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CHARTERED FINANCIAL PLANNERS

SKERRITTS VIEW – JULY 2019

"That'll Never Happen" Chapter XIV:

Regular readers will know that, since 2008, we have been consistently using the phrase "that'll never happen" as a tool to forecast what is likely to happen at some point in the not too distant future. It has been spookily accurate. At the very least, it has acted as a warning to expect the unexpected. It should have been no surprise, therefore, when Woodford Investments saw its funds seize up in an illiquid log jam as redemptions eroded the large cap stock within the portfolios and began to eat into the smaller stuff that had always been lurking at the foot of the funds' factsheets. Presumably, any professional investor that was still invested in the funds, or who still had clients invested in them, had done so on the basis that such a situation "would never happen". One adviser known personally to the author was heard to often justify their investment recommendation on the basis that "no-one will ever get sacked for recommending Woodford." Make no mistake, Neil Woodford did not suddenly "lose it" as a fund manager. His funds fell victim to the changing environment that we have been continuously highlighting since the 2008 Financial Crisis. More of this later.

"That'll Never Happen" Chapter XV:

Hot on the heels of one chapter comes the next. Imagine a fund group called H2O suffering from illiquidity. That'll never happen. A bigger concern on the Continent than it was in the UK, it nevertheless caused some discomfort when some H2O funds suffered several billion of redemptions in just a few days due to some less than liquid holdings causing angst among its investor base. Liquidity is being far more recognised as a potential problem in daily traded funds and the mere whiff of a problem causes a stampede for the exit, which in itself can fuel further issues. Such behaviour is classic late cycle fare and should act as a warning for what may lay ahead when the panic spreads from being a proportionately small sample to millions of people all wanting out at the same time. The bottleneck will be far too small to allow everyone out at once, particularly if they've all bought the same thing due to cost and duplicated investment "processes". It's not worth worrying about though. Why? Because that'll never happen.

It Feels Like The 1990s – Revisited:

We make no apologies for going over previously trodden ground yet again by mentioning how very like the end of the 1990s it currently feels (for those who remember). This time it is the problems faced by Woodford that brings back memories. The last time that it was widely touted that he had "lost it" was in 1999 when his funds (then under the Perpetual banner) suffered a similarly prolonged period of underperformance against the backdrop of a largely tech-driven bull market. What has changed dramatically since then is today's short termism. Back then, it was quite difficult to buy and sell funds as it necessitated a fair amount of form-filling, postage, and other time-consuming activities. Also, it was the time when one only received an annual valuation unless you actually phoned someone up to get a more current one. The consequence was that despite the

underperformance, not so many people actually knew about it unless they read the financial pages of the Sunday newspapers (remember them?) and even fewer could be bothered to do anything about it. Nowadays, the longer term doesn't exist with online access to valuations and dealing, quarterly statements and daily saturation from various online media sources. The longer term now equates to around 9 months. The long term now is made up of a series of ever shorter term horizons. Woodford, today, suffered from the consumers' consuming short termism. He ran out of time.

So What Of The Short Term Now?:

In the immediate short term, it appears that a major risk has (at least temporarily) been avoided with the US and China dialling down on the Trade War rhetoric. No deal was struck at the G20 meeting as such, but at least things didn't get worse, which means the market thinks things got better! The Federal Reserve has surprised most people by performing an about turn from a rate *rising* trajectory to a rate *cutting* one. Central banks around the world are also in easy mode, which has seen bond yields tumble too. This scenario is normally supportive for equities and the S&P 500 has been nudging all-time highs accordingly.

All is not completely rosy though. Just because interest rates and bond yields have come down, and seem set to stay low for a while yet, it doesn't mean that it's a one way street for equity prices. If it was as simple as just having low rates and bond yields to raise prices, the Japanese market would be through the roof by now. It is the ***rate*** of decrease that is important, and having fallen so low so quickly, it is becoming mathematically impossible for bond yields to continue this move, flagging a warning sign for over complacency.

It is also a fact that the path to higher rates is paved by lower rates, and when rates and yields start to rise again, things could turn ugly. Will this be in the shorter term or longer term? That depends upon your definitions. Peter Berezin, Chief Global Strategist at BCA Research, sees the first accommodative stage as continuing most likely through to late 2021 and calls this "heaven" for risk assets. However, the second stage which will most likely see the Fed raising rates more aggressively to combat the consequential rise in inflation will, in his words, be "hell".

