Melville Douglas Balanced Fund Ltd - Balanced Class

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Quarterly Commentary

The focus of macroeconomic policy seems to be shifting. It may be simply that central banks have discovered that managing zero and negative interest rates has high costs and limited benefits. In spite of a good bit of speculation this year about the introduction of "helicopter money", particularly ahead of the latest Japanese central bank policy meetings, it has not happened and for whatever reason, central banks have stepped back from this brink.

If this much more moderate approach of central banks is sustained, the result will be to place pressure on governments to provide additional adjustment by fiscal means. For the most part, having taken on the burden of rescuing banking systems which were under threat as a result of the financial crisis, governments have tended to reduce fiscal deficits and in some cases even claw back some of the assistance that was provided. In Europe, this was most publicly visible as a drive for "austerity"; but the impact was not limited to Europe by any means, and it was not necessarily limited simply to restoring pre-crisis deficit levels. In the UK, for example, the government famously trumpeted a return to a balanced budget (zero deficit as a % of GDP) by 2020; of course, post-Brexit, that target has had to be abandoned.

As a result, there is increasing speculation regarding more aggressive fiscal measures. The combination of reduced or reversing asset purchases by central banks and the almost inherently inflationary results of larger fiscal spending will make bond markets very nervous, and with very low prevailing yields it is arguable that a clear shift of the balance from monetary to fiscal adjustment would produce a potentially disruptive change in interest rates.

Inflation, interest rates and inequality

There are more reasons than the purely economic that might make such a shift unavoidable. Since the crisis, the main focus of central banks has been to encourage higher real growth by stimulating the credit cycle (in spite of the much larger hurdles put in place by banking regulation) and by encouraging consumers' and businesses' propensity to spend both by boosting asset prices (the wealth effect) and by avoiding deflation and encouraging higher inflation (because consumers logically should prefer to spend now rather than later to avoid higher prices). Neither goal has been met after years of extraordinary monetary policy.

In the developed world, only the US economy looks remotely normal. Employment and consumer spending have recovered quite well; there are even signs of inflation and the credit cycle is beginning to gain traction.

As neither the consumer price inflation rate nor "PCE inflation" rate suggests that low inflation is a problem, much less deflation, the debates over whether the Fed should or should not raise interest rates are debates not so much about the fact of rising rates but of timing and whether the unintended consequences should be taken into account. Taken together with the lowest unemployment rate in 10 years this data, and much else besides, make the case for a robust economy in a slow but steady recovery.

And yet even in the US there are underlying tensions. The recovery has not pulled the manufacturing sector out of the doldrums, and spare capacity remains high by historical standards. The quality of employment and other factors are such that even with an historically low unemployment rate there are significant income distribution problems.

Quite a bit has been made in recent years of the issue of rising global inequality, and the US is usually cited as a principal culprit. An analysis of the long term ratio between a high level of income (only 10% of the population earn more than this) and a low level (only 10% of the population earn less) shows, rising income inequality is not a recent phenomenon, but it has clearly had a boost since the crisis. So why is it an issue now? The main reason is probably that throughout the period before the crisis, economic prosperity spread real benefits to all income groups: even though higher income groups did better, low income groups still did better in real terms. Post-crisis, that has changed: the lowest income groups are worse off in real terms than before the crisis, but the rest are not.

The overall trend is exacerbated by a number of issues, such as demographics and technological disruption, which may not be amenable to short term fixes. But voters are unhappy and so politicians have taken notice. The UK referendum in June, which produced a very unexpected vote to leave the EU, was another in a series of post-crisis electoral upsets (in Europe particularly) that express dissatisfaction with the status quo. The next year is full of more potentially disruptive elections, starting with the US next month.

Politicians can broadly speaking deliver change only within the limits of fiscal possibility, as some European countries have already found out. Nevertheless, it now looks as though the political environment and macroeconomic policy may be more goal-aligned than at any time since the crisis: if so, anti-austerity advocates may finally be about to have their time.

It has also become clear that the world is moving towards a more nationalistic, protectionist stance. That cannot be helpful to global growth, as it simply raises the cost of doing business without conferring higher output; very likely it reduces overall output, because production at a higher cost may or may not mean higher production overall in the protected economy, but it will certainly reduce imports.

The impact of the political groundswell is thus hard to predict. When governments become more involved in directing production, inefficiency is almost certain to result; some sectors or producers will be favoured randomly over others, and there will be a misallocation of capital, which won't be corrected by the normal processes of bankruptcy. Overall the cost of capital must go up, and very likely inflation will rise.

Global Markets

Globally the past quarter was a bit less volatile than the first half, but later in the quarter markets began to struggle with the fact that central banks, particularly in Europe and Japan, have disappointed this year in the extent of their response to weak growth. So far this year, and unusually for a period of dull overall returns, sectoral leadership has come from energy and materials. Mostly, you would expect commodities to outperform only in a period of above-trend growth and typically one of high inflation as well. Neither condition has prevailed, so sustainability must be in question. The fact that higher commodity prices were a response to unsustainably low prices driven by unprecedented supply/demand imbalances reinforces this idea, but it is notable that for some metals, the adjustment has been more sustained.

While the debate continues over who should do the heavy lifting to get economies back on track, markets still have to contend with some basic realities. Over time, it is indisputable that the level of asset prices is determined by the cash flows generated. Aside from that, the only debate is how to value the cash stream.

Over the past year and a half, earnings (a proxy for cash flows) have been declining and the extent has not been negligible, and yet forward looking consensus earnings estimates have persistently indicated positive growth. At the same time, price levels have not adjust downwards, and so assets have become more expensive, at least on the basis of current earnings levels.

The only justifications for this are that earnings will recover (markets are forward looking), or that the cost of capital has fallen to the extent that can justify higher multiples. The earnings yield on the S&P 500 has continued to fall even while earnings have dropped. If share prices had just followed earnings down, the yield would have stayed constant.

The 10 year bond yield which is the reference "risk-free" rate which is the starting point for valuing all other assets. The markets appear to have become accustomed to the idea that interest rates are permanently low and have started to build them into pricing assumptions and valuations.

If so, and the US economy by some combination of cyclical improvement and government intervention becomes more inflationary, it is almost certain that the 10-year bond yield will have to rise – bonds that don't yield a real return are basically uninvestable, and so to accommodate a higher inflation rate higher bond yields would result. The risk is that in the adjustment phase to a higher inflationary setting, corporate earnings would come under some pressure: pricing power would not emerge as fast as costs went up, squeezing margins, and at the same time the cost of capital would rise as investors demanded higher nominal returns to compensate for rising inflation.

Thus there is a non negligible risk that even if economies improve, there could be earnings pressure and asset prices would have to adjust.

Conclusion
Globally, it is hard to see that cheap assets are widely available. It appears also that the world generally may be about to embark on yet another macroeconomic experiment, this time one with poor precedents. If the political trend indeed produces more protectionist and nationalistic policies, in theory global trade will deteriorate; but this might be happening at a moment where the cyclical impetus that central banks have so long pushed for begins to emerge more convincingly, as now seems likely in the US. If so, the outcome might be somewhat unpredictable, but perhaps less dire and certainly not worse than the current state of play. For investors, however, almost any likely scenario is well priced in, and even with positive economic surprise, volatility will likely remain high. As a result, we remain cautious and particularly careful with valuation and determining margins of safety.