PRICEVALUEPARTNERS

Trend following

"The problems created by printing money cannot be solved by printing more money."

- Tweet by economist Daniel Lacalle.

The good folk at Absolute Return Partners have identified eight megatrends, long-term investment themes that they believe will define the world of the future. Those themes are:

1) The end of the debt super-cycle

2) The retirement of the baby-boomers

3) The declining spending power of the middle classes

4) The rise of the East

5) Mean reversion of wealth-to-GDP

6) Disruption

7) Running out of fresh water

8) Electrification of everything.

These are "secular trends, expected to fully develop over a five to ten year horizon and provide useful reference points for us when forming our views of where to dedicate our resources and, ultimately, where to allocate our clients' money."

They may not be properly investible theses as such, but we would add the following: the poisonous intensification of identity politics; the collapse of economic knowledge and respect for free markets; the dismal rise of unaccountable technocrats at our central banks; and the calamitous rise of the intrusive Big State and all the unintended financial and cultural consequences of its various interventions. (We discuss some implications of the latter in our recent interview with Chris Snowdon of the IEA.)

Putting to one side any caveats about succumbing to narrative fallacy, the Absolute Return Partners list implies two requisite actions on the part of concerned investors: moving capital ***away*** from those areas most jeopardised by these trends, and moving capital ***towards*** those areas most likely to benefit from these same trends.

The "end" of the debt super-cycle seems a clear example of the former. (Avoid bonds !) First, a quick historical recap. The following extract is from *Investing Through the Looking Glass – a rational guide to irrational financial markets*:

> The downfall of the Western financial system began during an episode of *Bonanza*. Speaking to the American nation on television on 15 August 1971, interrupting the popular western series in the process, President Nixon announced that the US dollar would "temporarily" no longer be convertible into gold. (The temporary prohibition lasts to this day.)
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> For nearly 30 years leading up to that announcement, a system known as Bretton Woods had fixed the value of foreign currencies to the US dollar, and pegged the US dollar itself to the price of gold, at an exchange rate of $35 per ounce. But by 1971, the US government was *en route* to bankruptcy, courtesy of a guns and butter economic policy initiated by the earlier President Lyndon Johnson, who had landed America with the costs not just of a Great Society welfare programme, but of the Vietnam War into the bargain. Foreign countries, not least the French, were queuing up to exchange their increasingly worthless dollars for gold. The run on the US' gold reserves had begun.
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> By removing its last links with gold, and slamming shut the window where currency could be exchanged for gold, Nixon was effectively devaluing the dollar. But by removing any practical constraints to the printing of dollars, Nixon also ushered in a period for the unrestrained creation of credit. If the US government was unable to balance its budget through tax revenues, it could simply print dollars to its heart's content to make up the shortfall. And the US government has been no slouch when it comes to money printing ever since.
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> By closing the gold window, the US government consciously removed the brake restraining the Fed from money creation without limit. The Fed was given the very tools that, if abused, would bring down the system. In the aftermath of the so-called *Nixon Shock*, governments and central banks around the world, with their own currencies no longer pegged to the dollar, have enjoyed a similar privilege. 1971 marked the start of the world's biggest orgy of debt. It was a starting gun for what will ultimately prove an economic race to the bottom.

We are closer to that economic base today. Central bank policy increasingly resembles a desperate scraping of the bottom of the barrel. Mario Draghi is probably asking himself what's ***underneath*** the barrel. In last week's commentary we highlighted the economic insanity of negative interest rates – a state of affairs that already exists in the euro zone, and which US monetary policy officials have threatened in the event of another lurch downwards by the US economy. John Plender for the *Financial Times* ('Why 'Japanification' looms for the sluggish euro zone') was not alone in drawing comparisons between the economic desperation that has overwhelmed the ECB and the malaise which so insidiously gripped post-bubble Japan:

> Confronted with slowing economic growth, uncertain politics and wobbly markets the

> European Central Bank reliably came to the rescue last week with new stimulus measures and a deferral of the start to any normalisation of interest rates. Yet, despite the soothing medicine, equity markets were initially unsettled.
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> This was partly because of the sharpness of the ECB's downgrade to this year's growth forecast from 1.7 per cent to 1.1 per cent. But it was also a response to the downbeat rhetoric of ECB president Mario Draghi, who described the eurozone as being in "a period of continued weakness and pervasive uncertainty". That lends topicality to a recent report by economists at ING who point out that a low-growth, low-inflation environment in the eurozone, along with a negative deposit rate and ample central bank liquidity, bears a striking resemblance to post-bubble Japan. Is the zone, they ask, heading for "Japanification"?
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> ..It could equally be argued that the eurozone has its own version of this syndrome. The bloc runs a large current account surplus reflecting northern Europe's tendency to save more than it invests. It also has a flawed monetary union that delivers an over-competitive exchange rate to Germany and other northern Europeans. Their fiscal conservatism militates against any attempt to address the north-south imbalance that results from these ramshackle monetary arrangements. The conclusions: the eurozone will continue to be overdependent on the rest of the world for demand stimulus; Japanification will become a more familiar word in the European vocabulary; populism will advance; and the ING authors may be right in arguing that interest rates will remain lower for much longer than most people now expect.

Japan has had a quarter of a century to work through its own deflationary mess. It got there well before the rest of us, so it is only fair that it should now be finding its feet again. Abenomics has helped. And Japanese companies, for example, now have the healthiest balance sheets in the world. But the euro zone lacks Japan's social cohesion and, being a mongrel assemblage of disparate cultures, any ingrained natural willingness to "take one for the team".

We have long held the view that, with central bankers collectively having lost their minds and any relationship with reality, the smartest move in the game is likely to be "not to play". So other investors are welcome to "invest" in government bonds, especially those issued by colossal debtor countries. Since the ultimate outcome from the global debt predicament is predestined to be inflationary (regardless or perhaps even because of the shorter term deflationary outlook), it makes all the sense in the world to favour sensibly priced real assets over ridiculously priced nominal ones.

Items 3) and 4) on Absolute Return Partners' list amount to two sides of the same coin. Middle and especially working class populations in the West are already suffering from declining spending power thanks to the inflationary, unproductive Big State policies of their governments. But on the other side of the world, the opposite is true. The OECD forecasts that the Asian middle class population, currently a little over 500 million, will reach 3 billion people by 2030. This will equate to the greatest creation of wealth in human history. And all thanks to free markets and capitalism, not despite them. Things have reached a strange place in market history when the Chinese Communist Party does more for wealth creation than politicians in the West.

We have frequently discussed our enthusiasm for valuations in Japan's stock market – arguably the cheapest developed stock market in the world. Vietnam is a good example of an emerging (strictly speaking, "frontier") power. The country recorded its eighth successive current account surplus in 2018. These surpluses, plus low inflation, led to Moody's upgrading the government's credit rating to Ba3 with a positive outlook.

The Vietnamese stock markets are not blind to these trends. In 2005 there were just 42 listed companies in Vietnam. Now there are 1,564 of them – a 37-fold increase. Vietnam's total market cap. in 2005 was $551 million. It now stands at $173 billion – a 314-fold increase. Within our main Vietnamese investment, SSI's Vietnam Active Value Fund, the top ten holdings generated an average return on equity of over 22% last year. Not one of those companies has a forward p/e ratio in the double digits. There may be some pretty baleful cultural, economic and political trends here in the West, but from the perspective of this value investor, Asia's looking just fine.

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Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.