►On Target

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Stock Markets: Answers to Three Key Questions

Here's what my favourite commentator on global stock markets, California-based Eoin Treacy, has to say in his newsletter FullerTreacyMoney *about the outlook now. He's an excellent technical analyst, but his insightful comments about investment are always wider-ranging…*

There are three important considerations when looking at market reaction [the bounceback from the plunge in March]. These are: where are we in the secular trend? Is liquidity expanding or contracting? What does the chart tell us about sentiment?

The secular bull market that became obvious on Wall Street in 2012 is being driven by technological innovation and liquidity.

Technological innovation remains a significant growth driver. Cloud computing has been a saviour for many businesses during lockdowns, but it is the cost savings over maintaining on-site architecture that will make it sticky. Meanwhile the roll-out of 5G will greatly enhance the availability of services via mobile devices.

In the energy sector there is a clear need to build additional electricity generating capacity. The evolution of industrial-scale batteries is currently the missing link in developing a lot more renewable sources of energy in the absence of additional nuclear facilities.

It is quite likely [that] infrastructure development on an epic scale will result from the stimulative measures deployed following lockdowns. The continued outperformance of renewables and especially hydrogen stocks, relative to oil, suggests investors are already betting on this outcome.

The evolution of deep learnings, artificial intelligence, automation and 3-D printing all represent trends that are going to be amplified over the coming years. The promise of autonomous vehicles is only a promise today, but when eventually delivered it will represent a further iteration of the dehumanization of the economy.

That's the internal contradiction of technology. The trend of innovation is towards dematerialization -- when physical products and locations are replaced by virtual applications.

Books, music, entertainment and retail all now exist on the Internet. The trend is towards dematerialization of banks, lawyers, doctors as all their administrative

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staff move routine visits on-line. This in turn creates a trend of dehumanization where people are removed from the supply chain.

The challenge therefore is if consumers see fewer opportunities to increase their income, and work is further delineated between the highly-educated and the less-well-educated, where is the money to support all the new services going to come from?

Technology companies are now the biggest in the world, dominate the global economy, and prosper by removing the need for workers. Ultimately they depend on workers to be able pay for their services.

Liquidity stagnated between the end of 2017 and Q3 2019, which contributed to a loss of momentum on Wall Street. The ramping up of liquidity is a net positive for asset prices and there is a strong correlation between new monetary infusions and stock market rallies. The opposite is also true. The tide of liquidity remains upwards. The only thing that has any chance of derailing it is inflation.

Low energy prices put a significant dent in the potential for commodity inflation. Wage demand growth has probably been boosted [in the US] by the overly generous unemployment benefits where people earn more from doing nothing than working. Deglobalization and the increasing awareness of China's clear intention to dominate the global economy is probably the biggest potential source of inflation.

All three of these topics needs to be monitored because they are the clearest threats to the continued supply of liquidity.

Everyone is asking whether the massive reaction against the prevailing trend is meaningful, or should [it] be ignored because it is exogenous event? The very fact we have to ask the question tells us it has had an impact on sentiment. That suggests we have in all likelihood seen a medium-term top.

After the Virus, Life Will Be Different

The largely self-inflicted disaster of the war against Covid-19 is likely to have some permanent adverse consequences, analysts predict. Here are some of them…

► Governments will continue to get bigger, more interventionist, more authoritarian and more powerful, involving themselves more extensively in economies. Populist pressures will mean they're likely to favour less austerity, but more protectionism.

► Explosive growth in technology and lessons learned from fighting the virus will encourage governments to expand their control over where individuals are and what they're doing. One analyst suggests we are "entering the era of tech control and the omnipotent bureaucrat."

► Central banks will continue with their experiments of ultra-low interest rates, bond-buying and money printing, and go further.

► Policy changes arising out of lockdowns will make many businesses unprofitable and bankrupt them. Those that survive may be more cautious about investing in expansion. However the avalanche of government giveaways and life support for zombie companies in virus-fighting programmes may encourage some

managers to take higher risks, including higher leverage and minimal cash strategies -- if their enterprises are large and important enough to feel sure of a public safety net.

► Consumers will also become more frugal after losing their livelihoods due to actions outside their control.

► Working from home won't be an easy substitute for lost jobs as that can only be done in 29 per cent of cases, according to a US agency. Women will be most affected as they are 60 per cent of those who have lost employment.

► All economies will emerge from the crisis with much higher levels of debt, leading to a period of financial repression (interest rates below inflation) and higher taxes on both corporations and personal wealth.

