PRICEVALUEPARTNERS

Wrong turn

"Ignorant men raise questions that wise men answered a thousand years ago."

- Johann Wolfgang von Goethe.

"Grateful the building society texted me instantly about the interest rate rise & mortgage. Odd silence from bank with our cash savings."

- Tweet by @graemearcher.

It's not quite a thousand years ago, but the principle still holds. As far back as 1810, the Bullion Committee in Britain acknowledged that economic central planning, and control of the money supply by way of interest rates, was essentially impossible:

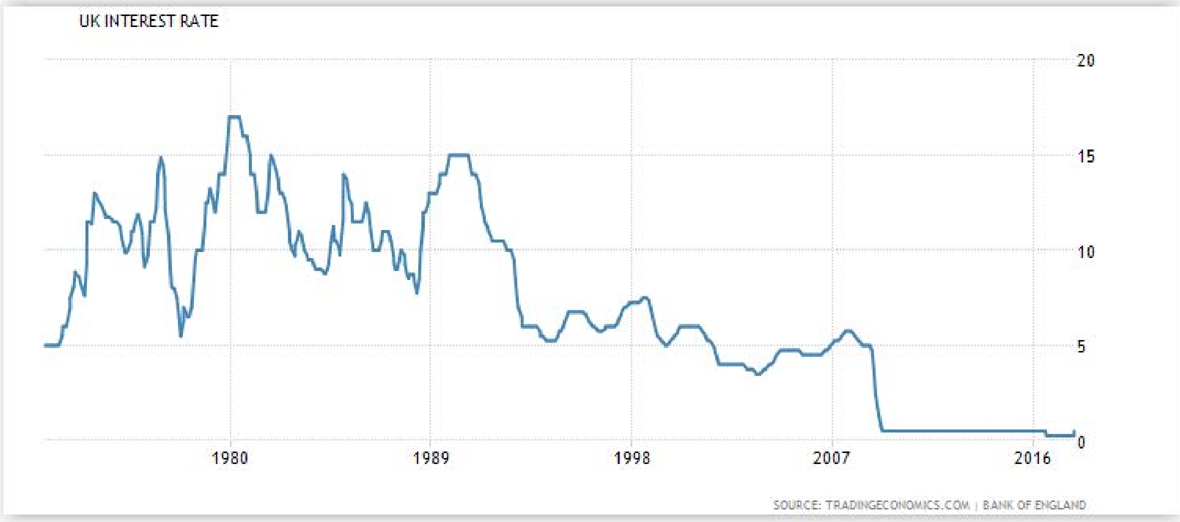
> The most detailed knowledge of the actual trade of a country, combined with the profound Science in all the principles of Money and circulation, would not enable any man or set of men to adjust, and keep always adjusted, the right proportion of circulating medium in a country to the wants of trade.

Sadly, it is the curious fate of every generation to forget the lessons learned by those that preceded it. So the press have seized on two recent events – the microscopic base rate hike that the Bank of England has just delivered after a decade of near-zero rates; and the nomination of Jerome Powell for next Federal Reserve chairman – as if they meant something. If these announcements have any significance, it is that the mainstream media are still in thrall to the unelected central banking technocrats whose easy money policies culminated in the Global Financial Crisis, and these same media are philosophically unable, or unwilling, to challenge the primacy of central planning and directed markets – ***or*** the perverse idea that easy money, having triggered a credit crisis, is at one and the same time the solution to it. Well, there's no accounting for taste. Or intelligence.

They say that science advances one funeral at a time. New and superior theories can only gain acceptance by open-minded *moderns* once the old guard who opposed them die off. The (false) science of economics is unlikely to be any different. While the efficacy of quantitative easing as a reflationary mechanism remains doubtful at best, there are other rules of thumb in finance that stand on somewhat more solid ground. One of them is that if interest rates rise, bond prices fall. What, then, should bond "investors" make of the fact that the interest rate cycle in the Anglo-Saxon economies is conclusively on the turn ?

The chart below shows the history of the UK base rate between 1971 and today. Last week's 25 basis point rate hike is the barely visible hiccup on the far right of the chart.

