VERMEER
NEWSLETTER

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THOUGHTS ON 2019

Groundhog Day

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We are fast running out of snappy titles to describe yet another period of little change, but the 1994 Bill Murray movie seems very apt; each day brings a different narrative but when we wake up the next day, we are back where we started. As we look back over the third quarter of 2019 and ahead into 2020 it is a little dispiriting to be facing the same uncertainties and issues as before, but perhaps we are a little closer to resolving some of them purely as a result of the passage of time.

The third quarter followed a similar pattern to the rest of 2019, although it contained a few nuanced differences, particularly, a short-lived rotation into previously unloved areas of the market. All developed equity markets rose slightly during the quarter, despite generally poor news flow, with emerging markets largely posting falls. Overall global markets increased by 3.8% in sterling terms, the US by 5.0%, the UK by 1.3% and Japan by 6.5%. Yields on 10-year government securities dipped by 30bps in the US, 24bps in Europe and 34bps in the UK.

Generally, markets reacted to trade negotiation news flow with a further slide in US Treasury yields which in turn meant it was the bond proxies in the equity markets that outperformed. Despite all the noise and short-term volatility, markets are tending to revert to the same patterns, namely growth stocks outperforming value stocks, big companies outperforming smaller companies, a rising US dollar and falling bond yields.

We have seen a pickup in the number of takeover approaches in the UK, a trend we have commented on in previous thought pieces. We expect this to accelerate when we finally get a Brexit outcome of any flavour. A major rally in sterling, which we think is unlikely, would be the only thing that would slow this process down. Everyone we talk to comments on a wall of overseas money waiting to invest in UK assets of all varieties. If we are correct and this theme continues then this will lead to another major issue which is de-equitization, put simply that there will be fewer and fewer stocks in which to invest. As such we will have to be even more diligent in seeking out appropriate investments to gain exposure to growth companies eg private equity funds and specialist vehicles.

Some clients may have noticed press comment in September on a market move from “growth” to “value” stocks. At Vermeer Partners we do not really focus on labelling stocks but the fact other people do means we have to be cognisant of it. The important point here is that “growth” stocks as a category have significantly outperformed in the past 10 years in virtually every major market. Traditionally there would be phases where “value” stocks would return to favour, but this has simply not happened despite a number of false dawns. The move in September has not persisted and it will be difficult for it to continue if the recent trend of poor earnings reports from “value” stocks remains a feature.

In terms of the outlook for the remainder of 2019 and into 2020 we are in danger of sounding like a broken record. Ultimately, we prefer to look at individual stocks and assess their attractions and prospects rather than focusing on grand theories on macro and political events and possibilities. We have to get through a potentially difficult six months. Corporate earnings reports are likely to disappoint both in Europe, Japan and to a lesser extent in the US, as the Trade War induced slowdown starts to bite. Unfortunately, individual company analysts are perennially over-optimistic and there is still a big gap between their forecasts and their generally gloomier top down counterparts who unfortunately tend to be more accurate.

After this period, we expect the US to pick up as we enter the pre-election phase and hopefully Mr Trump moderates his actions and language on several issues, most importantly on US relations with China. We think this is likely since he will want to be running into the election with a rising stock market. We continue to believe that Japanese corporate performance will pick up as restructuring continues. Europe is more difficult to fathom, as Brexit has tended to mask generally slowing economic performance and emerging structural problems. Political uncertainty may well slow the necessary reaction to any sustained slowdown.

We remain positive on the UK but stress the point that its attractions lie more in the mid and small cap arena where it is possible to get more precise exposure to the domestic economy. We may well see a rally in the UK without the biggest stocks participating. If and when we get some sort of normality post a Brexit resolution and potentially a general election, then whatever the political hue there will be a major burst of activity. Government has been in virtual lockdown for nearly three years and has deferred, delayed or ignored a series of important policy decisions across a wide range of areas. Merely correcting these issues will produce a substantial increase in economic activity.

We continue to fret over the lack of productivity improvement in the world in general. More bullish commentators point to the recent short-term uptick in productivity numbers as a sign of improvement. Although we are hopeful that they are right, we have been in this position on several occasions in the past 20 years and it has fizzled out. If improvements are not maintained, then we must continue to ask more fundamental questions. We suspect that investment in technology may be part of the problem. Companies invest vast amounts of money in

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technology but find it difficult to measure the financial returns it produces. As such when everyone is telling companies to digitise, money continues to be poured in to what may well be unproductive investment. The benefits of this IT spend have, in our view, largely accrued to the providers of the technology and associated services. This has made them excellent investments and in turn have led to a mad rush to invest in unprofitable companies which has both led to further unproductive investment and the crowding out of existing profitable players.

Overall, we expect markets to be supported by continuing and even increased fiscal loosening across the globe. It appears that this is the only policy tool being considered in terms of dealing with both short term recessions and longer-term structural issues. Politically it may have to take a different form than previous versions of easing, to deal with the undoubted social inequalities that they have produced. We believe that whatever form they take they will be supportive of most asset classes and that equity markets will continue to nudge forward. Ultimately the only way out of the current malaise is inflation, of the positive and managed variety. The problem is figuring out how to engineer this.

At Vermeer Partners, portfolios continue to be skewed towards a broad mix of investments but with a tilt towards large-cap companies that can grow profits in a low growth world, while maintaining strong balance sheets and the ability to return excess cash to shareholders. These sorts of companies are often multi-national businesses and any further weakening of sterling against other major currencies would lend further support to their share prices. However, we must not lose sight of the fact that many domestic UK companies are now trading at unprecedently low valuations and any resolution of the Brexit negotiations would result in a significant re-rating in their share prices. We also continue to hold uncorrelated or lower correlated investments within portfolios. Diversifiers such as infrastructure (both equity and debt) with stable inflation-linked cash flows or more esoteric asset classes such as gold should still form part of a balanced portfolio. While global equity markets still appear attractive relative to fixed interest investments, liquidity and leverage concerns continue to remind us that it is important to hold a broad mix of asset classes in the current environment.

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