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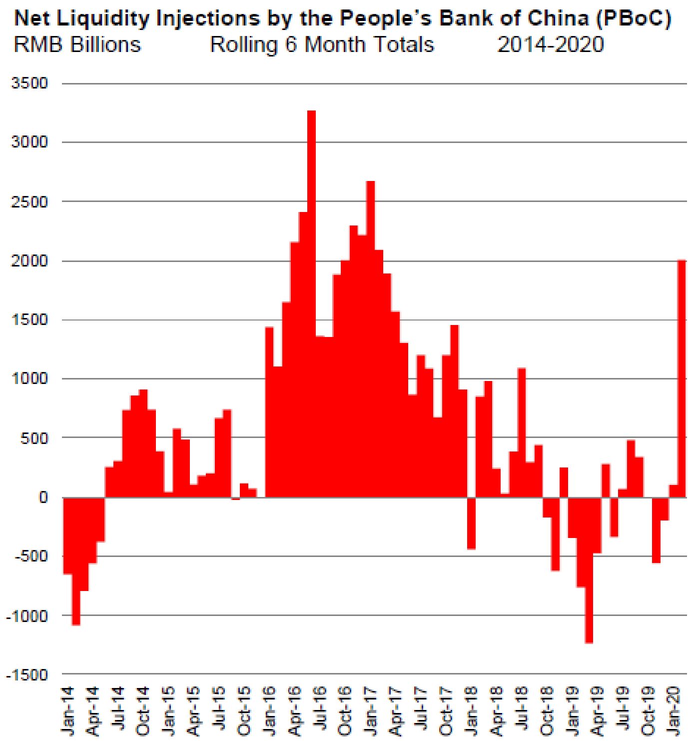
Source: Bob Moran's take on the Johnson - Cummings reshuffle 14 Feb 2020

V-shaped recovery focus for Valentine

While investors enjoyed another upbeat week, the world's medical profession (and the wider public at large) remained in a more troubled state, with concerns increasing after the World Health Organisation officially renamed this strain of the Coronavirus to Covid-19.

Last week, we wrote how capital markets had recovered from the late January sell-off, seemingly unconcerned that pandemic avoidance may devastate the global economy more than the illness itself. This theme continued this week, despite the count of infections and deaths jumping up after the Chinese authorities adjusted their detection method to a more realistic, if slightly less scientific approach.

Many market professionals ascribe market action to a massive monetary liquidity injection by the People's Bank of China to ease corporate financial stress. The consequence of the unprecedented virus containment actions across the nation has slowed deliveries and therefore payments. The central bank's response was seen as timely by market bulls, given the US central bank is likely to slow their support of transactional cash levels that started last September.



Source: Cross Border Capital Research, 12 Feb 2020

On the other hand, beyond the stock markets, there are capital markets areas which have started to price-in a worsening outlook, at least for this current quarter. We wrote last week that the US and UK yield curves had once again inverted at the very short end of bond maturities – which historically has been a sure sign that investors are concerned about the near-term outlook.

The currency markets have also reacted, with the Euro falling back (against the US Dollar) to levels not seen since the 2012 Euro crisis. There was a fair bit of head scratching, because the week also marked the first time Greece's 10-year government bonds traded at yields below 1% - unlike the Euro crisis when they were at 35%.

The €-Euro's renewed weakness was more likely caused by concerns about the erstwhile bulwarks of the north. Germany remains highly dependent on Chinese demand. Industrial production data last December showed manufacturers activity levels were at rock bottom and still falling. The obvious concern is; how much worse will it get now - with the added impact of the virus disruptions - before it gets better?

For now, investors appear to be content to look through near-term weakness and foresee a 'V-shaped' recovery for global growth. The predicted recovery is seen as merely suffering a postponement and it may well be that aggressive stimulus delivers an even stronger revival.

Optimism is clearly supported by the plentiful liquidity and welcome for investors, but it is likely predicated on expectations that Covid-19 will be no more disruptive than the 2009 H1N1 Mexican Swine Flu, which according to WHO research affected up to 1.4 billion people worldwide and had an ultimate fatality count in excess of 160,000 (although most of these poor souls would have died from other infections in due course).