► As they cut their reliance on global supply chains, multinationals are likely to resort to greater automation (more robots) to shield themselves from cost increases.

Uncomfortable Facts About Lockdowns

It's now becoming clear that most of the policy decisions taken by governments on the advice of their experts to combat Covid-19 – stay-at-home orders and enforced shutdowns of businesses considered non-essential -- with the disastrous consequences for economic collapse that are still gathering momentum, have been wrong… so wrong that some of them turn out to have been nonsense.

Detailed analysis of outcomes in America by David Stockman shows that there is no case at all for the severe lockdowns strongly advocated by scaremongers.

Death rates by April 28 in states that have been imposing harsh lockdowns ranged from 143 per 100,000 of population in New York city to just 4.6 in California, from 45.7 in Massachusetts to 3.8 in Maine. By comparison Iowa, with no lockdown at all, has had a mortality rate of only 4.3 while Texas, while imposing only a light lockdown, had a rate of just 2.4.

Sweden, which has one of the least restrictive lockdown regimes in the world – schools, businesses, restaurants and retailers allowed to remain open – has a mortality rate way less than several American states with severe lockdowns.

"Self-evidently, what matters is not how economically suicidal the lockdown regime is… but the age, health status and general frailty/vulnerability of the population."

Mortality rates attributable to the pandemic are so small relative to deaths from all other causes that, Stockman argues, they are no more than "rounding errors on the scheme of things."

He gives as an example Washington state, where the first Covid-19 cases in the US were reported. Upwards of 40 per cent of the 690 deaths to date have been in nursing homes. If you adjust for those, mortality in the general population has been just 6.0 per 100,000. The rate of deaths in a year from all causes is 900 per 100,000. So the risk of Covid-19 death so far has been less than 1 per cent of the normal average. Does that warrant a heavy lockdown that is driving the state's economy "into the drink?"

There are 15,600 nursing homes in America, with 1½ million residents, a quarter of whom are older than 80. In the case of Massachusetts, where the majority of Covid-19 deaths have occurred in nursing homes, the average age of those dying has been 82.

Rather than destroy $4 trillion of economic activity via lockdowns it would have made much more sense to spend much less – say $25 billion to start with – on Medicare/Medicaid and state public health agencies “to zero-in on protecting, isolating and treating nursing home residents.”

Rather than trying to force all Americans into a one-size-fits-all regime of state control, policy ought to have been divided into three categories according to age:

► The Kids Nation of those younger than 15, where to April 28 there were only five deaths where Covid-19 was involved. By comparison, children suffered 44,000 deaths from all causes last year. “In no sane world would it be a reason for shutting down the schools.”

► The Parents/Workers Nation of those aged 15 to 64. They account for the overwhelming share of commerce, jobs and economic activity. They experienced just 8,267 Covid-linked deaths. Their normal mortality rate – annual deaths from all causes – is 335 per 100,000. The Covid rate to date has been just 3.6. “So we are talking about shutting down the entire economy owing to a death rate to date which amounts to 1.1 per cent of normal mortality.”

► The Grandparents/Great Grandparents Nation of 52 million. They accounted for 32,000 or nearly 80 per cent of all Covid-associated deaths, with 15,000 of them being among those 85 years and older. Their Covid mortality rate has been 61 per 100,000 to date.

It has not taken “a catastrophic experiment with Lockdown Nation” to figure out that their risk of death from Covid-19 has been 7,600 times greater for them than for children; 29,000 times greater for the several million great-grandparents afflicted with severe comorbidity, and probably in the care of a nursing home. These realities were already known from China and the history of other coronaviruses.

Although Stockman’s analysis is limited to America, it is clear that much of it applies to other countries. Policies could have been focused almost exclusively on the shielding and treating the elderly.

Why Did They Ever Believe This Man?

It has become increasingly clear that the largely misconceived war against Covid-19 was triggered and driven by absurd forecasts about the numbers of people who would be killed by it.

At time of writing mortality has topped a quarter-million… still far short of a conventional flu epidemic. A massive campaign focused on the elderly would have been far more sensible, cost a fraction as much, and avoided most of the massive economic damage.

I can understand why governments panicked, but not why they gave such credence to the predictions of Imperial College London, now totally discredited and revealed to have been based on defective software giving false calculations.

