►On Target

Martin Spring's private newsletter on global strategy

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Brexit: Putting Off the Hard Decision

As I predicted would almost certainly happen (*On Target*, December 8), Brexit wasn't implemented on March 29 as the UK asked the European Union, and its request was granted, for more time to resolve the deadlock over the issue.

What's likely to happen now?

Unless the matter is quickly resolved – which is unlikely – Britain will have to comply with EU law and the terms of the delay it asked for, by participating in the European election taking place May 23-26. This will amount to an unofficial second referendum for British voters on whether the UK should exit the Union or remain a member-nation.

It won't be a straightforward referendum as there won't be clear-cut questions about Brexit on the ballot papers. However, participating political parties will have to say what they want to do about it, as that will be overwhelmingly the most important issue.

For some, that won't be difficult. Nigel Farage, the most successful British politician in a generation, has launched his own Brexit Party to try to force the government and parliament to deliver on their promise to voters. Others, such as the Liberal Democrat party and a new Independent group formed by centrist rebel MPs, can be sure to campaign for the UK to scrap its exit application.

The two major parties, the Conservatives and Labour, will find it difficult to position themselves clearly, as both are so divided on the issue and neither wants to alienate its supporters who favour Brexit.

It's going to be a very emotional business. The Brexiteers are being given an unexpected opportunity to savage the government and parliament, both dominated by Remainers (those who voted against Brexit), for betraying their commitment to implement what the majority of people voted for in the 2016 referendum. And to prove that there's still a majority for Brexit.

I suspect that the voters will remain broadly split 50/50, resolving nothing. But that they'll punish both the two biggest parties for making such a disgraceful mess of delivering Brexit. However, the election won't necessarily determine what happens as they'll be electing members to Strasbourg – not to London, where outcomes will finally be decided.

The six-month delay isn't likely to finalize anything…

► Parliament has repeatedly refused to approve Theresa May's Brexit deal and it's hard to see that changing.

The opposition parties, which are only a few votes short of bringing down the government and forcing a general election, which they have a fair chance of winning, have powerful reason to deny the government support on its Brexit deal or any other. Added to that is the intransigence of a few dozen Conservative MPs who hate the May deal for some good reasons – it risks locking Britain into a customs union with Europe from which it could not readily escape.

► There is strong opposition to a "no deal" Brexit – the UK's ceasing its membership of the Union without an agreement legally approved by both parties. Both the British and European politicians are terrified that they'd be blamed for the disruptive consequences.

Brussels has an additional reason. It doesn't want the Brits to crash out without being committed to many important benefits Europe's tough and highly-competent negotiators were able to screw out of them – in particular, the very large sums they'll continue to pay into the EUs coffers after Brexit.

► Britain could simply stay in the Union by cancelling its application to exit. I couldn't see that happening without clear-cut majority public opinion to do so, reversing the outcome of the 2016 referendum. Both major parties are nervous about alienating the large numbers of their supporters who are pro-Brexit.

Nevertheless, the Remain option cannot be excluded as an eventual outcome if Brexit remains blocked, with or without a deal.

► The deadlock could be broken if May is replaced as prime minister. That could happen if her government loses a vote of confidence in the House of Commons, triggering a general election, That remains unlikely. The threat of Marxists taking over government is the only thing that holds together the ruling coalition.

Although viewed with contempt by most of her party because of her mishandling of Brexit, May cannot be sacked before December because of party rule constraints. Even then, it might not happen. She hangs on to power because of fear that she would be replaced by a hardline Brexiteer such as Boris Johnson (who is widely disliked by MPs, but would give the Conservatives the best chance of winning the next election because of his personal popularity).

What happens if October comes without a deal?

I would not be surprised if, when it gets to the next Brexit deadline in October, there's more "kicking the can down the road" as neither of the ruling elites in Britain or Europe want Brexit to happen. If it can't be reversed, they'll try hard to produce an outcome that leaves Britain locked into many of the constraints it's been experiencing as a member of the Union. And in particular prevents the UK from employing its most feared political weapon – tax competition.

I have not changed my opinion that Britain probably faces months, perhaps even several years, of continuing political deadlock, unable to implement any of the three feasible solutions – capitulation to Brussels' terms, a "hard" or "no-deal" Brexit, or scrapping the whole idea of leaving the Union. Eventually it has to be one of those.

Although the negative consequences of Brexit for the British economy, business and investors are gathering momentum because of never-ending uncertainties, they remain far short of the levels of hysteria long-predicted by the anti-Brexit elite. In fact the reverse is true, so far.

