The Big Picture

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Sell in May and go away?

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How optimistic are you about the world economy?

More optimistic than for some time. In 2014 we are experiencing a synchronized worldwide recovery for the first time in many years. Global growth should increase from 3% last year to 3.4-3.7%, driven by America and Europe. Growth in America could accelerate to 3%, while Western Europe should overcome the zero growth seen in 2013 and grow again at a rate of 1.3-1.5% this year. After a long recession the Eurozone should find its way back to positive growth of 1.1-1.3%, instead of -0.5%. This is a marked improvement, characterized by an expected surge in growth in Germany from 0.5% in 2013 to about 2%. Japan, the third-largest economy, is different. With luck, growth in Japan will be 1.4%, which is as strong as last year.

Finally, growth in emerging economies will be no stronger than it was in 2013, though at roughly 4.8% it will be at least twice the growth rate of developed countries. Big uncertainties remain, above all regarding developments in China. The main question is whether the slowdown in growth will gradually end, or whether it will continue this year and the next. The economic indicators present a mixed picture, and so do the emerging economies as a group. While China is expanding at about 7%, it is likely that growth in Brazil and Russia will barely be any faster than in Western Europe. In short, this is a global, largely non-inflationary, moderate upturn in economic activity which should continue in 2015.

This positive picture is rounded off by faster growth in world trade this year. In 2012 and 2013, world trade expanded more slowly than world production, which is very unusual. Now we have “normal” conditions again – world trade should expand by 4.3-4.6% in 2014, and thus faster than global production of goods and services.

So, is the driving force the United States?

Yes, but not just from this point onwards. It took over from the emerging economies as the world’s engine of growth as much as two years ago. But America is still a long way from its previous trend rate of growth. Nevertheless, per capita income is now at the record level of 2007/08 once more! In contrast, in terms of its economic development, Europe is a long way behind the USA and still looks vulnerable to me. It would not take much of a shock to plunge Europe back into recession. But it must be stressed that the continent is on the right track, which is why we currently hold more European than American shares in our customer portfolios. The process of adjustment is under way, even if it will take a long time.

What do you mean by that specifically?

The basic problem is differences in the competitiveness of the individual countries. Because they are in the same currency zone, they cannot narrow these differences by devaluing their currency, only by reducing costs. A positive example is Spain. Wages and prices are falling, which makes the local economy more competitive. However, this welcome development has a downside. It is increasingly causing concerns for French companies regarding competition because the country is struggling with structural improvements – France’s labor costs are high and the tax burden is increasing.

The fact that the process of adjustment has been made easier in recent months by a marked reduction in the cost of servicing debt is to be welcomed. Spain, Portugal and Italy can raise capital again at very low rates of interest. Additionally, the two big patients, Spain and Italy, are no longer reliant on foreign capital since both of them are running current account surpluses. The downside is that the pressure to continue with overdue and wholly necessary structural reforms and to reduce debt is easing.

In the short term, order is being restored again in Euroland. However, that order will be deceptive if the vitally necessary improvement in the long-term fundamental conditions is delayed. It is not cheaper capital that is needed, but a significantly higher growth trajectory. An economic flash in the pan alone will do little to change the disastrously high unemployment rates of 20% and more in Spain, Italy and Greece.

What role does Germany play in Europe?

Wages and prices in Germany would need to rise for these imbalances to be further reduced. But in the past year, actual wages have fallen. There are plans to introduce a minimum wage in Germany. Although I am opposed to such interventions in principle, it will at least help to raise cost levels.

Germany is, and will remain, Europe's strongest economy, driven by the export sector. Of course, competition from Japanese firms has greatly intensified due to heavy depreciation of the yen since the middle of 2012. Therefore, in Germany, and in the rest of the euro area too, we are focusing not just on the well-known big multinational companies, but also on the ones which are profiting from an upturn in the domestic economy, and are investing in companies such as Tod's, Rexel, E.On, Aviva and selected banks.

Together with the European Central Bank, Germany is also playing a leading role in the sphere of economic policy. We have this duo to thank for the fact that the euro has survived and that long-term interest rates in Southern Europe have fallen close to record lows. The financial markets confidently expect the ECB to keep its promise to do everything necessary to save the single currency, and Germany to continue to pay up in order to safeguard unity in the Eurozone; work has already begun on a third rescue package for Greece.

