PRICE**VALUE**PARTNERS

Worrying quotes

"The most underrated investing skills are controlling your emotions and having your career coincide with a 30 year decline in interest rates."

- Morgan Housel.

You can listen to our latest podcast with Paul Rodriguez of thinktrading here.

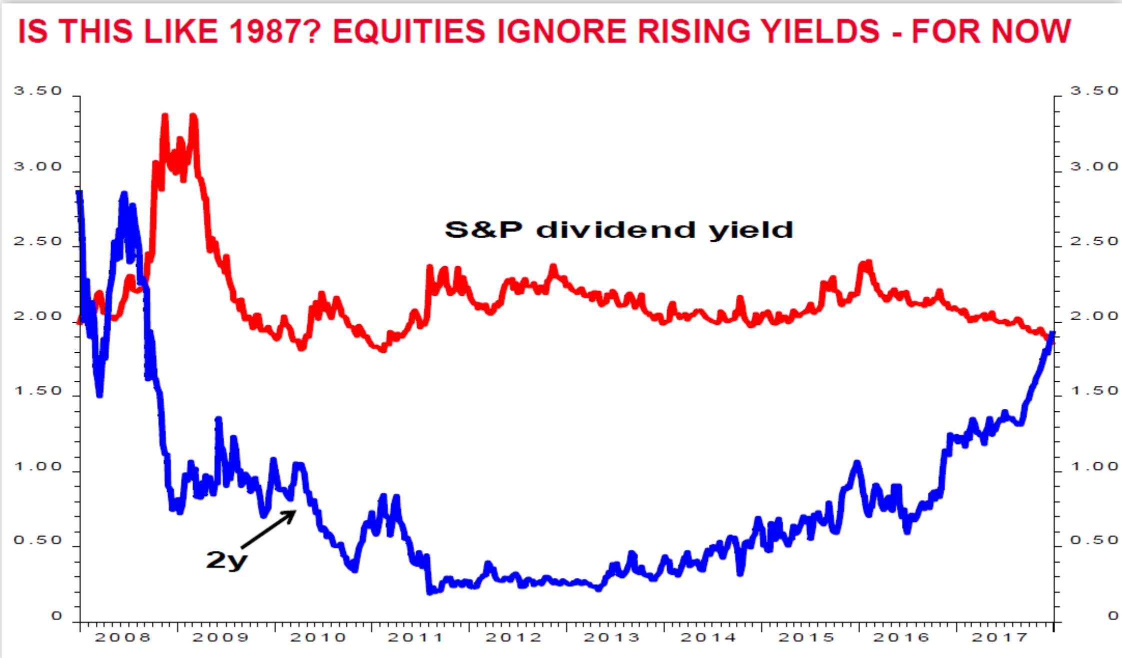
To fund managers of a certain age, January means more than just nursing December's grisly accumulated hangover. It carries hopes for a better year, dreams of world peace, and the arrival of SocGen's annual investor conference hosted by Albert Edwards. The audience numbers at this event have long been treated by some as a reliable contra-indicator. Human nature being what it is (flawed), and given Albert's reputation as a permabear, an audience "packed to the rafters" at the Grosvenor Marriott in early January equates to unusual interest in the bear thesis – which is typically followed by a barnstorming year for the markets. "Tumbleweed" equates to widespread complacency – which is typically followed by distinctly sub-par market performance. This year's attendance was solid but not exactly Beatlemania, so its implications for market returns are as yet unclear.

What ***is*** perfectly clear is that there may well be trouble ahead. Albert's original 'Ice Age' thesis held that the West would ultimately follow Japan's 1990s descent into outright deflation:

> The big Ice Age call was that the tight positive correlation between equity yields and bond yields that market participants had enjoyed since 1982, driven by ever-lower inflation, would break down. The "long bull market" had been a mirror image of the 1965- 1982 period when yields on both assets had risen together. The Ice Age thesis, drawing on our observations of Japan, predicted that while interest rates and bond yields would continue to fall, equity yields would decouple and begin to rise on a secular basis. For those with a historical perspective the Ice Age would be a mirror image of the 1950-65 period, which had been dubbed in the 1950s "the culting of the equity market" - a term popularised by George Ross-Goobey. In the Ice Age, government bonds would rerate relative to equities, with the latter declining in absolute as well as relative terms.