Turning to market-influencing politics, Sajid Javid's resignation, and the perception of a botched cabinet reshuffle, did not knock the £-Sterling. Indeed, it surprised by strengthening sharply, which is good news for Easter holidays overseas although not welcome for UK exporters.

An interpretation of Johnson's more stratified executive appears to be that deficit spending will be quicker in coming. The domestic demand stimulus would strengthen the economy, pushing the Bank of England into a hawkish stance given their recent assessment that there is no particular spare capacity left in the UK economy.

We are not sure the consequences of the reshuffle had been entirely thought through (beyond the obvious Machiavellian dynamics), but it will most definitely lead to a much more unambiguous accountability of the UK's head of government and his advisers.

Outside the UK, the jury is out whether the stepping down of the designated successor to Germany's chancellor Angela Merkel will weaken or strengthen her position. Nevertheless, the shorter-term increase in political uncertainty will have added to the downward pressure on the Euro. In the US, stock markets' complete ignoring of self-declared 'socialist' Bernie Sanders winning the Democrat's New Hampshire primaries can be interpreted in two ways. Either an expectation that the UK's general election outcome will repeat in the US with a landslide re-election of Donald Trump in November. Or – less written about – the fact that the candidates of the political centre ground gained far more support in New Hampshire than four years ago, pointing to a higher probability that a moderate like Mike Bloomberg will challenge Donald Trump.

In summary, while there may have not been much in the national headlines about the economy and capital markets, there is plenty to consider at the moment, with the many variables currently far more in flux than we had thought possible at the end of last year.

Lagarde, the presidential ECB President

Modern-day central bankers are just as much politicians and PR managers as they are technocrats. With constant media attention, every word from officials' mouths is dissected and analysed by those trying to find out which way monetary policy will go. For the modern central banker, playing the game – not only with markets but with elected officials – is essential.

Former European Central Bank (ECB) head Mario Draghi was widely considered by capital markets as a competent and credible force. But he was not widely regarded as the most presidential of presidents by Europe's political establishment. His tenure certainly had its dramatic moments – like the "whatever it takes" speech that effectively rescued the Eurozone from crisis. Nobel laureate economist Paul Krugman even called him "the greatest central banker of modern times". But escaping the stigma of grey technocrat was always difficult for Draghi. This is not so surprising, considering his CV took him from private banking to regulatory boards to the Bank of Italy and finally to the ECB. It was a career that definitely put the 'banker' in central banker.

New ECB President Christine Lagarde, on the other hand, is cut from a different cloth. While the Draghis of the world filed into the top American Economics PhD programs, Lagarde read English and Law. Before her directorship of the International Monetary Fund, she held several senior ministerial positions in the French government, after serving as chair of one of the world's largest law firms.

Lagarde's Presidency is only a few months in, but like any committed politician she has already begun her first campaign. She made her way to Strasbourg this week to tell the European Parliament that "Monetary policy cannot, and should not, be the only game in town." Instead, "Other policy areas – notably fiscal and structural policies – also have to play their part. These policies can boost productivity growth and lift growth potential, thereby underpinning the effectiveness of our measures."

She directly addressed the unpopularity of some of the ECB's measures, lamenting that the institution's loose monetary policy is hitting savers, weakening banks and stoking asset prices. The longer the ECB's extraordinary monetary policy continues, the worse these side-effects will be. The President noted that the ECB's own reputation is on the line, but once again put the onus on European governments, particularly (if implicitly) Germany and the Benelux nations, to enact genuine structural change – and loosen their own purse-strings.

