# ►On Target

Martin Spring's private newsletter on global strategy

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## Why Bad News is Good News for Investors

The International Monetary Fund says in its latest *World Economic Outlook* that the risk of a global slump is now "alarmingly high." Yet most stock markets, led by the US and Europe, although currently pausing for breath, remain in strong uptrends.

What on earth is happening? Where do things go from here? And as investors, what should we do?

The key to understanding investment markets since the eruption of the financial crisis is always to keep in mind this piece of counter-intuitive logic – poor economic growth is GOOD for the value of most investment assets; when growth eventually picks up strongly, that will be catastrophic for most of them.

Why?

The reason is that the major tool governments are using to try to stimulate economic growth is monetary policy – "money printing," plus abundant and virtually free credit for the least deserving, such as megabanks and fiscally incontinent nations.

It's not true to say that this policy is a complete failure. It has almost certainly prevented a global economic catastrophe. But it has failed to restore strong economic growth, and is unlikely to do so in future.

It will continue to fail because it's not the solution to the problem. That requires fundamental reforms that the inept and wrong-thinking political classes are unwilling to implement and for which the voting masses are unprepared.

If I am right about the prospect of continuing failure, you can be sure that the central banks will persist with their easy-money policies, implementing them in increasingly desperate (irresponsible?) ways. It is commonplace for those in power whose policies are a failure because they're fundamentally wrong, to believe that doubling a dose of the poison will produce the desired cure.

The easy-money policies are having a devastating impact on those without the political or financial power to defend themselves. In Britain, for example, those retiring and having to convert capital into annuities to provide an income stream now get 20 per cent less income that they could three years ago, 7 per cent less than they could just three months ago. The central banks' strongly depressed interest rates are devastating the incomes of retirees.

But easy money is great for speculators and – for the moment – good for investors,

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as its abundance is driving up values in most major asset classes. That's why we have the illogical situation that gold, the best defence against inflation, and bonds, the investment most at risk from inflation, are both in powerful bull-market trends.

How about shares?

Like other major assets, they are being lifted by the flood of cheap money. Their dividend yields look attractive compared to the low interest yields of bonds and bank deposits. The best companies seem to offer long-term growth opportunities. And the liquidity of stock markets makes shares attractive to both investors and speculators.

But ultimately their values depend on earnings, and those are driven by economic growth.

With Europe facing economic contraction, and China in the grip of economic readjustment driven by sluggish export demand and a policy squeeze to depress property speculation, the global economy, more than ever, depends on its principal locomotive, America.

But the US is also slowing down, burdened by its legacies of a housing bust, excessive debt and poverty traps, plus its new phenomenon of political paralysis:

► The painful readjustment in the housing market following the bursting of the credit bubble still has a long way to go. 1½ million properties are in foreclosure and 11 million in negative equity (debt greater than market value), yet residential mortgage debt has contracted by only 7½ per cent since 2008.

► Consumer demand is soggy because most people aren't earning more and are less willing to borrow to pay for luxuries. Employee compensation has been in a downtrend for decades and wages relative to the size of the economy are at a 50-year low.

The true unemployment rate is around 11 per cent, 46 million Americans depend on food stamps, 43 million retirees are seeing their incomes squeezed by rock-bottom interest rates.

► Wealthier people (20 per cent of the population enjoy half the national income) are cautious about investing in the future after the shock of the 2007-8 collapse. They despair of inept politicians and see the many risks – enormous budget deficits, soaring national debt, declining earnings growth and climate change.

## Political deadlock raises the threat of überausterity

The immediate risk is the "fiscal cliff" – tax rises and spending cuts due to come into effect next year that would depress the economy by 3 or 4 per cent, plunging it into recession.

Congress is deeply divided over how to prevent that happening and to address the fundamental problem of fiscal deficits because dominant groups in both parties fiercely oppose the compromises necessary. Republicans refuse to agree to tax increases, Democrats veto cuts to most public spending.

Lack of certainty undermines confidence and discourages corporations from investing to expand their businesses, preferring to continue adding to their huge cash reserves.

The immediate problem for US shares is the collapse in corporate earnings growth.

Although profits are at exceptionally high levels due to cheap credit, aggressive cost-cutting (including shifting production to Asia), and investment in labour-saving technology, they have stopped growing.

