Investors Mutual
Market Musings
February 2016

INVESTORS MUTUAL LTD

Sustained Sluggishness

In this edition of IML Market Musings, Hugh Giddy, IML's Head of Research and Senior Portfolio Manager, reflects on the current state of global growth & indebtedness in the years since the GFC. Musing on the various measures taken by central banks, governments and public companies, he explains why here at IML we are well conditioned to the mindset of selectively investing in quality & value, given this low growth world.

In December the US Federal Reserve finally raised interest rates by a miniscule 25 basis points after six years of effectively zero rates. It has surprised almost everyone, not least of all the Federal Reserve, how sluggish the recovery from 2008's Global Financial Crisis has been. Over that period economists have continuously forecast growth levels more reminiscent of previous recoveries and steadily had to cut those forecasts as actual events unfolded.

The authorities have tried many different approaches to stimulate growth, including punitively low interest rates for savers (in an attempt to make borrowing even more attractive), and in some European countries both short and long rates are now negative. Japan has just joined the club of central banks charging depositors to store their money in the banking system by lowering rates [1]below zero. This can hardly be popular amongst Japan's large population of retirees who would be hoping to get a positive return on their savings.

"First came zero interest rates, then quantitative easing, and now negative interest rates — one futile attempt begetting another"

Stephen S Roach-Marketwatch

Quantitative easing (QE) has been tried repeatedly without leading to any useful real economic benefit – inflation remains low (higher inflation encourages people to spend rather than watch the real value of their savings erode), credit growth is anaemic despite low interest rates and growth has barely budged. Japan continues to experience swings in and out of recession despite aggressive monetary easing and money printing through QE. Indeed one could argue that the flailing efforts of monetary authorities to stimulate economies has actually been harmful in that the only noticeable effect has been a sharp rise in financial asset prices – with strong rises in selected share prices and indices, probable property bubbles, particularly in commodity exporting countries such as Canada and Australia, and very low spreads for high yield debt, i.e. very high risk debt, - until recently. The surge in these financial assets has distorted the pricing mechanism, and bubbles inevitably end in a bust.

I have already expressed dismay in previous musings that authorities seem to feel the cure for over-indebtedness is to get the hapless borrowers to take on more debt. Hence Europe had to lend Greece more money so that they could service the debt that was too great to be serviced without...more debt. Easy money has spilled over to Emerging markets. Public and private debt combined

[1] S. Roach, 18.02.16
http://www.marketwatch.com/story/negative-interest-rates-set-stage-for-next-crisis-stephen-roach-says-2016-02-18

has surged to all-time highs of 185% of GDP in emerging markets and to 265% of GDP in the OECD. Since the pre GFC (a major global debt crisis) high in 2007, both figures are up by 35 percentage points. Ambrose Evans Pritchard from the UK's Daily Telegraph interviewed William White, the Swiss-based chairman of the OECD's review committee and former chief economist of the Bank for International Settlements, on 19 January 2016:

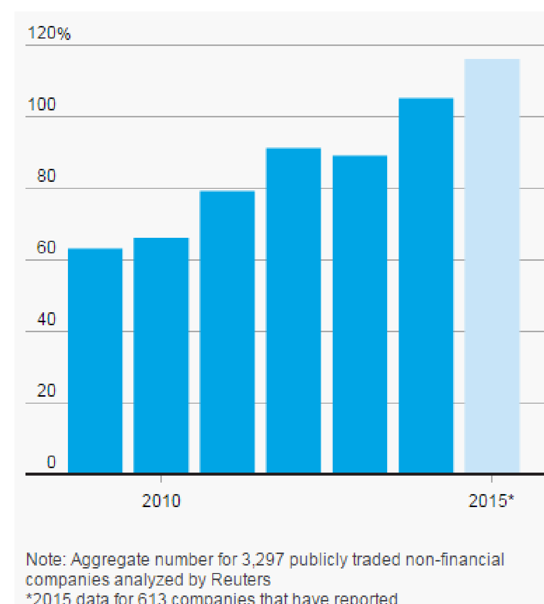
"Debts have continued to build up over the last eight years and they have reached such levels in every part of the world that they have become a potent cause for mischief," [White] said.

"It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something."

Monetary authorities may well understand the limits of what they can do. Nevertheless, they seem to feel the need to do something, and with the Keynesian orthodoxy holding sway amongst most central bankers they think their role is to stimulate weak economies and to attempt to manipulate credit growth, inflation and so forth. Other schools of thought appreciate that such attempts at manipulation, however well intentioned, normally lead to unintended distortions with poor consequences in the long term. Hence easy credit has spawned housing booms (and busts) in many countries (for example, UK, USA, Spain, Dubai), overinvestment in fixed assets in places like China, and unwanted excessive leverage in many parts of economies – from consumers to hedge funds to commodity producers.