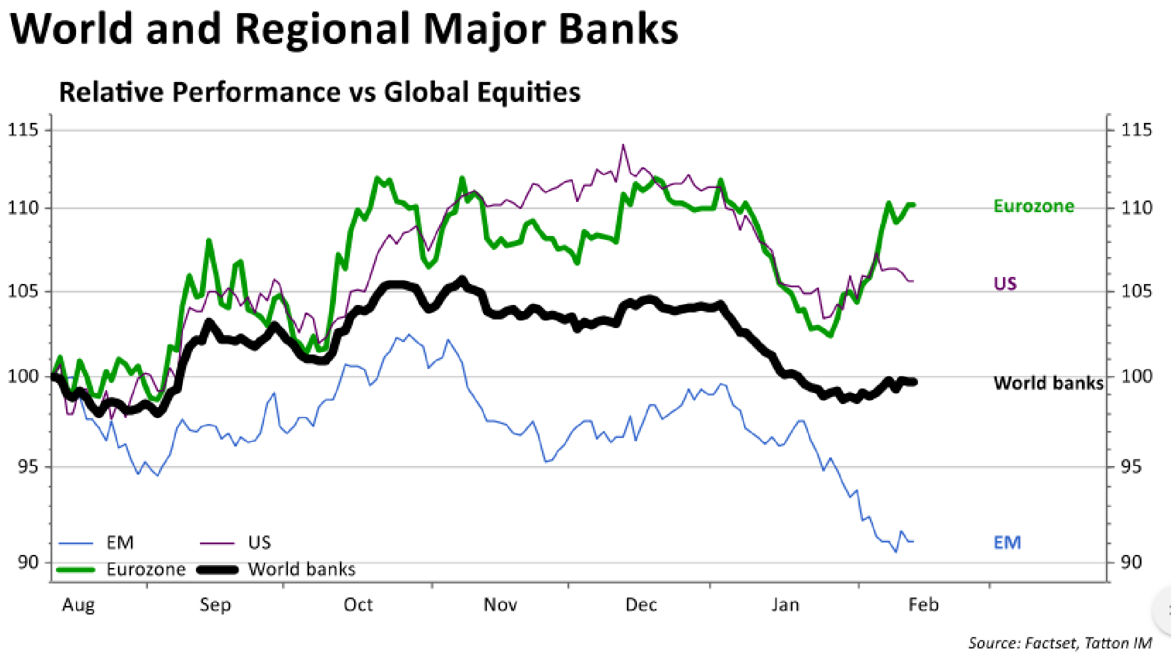
Mr Draghi said as much towards the end of his tenure. But the new regime is intent on backing up these words with action. Lagarde has already ordered a review into the goals and workings of the ECB to be completed by July (with some unnamed ECB insiders claiming they are faced with a rushed agenda). Two weeks ago, Chair of the ECB's Supervisory Board Andrea Enria laid out the bank's vision for an integrated banking system on the continent, which she claimed to be "The road towards a truly European single market".

Draghi's policy focus was that of the traditional central banker: setting interest rates at the right level for driving credit demand without overheating the economy. Lagarde's focus seems to be not so much on what the 'right level' is – and instead on how interest rates feed through into the economy. Achieving the correct interest level for corporate borrowers is all for nought if the banks they borrow from are too impacted by low rates to lend. There is little point in interest rate setting without a functioning banking system to implement those rates.

The biggest problem for Lagarde and her team is that the "European banking system" does not work because it does not exist. What does exist are 27 different banking systems serving their own nation's interests. Banks are hived off along border lines, each nation has its own national regulator and political patronage is rife. This is particularly prevalent in the larger nations like Germany and Italy, where financial regulation from Brussels is often watered down by local implementation tweaks (as we ourselves noted when we compared MIFID2 retail distribution implementation levels between the UK and Germany).

Ms Lagarde wants instead the ECB to serve as the continent's main banking regulator. That way, banks can scale and capital can flow from areas where savings are high (say, Germany) to areas where lending demand is high (say, Spain) without wasted costs. As their competitors in the US have proven, banks could even recover the profitability they have lost from low interest rates without rates going any higher.

The idea is, for now, still just that. As ever, any change will require the approval of hard-to-please European politicians vying for the approval of their domestic electorates. But the prospect seems to have already excited equity markets. A genuinely single market for banks would help to establish 'European champions' in the financial sector. And as the chart below shows, European bank stocks are the best performing of the last six months, and have outperformed global equities over that period by 6%.



