Absolute Return Partners

The Absolute Return Letter

November 2014
Snail Trail Vortex

"The single most robust and striking fact about cross-national growth is regression to the mean."

Lawrence Summers and Lant Pritchett

Low growth is printed on the wall

When financial markets capitulate, many investors lose the ability to keep things in perspective. That is a fact of life. Instead the little things take over and begin to drive decision-making. The last few weeks provide an example of this behavioural pattern. We have a bit of a wobble in global equity and commodity markets and – lo and behold – the next 2008-like meltdown is literally around the corner, or so many seem to think. I think otherwise. In last month's Absolute Return Letter I wrote:

"… there are good reasons to believe that the prolonged rally can continue for a little longer…"

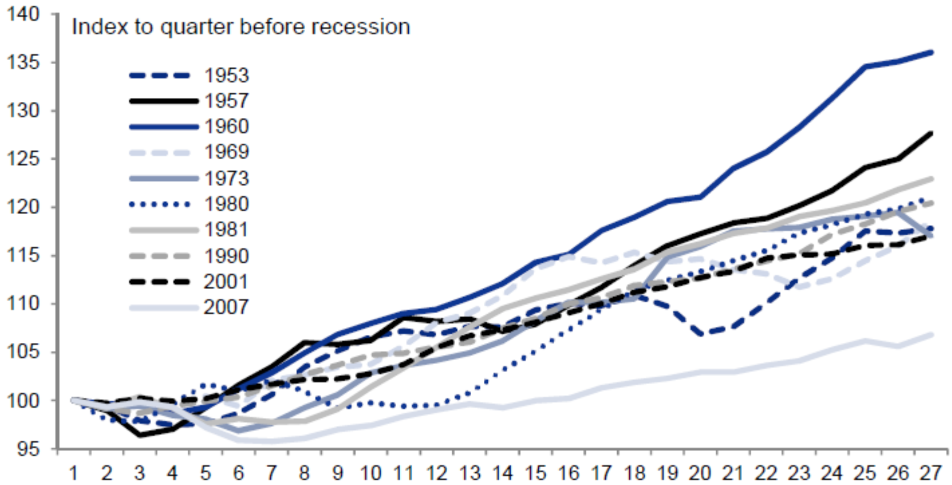
The markets have an amazing ability to make a mockery of predictions. Literally days after going public with this statement, equity markets tanked, but I am not quite ready yet to throw the towel in to the ring. I continue to see positive economic growth on the horizon, at least in some of the bigger, and hence more important, markets but, at the same time, I also see low economic growth (as in lower than average) for several more years to come, and in the following I will give you my reasons for this. Importantly, markets do not normally collapse when economic growth remains positive.

At this early stage, I ought to point out that I could be overly optimistic on economic growth and still be just about right on my expectations for equity returns. Economic head winds do not necessarily imply negative equity markets. After all, the correlation between the two isn't very high.

This month's Absolute Return Letter is in effect a continuation of last month's letter. If you didn't read it, I recommend that you do so before going any further with this month's letter. However, whereas the overall investor mood was gung-ho last month, a great deal of scepticism has crept in only a few weeks later.

First the negatives. Why do I expect economic growth to be lower than average for a prolonged period of time? That is what this Absolute Return Letter is about. Even the U.S. economy, which has now been out of recession for 5 years, is undergoing a remarkably weak recovery (chart 1) even if the last quarter was robust. For the record, other economies are faring even worse.

Chart 1: The U.S. economic recovery is below par



Source: Goldman Sachs Global Investment Research, Haver Analytics.

Meanwhile, many investors and/or commentators, whilst negative in the short term, are currently trying to predict ***when*** economic conditions will return to levels experienced in the past. Whilst we are approaching Christmas, and it is almost time to collect wish lists, I don't think GDP growth ***at an aggregate level*** will return to levels experienced in the past anytime soon. Having said that, some countries will surprise on the upside, whilst other will fail miserably.