The very low interest rates of recent years around the globe have distorted decision making and changed behaviour. One of the purposes of low interest rates in the US was ostensibly to foster capital investment which in turn creates jobs and longer term economic prosperity. However, business investment has been muted outside of the energy sector. The energy sector was boosted by technological advances in drilling for shale oil as well as what has proved to be an inflated crude oil price. Instead of investing in growing their businesses, corporates have been piling into investing in shares – mostly by buying their own shares. US stock buybacks have been running at elevated levels in recent years, at what are relatively high valuations, while corporates were raising money at low valuations post GFC. *Investors would do well to be sceptical of CEOs who claim to know what their company's shares are worth.*

Buybacks & Dividends as a percentage of net income



[2]

IBM and Hewlett Packard, both well known companies, are notable for buying back stock, arguably at the expense of investment and

[2] Aggregate number for 3297 publicly traded non financial companies, *2015 data for 613 companies. Source: Reuters, http://www.reuters.com/investigates/specialreport/usa-buybacks-cannibalized/

spending on R&D. Both firms sport an innovative history but have not delivered at the sales and profit lines in recent years, masked to a degree at the per share level by the buybacks. Disturbingly, Reuters reports that buybacks in aggregate now exceed net income across listed companies. Combined with dividend payments it means companies are increasing their borrowings to fund shareholder related payments. In Australia buybacks are less common, but there has been a steady rise in the dividend payout ratio, as companies increase shareholder payments and reduce capital investment. In the notable case of BHP, the dividend is so high relative to profits that the company will significantly weaken its balance sheet if it does not cut its dividend appreciably.

At IML we have been cautious about economic growth for many years for a variety of reasons, and in general terms nothing has happened to make us more optimistic. Most economists continue to view the economic future as more rosy if their forecasts of economic acceleration are any guide, and the Federal Reserve in the US is implicitly saying the same thing by raising rates and forecasting further rate rises.

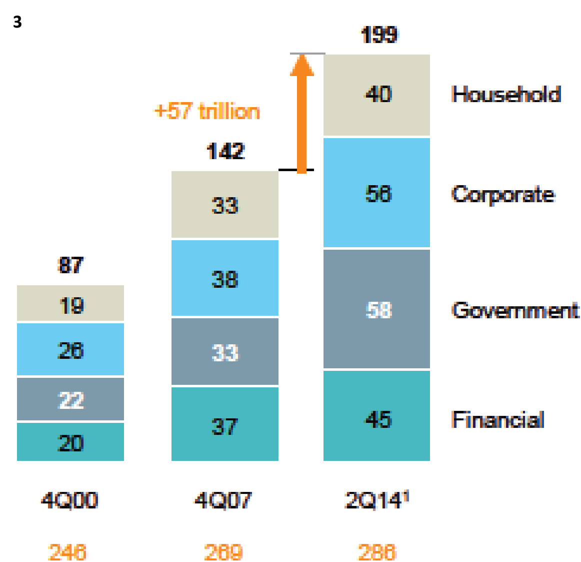
Why are we at IML so cautious in our assessment of global economic prospects? There are three main reasons: high levels of debt, demographics, and the weak underpinnings of some of the growth we have seen in recent years.

1. Excessive leverage remains a major issue

Global debt levels have continued to rise since the "credit crisis" of the GFC, implying that the world's financial system is as vulnerable as it was in 2008. The debt has been redistributed with some households de-gearing (particularly in the US as banks had to write off a lot of mortgage debt), and many corporates raising equity to strengthen balance sheets (the orgy of share buybacks producing the opposite outcome), while almost universally government balance sheets have worsened on the back of bank rescues, weak economies, sluggish tax revenues and high spending on attempts at stimulus and delivering on welfare promises.

Debt allows businesses, households or governments to pay for things now that they would otherwise have to wait for, akin to buying a household appliance such as a washing machine on finance rather than saving up the money before you go to Bing Lee to pay upfront. Because consumption, investment and so forth are brought forward by the accumulation of debt or credit, growth gets a boost. The large mountain of debt requires greater and greater increments of debt to be taken on to grow at the same rate. Furthermore, because debt levels are high and repayment and servicing are challenging even with historically low interest rates, private credit growth is low and the boost to growth from extra leverage is fairly muted.

Global Debt has increased by $57trillion since 2007, outpacing world GDP Growth



[3] *Source: Haver analytics, national sources, BIS, McKinsey Global Institute*

2. Demographics

The ageing population is quite well known but the consequences are not fully appreciated. As more people retire, the working age population shrinks, or grows slowly. This impacts tax revenues, while placing more demands on public spending through pensions and the health budget, creating hard budgetary choices for governments. A smaller labour force has to be more productive to achieve the same level of output.

Furthermore, older people's demand for many goods slow as they have accumulated most of the material possessions they will require in their lifetimes. They are also less likely take on debt as they no longer have salary income to service the debt. For many people their peak spending years is in their early forties, as they are generally spending their income on things such as renovations, school fees and family holidays. Income might continue to increase thereafter while an increasing portion is applied to paying down debt.