That this thesis has yet to play out as predicted does not entirely discredit it. Facts do not cease to exist simply because they are ignored. Investors seem to value the intellectual substance of the thesis despite the timeliness of its predictive qualities: Albert was once again rated first in 2017 in the Extel survey of analysts in the Global Strategy category – for the 14th year in a row. Perhaps his purpose is to serve as the market's Auriga, the slave who would whisper in the ear of a victorious general during his Triumph, 'Remember, you are mortal'.

Stock markets, as we all know, spent the last year climbing yet another wall of worry. Why should 2018 be any different ? Perhaps because the death of the great bond bull market will have implications for other asset classes, none of them likely to be good. Could this environment perhaps have something in common with that of 1987, when equity investors ignored rising bond yields – until they suddenly started paying attention ?



Source: Société Générale Cross Asset Research

The surge higher in bond yields does at least give income-seeking US investors a choice. Whether 2018 turns out to be an *annus horribilis* for equity investors may well depend on whether the 36-year downtrend in US Treasury yields is conclusively broken in the months ahead. Bill Gross tweeted last week that the bond bear market had already begun, but later recanted, perhaps remembering what his day job is, telling CNBC that

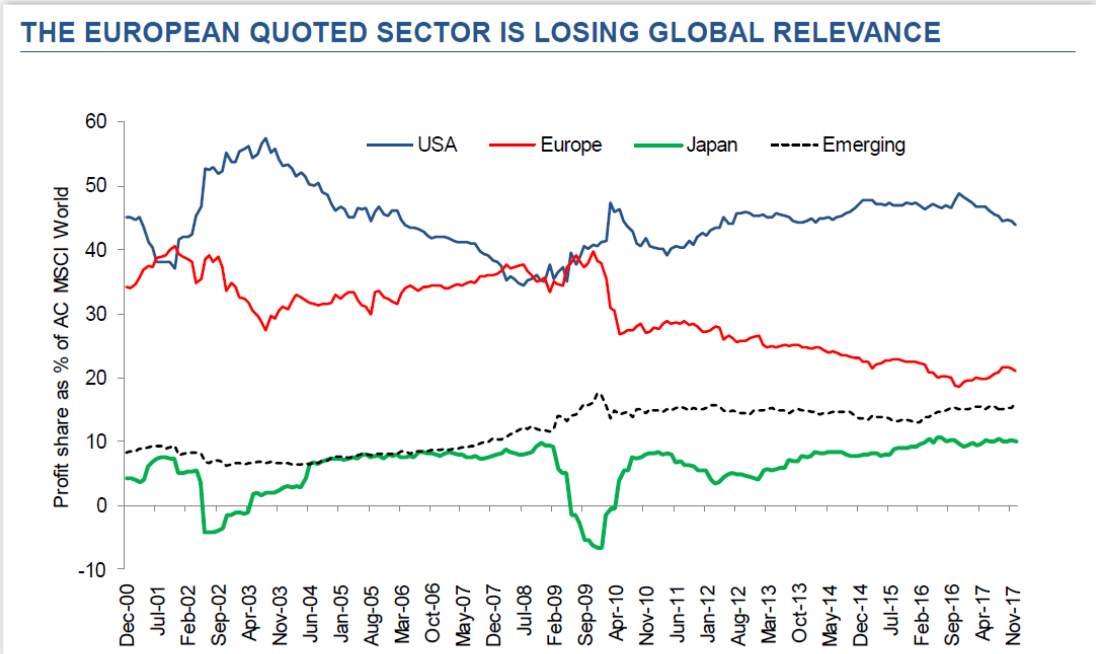
> It's not a strong Colombian bear market – it's a decaffeinated bear market.

If only other high profile fund managers could speak with such unconflicted conviction.