Its team has been led by Britain's best-known yet least credible epidemiologist, Neil Ferguson. This was his track record even before he terrified the British and American governments with his projections of death rates as high as 500,000 in the UK, 2.2 million in the US…

► In 2002 he predicted that up to 50,000 people in the UK would die of BSE (mad cow disease). Actual number: 178.

► In 2005 he predicted 200 million people would probably die of avian flu H5N1. Actual number (according to the World Health Organization): 78.

► In 2009 he predicted that swine flu H1N1 in the UK could kill 65,000 people. Actual number: 457.

Worldwide there is mounting recognition of what a disaster has been the handling of the pandemic. In poor countries the human consequences are greater than if governments had done nothing and let the virus run its course just like conventional flu.

In South Africa, for example, the government has followed the lead of the rest of the world and imposed a lockdown, but it admits that as a consequence 7 million people could lose their jobs – and that this could lead to tens of thousands of deaths not caused by the virus. So far there have been fewer than 200 Covid-19 deaths. By comparison, 410,000 South Africans die from natural causes each year; 21,000 are murdered; and 15,000 die in road accidents.

Less than 3 per cent of South Africans are older than 70 – are in the age category at significant risk from the virus. A policy focused on them would cost a fraction as much in human and economic terms.

Those of us who are privileged to live in Chiangmai, Thailand – just one death from the virus – watch with fascination, and horror, how the pandemic is being dealt with around the world. A friend summed up our reactions in these words: “It is absolute madness bordering on criminality to incarcerate the vast majority of the young, healthy working citizens in order to protect the very small minority of morbidly sick, and then dumping infected people into nursing homes.”

It's interesting to see how opposition is mounting to anti-Covid policies on the grounds that they're wrong, even crazy.

Ryanair chief executive Michael O'Leary has publicly attacked the 14-day quarantine plan on passengers arriving in the UK as “nonsense” and without any scientific basis.

Egon Musk was so angry at the Californian government's enforced shutdown of Tesla's huge Fremont car plant that he threatened to shift operations to business-friendly Texas.

Glenda Gray, chairperson of the South African Medical Research Council, says the country's continuing lockdown has no basis in science and should be scrapped. It is having such devastating effects – jobs destroyed, so no food – that hospitals are seeing children with malnutrition; something not seen for decades.

Equities: Companies Shift Their Priorities

Once the Covid-19 crisis comes to an end and governments remove all or most of the growth-destroying measures they imposed, there will be a major recovery in corporate profits. But that won't mean that shares are going to be as attractive as they were before the Great Stop.

Many companies, many sectors, will face the costs of structural changes brought about by, or enhanced by, the crisis.

The most obvious one will be an acceleration of deglobalization. Multinationals will no longer be keen to pursue the benefits of international diversification, while both their own nasty experience of pandemic shocks and political pressures ("we mustn't depend on China") will drive them to reform their supply chains… which is going to be an expensive business.

There are also likely to be significant changes in consumer behaviour to which companies will have to adapt. Airlines, forced to move towards more viable fare structures, will permanently lose a chunk of dirt-cheap recreational travel. Stay-at-home lockdowns gave consumers a taste for delivery services such as food from "dark kitchens" and for learning on-line.

If earnings are going to be harder to achieve, they are also going to become harder to deliver to shareholders.

In the US the public is demanding in the various aid programmes to combat the damage done by coronavirus measures that there be five-year limits on dividends, share repurchases and executive compensation.

Even without such pressures the need to repay emergency borrowings made in the crisis, rebuild cash resources (which were often too low to start with), and boost capital for restructuring and expansion, will induce managements to be financially conservative. By recent standards, VERY conservative.

In the US traditionally dividends account for about 2 per cent and share buybacks about 3 per cent of the historical annual average stock market return of 5 per cent. Share buybacks will evaporate while dividends will be cut or suspended. Investors' expected returns are going to be savaged.

Although buybacks have not been important outside America, the rest of the negatives are similar for investors everywhere. Holding on to shares, or buying more, requires a strong commitment for the long term. Eventually equities will recover their pride of place in personal investment portfolios, but probably not for some years. Curb your optimism and have a lot of patience.

Tough Times for Equity Income

Terry Smith, Britain's currently most successful active fund manager, has long argued against the wisdom of investing in the equity income sector. One reason is that so many of the companies earn profits far short of the level needed not only to cover their dividends, but also to finance the reinvestment essential for their future – typically, twice earnings. As at mid-April the dividend cover of the top 20 highest dividend yield stocks in Britain was only 1.3 times.