Earnings growth, having fallen in every quarter bar one since the end of 2009, has now plunged into the negative. The current earnings season is “the weakest… since the days of the dot.com bust,” says Brewin Dolphin’s chief strategist Mike Lenhoff.

Analysts’ predominant view is that earnings growth will soon bounce back, but how likely is that without a strong rebound in economic growth?

Money printing is also losing its power to boost share prices.

According to the respected Canadian analyst Denis Ouellet, undervaluation of US equities fell from 40 per cent to zero as their prices rose under the impact of the first bout of quantitative easing. But undervaluation only declined from 23 to 7 per cent during the second round of QE, while the latest rally associated with QE3 has only narrowed undervaluation from 27 to 19 per cent.

## Cheap credit and reasonable valuations

Despite the negatives, there are grounds for optimism, if not about economic growth, then at least about global equities:

► “As long as the printing presses are humming, risk assets have tended to rally persistently,” as *Fullermoney*’s Eoin Treacy puts it succinctly.

The US Federal Reserve has made it an explicit policy objective to raise equity prices in the hope that making households feel richer will encourage them to boost their spending. “All 500 S & P companies have the same chairman… his name is Ben Bernanke” (the Fed’s chairman), says Jurrien Timmer of the Fidelity Global Strategy Fund.

The central banks of America, Europe, Japan and the UK are all committed to extreme easy-credit policies, while even China’s is starting to ease. Although bouts of money printing may give less of a boost to investment asset values than in the past, they will continue to do so.

The *FT* reckons central banks “may well keep investors trapped in risky assets INDEFINITELY” (my emphasis).

► There is no bubble in equities, with most analysts considering valuations to be moderate in the US, low in Europe and Japan. In China, current levels of price/earnings and dividend yield are at lows of “historic extremes from which impressive rallies have previously been initiated,” Eoin Treacy says.

► The general pessimism about the outlook for the global economy may be overdone.

Speculators on Intrade give only a one-in-four chance that the US will suffer a recession in 2013.

Once the presidential election is out of the way, whoever wins, circumstances will force the two parties to negotiate compromises over taxes and federal spending. Even though they are unlikely to be permanent, or far-reaching enough to be

satisfactory, especially if Barack Obama is still president, they will probably be enough for the comfort of equity investors.

Europe – in combination the world's second biggest economy – is a serial drama in inchoate grappling with its debt crisis. But a complete collapse in the euro is very unlikely, while any weakening in its exchange rate against the dollar would help soften the impact of recession.

China, the world's third biggest economy, continues to deliver astonishing growth of 7 per cent even in these "hard times," and seems certain to get some policy boosts once the new cadre of top officials move into their posts next month.

In the short term, investment markets are likely to continue with the period of consolidation now being experienced after strong rises since early June. Falls may only become significant if triggered by unexpected political or financial developments in the US, Europe or Asia.

However, that would present another opportunity to take bigger positions in the investment classes I favour for the long term and write about often – precious metals, Asian shares, equity income plays, the strongest multinationals, and the safest longdated bonds.

They are all likely to remain in bull markets for some time to come.

# The Key to China's Future Growth

Pessimists' scary reports about "ghost cities, bridges to nowhere and empty new airports" overlook "one of the most important drivers of China's modernization – the greatest urbanization story the world has ever seen," says NT Asset Management's Kenneth Ng.

The nation's burgeoning city-dwellers should expand by more than 300 million by 2030, an increment almost equal to the current population of the US. "With rural-to-urban migration averaging 15-20 million per year, today's so-called 'ghost cities' quickly become tomorrow's thriving metropolitan areas."

The Chinese leadership is well aware of what premier Wen Jiabao publicly described as "the Four Uns," warning in 2007 of an "unstable, unbalanced, uncoordinated and ultimately unsustainable" economy. And it's acting to re-shape "the producer model," depending on global markets, towards an economy driven by internal growth.

"China has adopted the pro-consumption 12th Five-Year Plan" to drive development. Urbanization is a key pillar of this strategy, as incomes in cities are more than triple the average in rural areas. Combined with that is a push into services-led development to create jobs.

Although over-investment in capital assets could hold back growth in the medium term, "unproductive assets could become future drivers of domestic economic growth."