Even though it is now quite a few years since I graduated from university, I don't think economic growth theory has changed meaningfully in the interim. Two fundamental factors back then would be, and are still, considered the most important drivers of economic growth over the longer term – population growth and productivity enhancements.

Having said that, there are a number of other factors in play at the moment which are likely to drive economic growth down over the short to medium, and maybe even longer, term. These are:

1. Demographics
2. Continued high debts in the western world
3. A sizeable output gap
4. Skyrocketing use of debt in China
5. Irresponsible corporate policies
6. Weak global trade growth
7. Poor credit conditions
8. Deflation

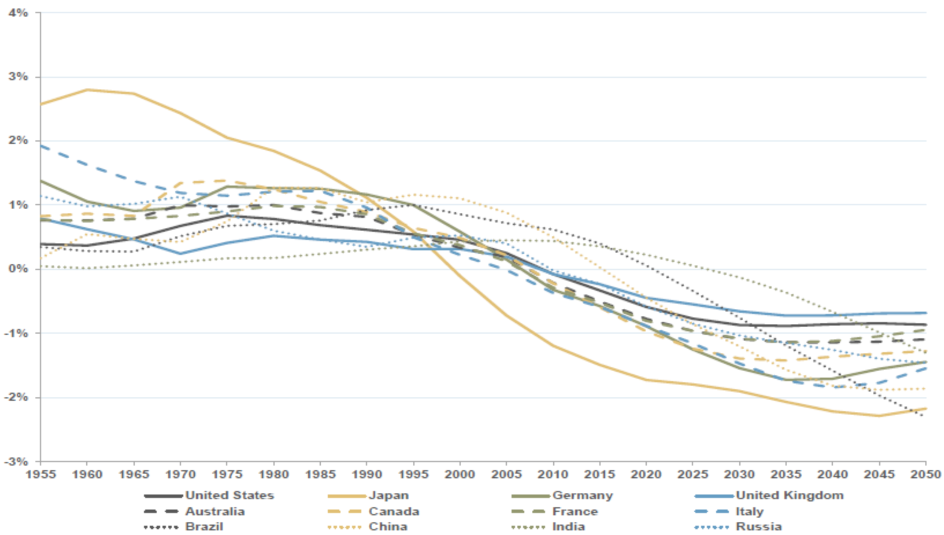
I have deliberately not included unfunded pension liabilities. Although significant and with the potential to wreck serious economic havoc, in particular in the UK where unfunded pension liabilities are now approaching £5 trillion (the number should be compared to the size of the annual UK GDP which is not much more than £1.5 trillion), the government does what governments do best and ignore the problem (admittedly, it is not a vote winner). We are probably 10-20 years away from this turning into a serious problem

Demographics

While in no way trying to under-estimate or under-appreciate the importance of the overall growth in population on economic growth, it is remarkable that, until quite recently, demographics did not receive a great deal of attention in economic theory. Perhaps it is because, until fairly recently, the demographic composition of the largest countries in the world boosted economic growth. The aging of the baby-boomers changed all of that.

Rob Arnott and his team at Research Affiliates have done some of the most interesting work in the field of demographics. In a paper from June 2013, *Mind the (Expectations) Gap*, they wrote (and I couldn't say it better myself):

Chart 2: Demographic forces will impact growth negatively over the next decade



Source: Research Affiliates, Mind the (Expectations) Gap.

"If we expect our policy elite to deliver implausible growth, in an environment in which a demographic tailwind has become a demographic headwind, they will deliver temporary outsized "growth" with debt-financed consumption (deficit spending). If we resist the necessary policy changes that can moderate these headwinds, we risk magnifying their impact."

Demographics won't turn into a positive for GDP growth until the mid-2020s at the earliest (chart 2). It doesn't imply negative economic growth, but it certainly implies growth below that of the past 30-40 years.