But not everything Germany is doing is laudable. The criticism that the country is doing too little to reduce the big growth differentials in the Eurozone is justified. For example, public-sector investment is being blocked by the brake on increasing debt levels. Aggregate domestic demand needs to be stimulated, which will automatically stimulate demand for foreign products too. In the context of the debt crisis, it is absurd that even Germany is striving to balance its budget. It is similarly misguided for Europe's largest country by far to generate a huge current account surplus amounting to nearly 7% of gross domestic product. Germany imports too little! In short, we cannot brush aside the danger that Europe might economize itself to death.

Let's move on to the corporate world. Companies around the globe are holding huge cash reserves. The amount is about 1.5 trillion dollars in the USA alone. So far, company directors have been using cash mainly to buy back shares. When are they going to make large-scale investments in the real economy again?

It is difficult to say exactly when, but it will definitely happen. Not for 25 years has so little capital been invested as it is today, relative to revenues. The average age of capital stock, in other words companies' machinery and equipment, is more than 20 years and thus at its highest since 1958. We are seeing the first anecdotal signs of greater confidence among companies. For example, the chip manufacturer Intel is investing five billion dollars in its production plants in Ireland. However, the macro data shows no trend reversal yet. There could be a veritable boom when the investment cycle begins. For this reason, we are making targeted investments in producers of capital goods and technology firms such as MasTec, Cisco, Teradata, Schlumberger, MRC Global and Precision Castparts.

Would an investment boom really be positive from the shareholders' point of view? After all, they have to make do with lower earnings if firms invest heavily.

That is too narrow a perspective. In the wider context, there can be no growth without investment. What matters to the shareholder is that scarce capital is not wasted but invested so that the value of the company rises in the long term. Return on investment is the key. Various studies have concluded that companies which invest fare better in the long term than those which hoard cash and stagnate.

When the economy starts to pick up again, interest rates will probably rise.

That is one of the most important issues that investors need to consider! The question is not whether interest rates will rise, but how fast. Any rise which is too quick would be calamitous. But the management teams at the central banks are aware of this. There is always the danger that tightening will be too aggressive and interest rates will overshoot their target, for example, if inflation suddenly takes off. Nevertheless, I am confident that the central banks will not make that mistake this time around.

The time to raise interest rates is drawing close only in the USA. In Europe and Japan it is still a long way off, so it's clear the world economy isn't overheating any time soon. Business activity in the USA is on comparatively solid ground. This view is supported by the fact that cyclical unemployment has fallen more quickly than expected to a level (4.3%) at which the pressure on wages and prices typically arises. A monetary turning point is visible on the horizon! Even so, monetary policy will remain expansionary in the USA as well until the end of 2014. The first rise in interest rates will probably not be until the spring of 2015. The lingering fears of deflation should have evaporated by then. This is a scenario that is still pro-equity. A stock market downturn is unlikely so long as the global and non-inflationary economic upturn strengthens, interest rates rise only slowly from their extremely low levels, and at the same time economic policy remains highly supportive.

What do bondholders need to prepare for?

The period during which a change of direction in monetary policy begins to emerge at the most important central bank in the world is associated with big uncertainties. Even if rates remain stable, investors will soon start to factor in the risks associated with the transition to a world of higher interest rates. I therefore consider the risk of a crash in a generally overvalued bond market to be higher than in the stock market. The reason is the previous unprecedented increase in liquidity, as reflected in the mounting balance sheet totals of the major central banks. It is difficult to give a view on the medium to long-term effects. The only thing that is certain is that the ammunition exists to produce a credit-induced, inflationary boom. It is a negligible risk for this year and next, but a bigger risk in the years after that.

As long as the banking system prefers to build up capital buffers rather than lend out reserves, and the corporate sector reduces debt instead of borrowing from banks, the path to a new inflationary economic boom is blocked. No one knows how long things will stay that way. And it is impossible to predict whether the central banks will manage to withdraw the excess liquidity in good time. "There is no free lunch!" as the Americans are fond of saying. This means that inflation may ultimately be the price to pay so that deflation and a further economic slump can be prevented by opening the monetary flood gates. Interest-bearing securities have turned into time bombs!

In this respect, it is useful to cast our minds back to 1994. At that time a slump in the bond market was triggered by several interest rate rises in the USA. Suddenly, everyone wanted to sell. That type of scenario can happen again, and therefore, whereever we can, we are holding cash in preference to bonds as a precaution. At the same time, we are placing our faith in the "great rotation," namely in the expected shift from fixed-interest securities to shares, which are fairly valued if you take the long-term view. In 1994, losses in shares were less than in bonds. The lesson to be learned is that no asset is absolutely risk-free. Risks can shift from one asset class to another over time. Even government bonds can become junk. And even the safest government securities – Swiss federal bonds – can become so expensive that equities are preferable.