The central bank of Australia also takes a positive view on the long-term outlook for that nation's biggest export, iron ore, on the grounds that urbanization still has a lot further to go, with the proportion of China's population living in cities, now about half, rising to about three-quarters by 2040.

The building sector is also becoming more steel-intensive owing to taller buildings and underground car parks. Steel demand in the residential construction sector is not expected to peak until about 2024.

Although global fund managers are currently generally negative on the outlook, "a reasonable contrarian case can be made for investing in Chinese shares," says Tom Stevenson, investment director at Fidelity Worldwide Investment.

"One reason to believe the pessimism may have been overdone" is that there could be policy-driven stimulus following next month's takeover by a new leadership cadre, as such splurges have "followed leadership transitions ever since the new market-oriented regime began, following the death of Mao in 1975."

Chinese shares are cheap by historical standards "and compared with other markets, while the government has both the incentive and the firepower to continue easing.

"Inflation is not a problem, interest rates are higher than any country in Asia bar India, and public debts as a proportion of GDP are lower than anywhere except almost-debt-free Hong Kong."

Stevenson says "any long-term portfolio should have an exposure to China," although as an alternative "big Western companies with extensive operations in or selling to China look an attractively low-risk way of gaining that exposure."

## Wabenzi Feast on the Fruits of Liberation

"The people in our townships, rural areas and squatter camps are bitter [that] democracy has not delivered the fruits that they see a tiny elite enjoying," says a disenchanted longstanding leader of the South African liberation movement, Jay Naidoo.

"Many of the leaders they revered have abandoned the townships for the Armani lifestyle previously exclusive to leafy White suburbs. They have long lost touch with the disgruntlement brewing in society.

"To compound the situation, a new, predatory elite of middlemen is unashamedly corrupting state officials and stealing tenders and licences.

"They cloak their crime of looting the state treasuries with militant, populist rhetoric that further inflames the already-difficult reality.

"There is legitimate anger and restlessness at the obscenity of wealth inequality… A new apartheid grows…

"Communities see violence as the only language leaders will listen to… A militarized, over-armed and poorly-trained police force is mobilized as the battering ram of political enforcement."

Naidoo says 15 million South Africans – about a quarter of the population—are only saved from starvation by the social grants they receive every month. Because of vast structural unemployment, the average worker supports up to eight people on a take-home minimum wage. 50 per cent of all workers earn less than R3,000 a month – the equivalent of about $350.

## Banking: Lunacy in the US, a Bubble in Europe

A small American bank has been punished by US regulators for NOT lending enough to people who are poor risks. Sounds crazy? It is.

The Luther Burbank Savings Bank in California was told by its regulator to diversify its portfolio by lending to higher-risk borrowers… which happen to be concentrated in minorities.

The bank complied, but nevertheless insisted that borrowers met its prudential rules. Its caution paid off. Over the period 2006 to mid-2011, the bank only needed to foreclose on 1.75 per cent of outstanding loans.

In a sane world, the bank would be praised by regulators for risk management. Not in the US, whose administration is increasingly obsessed with social engineering. Instead the Justice Department targeted the bank for failing to meet lending quotas to minorities, regardless of whether they can afford to borrow.

The other side of the pond, although banks in Europe have been reducing their loan books, with small and midsized companies suffering the most as a result, the banks are actually more bloated than ever, reports Niels Jensen of Absolute Return Partners, as they have shifted out of such loans into "speculative investments" funded cheaply through the European Central Bank.

"In other words, the European banking industry has become one massive hedge fund taking a punt on the ability of European sovereigns [governments] to service their debt.

"All of this will have to be unwound at some stage… Assuming that European banks eventually must bring the leverage down to US levels or thereabouts, total assets in the European banking industry must be reduced from around $45 trillion today to less than half that number."

## Threats to Investors

In the Eurozone, "the required mechanisms for capital controls are already being put in place," John Dizard warns in *FTfm*. If they were imposed, it would make it possible for banks – and governments – "to unilaterally extend the terms, and soften the conditions, of their bond debts."

It has already become "much, much more difficult" to place cash in bank deposits, and even to move money from one country to another within the zone. "There has been a significant increase in the amount and intrusiveness of documentation."

The Swiss central bank has already publicly threatened to impose capital controls (on foreigners) if needs be to stop money flooding out of the euro into the franc.

