►On Target

Martin Spring's private newsletter on global strategy

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The Outlook for Markets: Not Enough Bad News!

Investment markets are unusually confusing. On the one hand, there's a lot to worry about. But on the other hand, there's no panic. Investors generally seem willing to hang on, believing that the slowdown we're experiencing won't get anything worse than a mild recession… No serious threat to a world that's steadily growing richer.

Nevertheless… the International Monetary Fund says the global economy is weakest since the financial crisis a decade ago. Its new managing director, Kristalina Georgieva, says the chill in the air reminds her of a line from the Russian poet Alexander Pushkin: "The breath of autumn begins to ice the roadway."

America increasingly pays the price for the Trump administration's trade war, troubling its central bank enough to abandon its policy of "normalization" and revert to cheaper-money stimulus. Although investors generally expect Trump to declare "victory" in his fight with China to clear the path for his re-election next year, that still hasn't happened.

Europe struggles to achieve economic growth in a global environment of trade conflicts. Germany, its locomotive, is in the vortex of trouble. The major industry in this, the land of Mercedes, BMW and Volkswagen, is being hammered simultaneously by weak demand, the flight from diesel, increasingly aggressive carbonatic requirements by governments, and the hugely expensive transformation to electric vehicles.

Brexit hasn't happened yet, and its execution remains uncertain. Boris Johnson needs to win the general election with a clear majority in parliament. But even if Brexit does come about, years of uncertainty will follow as both Britain and its European partners re-shape their trade flows to conform to a massive new rule-book of tortuously negotiated agreements. And obligations.

China continues to grow, but more slowly than for three decades. It has to juggle conflicting priorities of countering trade war negatives, greater focus on developing high-tech industries, and keeping happy more than a billion people.

The biggest long-term threat to investors would seem to be that globalization, spreading development through infotech, free trade and supply chains, is losing its power to drive economic growth. Even if the tariff war comes to an end, it has frightened multinationals enough to make them reduce their

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dependence on global supply chains that maximize profits.

The world is moving away from “asset-heavy” growth based on construction and huge manufacturing plants consuming vast quantities of metals and fossil fuels to “asset-light growth” based on advanced technology, with small numbers of highly-skilled staff, automation, scarce minerals and harvested data.

There is also the new threat of social breakdown. Our news screens are awash with riots. In some countries radicals of Left, Right or even both are gaining support, even power. Causes seem to be very different or even contradictory.

What does seem to be in common is rebellion by populist masses against elites that have managed things too long exclusively for their own benefits; rebellion made possible and incited by the explosion of social media that cannot be controlled by the elite’s institutions. It’s too early to judge how far this will go, how damaging it will be for economic growth – but it won’t be good.

How will this impact on investment? Are the markets reflecting something more than cyclical slowdown magnified by the (hopefully) temporary factor of the trade war?

In American stock markets the consensus expectation of analysts for earnings growth of the 500 biggest companies is down from a peak of 23 per cent in September last year to just 1 per cent.

The bloom has gone off the amazingly high-growth tech sector as political hostility mounts to Google and Facebook, which seem to be incredibly inept at handling the firestorm. (Their censorship “precludes anyone who wishes to express a sharply bearish view from acquiring advertising space,” Eoin Treacy reports). They face major threats of tough regulation, punitive taxes and being forced to break apart.

However, it’s unwise for investors to be too pessimistic. Many trends remain surprisingly positive….

► American share markets, far from falling, as you would expect if investors were anticipating bad times, have been climbing to new highs. In the case of the S&P 500 index of the biggest listed companies, to a new record. Wall Street continues to lead as it has over the past ten years, when it has outperformed the rest of the world, partially thanks to buybacks leveraged with dirt-cheap credit.

Europe, Japan and emerging markets are rising

► Other major stock markets, although still far short of highs, are also doing well. In Europe, despite slowing economic growth, shares have been rising and have reached a new high for this year. Shanghai isn’t going anywhere, but isn’t falling either, despite the highly-publicised trade and technology-theft fight with the US. Tokyo has broken out upside to its best levels so far this year. Emerging markets have been rising strongly since they bottomed in August.

► Bond markets refuse to collapse despite horrendous valuations. Bunds have weakened somewhat, but Treasuries have been hitting new valuation highs.

► Gold looks as if mid-year it started a renewed bull market, but since then has been showing no sign of take-off to new highs in anticipation of some major crisis.

► Oil has been drifting sideways for months, refusing to fall to $50 and below, suggesting that few players in the market expect a collapse in global demand.