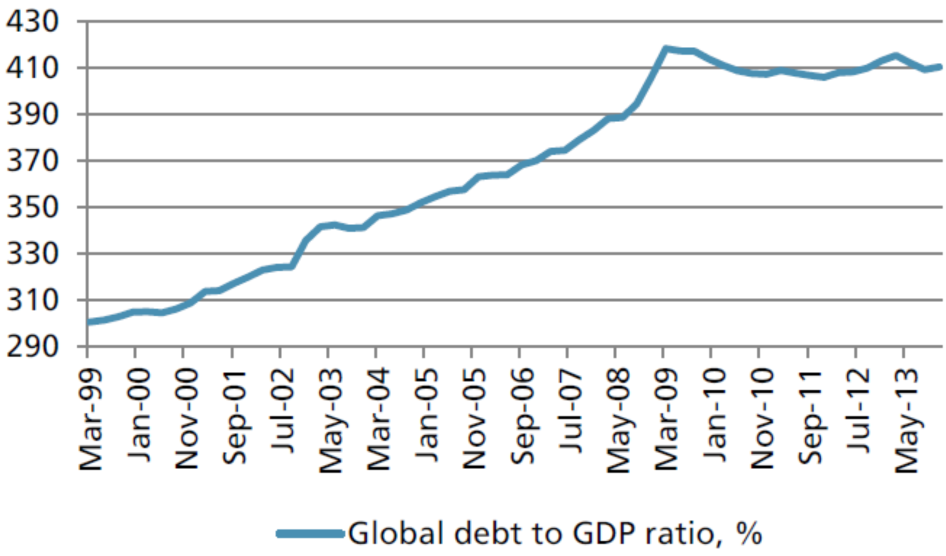
On a side note, I should also mention (and I am turning political now) that all the immigration unfriendly nations in Northern Europe (my home country none the least) will suffer more than average from this dynamic for the simple reason that countries with large groups of aging people will suffer badly unless they take in more young people to compensate. I just wonder what will happen 10 or 20 years from now, when governments will say they can't afford to keep the welfare system at current levels.

Continued high debts in the western world

I covered this dynamic in last month's Absolute Return Letter, and shall therefore not dwell on it for too long. Suffice to say that debt has not, as many think, declined since the 2008-09 crisis. Some agents (e.g. households) have reduced debt, but at the cost of others (most notably governments) picking it up (chart 3).

This could come back and bite us at some stage, as the cost of capital (interest rates) is presently extraordinarily low. Should rates at some stage normalise, while debt levels continue to be high, higher interest rates could do substantial damage to economic growth.

Chart 3: Global debt levels remain disturbingly high

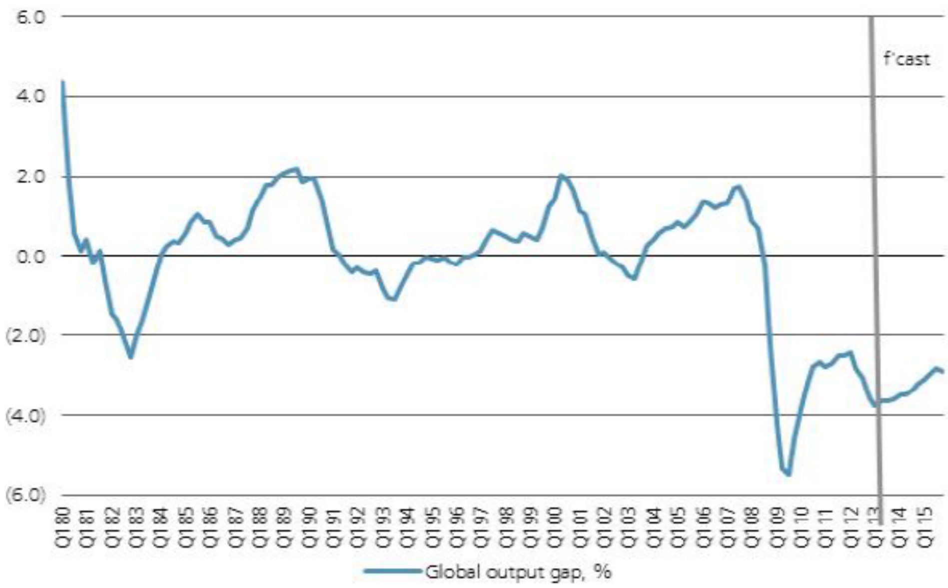


Source: UBS, Haver, OEF

A sizeable output gap

Unlike what you would expect, and what economic theory prescribes, the global output gap has never fully recovered from the 2008-09 crisis when it took a massive hit (chart 4). For those of you not familiar with the terminology, the output gap is the difference between actual GDP growth and potential growth, given the existing production capacity.