A different kind of threat, longer-term, face those of us who invest in gold.

An American friend tells me that when the US government banned private ownership of gold in the 1930s, requiring transfer of such holdings to the Treasury, his father was unable to open his bank security box except under the supervision of a policeman who stood by to inspect its contents and ensure that he wasn't hoarding any bars or coins.

Such punitive behaviour by governments could happen again, and not only in America, if soaring prices for gold threaten trust in currencies.

## Planning Investment Returns

"When it comes to investing for the long term, the important figure to consider," say Thailand-based moneycraft advisers Chad and Peggy Creveling, is the real rate of return – total return (capital growth plus income), less inflation.

"When planning, using a real rate of return provides a better idea of how much purchasing power you can derive from your investments" for long-term goals such as retirement

They give these average rates of return over recent decades for American investors in a "moderately allocated" portfolio consisting of half large-cap US stocks and half intermediate-period US bonds:

| | 1952-61 | 1962-71 | 1972-81 | 1982-91 | 1992-2001 | 2002-11 |
|---|---|---|---|---|---|---|
| Total return | 10.0% | 6.1% | 6.6% | 15.5% | 10.1% | 5.2% |
| less Inflation | 1.3% | 3.3% | 8.9% | 4.0% | 2.5% | 2.4% |
| = Real return | 8.6% | 2.8% | -2.3% | 11.5% | 7.6% | 2.7% |

When doing your long-term planning "it's better to consider a range of possible return appropriate to your investment time horizon, including some worst-case scenarios," the Crevelings say. This cuts the possibility of "either saving too little, or being surprised on the downside."

## Rewarding the Undeserving

The principal benefit of money printing goes to "the well-off" who gain from the boost it gives to asset prices, says CLSA Asia-Pacific commentator Christopher Wood.

US Federal Reserve chairman Ben Bernanke has an ideological faith in "monetary quackery, otherwise known as quantitative easing," assuming he can "torpedo the entirely natural human desire to deleverage in the wake of a debt bust by forcing economic agents to take on ever more risk."

He clings to this belief "despite the fact that the evidence since 2008 is that QE does not help the real economy."

Britain's central bank, through its "absurd policy of quantitative easing" – money printing, driving down interest rates to historic lows – it "has done an excellent job of further enriching the banking lobby while impoverishing those least able to add to their investment pot," comments Tim Price, director of investment at PFP Wealth Management.

He also says that political leadership within the Eurozone "could best be described as a cretinocracy."

## Where Being Older is an Advantage

Although lots of jobs were lost in the recession in the US, the number of older workers in employment actually rose.

"It seems employers value the skills and knowledge of older workers," says commentator Allen Brooks. A recent survey of employer attitudes towards older and younger workers pointed out "the lack of verbal, writing and dedication

characteristics among younger workers, which is holding down their employment opportunities."

This isn't a phenomenon confined to America, as youth unemployment is a huge problem in Europe.

The politicians all seem to think that the answer is better education, or more training. More important, I think, is radical improvement in youngsters' attitudes towards serving others, diligence, hard work and punctuality.

## Prosperity at the Heart of Empire

The Eurozone constitutes "a perfect economic environment for the German nation," argues GTI fund manager Iain Little.

"Germany has a large competitive advantages compared to Europe, built up since 2000 by having a lower rate of inflation and labour reforms.

"In the good old days their advantage would be taken from them by an ever-strengthening Deutschemark." But now, "trapped in the euro, they benefit by an artificially-weak currency." Although "there are problems in general in the euro area," there are also investment opportunities in the north of Europe.

"The big risk… is that if the euro falls apart, the winners and losers will be reversed."

## The Wealthiest Nations

Some investors, including some new funds, are allocating their capital according to "true wealth" – net foreign assets relative to the size of the economy – as a measure of lowest risk in fixed-income investments.

On that basis, Hong Kong is the wealthiest territory in the world, with net foreign assets of almost 300 per cent of GDP at the beginning of this year. It is followed by Singapore, Switzerland, Taiwan and Saudi Arabia, all with ratios above 100 per cent.

Deterioration in a country's ratio is a useful early warning indicator of problems. It would have signalled approaching disaster in Greece and Iceland.