Swiss bank UBS says that if the US economy bottoms in the final quarter of 2019, as interest rates now suggest, then historical precedent argues that Wall Street should start to price in a sustainable recovery some time between April and August next year. Eoin Treacy of *FullerTreacyMoney* says the rebound in bond yields, suggesting less demand for a safe haven, combined with the strength in investment asset prices, suggests we are more likely to see another leg higher rather than the kind of volatility we saw at the end of last year.

Nothing too much to worry about, then.

Heavyweights Start to Join the Party

For decades central bankers and their acolytes have been telling us that investing in the precious metal is foolish. Now they've changed their tune. Many are now swapping their fiat-currency reserves for gold. Central banks have been on their biggest gold-buying spree since the one that forced Nixon into taking the dollar off the gold standard in 1971.

The Dutch central bank now says in a published article that gold could be the "saviour" of the international monetary system. It says that if the system collapses, the yellow metal will be the "trust anchor" that "provides a collateral to start over." Assets such as "shares, bonds and other securities" all have inherent risk, but "a gold bar always holds value." According to most recent figures the bank holds 15,000 bars (615 tons), mainly in its Amsterdam vaults.

UBS bank says it expects gold, which has been consolidating its position around $1,500 since rising sharply this year, to achieve further price gains as its "primary drivers" remain in place. They are a slowdown in global economic growth, continuing easy-money policies, central banks' gold buying and a continuation of trade tensions.

An interesting idea from Rob Odell of Coin Telegraph is investing in a "smart contract" – ownership of physical gold via a legal title in cryptographic form… "a highly transparent, secure and liquid financial instrument." Such instruments have already been cleared by regulators for listing in New York and Singapore.

John Hathaway of Tocqueville Gold Strategy lists seven "red flag" factors suggesting that "it is gold's turn to climb to record highs."

► The world economy appears headed for recession. A trade deal with China, even should one be achieved, seems likely to reveal America's weakness and lack credibility with investors. In the US consumer spending appears to be wilting, while business investment is likely to remain in suspension until the outcome of next year's election is known.

► Monetary policy looks to be in disarray. The recent massive emergency "repo" facilities "give off more than a whiff of smoke." A growing federal fiscal deficit, which could be 30 to 50 per cent greater than expected, "may be crowding out private borrowing." Demand for private credit is slumping.

► Negative bond yields on $15 trillion or more of global sovereign debt "suggest potential for capital losses that will dwarf those of the 2008 toxic mortgage crisis."

Those who are buying such stuff, such as pension funds, stand to lose when interest rates rise.

► The breadth of share markets continues to narrow. while the averages that hover near all-time highs disguise underlying weakness. The scenario echoes the Nifty Fifties of the 1970s when major institutions concentrated their buying on a handful of “growth at any price” overpriced companies, many of which crashed in the 1974-75 recession.

► The proportion of major new listings of companies with negative earnings is 74 per cent so far this year. It’s a situation that looks like the 2000 prelude to the dot-com crash.

► Important investment luminaries such as Ray Dalio of Bridgewater, Rick Rieder of Blackrock, are predicting “a coming paradigm shift,” a possible “monetary policy endgame” – and turning to gold as a strategic solution.

► There is a “fractious US political climate.” If it worsens leading into the 2020 presidential election, “partisan discord could destabilize financial markets” and damage economic activity.

“Despite record low interest rates and massive fiscal deficits -- the traditional prescriptions to juice growth – the global economy seems to be slipping into recession. We could be at the threshold of even larger deficits and more radical monetary initiatives. Neither populist leaders nor their constituents would stand for belt-tightening or fiscal prudence.”

If precious metals are currently experiencing “a well-deserved rest,” Investors should take advantage of any near-term weakness to build their exposure… “a dip that needs to be bought.”

However, although we are in the early stages of a new bull market, investors should not fall into the trap of having too-high price expectations, warns precious metals consultancy Incrementum. “A look at the current situation in the financial markets shows that gold is still facing considerable headwinds:”

US equities are still the most popular asset class, and close to all-time highs. In almost every country, real estate is trading at or close to all-time highs and is considered to be the asset “without alternative.” Trust in the financial system and in banks remains relatively high. And price inflation is still relatively low.

Uncertain Risks: Start Planning and Acting Now

If you’re worried about how things are going in the country where you live – its economy looks headed for trouble, its politics are increasingly unstable, socially it’s breaking down -- you should give attention to reducing the risks to your yourself and family.