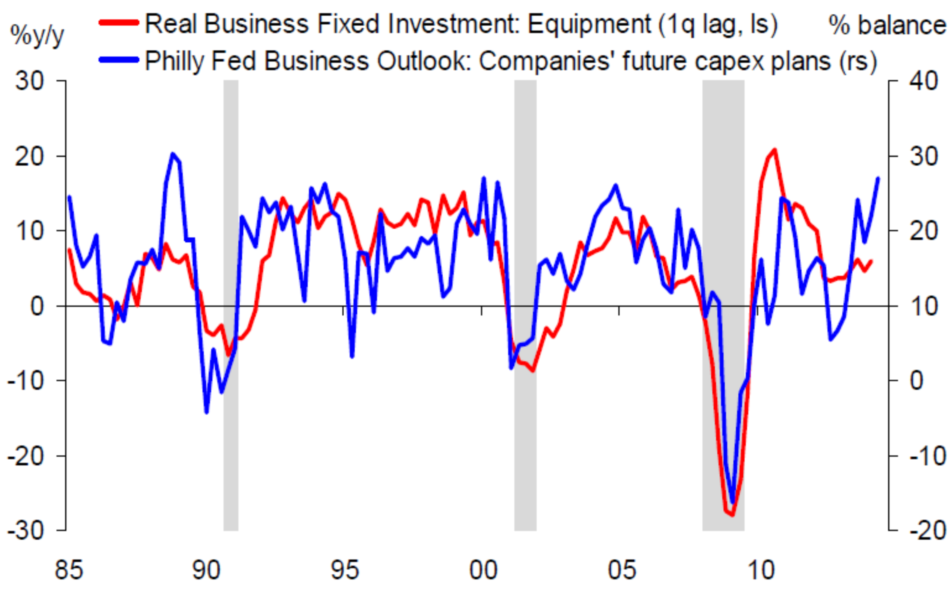
Chart 4: Global output gap (as % of world GDP) has never fully recovered



Source: UBS, OECD, Haver

A substantial output gap usually means limited inflation pressure, as production can rise without the need to increase capacity, which will keep producer prices under control and hold back wage inflation. There is a 'but', though. There are signs that U.S. industry is preparing for a rise in capital expenditures (chart 5) which at least has partly to do with the fact that the U.S. capital stock is getting long in the tooth. Private, non-financial, corporate fixed assets in the U.S, are now, on average, about 15.5 years old, much older than corresponding European assets, and the oldest I can remember ever having seen. This could potentially give inflation a kick in the U.S., but should have no effect on mainland Europe.

Chart 5: Expect a rebound soon in U.S. capex



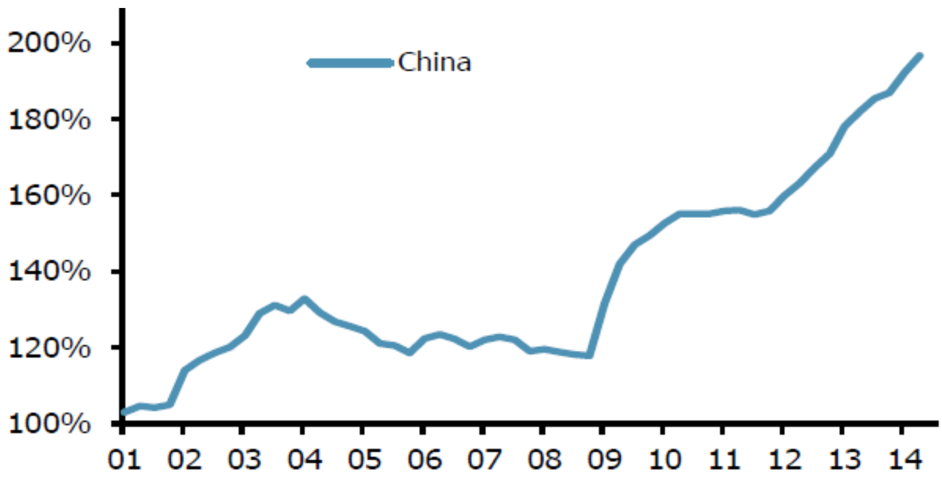
Source: Deutsche Bank Global Markets Research, BEA, FRB Philadelphia, Haver Analytics

