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A PERSONAL VIEW FROM PETER BENNETT

STRATEGY 2013 – PART I

Macro

It could be done and has been done in a small instance. (See later.)

Investment

Corporate Bonds – amber light
As well as quality debt.

Corporate Bonds / High Yield Shares

In recent bulletins I suggested these themes had become too popular. For a long time I have been bull of middle grade corporate bonds and high yield shares. But now both of these themes have become mantras. The great and the good talk about good yields, as well as strong balance sheets, dominant market positions, preferably lots of international business, 'dividend aristocrats'.

By the time something is an established mantra or fashion you are likely looking at medium term under-performance – at the best. To be fair, they are not bubbles – there is no hysteria, unlike tech at the turn of the century, then China, then solar energy and wind farms (solar quoted sector down 90% from top; wind power near the same too. Think Vestas. China down 75%-80% from the top). The main reason why corporate bonds are not bubbles is that, unlike equities, there is clearly no endless blue sky upside. And high yield stocks cease to be high yield stocks when their prices rise measurably – a self-limiting mechanism.

As for value in corporate bonds some of the figures have become quite grim. The FT reports a return to collapsing lending standards similar to the run up to the bubble top. (I am reminded of the Bourbons – forget nothing, learn nothing.) PIK bonds have reappeared – "payment in kind" where the borrower can roll up interest payments to maturity. (Who on earth lends on such a basis?!) Then there are "cov-lite" loans (flimsy 'covenants') – representing 28% of new loans this year; more than in any year ever. Indeed Terra Firma is back, fresh from its "spectacularly bad" (FT) deal with EMI. Someone has lent it the thick end of half a billion pounds in PIK loans, to leverage up to buy the largest UK private homeowner. I wish them luck. US industrial corporates now have a median BB- rating. In 1980 an A.

US short maturities are back at their lowest 'spreads' over Government Bonds since July 2007. These Government Bonds are themselves grotesquely over-priced. It is the usual case that, in investment banking circles, when the ducks quack you stuff them like Perigordian geese. I note that retail bonds – the completely recent fashion – are pouring off the printing press. Indeed, there is a Niagara Falls of supply of all sorts of

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bonds. Companies are often even borrowing to buy in their equity, thus weakening balance sheets – but helping short-term executive stock options. Another mantra of the age is the supposedly great cash balances in, notably US, corporate balance sheets. Near baloney. The US non-financial corporate sector has net negative underlying current liabilities. Not net cash. And much corporate cash is concentrated in a handful of mega-cap tech stocks, or piled up overseas, away from the tax man.

There is no obvious reason right now to rush for the exits – but there never is when confidence in a particular strategy is seemingly unlimited. By the definition of that statement.

If / As / When interest rates / monetary policy start to normalize, it will be like someone shouting "Fire" in a packed theatre, with only one small door. For what it is worth, I have started to pull back from corporate bonds in recent weeks. Indeed, we have one of the arguably 100% guaranteed red warning lights flashing in this sector. The well known bond management house, Pimco, has a closed ended bond fund which, would you believe it, stands at a 70% premium to its underlying asset value. When investment trust-like vehicles stand at large premia to asset value this is usually 'kiss of death' warning stuff. I reported on one such China investment trust in a Bulletin (50% premium), just before the Chinese stock market crashed. To be fair, an equity market, when highly inflated, is likely to have a larger potential downside than corporate bonds of reasonable quality. And you can hold the bonds to maturity- albeit at huge potential opportunity cost and accept the likely existing loss to redemption. Fitch Ratings suggest that a return to early 2011 levels in Treasuries would take about 15% off the price of the average US corporate bond.