There are two priorities, Jeff Thomas says in the *International Man* newsletter – get your money out, and get yourself out.

Typically advisers recommend that you diversify internationally, putting some of your wealth outside your country… say 10 per cent. That doesn’t make sense if you’re at risk from a tornado. Much, much more should be somewhere else.

Take radical action. For example, what about selling your home, leasing back from the new owner if you can, and "expatriate the proceeds to the safest jurisdiction you could find that's relatively near you. In Asia, that might mean Singapore. In the US, it might be the Cayman Islands. In Europe, it might be Switzerland."

What about getting yourself out?

Thomas says that's still quite easy to do, but over time that will change. At present most countries welcome North Americans and Europeans, but once a global economic crisis arrives, they'll pull the welcome mat. "The sooner you provide yourself with legal residence in another country," plus somewhere to live, even if it's rented, the greater your certainty of freedom.

You'll be able to remain in your home country, but when the crisis nears your doorstep "you can simply pack a bag, go to the airport and be in your destination-country the same day."

If you've chosen one of the best countries for storage of wealth, it shouldn't be necessary to move there, but the closer you can be, the more convenient.

Thomas says the countries he's recommended are costly to live in. You may wish to live in one that's less expensive, but nearby. You might keep your wealth in Singapore, for example, "but choose to live in Thailand, which is very inexpensive and, in the northern provinces, a very peaceful place, where you'll be treated well by the locals. You should always seek out a country… where you could find a life that suits you."

How do you know when it's time to leave? There's no definitive answer to that. But preparations take time if it's to be done well. The sooner the better. He reminds us that the time to flee Nazi Germany was before Kristallnacht, but when that happened on November 9, 1938, it came without warning. For many people, that was too late.

A Bad Idea Coming Back Into Favour

Rent control is a stupid strategy much favoured by socialists. No surprise, then, that it's coming back into favour in the US as Leftists there gain support. Oregon passed a state-wide rent-control measure in February. New York did something similar in June. Would-be Democratic presidential candidate Bernie Sanders promises nationwide rent-control.

The shortages produced by such measures, *The Economist* reports, "incentivize flat-hoarding by tenants and neglect by landlords." A rent-control scheme in San Francisco meant that affected landlords cut supply by 15 per cent. Often beneficiaries are not poor, but relatively wealthy. Old schemes in New York that were researched found that 25,000 households in rent-controlled or rent-stabilized units had annual incomes greater than $200,000 a year.

"Rent controls are a textbook example of a well-intentioned policy that does not work. They deter the supply of good-quality rental housing. With rentals capped, building new homes becomes less profitable. Even maintaining existing properties is discouraged because landlords see no return for their investment. Renters stay put in crumbling properties because controls often reset when tenants change…

The longer a tenant stays put, the bigger the disparity between the market rent and his payments, sharpening the incentive not to move.”

In Stockholm, Sweden, which has long imposed controls on rental housing, the average waiting-time to gain access to a controlled unit is ten years. At the end of last year 636,000 people were stuck in the queue for a long-term tenancy in a diminishing supply.

The answer to rents that are high is not to control them but to boost supply of accommodation. One way to make that better is to encourage private landlords. That’s not an idea that appeals to socialists in America, or anywhere.

Money Traps in the Share Markets

The current easy-money environment favours transfer of large amounts of cash from ordinary savers to ridiculously overconfident individuals says Merryn Somerset Webb, the highly-respected British commentator on personal finance.

She speaks in the wake of news about two men whose spectacular failures have impacted on the lives of so many. The business of Neil Woodford, the best-known British fund manager, has just collapsed, leaving hundreds of thousands of investors trapped with big losses. Adam Neumann, boss of the over-promoted WeWork global office service empire, has similarly seen its value evaporate, plunging from $47 billion to $8 billion.

Businesses such as Spotify, Uber, Lyft, Beyond Meat and Snapchat have been listed while making no profits “on the basis that the way to success these days is not to chase profits but to chase market share… while producing significant amounts of technobabble about how much the data you will collect as you pay to dominate your market will one day be worth. Shareholders don’t receive any income from them now; they just get to pay ultra-high valuations and imagine that they might one day. Or not.”

Merryl says these malinvestments are driven by the endless upward momentum provided by super-low interest rates. Not only will they never make money but their founders and managers know that. Their game is to keep it going at least until they are rich.

In the UK Metro Bank is a neat example of what’s been going on. “It had a big personality at the top, aggressively over-expanded, listed at rather too high a valuation and will now make losses for the foreseeable future. The share price has fallen 90 per cent from its highs.”