Skyrocketing use of debt in China

The continued use of debt in China (chart 6) to keep the economic momentum on track (have we seen that before?) should be seen in the context of the output gap discussion above. China's economic growth has for years been driven by investment spending rather than consumer spending, and many of the new factories that open in China look into a future of severe overcapacity concerns.

If China continues with this poorly coordinated strategy of adding capacity to industries that already suffer from plenty of overcapacity, not only will the global output gap continue to be sizeable, but producer prices will also continue to suffer, and China's misguided policy will continue to suppress global GDP as well as global inflation.

Chart 6: Chinese debt-to-GDP continues to skyrocket



Source: UBS, CEIC

Irresponsible corporate policies

Even though the critics are still few and far between, there is a growing number of people arguing that the stock buy-back 'circus', which is particularly prevalent in the U.S., has been taken too far, and that it is beginning to damage economic growth. They argue that instead of spending profits, and cash, on innovation (i.e. capex) a growing amount of money is returned to investors every year. Between

2003 and 2012, over 90% of all S&P500 profits were spent on either dividends (37%) or stock buy-backs (54%) (See here for details), leaving almost nothing for productive capabilities.

IBM is a good case in point. The company has spent $108 billion on buying back its own shares since 2000. An additional $30 billion has been spent on dividends over the same period, so the company has in effect returned $138 billion to shareholders over the entire period. Meanwhile, over the same period, IBM spent 'only' $32 billion on acquisitions and $59 billion on capex. In other words, more money was spent on shareholders than on growing the business (you can read more details about IBM here).

These lines have not been written to pick on IBM. I am sure I could find hundreds, if not thousands, of companies guilty of the same practise, if I looked long enough. However, I do have a problem with this sort of approach, because reality will indeed catch up at some stage. If you do not invest in the future, and earnings growth instead becomes a function of financial engineering, you will not grow longer term. Simple as that.

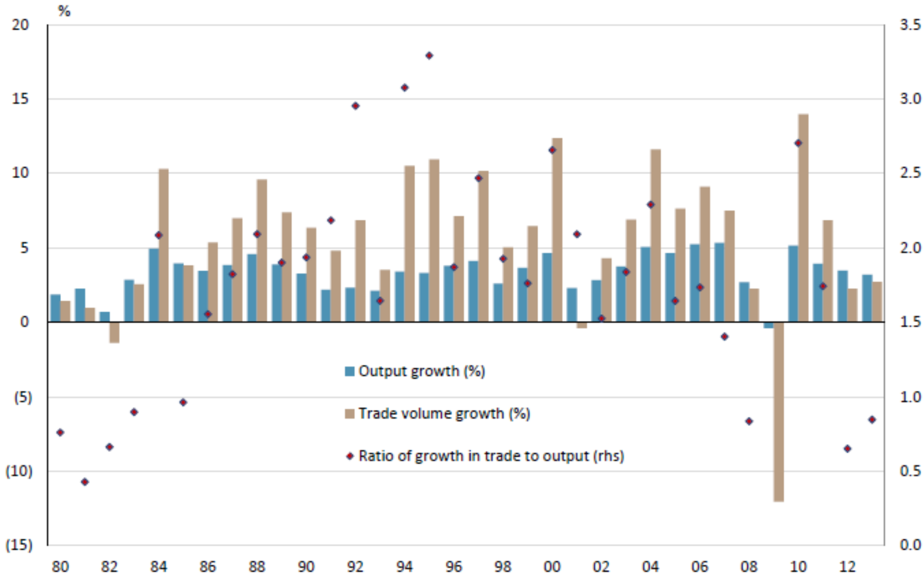
A very substantial reason why U.S. stocks have performed so well in recent years, has to do with this practice. If your stock keeps going up as a result, and you increase your salary package, who cares if there is a fool sitting in London who happens to disagree with this strategy? But the fool is still convinced that the chickens will come home to roost at some point. If you don't grow the top line, you cannot grow the bottom line forever. At least that is what the fool thinks, but it may take years before everybody realises that the emperor is no longer wearing many clothes[1].