Events – the double black swans – have now delivered dramatic confirmation of the risks lying in wait in the equity income sector. Most spectacularly in the decision of Royal Dutch Shell, the UK's biggest equity income stock, to scrap its famous policy of never cutting its dividend, by lopping off two-thirds of its quarterly payout in response to the current crisis.

But if you're uncomfortable with Smith's alternative approach to getting cash for income – invest for long-term growth and generate any income you need by cashing in some of your capital gains – where do you go if you want to stick with equity income in the current devastatingly negative environment?

Smith says you should invest in companies where the founding family is still in control. "Out of the 47 stocks in the Stoxx Europe 600 [index] that are 'family influenced,' only three have cancelled or postponed dividends. Very often these extended families, descended from the business founder, rely on the dividend income from the family business.

"Investing alongside them can help to preserve your income, too. And in this market environment you may get some attractive opportunities to do so."

Inflation: Is It Coming?

The world's major central banks are "printing" (creating electronically) money on a mind-boggling scale. Does that mean we're heading for an explosion in inflation?

Not immediately. Anti-Covid19 measures imposed by governments have destroyed demand for goods and services. Even though those policies have also seriously damaged supply, the overall balance is negative. That is seen most dramatically in the oil market, where prices have fallen so low, even negative, and remain low.

Karen Ward, a chief market strategist at JP Morgan, says that over the next few months inflation rates will fall away, then turn negative, as cheaper oil drags consumer prices lower.

"But within a year we will be looking at a very different picture." Oil will recover as the three major producing countries cannot survive with prices lower than $40 a barrel. Few new projects will be viable in America on less than $50.

"When stay-at-home restrictions are removed, demand will roar back. Families will flock to restaurants, shops, shows and mini-breaks. Households will, in many cases, have built up savings to fund such a binge," their finances boosted by subsidies in Europe, unemployment benefits in America.

"The recovery in demand will be much swifter than the recovery in supply," where "it will take some time for dislocations in global supply chains to be resolved and shop shelves to be restocked."

Some companies will find it easier to raise prices because some of their competitors will have failed to survive the shutdown, while households may find they have a smaller range of restaurants and shops to choose from – also meaning less competition.

There is also a risk that policymakers will leave their stimulus in place for too long. In recent years they have shown a clear tendency to err on the side of

delivering too much stimulus. And voters won't tolerate any renewed wave of austerity so soon after the last.

A rise in prices generally, plus some recovery in oil prices, "will see overall inflation jump."

Morgan Stanley's Mike Wilson lists these forces working in concert to raise the probability of inflation:

► Populism. This global trend is fostering various forms of protectionist policies that are generally inflationary – minimum wages, immigration controls, tariffs.

► Wage growth. This is perhaps the most important aspect of populism. In the US minimum wage laws are keeping pressure on compensation costs even in a recession.

► Deglobalization. Covid-19 has exposed the fragilities of heavy reliance on supply chains stretching around the world. Our recent survey showed that 40 per cent of executives plan to reduce offshoring. This trend will undoubtedly raise costs.

► Higher deficit spending by governments. It has been on the rise for almost two decades and has now got a big boost from Covid-19 fiscal spending and unlimited quantitative easing. When those measures are no longer necessary it may be difficult for politicians to really pull back spending or raise taxes.

► US dollar weakness. The significant shift we may be witnessing in US fiscal and monetary policy could lead to a materially weaker currency.

However, the inflation all these factors suggest is not an immediate prospect. Yields in bond markets show that they're expecting deflation for at least the next three years and inflation thereafter out to ten years at annual rates below 1½ per cent.

Why Do Value Strategies Fail to Perform?

Value investing is the strategy focused on buying and holding solid businesses whose shares are trading below their fair value. It's the strategy made famous by the world's most successful investor, Warren Buffett. And it's the one that many professional investors believe in and follow.

Trouble is, it hasn't been working for a long time.

Over the past decade Russell 3000 Value, the broadest measure of value stocks in the US, has risen 80 per cent. But the S&P 500, the measure of the largest, has increased more than 120 per cent. Growth stocks of faster-expanding companies returned more than 240 per cent.

The pandemic has magnified the trend. The market as a whole crashed, then rebounded. But a handful of giant growth stocks led the recovery,

Why have companies rated as value picks underperformed consistently for so long? Robin Wigglesworth offers these reasons, which are more about the relative strength of growth versus value:

► Market dynamics have been “warped” by the ascent of more systematic ‘quantitative’ investing… for example by simple exchange-traded funds that just buy cheap stocks; more sophisticated algorithmic hedge funds.