This plan of action and its underlying reasons seem easy enough to understand. But evidently, many investors are doing something quite different. They are buying ever more risky bonds in a quest for acceptable and supposedly reliable returns.

There are areas where I can detect bubbles forming, driven by the hunt for yield. It is a law of nature! Long periods of zero interest rates almost always end in a financial bubble. My suspicion is that it will be the bond market, with high-risk borrowers' bonds at the top of the list, both those of companies (junk bonds) and of highly indebted states, for example those in Southern Europe. The previously high rates of interest that applied to risky issuers have plummeted in recent months to 350 basis points in America for five-year rates and to less than 300 basis points in Europe. This segment looks completely exhausted, and a correction is looming. As an example, in April Portugal was able to raise long-term capital at an interest rate of 3.6%. This is a country whose debts have reached 135% of gross domestic product (GDP) and are still rising, and which still has a budget deficit of 5% of GDP. I would steer clear of Southern European bonds and instead buy sound, defensive shares which pay equally high, but increasing, dividends.

Following the past marked upswing in prices, many investors hardly dare invest in shares because valuations have risen so much.

The argument that shares are too expensive or even "overvalued" does not convince me. It might apply to individual securities, but not to all of them. Consider the following numbers: within a period of ten years, the volume of bonds worldwide has risen from 17 to 94 trillion dollars. Conversely, the number of listed companies has fallen. In the USA it has halved since 1997! Thus, the opportunities for investing in bonds have expanded enormously, but have reduced where shares are concerned. If the price for goods that are becoming relatively scarce rises, no one should be surprised.

When considering strategy, I do not focus on the usual, static, accounting valuation ratios, such as price-to-earnings or price-to-book, which can be manipulated. The driving economic forces, which can sometimes influence stock markets for years on end, are more important. Until about the middle of 2013, it was the huge expansion in global liquidity, fed mainly by expansionary monetary policy, which drove the market higher. Since then, expectations regarding the economy and earnings have played a more important role. This shift makes it more difficult to identify the "right" asset classes and the "promising" stock exchanges. This transition has made investing money more risky. We must expect falls more often, like the one we experienced recently in the US social media, cloud computing and biotechnology stocks. The next candidates could be small and mid-cap American firms, more or less the counterpart to the risky bonds discussed above. For the Russell 2000 index you pay a price that exceeds the earnings expected in 2015 by a factor of 19. That is way above the long-term average of 16 and a bit above the P/E ratio – currently 14 – of the 500 biggest US companies, which is a reasonable valuation given the extremely low interest rate levels.

What has not changed in recent times however is the fact that shares are a risky asset class. From today's perspective, shares are less risky than bonds. I am confident that in 2014 we will make money for our customers by investing in shares, but the returns will be lower than last year. But even if it is "only" a 6% return, I would prefer that to the meagre yields and associated risks in the bond market any day. We also need to bear in mind that the risk-free interest rate is practically zero! It would therefore be reckless to rely on being able to earn 10% and more systematically from shares. Performance of 6% in a diversified share portfolio is very acceptable! But it cannot be taken for granted. It is never easy to make money from higher-risk securities. However, general portfolio decision-making seems to me easier than it used to be. In a zero interest rate environment there are only two asset classes that a cautious investor can choose from: cash and shares. And where shares are concerned, we can make things easier for ourselves than we could previously by concentrating on the "mature" markets and almost completely avoiding the stock exchanges of the emerging economies. It is a strategy that still makes sense.

Does cash make sense as an asset class?

Definitely. You are going to object that there is no profit in cash. That's right, but only if you consider the nominal value. In Switzerland at present, the real return across the whole maturity spectrum has rarely been so high in recent years, for the simple reason that there is price stability, now and then interrupted by periods of slight deflation. This is an ideal environment for the cautious investor, for whom maintaining purchasing power is more important than performance. An additional advantage is that cash safeguards against the effects of rising interest rates and can be used as ammunition for taking opportunities on other markets, such as stock exchanges and commodity exchanges. In short, anyone who disparages cash is reasoning incorrectly.

Let's stay with shares. Which sectors do you find interesting?