The Spectator reported last month: "Never have so many people been in work [in the UK]. Never have household spending levels been higher. Inequality is at roughly a 30-year low. And salaries are now rising at the fastest rate in ten years… The [fiscal] deficit is at its lowest level since 2003 because tax revenues are flooding into the Treasury… Economic growth is this year expected to be 1.2 per cent – on a par with that of France and Germany.

'Outside of Westminster, there is plenty of optimism – perhaps the reason why, even now, so many still want Brexit happen."

Are Value Strategies About to Recover?

There is increasing evidence "that the Killer Ds – bad Demographics, too much Debt and persistent Deflation – are accelerating within the developed markets," says Morgan Creek Capital Management.

"Therefore investors should be prepared for a decade of below-average [annual real] returns" – probably 3 per cent for bonds and around zero for equities. The latter will take the form of a fall of 40 to 50 per cent over the next five years, followed by a recovery.

In 2019 markets are likely to experience several major fluctuations, with rises and falls of 20 per cent or so, but end the year down double digits.

With such a challenging environment, "focusing on margin of safety will be the key to preserving and growing capital – in other words, the return of value investing."

Is now the time to back that horse?

"From a risk/return perspective, the opportunity costs of holding value stocks have now become very low -- too low, perhaps" says Robeco.

Over the past decade quantitative easing has favoured growth stocks. It hasn't made sense to fish at the bottom for cheap, unloved companies when high-octane ones such as technology groups have been able to take advantage of cheap money to fund rapid growth. Monetary tightening could change that.

Even during the period that has favoured growth, some value counters have done well. According to Style Analytics, a strategy focused on dividend yields beat the market by 11 per cent.

Eoin Treacy of FullerTreacyMoney says: "In the momentum-driven markets that have prevailed since the advent of extraordinary monetary policy, Value has not been working because there has been such high correlation between the margins of all hues." This suggests that for Value "to begin to deliver the kind of returns it has historically, there is going to have to be a clear change in the texture of the market. That entails an end to quantitative easing.

However, "if anything, there is a likelihood we are going to see an amplification of quantitative easing as a response to the maturing market profile. Global monetary and fiscal policy is moving back to an expansionary footing while the bond market is pricing in a contraction.

"What does look likely is [that] private equity will successfully take some [of the]... prize assets out of the public markets."

Eoin adds that the "late-in-the-cycle outperformance of commodities has not yet occurred," although gold certainly has base formation characteristics. The dollar is susceptible to weakness if bond yields continue to price in rate cuts."

In recent months investors have shown strong interest in building their cash reserves. "That is not typical of a significant market top."

How to Succeed at Investing

Jeremy Grantham, one of America's best-known fund managers and commentators, offers this "Investment Advice from Your Uncle Polonius" (chief counsellor to the king, a fictional character in Shakespeare's *Hamlet*)...

► **Believe in history**. In investing, Santayana is right: history repeats and repeats, and forget it at your peril. All bubbles break, all investment frenzies pass away.

You absolutely must ignore the vested interests of the industry and the inevitable cheerleaders who will assure you that this time it's a new high plateau or a permanently higher level of productivity, even if that view comes from the Federal Reserve itself.

The market is gloriously inefficient and wanders far from fair price. But eventually, after breaking your heart and your patience (and, for professionals, those of their clients too), it will go back to fair value. Your task is to survive until that happens.

Here's how...

► **Neither a lender nor a borrower be.** If you borrow to invest, it will interfere with your survivability. Unleveraged portfolios cannot be stopped out, leveraged portfolios can be. Leverage reduces the investor's critical asset: patience.

Excessive borrowing encourages financial aggressiveness, recklessness, and greed. It increases your returns over and over until, suddenly, it ruins you. For individuals, it allows you to have today what you really can't afford until tomorrow.

It has proven to be so seductive that individuals en masse have shown themselves incapable of resisting it, as if it were a drug. Governments also, from the Middle Ages onwards -- and especially now, it seems -- have proven themselves equally incapable of resistance.

► **Don't put all of your treasure in one boat**. This is about as obvious as any investment advice could be. It was learned by merchants thousands of years ago.

Several different investments, the more the merrier, will give your portfolio resilience, the ability to withstand shocks. Clearly, the more investments you have and the more different they are, the more likely you are to survive those critical periods when your big bets move against you.

► **Be patient and focus on the long term.** Wait for the good cards. If you've waited and waited some more, until finally a very cheap market appears, this will be your margin of safety. [Then] the very good investment becomes exceptional.