As well as the drive for integration, the ECB is now taking more seriously the need for bank profitability. Higher reserve requirements are aimed at improving bank stability. But, as the era of low rates and quantitative easing has shown, banks can only be stable if they are profitable. This should give policymakers the incentive to broaden reserve requirements beyond domestic government bonds and create large cross-border banks. Whether that incentive can trump entrenched political opposition remains to be seen. But President Lagarde's ability to play the political game may well prove be a more valuable commodity than the banking instincts of her predecessors.

Growth or Value – Take Your Pick

Equity investors often deliberate over which "factor" strategy to choose from. Should you pick companies that are good "growth" stocks or "value" stocks? Do you pick "size", "momentum", "quality" or low-volatility"?

Such factors are observations about companies' financial metrics (generally, relative to their share price) rather than about their business line (their "sector"). Companies usually display the characteristics of more than one "factor". We won't go through all of them here, but it's worth exploring the two factors that are most complementary.

Growth stocks – as the name suggests – are companies expected to produce better-than-average sustainable growth in earnings. As such, their share price tends to be high relative to their current earnings. It's the earnings in five years' time that matter.

Defining value stocks can be more of a mixed bag. Sometimes they can be valued on balance sheet assets (the "price-to-book value"). An alternative is to look for strong cash flows. The many different definitions seem to lead to stocks that show reasonable but lowish growth in future earnings. The 1992-3 work done by Eugene Fama and Ken French (updated in 2015), which concluded that stocks with a low price (relative to the balance sheet "book value") showed better long-term investment performance than the general market. It is possible to find companies that seem to be both "value" and "growth" at a point in time, but they tend to gravitate towards one of these two factors over time.

There is, of course, plenty of debate about the relative merits of each style. But one thing everyone can agree is that, over the last decade, value has had a bad run. The difference in valuations (price-to-earnings ratios) between value and growth stocks in the US is now almost as high as it was at the height of the dotcom bubble.

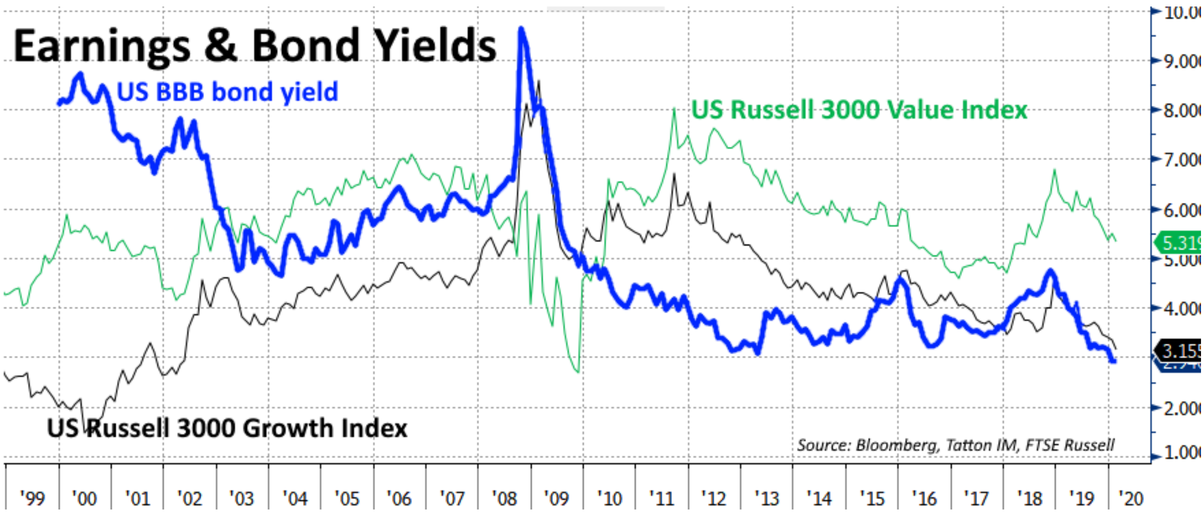
From our point of view, one of the most important things to point out is that the stellar performance of growth stocks around the world is hugely distorted by the presence of the US mega-cap technology companies. The FAANG stocks (Facebook, Amazon, Apple, Netflix, Google – now "Alphabet") have racked up incredible earnings growth and share price performance over the last couple of decades. They are the largest companies in the world, and it is questionable whether they should even be considered in the same category as traditional smaller growth stocks.