Weak global trade growth

Trade growth remains very weak and well below the levels seen in the years before the 2008-09 crisis (chart 7). Whilst not a massive problem for more developed economies, weakness in global trade is a major challenge for emerging economies, as international trade is predominantly where their economic growth comes from. And to make matters worse, I suspect that a rapid improvement in global trade is highly unlikely given the debt picture I talked about earlier.

[1] *I haven't even touched on the more cynical explanation on why buy-back programmes have become so widespread. It has to do with how many companies reward their management teams, which have created a strong incentive to support the stock price. However, let's not turn overly cynical!*

Chart 7: International trade growth remains weak



Source: UBS, Haver

This may not materially impact economic growth in countries such as the U.K. and the U.S., but it will almost inevitably have an effect on global GDP and it is not positive.

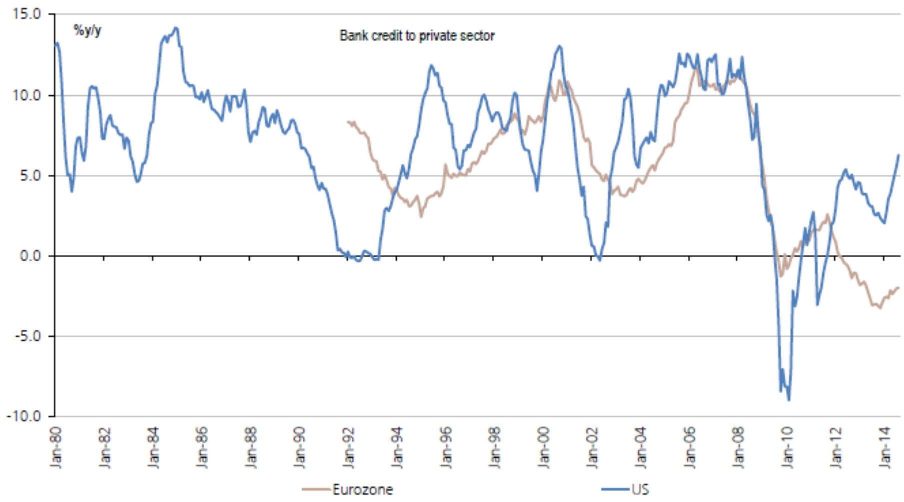
Poor credit conditions

In fairness, credit conditions have improved in the U.S., even if they haven't fully normalised yet. Unfortunately, the same cannot be said of Europe where, in many countries in the Eurozone, credit conditions remain very bleak indeed. As discussed in last month's Absolute Return Letter, access to credit is a necessary condition for economic growth in today's environment, so it is not difficult to understand why economic growth remains so poor in Europe.

The ECB has recently published its long awaited results of Eurozone bank AQR stress tests, which, quite frankly, turned into a bit of a joke. While we all know that Europe is flirting dangerously with outright deflation at the moment, the banks in the survey were never tested for this potential outcome. The ECB's worst case scenario was for inflation to drop to 1% when it is already at 0.3%. It doesn't exactly increase the credibility of the ECB – at least not in my book.