Macro

As this goes to press a large article in the FT awards Bernanke a silver medal; Draghi a gold. Was he the chap who also wrote the book "Maestro" on Greenspan?! Delusion still rules. Re. the Fed, I let Charles Gave of GaveKal make some points:

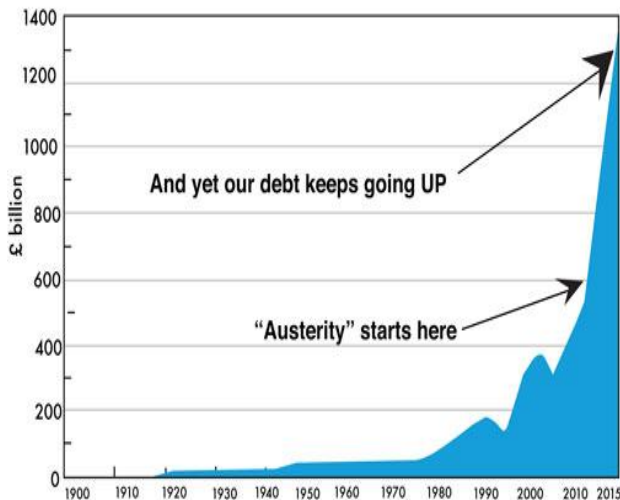
Since the 2001 recession, the trade-weighted US dollar has collapsed by more than -15%, and the real median income in the US by more than -10%. Oil prices have quadrupled, gold has risen six-fold, the so-called 'misery index' (inflation + unemployment) is up 50%, the US stock market vs. the German bond market is down -60% on a total return basis, the US structural growth rate has declined from 3% to less than 1% - and, of course, we have had the biggest financial crisis in history.

Where are we now? Roughly where we were a year ago! Cracks have been papered over and cans kicked down the road. The debtor economies are going nowhere. The growth rate of the creditor economies and those with good international financial standing are not running near their potential.

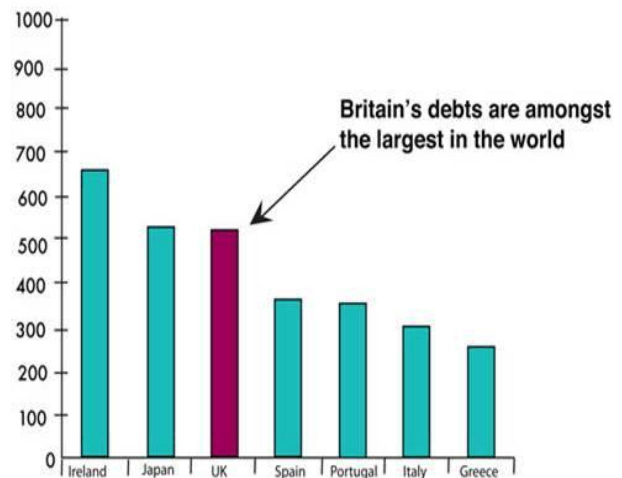
UK Gilts

Almost unnoticed the yield on the 10-year conventional gilt has recently shot up from about 1.47% to 1.87%.

Is it only coincidence that this happened just as murmurings about the UK losing its AAA credit rating started doing the rounds? The UK's debt pile, as you know, is worse than that of the USA. See below:



Source: ukpublicspending.co.uk



Courtesy: The Daily Reckoning

Indeed, the DR suggest that adding in contingent liabilities, e.g. unfunded pension promises, the UK debt heap represents some 900 % of GDP. Also (I hope!) coincidentally almost identical to Weimar Germany when it found out it could no longer pay its debts. Imagine you are on a salary of £20,000. You have nine times that, i.e. £180,000, of debt. You have to pay 5 % pa interest and make repayments over 20 years in equal amounts. In the first year that adds up to £18,000 of salary gone. £2,000 doesn't buy many nights in Claridges. In the US, the endless droning about the fiscal cliff misses the point. This is but a tiny step on a massive staircase. Including contingent liabilities (as companies have to) it is estimated that government debt represents some $85 trillion. And still exploding. GDP is about $14 trillion. Debt plus contingent liabilities currently increases at 27 times the rate of 'GDP growth' (source: The Daily Reckoning) so far this year's GDP growth (whatever that is supposed to mean) is shown as 1.7 % pa (or all of 0.7 % per head, if you believe the calculation). This is lauded as some sort of recovery. Try the Wall Street Journal "we borrowed $5 trillion and all we got was a lousy 1.7 % growth". Amen.