Nevertheless, the outperformance of growth over value needs exploring. And again, there is little agreement on the reasons for this. Some point to the fact that value stocks tend to do better towards the end of the economic cycle, and the current one has been going on for over 10 years but is not (yet) showing signs of ending. Others suggest the Fama-French discovery of the 'value effect' caused investors to cancel it out by investing more heavily in value stocks, thus turning the potential excess return to a negative.

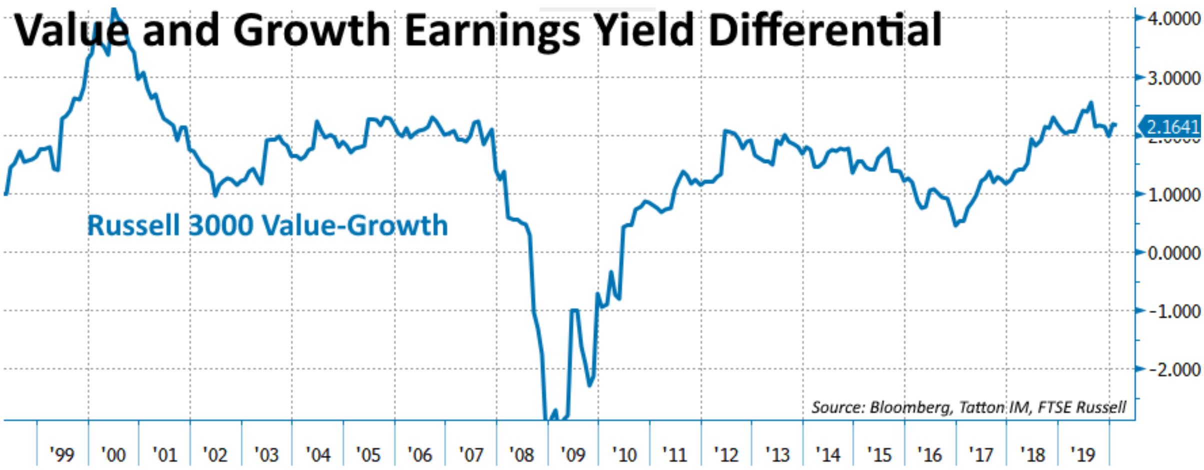
The standard way to think about equity valuation is in terms of the ratio of price over earnings (the P/E ratio), which effectively tells you how 'expensive' a stock is. As written before, on this basis equity valuations have become extremely stretched (to multiples above where they were in 2015, before the sizeable stock market correction of Q1 2016). Some of the top US tech stocks look uncomfortably expensive on this basis (especially Amazon and Netflix), similar to levels not even seen since before the bursting of the dotcom bubble in 2000.

We prefer the inverse of this ratio, earnings over price. This gives you the 'current yield' or 'earnings yield' of a particular stock. When comparing growth and value stocks, and assuming you held the stocks forever, the difference in yields tells you how much extra the growth stocks need to grow earnings in order for them to equal the value stocks.

The US Russell Indices have growth and value indices drawn from the top 3000 public companies (by market capitalisation). The earnings yields for both has moved somewhat in line with corporate bond yields.



The interesting thing to note is that, looking at these, the difference in earnings yields between growth and value have not actually changed that much over the last decade. It was around 2% before the financial crisis, after which yields for both growth and value soared (since prices sank).



After a decade of extraordinary monetary policy, yields on all assets have sunk due to the financial system being awash with cash. But throughout all of that, the effective yield difference between growth and value has stayed at around 2%. This suggests that, despite the gulf in price performance, market expectations about the expected outperformance of growth companies (in terms of fundamentals) has not changed all that much.