We know from Japan that deflation is a serious risk to bank solvency. Going into their deflationary experience, they had over 20 large banks. Now they have less than a handful. I am sure the ECB tested the European banking system for deflation, but the numbers were probably too ugly to publicize. Instead they chose to say that there was no need to test for something that is not going to happen!

Chart 8: Credit conditions in Europe remain poor



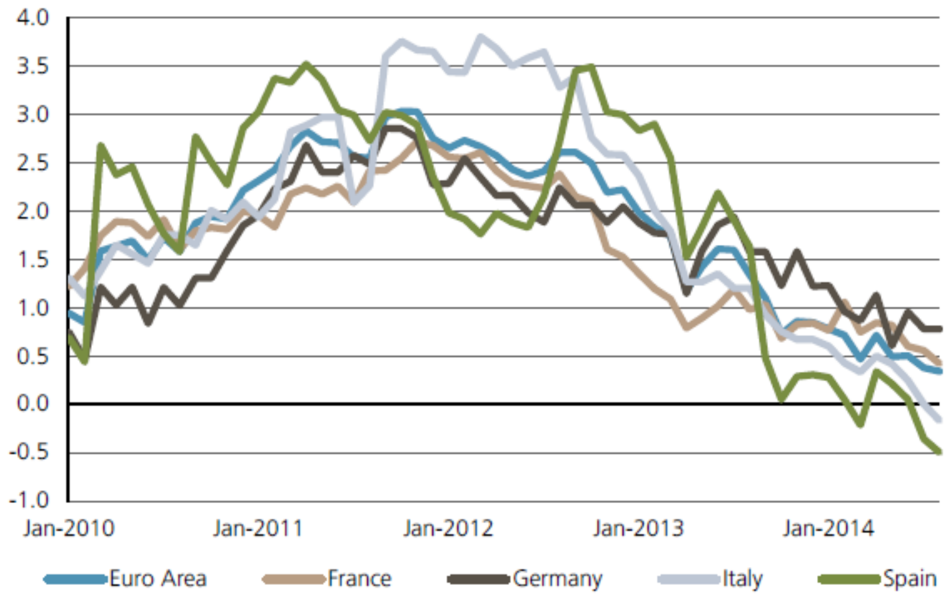
Source: UBS, Haver, ECB, Federal Reserve

Deflation

Deflation typically has a noteworthy impact on economic growth, and it is not positive, as the Japanese have learned over the past couple of decades. It ruins economic growth because it discourages consumer spending as well as investment spending, and it is particularly harsh on societies with high levels of debt; it is effectively a tax on debt.

As debt levels are very high at present, the move towards zero inflation in the Eurozone (chart 9), and quite possibly beyond, is very risky indeed, and it explains why the political elite in Europe is so busy telling everyone who cares to listen that deflation is not a risk worth taking seriously, because it is simply not going to happen. If only life was that simple!

Chart 9: Eurozone inflation continues to soften



Source: UBS, Haver

Sod's Law (Murphy's Law in America) will ensure that deflation will indeed become a problem we'll have to deal with, whether we like it or not. In fact, around the southern periphery of the Eurozone, deflation is already widespread, and some countries further north are not far behind. Once low to negative inflation expectations get well anchored, as we saw in Japan, it is an uphill struggle to change those expectations again. Precisely for that reason it is perfectly reasonable to expect below average economic growth in the Eurozone for several, possibly many, years to come.

The good news

Fortunately it is not all bad news. There are several things happening which, between them, will pull economic growth in the other direction, i.e. up. Geographical differences will increase the likelihood of global economic growth not collapsing altogether. I mentioned earlier that U.S. capex may be on the verge of a meaningful recovery, and that is only one example.

5-year inflation expectations in the U.S. and the U.K., although slipping recently, are still almost 2.5% and 3.0% respectively. In a world toying with deflation, these are very respectable numbers, raising the probability of those two countries escaping outright deflation. Expectations are very important as they dictate the overall behavioural pattern.

Shale gas is another piece of good news (completely ignoring the environmental aspects of shale), and the recent weakness in the price of oil should be seen in the light of the ongoing shale gas announcements. As at last Friday, WTI crude oil closed around $80.50 per barrel, and the price of oil continues to drop.

