury properties are now growing fastest there of any of the world's cities – at an annual rate of 13 per cent in the third quarter, according to leading consultants Knight Frank. Next strongest are Edinburgh and Madrid.

**Wise words:** *While financial fortunes are often made buying out-of-favour stocks, institutional investors deplore being lonely investors.* Allen Brooks.

Martin

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