We think technology stocks are attractive again. We avoided this segment until 2009. But now well-known, large companies such as Cisco, Qualcomm, eBay, Amazon (since the fall in the share price in April), Microsoft and many others are valued attractively. Of course, there will always be corrections. These require patience. The biggest mistake many investors make is to sell winners too early. It takes a bit of courage to invest! Based on the starting conditions outlined above, there is no need at present to take cover exclusively in defensive stocks, but so-called cyclical shares also need to be held, consistently and with an eye on the economy. And there are excellent companies in the Swiss market. I am thinking of names such as Georg Fischer, Rieter, Clariant and Sika. But these stocks, like many shares of small and medium-sized companies, have risen considerably in the past two years.

Generally speaking, many investors have been put off by exactly that. Prices have been climbing ever higher for some time. In the USA, the bull market began in March 2009. It is now in its sixth year. How long can this go on?

As they say, quite perfectly and correctly: “Bull markets don’t die of old age.” A bull market does not come to an end just because it has reached a certain age. Furthermore, every cycle is different, and this one is in fact very different! The financial crisis caused an unusually deep recession. A 60-year credit cycle came to an end, which is why the economic recovery is unusually slow and protracted. We are not yet at the end of the economic cycle, but in the middle of it. A bear market nearly always precedes a recession. I am assuming that the bull market will continue, since I see no signs of renewed recession.

Which regions are best for investment – the expensive US share market or precarious Europe?

Both – in order to reduce risk through diversification. US firms are profiting from cheap labor, cheap capital, cheap energy and a cheap currency. That is why profitability and, consequently, valuations are higher than in Europe. The US profit cycle is at a much more advanced stage. That is why I would put Europe in first place if asked to rank them. The economic and earnings cycle is still at an early stage, and macro risks are higher, but so is the potential for improvement. Companies are coming out of the recession with momentum, and are making increasingly better use of their capacities. The leverage effect on earnings is much bigger than in the USA.

As far as regions are concerned, Japan follows in second place, not the USA. The deflationary headwind has turned, the financial system is in rude health, the export economy is very competitive, and many well-known companies are therefore in splendid shape. Last year corporate earnings more than doubled. Only a few investors are aware of how strongly profit margins have improved in the past two decades, from an average of around 3.5% in the nineties to 9% currently. Unlike in the USA, valuation is not a stumbling block. Quite the opposite; while US shares cost on average well over twice the book value, Japanese shares can be bought at book value. In short, Japan has at long last overcome two decades of economic stagnation. Therefore, all portfolios should include a solid position in Japanese shares.

Are there emerging economies in your ranking as well?

As far as we are concerned, the time for substantial investment in emerging economies has not yet come. The boom in the BRICs (Brazil, Russia, India and China) in the 2000s was driven not only by a credit boom, but also by a commodity super cycle and by foreign companies building global supply chains. All three driving forces have since gone into reverse, and hence the growth potential of the emerging economies is only half the level it was ten years ago. Defective structures are now being revealed which are depressing the trend rate of growth. In China, for example, there has been too much investment. There are now struggles with overcapacity and high levels of debt accompanied by falling capital productivity and declining profitability, which is why Chinese stock market values look only superficially attractive. The long-awaited opening up of the financial system has begun, but the banking system remains vulnerable as long as credit growth is not constrained and the property market has not stabilized. All the same, Xi Jinping’s government is making a good impression. We are going to wait and see. The best outcome for us would be another big stock market correction. Then it would be possible to venture back in slowly, making further reductions in the USA.

Is the US market now expensive enough to allow profit-taking?

It is definitely more expensive than Europe, no matter which measure you use. I find the so-called Q ratio, the ratio between the stock market value of a company and the replacement value of its assets, illuminating. This value is currently higher than average. That is a good reason for proceeding with caution where new investments are concerned, and it also suggests that the investment cycle I predicted should start soon, because a high Q ratio means that it is cheaper to build factories than to buy them. And the big companies have enough cash available. In fact, surveys confirm that business leaders are also taking an increasingly positive view of the economic outlook. I venture to suggest that the current takeover boom will be replaced, or accompanied, by an incipient investment boom next year.

What is holding you back then?

We will invest only when we can reasonably assess what will happen in the future. And that also includes clarity on taxation policy, a much underrated aspect. Such clarity does not exist in the USA. Unstable conditions have an even worse effect on the economy than a restrictive monetary policy. And that applies not just to the USA but to all countries, including Switzerland. Nevertheless, we are sticking with our distinctly pro-equity investment policy, also in America. Even if America seems relatively expensive, it is by far the biggest and most broadly based market. No investor can avoid America. “Sell in May” is not on our agenda.