Dollar and Yuan Going to Dance?

Are we about to see a “currency pact” between the US and China? Investment bank Jefferies’ Hong Kong-based Christopher Wood sees it as a possible significant development in the difficult ongoing trade negotiations between the two countries.

It could give Donald Trump “a face-saving ‘out’ in terms of declaring victory in negotiations, where he has clearly over-estimated his leverage, for the simple reason that the Chinese leader has more tolerance to take pain than does America’s.”

A currency agreement based on a Chinese commitment not to engage in a competitive devaluation of its renminbi makes sense as both Washington and Beijing want the same thing. Neither wants a stronger dollar and a weaker yuan.

Beijing may see such an agreement as a way at least to end an escalation of the trade war or even to end it. It has no desire to see a major devaluation against the dollar. That would encourage accelerating capital outflow – “the Achilles heel of China’s command economy” -- at a time when such pressures are rising because wealthy citizens are keen to achieve international diversification. The outflow reached about $240 billion in the 12 months to the second quarter.

Devaluation would also make Chinese consumers poorer in dollar terms, undermining the policy of seeking to make the economy more driven by domestic consumption. And it would undermine the current successful policy of attracting foreigners to invest in China’s stock and bond markets.

“The last thing China needs right now is a further sharp appreciation of the US dollar – and that also seems the last thing Trump wants.”

Wealth Potential of the Middle Kingdom

China is on the way to matching, then overtaking, the US’s cohorts of high-level human capital, reports Singaporean commentator Bernard Tan.

Its numbers enrolled in tertiary education, already 2½ times America’s, could triple or even quadruple, It has already produced more than 100 million bachelor’s degree holders in the past 12 years and another 100 million can be expected within a decade.

“This enormous human capital is already reaping rewards. Chinese publications of academic papers and patent applications are already fast catching up with the US, and in some areas [have] overtaken it already.”

Tan says the success of overseas Chinese populations all over the world is in large part a result of their commitment to the education of their children, and to a frugal existence, a work ethic, and investment in property. It’s natural that the same cultural affinity should apply in China.

The growth potential for millions of college graduates entering the economy is undisputed. But the extent to which that potential reaches fruition depends on environment.

“South Korea had unfettered access to the global economy, which allowed it to make the best of its innovative and inventive educated population. That allows it to punch well above its weight on the international stage. Russia on the other hand has some of the best-educated and brilliant minds in the world, but the lack of basic infrastructure, poor governance and patchy capital markets inhibit growth.

“I suspect China is going to be somewhere in the middle between these two because the overarching influence of the Party puts a focus on control – rather than growth and innovation.”

Choosing a Fund to Manage Your Money

The bigger a fund, the harder it is to outperform because the institutional culture drives its manager towards focusing on getting bigger rather than investing better, argues commentator Tim Price.

Before buying a fund, he says, ask these questions:

► How big is it? Managers' pay is invariably linked to the size of funds under management. The more assets, the more pay. It takes guts (and principles) to turn money away and concentrate on investment performance. But that's what many smaller investment boutiques do.

► Has the manager invested his own money? If he hasn't, why should you? Personal investment is by itself no guarantee of outperformance, but it shows the most basic alignment of interests between manager and investor.

► Is the fund independent and owner-managed? David Swensen, the famous manager of Yale university's endowment fund, has said he prefers the smaller, private partnership over the big, listed full-service operator. How many mouths must your fees feed?

► Is it an asset manager… or an asset gatherer? This gets to the heart of the challenge facing investors today. The investment world is polarized between managers, who focus their energies on delivering the best possible returns for their clients, and gatherers, who just want to maximize number of clients.

"Try to find managers like the celebrated investor Jean-Marie Eveillard, who once remarked: 'I would rather lose half my shareholders than half of my shareholders' money.'"

US Politics: Will Pocahontas Be the One?

I have long believed that the Democrats' presidential candidate with the best chance of defeating Donald Trump is Elizabeth Warren. Now it's becoming clear that the party is likely to end up choosing the Massachusetts' senator as its candidate.

Trump likes to insult her by calling her "Pocahontas," a reference to the one major blemish in her record, her one-time false claim to partial Native American ancestry to advance her career. Other than that flaw -- a political negative whose importance is greatly exaggerated -- Warren has none of the dubious history of the kind that ultimately deprived Hillary Clinton of becoming the first US female president.