Individual stocks usually recover, entire markets always do. If you've followed the previous rules, you will outlast the bad news.

► **Recognize your advantages over the professionals**. By far the biggest problem for professionals in investing is dealing with career and business risk: protecting your own job.

The second curse of professional investing is over-management caused by the need to be seen to be busy, to be earning your keep. The individual is far better-positioned to wait patiently for the right pitch while paying no regard to what others are doing -- which is almost impossible for professionals.

► **Try to contain natural optimism**. Optimism has probably been a positive survival characteristic. Our species is optimistic, and successful people are probably more optimistic than average.

Some societies are also more optimistic than others: the US and Australia are my two picks. I'm sure (but I'm glad I don't have to prove it) that it has a lot to do with their economic success. The US in particular encourages risk-taking: failed entrepreneurs are valued, not shunned. While 800 Internet start-ups in the US rather than Germany's more modest 80 are likely to lose a lot more money, a few of those 800 turn out to be today's Amazons and Facebooks. You don't have to be better; the laws of averages will look after it for you.

But optimism comes with a downside, especially for investors: optimists don't like to hear bad news. Tell a European you think there's a housing bubble and you'll have a reasonable discussion. Tell an Australian and you'll have World War III!

In a real stock bubble like that of 2000, bearish news in the US will be greeted like news of the Bubonic plague; bearish professionals will be fired just to avoid the dissonance of hearing the bear case. This is an example where the better the case is made, the more unpleasantness it will elicit.

It is easier for an individual to stay cool than it is for a professional, who is surrounded by hot news all day long (and sometimes irate clients too).

► **On rare occasions, try hard to be brave**. You can make bigger bets than professionals can when extreme opportunities present themselves because, for them, the biggest risk that comes from temporary setbacks – extreme loss of clients and business – does not exist for you. So, if the numbers tell you it's a real outlier of a mispriced market, grit your teeth and go for it.

► **Resist the crowd: cherish numbers only**. In real life as opposed to theoretical life, this is the hardest advice to take: the enthusiasm of a crowd is hard to resist. Watching neighbours get rich at the end of a bubble while you sit it out patiently is pure torture.

The best way to resist is to do your own simple measurements of value, or find a reliable source (and check their calculations from time to time). Then hero-worship the numbers and try to ignore everything else.

Ignore especially short-term news: the ebb and flow of economic and political news is irrelevant. Stock values are based on their entire future value of dividends and earnings going out many decades into the future. Shorter-term economic dips have no appreciable long-term effect on individual companies, let alone the broad asset classes that you should concentrate on. Leave those complexities to the professionals, who will on average lose money trying to decipher them.

Remember too that for those great opportunities to avoid pain or make money – the only investment opportunities that really matter – the numbers are almost shockingly obvious. Compared to a long-term average of 15 times earnings, the 1929 market peaked at 21 times, but the 2000 S&P 500 tech bubble peaked at 35 times! Conversely, the low in 1982 was under 8 times. This is not about complicated math!

► **In the end it's quite simple**. Really. Let me give you some encouraging data. GMO [Grantham's company] predicts asset class returns in a simple and apparently robust way: we assume profit margins and price earnings ratios will move back to long-term average in seven years from whatever level they are today. We have done this since 1994 and have completed 40 quarterly forecasts. We have won all 40 in that every one of them has been usefully above random and some have been, well, surprisingly accurate.

These estimates are not about nuances or PhDs. They are about ignoring the crowd, working out simple ratios, and being patient. (But, if you are a professional, they would also be about colossal business risk.) These forecasts were done with a robust but simple methodology. The problem is that though they may be simple to produce, they are hard for professionals to implement. Some of you individual investors, however, may find it much easier.

► **This above all: to thine own self be true.** Most of us tennis players have benefited from playing against non-realists: those who play to some romanticized vision of that glorious September day 20 years earlier, when every backhand drive hit the corner and every drop shot worked, rather than to their currently sadly atrophied skills and diminished physical capabilities.

Doing this in investing is brutally expensive. To be at all effective investing as an individual, it is utterly imperative that you know your limitations as well as your strengths and weaknesses.

If you can be patient and ignore the crowd, you will likely win. But to imagine you can, and to then adopt a flawed approach that allows you to be seduced or intimidated by the crowd into jumping in late or getting out early, is to guarantee a pure disaster.

You must know your pain and patience thresholds accurately and not play over your head. If you cannot resist temptation, you absolutely MUST NOT manage your own money. There are no Investors Anonymous meetings to attend.