There is nothing easier to get used to in this world than higher living standards, and the populations of most oil producing nations have seen plenty of that in recent years. Shale gas is a threat against those living standards, and falling oil prices are the best assurance they can hope for that shale gas will never become the major production factor that we are all being told that it could become. It is very expensive to produce and thus requires high oil and gas prices to be economical.

In a rather bizarre way, shale gas has thus become an insurance policy, as the western world never have to ramp up shale production to levels that have been discussed. The sheer threat of doing so should keep the oil price at acceptable levels.

Falling commodity prices are also a positive. In some corners of the financial media, the multi-year fall in commodity prices (the Bloomberg Commodity Index recently hit a 5-year low) has been presented as a sign that we are on the cusp of the next major economic downturn. This view is, in my opinion too simplistic.

A $20-per-barrel drop in oil prices transfers $6-700 billion from oil producing nations to consumers worldwide or nearly 1% of world GDP. Assuming consumers will spend about half of that on consumption, which historically has been a fair assumption, the positive effect on GDP in consumer countries is c. 0.5%. Obviously, oil is only one of many commodities to have fallen in value, i.e. it is not unreasonable to expect the total GDP effect to be higher than 0.5%.

If commodity prices were to signal an economic downturn, cyclical commodities would perform more poorly than non-cyclical commodities and that hasn't consistently been the case. Yes, some cyclical commodities have done very poorly (e.g. iron ore), but so have some non-cyclical commodities (e.g. several agricultural commodities).

Commodity prices experienced one heck of a bull market between 2000 and 2011 with prices tripling. When prices rise that much and that fast it is only natural to add to capacity which is exactly what has happened. Much of that capacity has come on stream in the last couple of years, into a very different world from that in which the decision was taken.

As a result, I believe that falling commodity prices are more a reflection of too much supply coming to the market in a time where demand is not quite as strong as everybody had believed it would be during the period of almost limitless optimism in 2003-07, than it is a sign of a collapsing global economy.

What does it all mean?

If my prediction that global economic growth is in for an extended period of time of sub-par growth, then many portfolios need to be re-structured.

If my growth expectations are about correct, QE is far from over – at least not in some parts of the world, and it is even possible that the Fed will come creeping back after having distanced itself from QE recently. Interest rates should generally speaking perform better than expected, although credit concerns may hold certain names (and countries) back.

Even countries less likely to suffer from deflation (e.g. the U.S. and the U.K.) are very likely to keep interest rates relatively low and certainly lower than they would normally do, considering the macro-economic circumstances. For that reason I expect rates to stay comparatively low universally, even though rates are likely to increase modestly in some countries.

Equities are a minefield. Some will do reasonably well, whereas others will do very poorly. However, the overall return on equities is likely to be below historical norms yet positive. Many commentators have pushed cyclical stocks recently, mainly for valuation reasons. If my thesis is correct, earnings of cyclical companies will continue to disappoint for a long time to come (as in years), and investors will be better off in more defensive names. Companies that look after their balance sheets will also do comparatively well, so investors will do well to do a bit of homework in this respect.

In the alternative arena, equity long/short – the single biggest alternative investment strategy - is likely to prove a major disappointment. If equity markets only deliver mid-single digit returns for an extended period of time, and you charge 2+20 on the money you manage, many managers (but not all) will deliver disappointing net returns to investors, even if/when using a bit of leverage. Hence I predict that the fee structure will come under increasing pressure as a result of this whole escapade.

The alternative strategies which are likely to do relatively well are those which are not too dependent on economic growth and not reliant on the equity market to deliver its usual 10% per annum. At ARP we spend a lot of time trying to identify those types of strategies.

Have a great November.

Niels C. Jensen
4 November 2014

Important Notice

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns and our thinking, product development, asset allocation and portfolio construction are all driven by a series of long-term macro themes, some of which we express in the Absolute Return Letter.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Conduct Authority in the UK.

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