# Tailpieces

**Dividend power:** Over the past three years America's "dividend aristocrats" – companies that have without fail sustained or increased their payouts over 25 years – has outperformed the market generally by half as much again. That is encouraging firms to start paying dividends, or to improve them.

Guinness Atkinson's new Inflation-Managed Dividend Fund will focus on companies that have returned a real cash flow return of at least 10 per cent for each of the last ten years, suggesting their ability to increase their dividend payments consistently over the next ten.

**Best performers:** "Listed companies in which families are big or controlling shareholders have been better stock-market performers than non-family-owned peers over the past five years," the *FT* reports.

According to a study by Credit Suisse, they extract better returns from the cash they invest, often focus on the long term – such as being ready to wait ten years before getting any return on their money – and often invest during downturns.

"Family ownership can add serious value." In Germany, for example, companies Adidas, Fresenius, Henkel and Volkswagen have helped the Dax Family Index outperform.

**US growth:** The housing crash – a major contributor to the 39 per cent fall in the average personal wealth of American families between 2007 and 2010 – is at the root of the US's economic problems, argues investment banker Allen Brooks.

"We have not found another sector to replace the housing engine that drove our economy for nearly 20 years.

"Until American family balance sheets are repaired – debt reduced and savings rebuilt – the pace of economic activity will be slow."

Based on the experience of what happened to deleveraging in the Swedish economy in the Nineties, "we have a considerable way to go, as we are less than half-way there."

**M & A:** While this business is "fantastically lucrative" for investment bankers, it has been "less rewarding for investors," says the *FT*.

Companies that do a lot of acquisitions often purchase duds. Britain's biggest manufacturer, arms maker BAE, for example, had to write off a quarter of the purchase price of its biggest US deal within two years.

It is hard for acquirers to buy cheaply, as sellers' shareholders take deals mainly when they know their company is being overvalued.

"Overpaying is not the only problem. Acquisitions inevitably distract management from the core business. Bosses spend too much time identifying, acquiring and then trying to manage target companies."

**Fund managers:** Investors should be wary of "large investment management companies with links to banks, and 'perfect products'… based on complicated derivative contracts," Russell Taylor advises in *Money Management*. What sounds too good to be true is all-too-certain to disappoint.

One of the secrets of a good strategy is that the investment manager has the courage to concentrate on a few cash-rich companies in promising business sectors, allowing growing dividends and compounding to work their magic.

"This also keeps management costs low – to the advantage of the investor, if not always to the manager."

**Robots:** This is now a boom industry as manufacturers, particularly in China, focus on replacing high-cost labour with mechanical substitutes.

How can you invest in it?

*Fullermoney*'s David Fuller says Japan's Fanuc "is an industry leader in robotics and has been a stock-market outperformer." Some engineering giants such as General Electric, Honeywell, Illinois Tool Works and Chiyoda are involved. Cadence Design Systems produces software for robotics. European firms include Siemens, Krones and ABB.

**Bonds:** The global market is increasingly controlled by officials rather than investors as central banks buy their governments' securities with digitally-created money, while other state agencies recycle export surpluses. The JP Morgan bank reckons that central banks and reserve managers now control a quarter of all government and corporate bonds at issue, including a third of the high-quality paper.

**Japanese lesson**: Paul Krugman, economics professor at Princeton, contradicts the widely-held impression that Japan's policies of monetary and fiscal stimulus to counter its economic stresses of the past two decades have been a failure.

"It has turned out Japan was almost a role model. They never had as big a slump as we have had (in the US). They managed to have growing per capita income through most of what we call their 'lost "decade."'

**Politics:** The success of an outsider, Joko Widodo, in gaining election as governor of Indonesia's capital, despite strong opposition from the establishment parties, shows "the reduced importance of political machines and traditional patronage politics as a consequence of the explosion in social media," says one analyst.

**Crippled by fundamentals:** "Even if Europe's political leaders can find a way to save the euro, it will not mean they have resolved the underlying structural problems of uncompetitive economies, undercapitalized banks and unaffordable social welfare commitments," says *Independent Investor* commentator Jonathan Davis.

**Labour costs:** They don't matter much in high-tech industries. At a typical plant of chipmaking giant Intel, they amount of just one-tenth of total overheads. Apparently tax rates, market access and the cost of land are far more important factors in determining where a multinational choose to establish a new plant.

Martin

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