Ageing demographics are a double edged sword as they will lead to a slowdown in demand for many items as well as pressure on government budget deficits due to reduced tax receipts and generally higher spending on areas such as pensions and the provision of free or subsidised healthcare.

3. Weak underpinnings

Since the GFC much of the global growth of recent years has come from Emerging economies and China in particular. China's growth has been marked by a heavy proportion of fixed asset investment – construction of apartments, offices, shopping malls, railways, highways, bridges, dams and so forth. Many people recognise that much of this investment was not required and was done purely to stimulate the economy post the GFC and to maintain a growth rate that ensured social stability and low unemployment. There are well known ghost cities such as Ordos – cities that have been built ahead of there being any demand for such a city, with no strong employment opportunities to draw people to live there. China has built a large high speed rail network ahead of consumers being able to pay economic fares. The network is far in excess of what one would find in the USA for example, a large spread out country like China with a wealthy population, albeit a smaller one. Once built, the network is in place and there is little justification to build another such railway on that scale again for many years.

Fixed asset investment accounted for almost half of China's GDP at its 2013 peak, an abnormally high number. Given the overbuild it would not be surprising if construction and fixed asset investment were to actually shrink, making it hard to transition to a consumer based economy while still achieving GDP growth in the mid to high single digits. The slowdown in fixed asset investment is particularly relevant for commodity based economies such as Australia and Brazil, as steel production growth has slowed and may decline, reducing demand for iron ore and metallurgical coal which is used to make steel.

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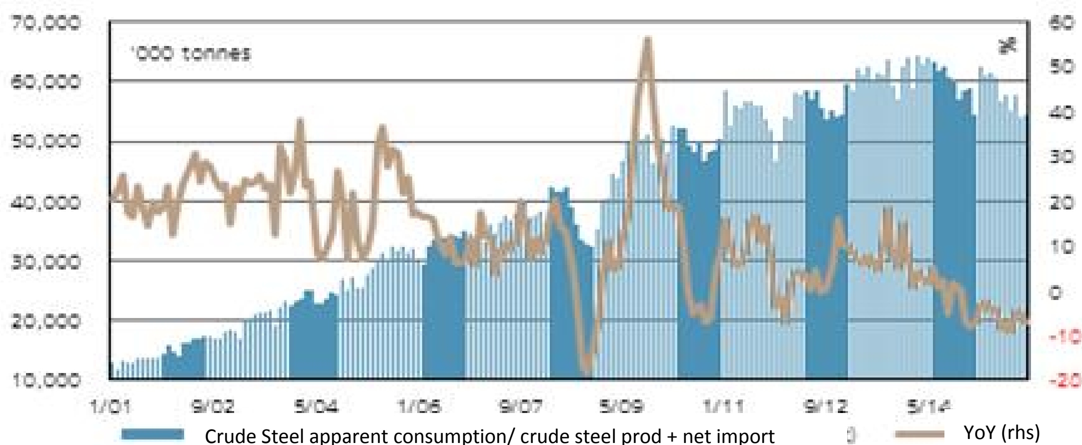
Chinese steel demand is falling:



Bubbles are born of overconfidence in a fundamentally understandable and valid upward trend lasting for an unrealistic length of time. Hence Chinese urbanisation and development led to a very understandable growth in steel production until China produced more than half of the global steel output. Iron ore prices soared as demand exceeded supply. New mines were planned and developed around the world, the most recent being the large Roy Hill development coming on line as the iron ore price sinks with supply exceeding weak demand. Bubbles sow the seeds of their own destruction by fostering overconfidence and bringing on supply of the temporarily overpriced asset or commodity.

I was tickled to read in the Australian Financial Review[4] of the plans for Dubai's Mall of the World. Not many years after defaults and troubles in the Dubai real estate market in 2009, Dubai's visionary developers are planning a US$20bn shopping mall. It was to be the world's largest, surrounded by *100 hotels*. Plans have been scaled back for the 162 hectare site, which is equivalent to 72 city blocks, and with the turmoil in the oil market investors may think twice about even the scaled back plans. It seems an incredible conceit to think that Dubai needs so many extra hotels and so much shopping space, given it boasts a limited natural population and a hostile climate, and questionable natural beauty. But such is the nature of bubbles that people think the good times will always continue to roll and accidents will not happen.

At IML we are well conditioned to the mindset of investing in a low growth world. It suits our selective stock picking style focussing on quality and value, as only quality companies will deliver reasonable returns in such a tough environment where there is limited help from overall economic strength. It is hard to see any of the causes of slow growth reversing: the debt load will only reduce if there is a major crisis and is written off or defaulted upon; the demographic trends are clear; and the slowdown in previously strong economies such as China, Brazil and Russia is well established. It is possible that governments continue to push ineffectual monetary policies such as QE, which may help financial asset prices and create more bubbles, but it is unlikely to foster faster or more sustainable growth.

[4] 12 January 2016, p32