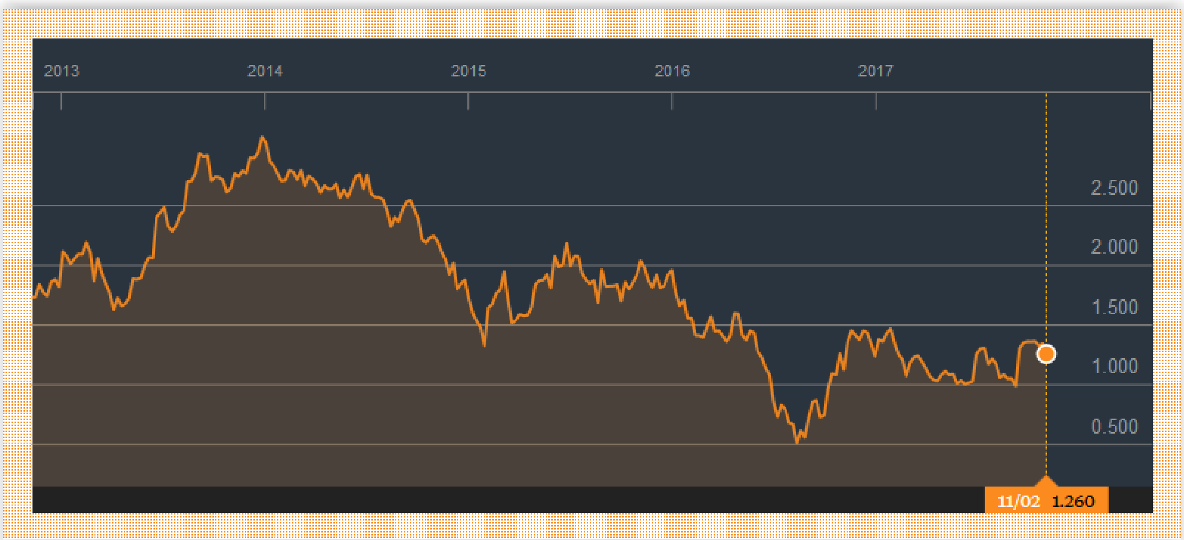
UK base rate, 1971 to 2017



A chart for the US Fed Funds rate would look pretty similar. Arguably, however, what matters for the bond market(s) is not the size of the tightening *per se* but what it says about the future direction of travel for interest rates. ***They're going up.***

This is an inconvenient truth for the bond market.

10 year UK Gilt yields, last five years



Source: Bloomberg LLP

10 year Gilts took the (well-flagged) UK rate hike stoically, as if having concluded that the Bank of England had plumped for a "one and done" policy, kicking any further rate hikes well into the future's long grass. Difficult to opine further, given that Mark Carney can always print a few more hundred billion pounds out of thin air and buy more Gilts if he wants to. *Le marché, c'est moi*, as our latter-day Sun King might casually say.

What the chart above does seem to suggest is that 10 year Gilt yields hit rock bottom at around 0.5% last year. That, of course, was their *nominal* yield. With CPI currently at 3%, last year's low equates to a *real* yield of ***minus*** 2.5%. Even at today's higher level of roughly 1.25%, Gilt "investors" are still getting a *real* yield of ***minus*** 1.75% for their trouble. We get that the Bank of England believes in rigging the bond market, but who in the private sector would willingly be buying this stuff ? (Thematically relevant question: do you know what's in your pension fund ?) When a 35-year interest rate juggernaut finally changes course, does it make sense to retain significant bond exposure ?

We suggest there are better homes for your money.

The Nikkei 225 index, for example, enjoyed 16 straight days of gains during October – a record-breaking run surpassing its previous longest ever winning streak dating back to the early 1960s. Japan clearly has ***momentum*** on its side. But it also offers ***growth***. The Nikkei Asian Review points out that roughly a fifth of the stocks on the Tokyo Stock Exchange's first section have reached all-time highs this year. Best of all, it offers ***value***. Within the Samarang Japan Value Fund, the single largest allocation within the VT Price Value Portfolio, we can access Japanese equity opportunities with an average p/e of 13 times, an average price / book ratio of 1.2x, and historic returns on equity of 13%. Good luck finding those kind of valuations elsewhere.

The tide is turning for bonds. The tide in favour of Japanese stocks, on the other hand, especially value stocks, has, we suspect, only just begun.

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