There are, though, two perfectly reasonable alternatives: either hire a manager who has those skills – remembering that it's even harder for professionals to stay aloof from the crowd – or pick a sensible, globally diversified index of stocks and bonds, put your money in, and try never to look at it again until you retire. Even then, look only to see how much money you can prudently take out.

On the other hand, if you have patience, a decent pain threshold, an ability to withstand herd mentality, perhaps one credit of college level math, and a reputation for common sense, then go for it. In my opinion, you hold enough cards and will beat most professionals (which is sadly, but realistically, a relatively modest hurdle) and may even do very well indeed.

A winning model for business success

When I started out in business in South Africa several decades ago, my products were packages of information about specialized subjects such as investing internationally, relocation, planning for political change. It was a tiny market, so I set the prices high.

Then we came up with the idea of charging monthly for a service instead of annually for a product, collecting the money automatically from customers' bank accounts. It was such a new idea at the time that no other business was doing it except insurance companies.

It turned out to be a key to the success of my publishing company. When I eventually sold my firm to retire, it was a mechanism that was gushing money, providing 80 per cent of annual income.

Today it's called the subscription model, and increasingly businesses want to follow it. Instead of selling for relatively high one-off payments, they sell a stream of benefits for relatively small repeated payments.

Rolls-Royce, General Electric and Pratt & Whitney, for example, now rarely sell their passenger-jet engines in one-off transactions. Instead they offer "power by the hour" through complex service contracts that tie airlines to them for decades.

Mass-market businesses find that the income from subscribers – locked-in customers -- is more reliable than from those who are asked to make repeat purchases. Marketing costs much less per sale, even though nearly all the resulting cash flow is not immediate. Firms are able to build deeper relationships with customers and better plan the future.

One new entrant into subscription marketing is Ikea, the global home furnishing business, which is going to invest heavily in the idea of leasing furniture to families as an alternative to selling them flat-packs to assemble at home. Tech groups are also entering the market, for example with computer games offered on subscription as an alternative to one-time purchase or advertising-choked free access.

Things have moved on a lot since the days when we pioneered subscription marketing as an alternative to one-off sales. Initially Liz had to write monthly debit slips to draw on customers' accounts because the banks refused to accept the computer program we'd developed to do so… it was too revolutionary!

Venezuela: Two Decades of Bad Politics

Energy investment consultant Allen Brooks provides some interesting background to the evolving crisis in this South American country – said to have the world's largest oil reserves, although they're mainly in the form of sticky bitumen.

Around the turn of the century Venezuela's president Hugo Chavez played a major role in restoring the power of the global oil cartel, OPEC. A key to the plan was getting member-countries to follow production quotas. Chavez was determined that Venezuela should comply. But executives of the state-owned oil giant PDVSA were committed to continuing to increase production.

The struggle for power eventually led to a general strike, which was broken by the army; 19,000 PDVSA employees were purged. "The mass firings and replacement with Chavez loyalists set in motion the slow destruction of the technical skills for operating the national oil company," Brooks says.

The government increasingly siphoned off funds to boost social spending. Under pressure from these diversions, and with competent managers replaced by less competent or incompetent political appointees, PDVSA's production stopped increasing, then began falling.

Decline followed for the economy. As things worsened over the years the failure has brought such suffering to the population that millions have fled as refugees to neighbouring Colombia and Brazil. Including half the skilled staff of the state-run electricity monopoly.

The developing political and economic crises have recently been magnified by failure of the national power grid, plunging most of the nation into blackout. Venezuela depends on hydro-electricity for 70 to 80 per cent of its power. The breakdown appears to have been the result of years of poor management, with failure to protect power lines against forest fires, lack of spare parts, and substitution of quality parts from Europe with low-quality Chinese products.

It's hard to believe that Venezuelans can make such a mess of things. And the outcome is still unclear.

The World Economy: Diminishing Growth

Pursuing a trade war at the same time that global economic growth is slowing for other reasons "is more than a little unwise," says the well-known American commentator John Mauldin.

Shipping and transport stocks are a kind of "canary in the coal mine" because they are among the first to signal slowing economic growth. The latest news from Fedex – shipping revenue down, earnings guidance cut – is ominous, as it signals slowdown unfolding in North America, Europe, Australasia and China.

Growth of world trade is diminishing for multiple reasons, Mauldin says. "Part of it is technology – the things we 'ship' internationally are increasingly digital, and they travel via wires and satellite links instead of ships and planes."