There is no doubt that she's a committed Leftist. She wants to tax the wealthy, bring socialist universal healthcare, free childcare and free college education, and use anti-trust policies to smash the dominance of arrogant tech giants. She wants to force the social media giant Facebook to disgorge its acquisitions of WhatsApp and Instagram.

Such radical views could bring her the candidancy, but she would need to soften them considerably to gain enough support from middle-ground voters to deliver the presidency.

Problems the Brexiteers Hope to Avoid

The “fundamental flaws” of the Eurozone, says a European (not British) analyst, are…

► Its interest-rate policy is really One Size Fits Germany. A policy that is appropriate for Germany is not appropriate for other member-nations such as Italy, Spain, Greece.

► The Target2 system, which allows the central banks of countries with capital outflows within the Eurozone to finance them by borrowing from countries running surpluses, is another fundamental flaw. If a member-nation crashed out of the Eurozone, it would immediately have to settle its outstanding bill – which could be huge. How could Italy pay back €444 billion to its creditors, primarily Germany? Spain also owes more than €400 billion. Germany, on the other hand, is owed nearly €900 billion.

► Agricultural policy is based on saving French farms to the detriment of everyone else.

► Rules governing employment vary widely. Italy and Greece are basket cases. France is almost as bad.

► Rates of major taxes and the way they apply also vary.

► European Union leaders want a European army, but Germany, which would have to pay for it, doesn’t want to know.

Hong Kong: the Disorder Rumbles On

42 per cent of Hong Kong’s people want to emigrate because of the social unrest which has started to have a devastating impact on its economy. Half of those say they’ve already started to make plans to leave, such as cancelling housing leases, selling homes and cars, and packing up their possessions.

Jefferies’ long-time Hong Kong-based Christopher Wood says Beijing seems to be holding back from radical action in the hope that the demonstrations will eventually burn themselves out, which is what happened to the Umbrella Movement in 2014.

Although damage caused by violence has become significant – for example 10 per cent of ATMs are reported to have been destroyed -- “there is still little sign of mainstream opinion pushing back against the demonstrators.” Apparently it’s widely believed that the vandalism is not being caused by bona fide demonstrators but by *agents provocateurs* trying to alienate mainstream support.

Tailpieces

Microsoft: Analysts are enthusiastic about the infotech giant. Bloomberg’s Ryan Vlastelica says it’s “the best positioned name in tech for the emerging hybrid cloud architecture.” Bernstein’s Mark Moerdler says the company is beating “virtually every metric.” RBC Capital Markets’ Alex Zukin says it began its new financial year “a strong start… with bookings strength across the board.”

Eoin Treacy says Microsoft "has transformed itself from a software maker to a software-as-a-service company. In the process it has transformed its lumpy cyclical cashflows into a steady revenue stream." The subscription business model affords Microsoft and other companies the growth rate and margins of a tech company, but with the cashflows of a consumer staples company.

Wise planning: Good timing plays a big part in making your life a financial success…

► Avoid making major investment decisions at peaks and troughs in the markets. Because they will almost certainly be too influenced by too much optimism and too much fear, they'll almost certainly turn out to be wrong.

► Don't wait too long to have children. If your family is complete by the time you are 30, you'll have perhaps 15 years after they leave home to save intensively for retirement.

► Your retirement date can be selected to maximum financial advantage. For example in many countries you can reduce tax on fund payouts.

Chile: If riots can happen in Latin America's stablest and most prosperous nation, they could happen anywhere, warns Bloomberg's John Authers. The Chileans revolted against the cost of living. It could easily happen elsewhere.

"The catalyst was a proposal to raise public transport fares and energy bills. There is ample evidence… that these will incite rebellion like nothing else – a point that those who hope to reduce greenhouse-gas emissions via a carbon tax should bear in mind. The violent protests of the Gilets Jaunes in France were over higher gasoline taxes." They were motivated by carbonatics as a means to penalize fossil fuels, but were seen as unfair penalization of car-dependants.

5G war: Nokia announced that fierce competition in the telecoms equipment market has forced it to cut its earnings forecast and suspend dividends. The *FT* reports: "The rollout of 5G has turned into a geopolitical battle between China and the West. The US, which has no significant company in the field, is so worried about the dominance of Huawei, fuelled by cheap financing for customers, that it is looking for ways to funnel money to Ericsson and Nokia," the Scandinavian giants.

A world divided: UN secretary-general Antonio Guterres speculates about the possibility of a "great fracture" with the two largest economies, America and China, "splitting the globe in two – each with its own dominant currency, trade and financial rules, its own Internet and artificial intelligence capacities, and its own… geopolitical and military strategies."

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