What has changed – since markets are swimming in liquidity – is that the returns investors require (the risk premia) are lower. Naturally, this increases prices for stocks with lower yields (i.e. growth) more than it does those with higher yields (i.e. value). The excess growth of growth companies over value has not changed much; growth companies just started at a lower yield.

What does this mean for the future of value investing? It is a little simplistic to compare current valuations to past episodes, highlight worrying comparisons and thereby declare a shift from growth to value is on the cards. Given accommodative central bank policy is still pegging yields down across the globe, we suspect the growth outperformance may have some way to go. But what is worth pointing out is that the current yield difference – with growth companies effectively needing to grow by an excess of 2% to beat their value peers – is a hard one to sustain historically. In terms of earnings-per-share, long-term excess growth is around 1%.

It will be especially hard for those companies that are growing at the expense of other players. No matter how massive the mega-cap techs are, they employ nowhere near as many as the companies they displace. In the current political environment, the techs may find the regulatory environment to be much tougher.

That suggests that growth stocks are punching above their weight somewhat. But as with everything in the low-rates QE world, the extreme levels of liquidity around make these effects difficult to judge. History would suggest that a return to value has to come sooner or later, but with financial conditions as they are, we don't have much to go on in terms of when that will be.

As a consequence of this, we will continue to apply the investment strategy that has prevailed as the most successful for long-term investors: Disregard the shorter-term hypes and diversify widely across all segments of capital markets, while being mindful not to be dragged into overweighting those sectors that had the most successful run over recent times.

Global Equity Markets

Market	FRI 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7420.4	-0.6	-46.3	↘	→
FTSE 250	21736	1.1	237.0	→	↗
FTSE AS	4138.3	-0.3	-12.9	↘	↗
FTSE Small	5982.8	0.0	2.7	→	↗
CAC	6073.0	0.7	43.2	→	↗
DAX	13740.7	1.7	226.9	↗	↗
Dow	29408	1.0	305.2	↗	↗
S&P 500	3375.9	1.4	48.2	↗	↗
Nasdaq	9615.7	2.3	214.6	↗	↗
Nikkei	23687.6	-0.8	-186.0	→	↗
MSCI World	2429.9	1.0	25.1	↗	↗
MSCI EM	1106.1	1.3	14.4	→	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
NMC Health	8.7	Centrica	-15.3
Barratt Devts	8.4	GVC	-6.1
John Wood	7.9	Ocado	-5.3
Taylor Wimpey	6.0	AstraZeneca	-4.4
Persimmon	5.9	RBS	-3.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.302	1.0	Oil	57.09	4.8
GBP/EUR	0.834	1.8	Gold	1582.2	0.8
USD/EUR	1.09	-0.8	Silver	17.76	0.4
JPY/USD	109.74	0.0	Copper	259.7	1.7
CNY/USD	6.99	0.2	Aluminium	1748.0	0.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.61	+0.04
UK 15-Yr	0.84	+0.03
US 10-Yr	1.57	-0.01
French 10-Yr	-0.17	-0.03
German 10-Yr	-0.41	-0.02
Japanese 10-Yr	-0.03	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.7	18.8	13.5	13.3
FTSE 250	3.7	24.8	15.3	14.3
FTSE AS	4.5	19.8	13.7	13.4
FTSE Small	3.4	298.8	-	13.9
CAC	3.0	22.7	15.1	13.5
DAX	2.9	26.3	14.8	12.5
Dow	2.2	20.9	18.6	15.0
S&P 500	1.8	22.3	19.4	16.0
Nasdaq	0.9	29.3	24.4	18.1
Nikkei	1.9	20.5	18.4	17.1
MSCI World	2.3	21.1	17.9	15.3
MSCI EM	2.6	15.5	13.2	11.9

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	2.51	2.48
2-yr Fixed Rate	1.45	1.45
3-yr Fixed Rate	1.59	1.57
5-yr Fixed Rate	1.69	1.69
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.28	4.28

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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INVESTMENTS LIMITED

17th February 2020

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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