Energy is another factor. Growth of shale production and renewable energy sources, means the US doesn't import as much oil and gas. "That shows up in both trade and currency values… Note the massive (and stealthy) growth in LNG (liquefied natural gas) exports in the past few years. Think what this will look like… with not one, but four, LNG terminals on the US coasts.

“Natural gas is also the basis for much of the chemical and fertilizer industry. Abundant US supplies – and prices less than half the cost of Russian gas in Germany – help many industries compete.”

China: Pumping Out ‘Bad’ Gases

While climate-change activists make a lot of fuss about the US, where emission of greenhouse gases has been in decline, they aren’t demonstrating loudly about China -- which attacks developed countries for not doing enough, while itself doing most to worsen it,

The *New York Times* reports that China, the world’s leading emitter of greenhouse gases from coal, now admits it’s burning up to 17 per cent more coal than its government previously claimed when it signed up for the Paris accord.

And it’s making things worse. Across China the government is building a fleet of new coal-fired stations with 259 gigawatts of capacity, while outside the country it’s financing even more new coal plants, providing $36 billion for 399 gigawatts.

“Chinese bankers and project planners like coal-backed projects because they are cheap,” says the energy consultancy IEEFA. “While they are restricted by Chinese pollution and emissions targets at home, they are free to fund coal-backed projects abroad.”

Europe: a Positive Outlook

From a valuation perspective, European equities have not been so unloved for quite some time. They’re trading on discounts relative to the rest of the world at or below the levels reached in the global financial and sovereign debt crises. Could that be about to change?

Invesco says the economic background has been weak – poor GDP growth – but blame can be attributed to some one-off events. Anti-diesel regulations that have produced a severe fall in car production; very low water levels in the Rhine, disrupting transport of goods; the Yellow Vest protests across France.

However, the anti-diesel and Rhine effects appear to have been largely normalized, while opinion polls show declining support for the Yellow Vests. “As the year progresses, a reversal in the impacts of some (if not all) of these temporary issues should be reflected in improving macro-economic data.” There are already signs of that. In December there was a sharp uptick in auto-related industrial production.

A British Cock-up Worse Than Brexit

The British government seems to have made a ghastly mess of reforming income tax allowances for pension fund contributions. Regulations aimed at restricting tax relief for higher earners are so complicated that, says the *FT*, they “can baffle the most sophisticated tax experts.”

Because of their inability to calculate the impact of tax on their pension contributions, and to plan accordingly, some consultants (specialists) working for the National Health Service have unexpectedly received five-figure tax bills.

Thousands of doctors are refusing to work overtime because doing so would shift them into higher tax brackets; they would actually earn less after tax. Thousands more are taking voluntary early retirement. The *FT* reports: "Cut to pension tax breaks risks crippling the NHS."

All of this was predictable, but apparently nobody in the top ranks of the Treasury or finance ministers did so predict. No wonder their Brexit forecasts proved to be so wrong.

Tailpieces

Under fire: Three German automakers – BMW, Daimler and Volkswagen – have been charged with violating European Union competition rules that prohibit cartel agreements to limit or control production, markets or technical development.

They are accused of co-ordinated agreement to avoid or delay introduction of particulate filters on petrol-powered cars.

Apparently this isn't related to the 2015 Volkswagen diesel scandal where VW lied to governments about how well its diesel vehicles reduced harmful emissions.

Too few Chinese: China faces a sharp contraction in its working population as a consequence of 30 years of the disastrous "one child" policy, and declining fertility rates. The Institute of International Finance says the working-age share of the population has been declining since 2010. By 2030 it will be falling faster than in mature economies. By 2035 the elderly proportion of the population will double, to 20 per cent.

The shrinking labour force will impact adversely on economic growth. Demand for residential property, for example, which has been an important engine of growth, will come under severe pressure.

Personal liabilities: The amount Americans have borrowed to pay for college education and have not yet repaid has grown to $1½ trillion. Baby boomers are entering retirement with a much greater debt burden than previous generations, A *Wall Street Journal* study reveals that those who reached their 60s by 2017 still owed an average of $33,000 in student loans.

Unfit: According to the Pentagon, 71 per cent of America's young adults are ineligible for service in the US military because they are too dumb, too fat, or have a criminal background.

Wise words: *The stock market is a device for transferring money from the impatient to the patient.* Warren Buffett.

Martin

If you know someone you'd like to receive ►On Target, click on Reply and send me his/her email address. Or email your request to me at: afrodyn@gmail.com.