Albert saved his best quote for last. Something suggests that former Bank of England Governor Mervyn King may come to regret his words of February 2012 when he stated baldly:

> I have absolutely no doubt that when the time comes to reduce the size of the [Bank's] balance sheet that we'll find that a whole lot easier than we did when expanding it.

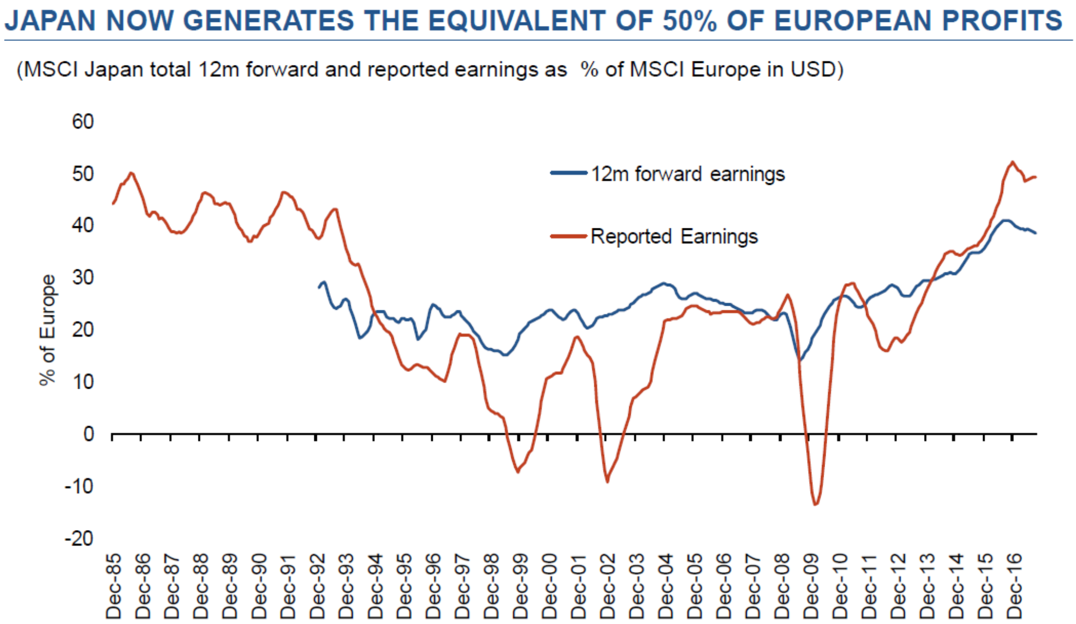
We found two slides from Albert's colleague Andrew Lapthorne especially striking. They may give ardent Remainers pause for thought. The first shows the extent to which the European economy is fast becoming much less relevant on the global stage. The profits generated by European listed companies as a percentage of the global market have, since 2001, halved:



Source: SG Cross Asset Research / Equity Quant, FactSet, IBES

Over the same period, both the US and Japan have largely held their own, and the profit share of emerging market companies has, as one might have expected, grown consistently. The implications for rational equity investors are quite clear.

Andrew's next slide reinforces the point in favour of Japan. Contrary, perhaps, to the understanding of many, the Japanese economy has been doing well over the past two decades, especially relative to Europe. The Japanese population stands at roughly 127 million. The population of Europe is roughly 743 million. Despite having only 17% of the human capital, Japan Inc. now generates the equivalent of 50% of European profits. It is unlikely that UK or European or for that matter US investors currently have half as much exposure to Japanese stocks as they do to European ones – but perhaps they should.



Source: SG Cross Asset Research / Equity Quant, FactSet, IBES

Stock markets have, by and large, defied gravity since the Global Financial Crisis low of March 2009. Quantitative Easing surely accounts for much of their anti-gravitational vigour. Markets now face a far colder climate when it comes to QE, along with the headwind of rising US interest rates. Valuations haven't much mattered for the past nine years – the rally lifted most boats, and in many cases the flimsier the better. We think valuations will start to matter in 2018. There is still time to sell out of grotesquely overpriced bonds, and stocks, in favour of compellingly inexpensive – and largely defensive – value opportunities, especially in Asia.

www.pricevaluepartners.com @timfprice

Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here.