► Some industries, especially technology, have become oligopolies that ensure extraordinary profit margins with continuing growth.

► Traditional measures of value such as price-to-book are becoming obsolete. The intellectual property, brands and often dominant market positioning of many of the new technology companies do not show up on a balance sheet in the same way as hard, tangible assets.

Accounting has not kept up with how companies actually use their cash. If a company spends a lot building factories it shows; if it spends that money on intellectual property it doesn’t show up in the same way.

Good News About the Chinese Economy

Mainstream media continue to ignore the really good news about how China’s economy is rebounding from the shutdown. Factory production is now back to 70 to 80 per cent of normal. In the first week of this month domestic flights were only 7 per cent less than in the start of May last year. Sales growth figures of major property developers have surged to surpass levels of last year. Volkswagen says demand for its cars in China is almost as high as it was this time last year. There is “stunningly strong” demand from first-time buyers.

All of this is being achieved without the panicky stimulus plans seen in America, Europe and Japan.

Jefferies’ Christopher Wood says it would make sense to invest in what is going to be the nation’s prime response to the pandemic – its medical infrastructure. This will probably be at least as big a priority as the One Belt One Road policy. 90 per cent of approved public/private partnerships are “single-function public hospitals,” typically big ones located in smaller cities.

Gold: Why This Megabank Is Optimistic

Bank of America has raised its target price for the next 18 months from $2,000 to $3,000 an ounce.

Headwinds remain – a strong US dollar, reduced volatility in financial markets, and there’s lower jewellery demand in India and China. Countries such as Russia, which has been a major buyer for its foreign reserves, are no longer buying.

However, demand for physical gold remains firm and the sector’s continuing strength is attracting more bulls.

The bank says financial repression – governments impose interest rates so low that savers earn less than inflation – “is back on an extraordinary scale,” and is likely to persist for a very long time. Fiscal deficits are soaring and central banks are doubling their liabilities.

Tailpieces

Debt: It's exploding as governments create monetary and fiscal stimulus on an unprecedented scale to offset the damage done by anti-Covid 19 measures. How are these huge liabilities going to be serviced and eventually paid off?

Eoin Treacy says the only way governments are going to deal with the problem will be massive currency devaluation. China's testing of a digital currency in parallel with the present one "is the first step in preparing for rebasing [its] debt, and it won't be the only country that goes this route or something similar."

Experts: The reputation of traditional economists has never recovered from the profession's guilt by association with the Global Financial Crisis, says investment commentator Tim Price. It was a crisis they were unable to foresee.

It was followed by the Brexit referendum, when almost all economists warned that voting for it would cause an avalanche of disasters – which never happened.

Tim says the reputation of epidemiologists may be about to join them "down there in the toilet bowl of public opprobrium."

Climate change: The well-known Leftist filmmaker Michael Moore has outraged environmental activists by producing a documentary that exposes the lies used to promote subsidized industries such as biomass fuels, wind turbines, even electric cars. You can see *Planet of the Humans* on Youtube. One example of its content is a promotion for a new electric car whose spokesperson didn't know where the power to fuel it would come from. It turned out to be 95 per cent from fossil fuels.

Dividend payers: Goldman Sachs has provided a US list of high-yielding Russell 1000 stocks with safe dividends. Here are the ones with the top dividend yields in each of the ten sectors… Omnicom Group (div. yield of 5 per cent); Home Depot (2.8); Archer-Daniels-Midland (4.0); Wells Fargo (7.6); Merck (3.9); Raytheon Technologies (4.6); IBM (5.2); Nucor (4.3); Regency Centers (6.7); Centerpoint (7.0).

Forecasts: Goldman Sachs forecasts that earnings of S&P 500 companies will fall 33 per cent this year; dividends by 25 per cent. It expects US economic growth, after falling 34 per cent in the current quarter, to bounce back with growth of 19 per cent in the third quarter, 12 per cent in the fourth.

Language: "Quarantine" is derived from the Italian word for 40… *quaranta*. The practice originated in Venice centuries ago. Ships arriving there from places known to be infected by plague weren't allowed to dock until they had waited out offshore for 40 days.

Investing for recovery: Eoin Treacy says the best sectors are likely to be biotech, cloud computing, semiconductors, e-commerce and dividend aristocrats.

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