It can be done

The debtor economies could be helped to major improvement, but this is sadly unlikely to happen voluntarily. Denial still rules. Cowardice too.

Creative destruction works, as I have repeatedly pointed out. I will not yet again go into the Asian crisis nor 1920+ USA, nor the 19th Century (nor even 1933, 1934, 1935, 1936, 1937 UK, strong growth at 3 % ± annually, contrary to conventional wisdom). I will, however, refer to just now – General Motors (and Chrysler). The companies were malfunctioning just like the debtor economies, the financial system and the banking system have been malfunctioning. However, they took the destructive hit, and quickly – and I mean quickly – their fortunes turned 180 %. They had been propped up in distortion and denial. Sounds familiar? When the financial crisis broke, it became impossible to carry on the charade. So: 1) uneconomic plants were shut; 2) staff took reduced remuneration, cutting costs; and 3) unpayable debt went where unpayable debt should go – to money heaven. Then the government recapitalized the business: $60Bn to GM. Short, sharp pain. Once again – rewarded quickly.

We have now a rejuvenated, booming, profitable GM. As for Chrysler, it is more or less propping up its European partner. People like me are now called ‘bleaters’ by a certain financial journalist. Well, let’s hear it for the sheep! And also for General Motors and the type of remedy that put an albeit reduced General Motors back together in a trice. So let’s get off butts, stop waffling about irrelevant economic theory and actually try at least measurably to solve the problems of the most costly, malfunctioning, distorted and debt raddled financial system in history. We are told for every debtor there is a creditor, so why worry? Wrong, if the debtor goes belly up there is no credit.

Of course, the above necessary action only occurred because of *force majeure*. It was no longer possible to “deny” and hold the crumbling dam together. Whilst no way can I predict in this matter, it would be no surprise if that was how the financial crisis is finally fixed. I continue not to suggest outcomes either re. the debt pile, nor euromess. It’s all politics and emotion.

What could be the trigger? Paradoxically, an apparent return to seeming economic normality. The banks – whole swathes of whom I believe are still insolvent but dare not admit it – are up to their necks in, supposedly, high quality debt. Debt which counts as Tier 1 Capital. ‘High quality’. Triple (or nearly) A sovereign debt of their own monster-debtor governments. Normality would likely cause interest rates to rise measurably and the price of quality debt to plummet. For the record, a 0.5% rise in interest rates wipes out the US central bank’s balance sheet equity. It’s £4 trillion cash effectively props up £54 trillion in credit (Source: Bill Gross, Pimco FT 18/12). Just like the CPDO, sub-prime leverage débâcle. I regard all this as potentially catastrophic. ‘Normality’ could conceivably blow the whole shaky, unsound edifice off the planet.

Sadly on valuation and unending ‘supply’, this ‘quality debt’ is pretty much rubbish in reality. But the regulatory system is fixed so that banks / pension funds / insurance companies are effectively forced into massive holdings. And this on top of ‘amend and extend’ duff private sector loans that are unlikely to be repaid, at least in full. An insolvency group estimates that the banks are propping up some 156,000 UK companies – rather than ‘admit’. Again, are these (and European) banks actually solvent, realistically accounting, as opposed to Micawberishly? This is why Begbies Traynor, insolvency etc specialist, complained that it was short of business like never before in a downturn. Mervyn King just now states that he thinks banks are still failing to admit to the real state of their loan books. He suggests £50Bn under reserved. And the rest, folks.

Do some General Motors and get the already near five-year rotten tooth extracted.

What other policy is there left? That of Gideon Gono and Herr Havenstein. There is a growing mountain of such government bonds piling up in central banks. These have to be sold back into the market (except in the Gono / Havenstein event). Given the likely effect of normalization, this could be pretty hair-raising.

So you want to buy them? Be my guest.

In fact, little by little, policy makers are already starting to crumble in their customary anti-inflation (so-called) resolve.

