VERMEER NEWSLETTER

January 2020

THOUGHTS ON 2020

Picture this

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As we commented in our previous investment report, we are running short of appropriate titles for our quarterly commentaries. We thought that by waiting until after the General Election to compose our thoughts, the outlook would be a lot clearer. After the initial euphoria of the Tory win has subsided and despite the fact that we are undoubtedly in a better place than prior to the election, we now have to refocus on all the other uncertainties that persist on a global basis and as such, the lyrics to the 1978 Blondie classic "Picture This" seem most apt: "All I want is 20-20 vision / A total picture with no omissions".

The size of the Tory majority is certainly a game changer for the UK. It will enable the government to be bolder and more pragmatic in its strategy both for delivering Brexit and for returning to the everyday business of Government which involves taking some actual decisions. How bold and pragmatic will probably depend on how long Dominic Cummings' influence continues to reign, but given the current high level of his stock, this will be for the foreseeable future. We therefore expect the Government to deliver a series of proposals to pump prime the UK. These will include targeted infrastructure projects, with a bias to the North and Midlands, and changes in property taxes to get the residential and retail sectors moving. We also await major delayed policy decisions on the NHS, Student Finance, Rail and Defence and others, all of which could have a material impact on short term spending decisions.

The major global macro issue in 2020 remains the US vs China trade war which has already had a severe impact on global industrial output and will continue to do so without a resolution in the near future. Despite the recent positive twitter messages from Mr Trump, we remain sceptical that there will be any substantive progress prior to the election. This is a classic case of different time horizons impacting tactics. Put simply, the leadership in China know that they will be around a lot longer than their US counterparts, even if the President is re-elected. As such they are happy to play the long game, slowly playing out their long term 10 and 20 year plans without wishing to upset the apple cart unless they absolutely have to. Although Mr Trump is probably predominantly driven by short term bravado and testosterone, his attempt to take on China's unfair trade policies is an admirable one but also one that he should carry on in a more concerted and aggressive manner. Unfortunately, he has an election to win and will not risk ratcheting up trade tensions with the negative impact to growth that it would bring.

Much has been made in the US about the likelihood of the breakup of some of the very large technology companies due to the monopolistic returns and behaviours they are currently exhibiting. This has largely focused on regulation but has also interestingly more recently included thoughts on market pressures exerting the same effect. We continue to invest in many of these companies predominantly because of the growth in their already prodigious levels of cash flow. We are not however deaf to the possibilities of changes in their corporate structures. We have long considered that the actual value of several of these technology behemoths is actually greater if they were to be broken up than their current valuations. As such, we continue to hold many of these stocks either directly or through collective vehicles despite their stupendous performance.

We continue to be attracted to Japan given the continuing underperformance of its stock markets. Much of the most recent underperformance has come from it being caught in the middle of the global trade war but is also due to the failure of the vast majority of its companies to engender more shareholder friendly capital structures and policies. We believe this is beginning to change. Japanese companies are very cash rich but have tended to hoard this cash. However, there is now a strong trend to both increase dividends to shareholders and start share buyback programmes. Furthermore, the tradition of complex cross-holding structures where companies own shares in each other also shows signs of being sorted out. In addition, poor alignment of management and shareholder interests, cosy relationships with banks, and the inherent protectionism of Japan as a nation are also starting to unwind. Given the underlying quality and cash generative nature of many Japanese companies, we do see this an attractive opportunity.

In terms of the outlook for markets in 2020 we are confronted with the same conundrums. For the twelfth January on the trot we sit and contemplate the probability of a rising interest rate / monetary tightening and conclude that it is extremely unlikely. As such cheap money will provide support to all asset classes and whilst corporate earnings and cash flow growth continues, equities will continue to look relatively attractive. The major themes are likely to be: the continued outperformance of the mega caps, as the markets remain momentum driven rather than switching to a contrarian or rotational phase; a focus on companies with high cash-flow yields; and the "de-equitisation" of many markets ie cheap money being used to take companies private. The major fundamental headwind for equities will be the fact that due to negligible global earnings growth in 2019 and very strong global equity performance, equities are above their long-term valuation trend.

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Performance in the UK stock markets will be held back by Brexit uncertainty and a poor earnings season, reflecting the pre-election slowdown, but if the Government can get on the front foot then domestic plays should react well. We also expect bids for UK companies, particularly from overseas buyers, to continue. The US will be dominated by November's election, which is usually a positive period for US equities, but given their stellar performance in 2019 this may be a little more muted than normal. Elsewhere we are slightly concerned about rising corporate and government debt levels in Emerging Markets but remain intrigued by the growth prospects in China and India. Overall, we expect global equity markets to make more modest progress in 2020 but we remain optimistic that we can find attractive individual opportunities for our clients.

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