Meanwhile, battalions of the great and good continue to map policies which most unethically and perilously re-distort the financial system. Keynesianism is still, would you believe it, dropped into the discourse by those in thrall to defunct economists (Keynes' own thoughts in the 1930s). Let us get this straight again. Keynes said that heavily indebted governments which go on borrowing heavily produce inflation. He said that government borrowing should be increased, as a fiscal stabilizer, only when there had been a substantial surplus in the prior expansionary stage of the economic cycle. Fine. But as I have pointed out a grillion times, the expansionary phase of the most recent cycle was merely an exercise of financial gluttony and a rake's progress of previously unimaginable proportions. Indeed this has been a secular trend for a generation.

Equities

I will not, in this bulletin, add to what I have said so far this year. More subsequently. But I would point out one thing, which, if anything, is somewhat bullish, longer-term.

First, the monstrous re-weighting of investment portfolios towards bonds and away from equities has reached such proportions that, in due course, the likely reversal of the bond trend is highly likely to benefit equities. Secondly, one often hears that the second 'cult of the equity' is dead. Bit late, folks, to have woken up and smelt that particular coffee. The time to say that was at the turn of the century – when these bulletins suggested that the second 'cult of the equity' in my lifetime had probably ended. It was in February 1972 that I wrote suggesting the (first) 'cult of the equity' was probably about to end. This attitude is a psychological plus. What is plain wrong is, as sometimes suggested, to expect the next secular US bull market to start from here. Valuation is way off for that to be likely.

To quote Bill Bonner, of the Daily Reckoning, re. the start of the 1980-2000 bull market:

Then, the US was still a creditor to the rest of the world, not a debtor.

Then, the US was still running positive trade balances, not losing money every month.

Then, US stocks were at bargain levels … selling for five to eight times earnings; today, they're twice as expensive.

Then, US bonds were cheap too … with yields for US Treasury debt as high as 18%, or nearly six times as high as today's long bonds.

Then, US households had debt of only 60% to 70% of their disposable income, not 120% like today.

Then, the Fed was determined to stifle inflation; now it is determined to cause it.

Then, the federal government's debt was less than 40% of GDP. Now, it's over 100%.

Then, even in today's inflation adjusted terms, the US government ran a deficit of $197 billion. Today, the deficit is $1.1 trillion.

Then, stocks had been going down for the previous 14 years; bonds had been going down for at least 31 years. Now, stocks and bonds have been going up, generally, for the last 30 y ears.

This final point is not a detail. It's the heart of the matter. With bonds at a 30-year low, Paul Volcker could squeeze inflation … begin a three-decade period of rising bonds (with falling interest rates) … and an 18-year bust in the gold market.

Will that happen again? Impossible!

What kind of strange history it would be if it could repeat itself …

Thirdly, equity investment is not predominantly about trying to guess a macro economic future. This is extremely difficult. As you know, out of some 64 past recessions, only four were predicted by the economic cognoscenti before they were well in progress. Equity investment is a matter of buying into asset classes when they are cheap(ish) and selling when they are dear(ish). Not Mystic Meg star-gazing. Despite quite sharp rallies in Europe and Japan, there is still some value out there. I will readdress this matter in due course.

For next year – bad technical news. James MacKenzie writing in today's (17/12) FT states that of all the investment bank strategic commentary for 2013 that has come across his desk **not one is bearish for US equities – fiscal cliff or no**. Readers remember I used to show the Barrons Christmas survey reporting the number of bulls versus bears for the year ahead. **Only once** was a large majority opinion correct.

Cash / Near Cash

Still a good case for a significant holding – despite small almost certain negative real returns. Better than large ones. And sets up opportunity to buy 'normalised' asset classes, as and when.

Gold

I have nothing to add to my many previous thoughts. We have had a huge bull market and Bank Credit Analyst recently suggested that it is well overpriced on a very long-term historical basis.

This is really an insurance policy for financial catastrophe. Which cannot be ruled out.

So, I am betwixt and between. Normally you hope you lose on your insurance premia in life. There's a thought.

A very happy Christmas, and good Luck!

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