For those who remember 1999, interest rates turned lower from their upward trajectory after the market fell by 22% in 1998. Compare this to the behaviour now of the Fed after our own 20% correction at the end of last year. The market in 1999 set off on a last hurrah in that bull market, with investors gaining more than 60% in their 90s Heaven. Schroders recently released a piece of research which suggests that investors today ***expect*** an annual return of just under 10% from their investments. Guess what? Back in 1999 I attended a conference where it was reported that investors in the US were ***expecting*** annual returns of around 15%. Investor Hell then arrived in the shape of a stock market crash that saw the technology sector fall by 85% and the general market fall by 40%-55% depending upon where in the world you were invested. The good news is that, if Berezin is correct, we won't find out what our version of Hell will look like for a while yet.

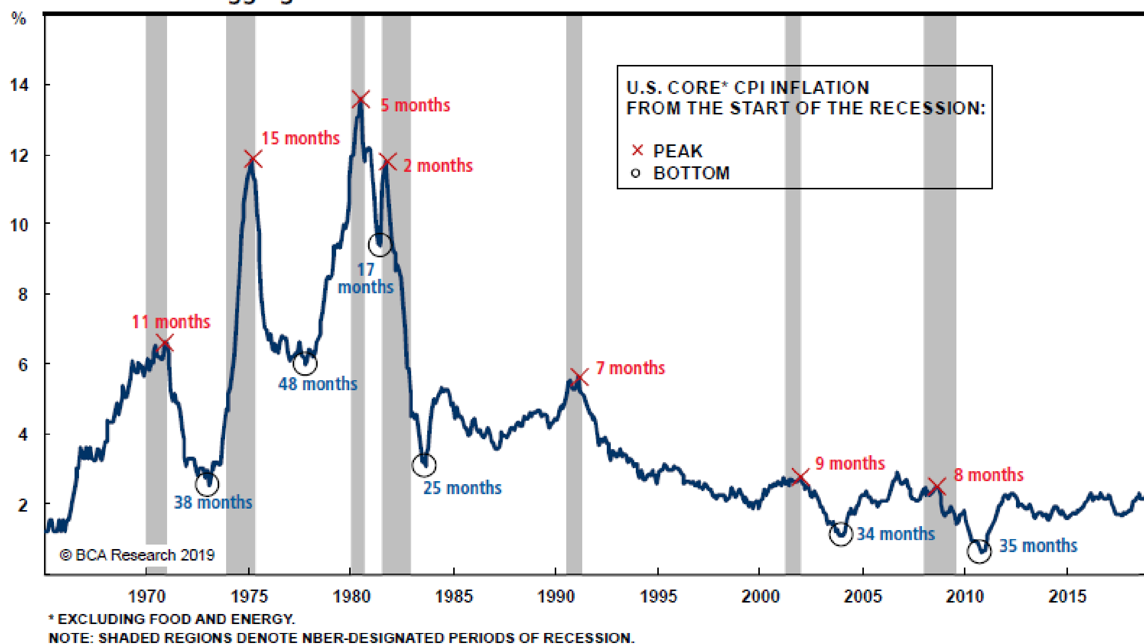
The Key Is, When Will It Turn?:

The key question is, if indeed it does turn ugly, when will this be?

The answer, of course, rather unhelpfully, is that we don't know. We can look for clues though. Inflation, at the moment, looks non-existent. The bigger threat appears to be the world going into a

deflationary spiral. However, there is a clear danger, in our opinion, that the risk to the oil price rising is being underestimated by the market. Two oil tankers being set alight in the Gulf of Oman is getting very close to the Strait of Hormuz (you'll have to check the map) and if the Strait of Hormuz is closed by Iran this will most likely trigger military intervention by the US (more than an unmanned drone will be at risk if this occurs). If the supply of oil is disrupted through the Strait of Hormuz, and depending upon how long this may last, global growth would take a hit and the oil price could go stratospheric. This is inflationary. But then again, that'll never happen.

If indeed this does not happen, inflation may take a more sedate route back onto the scene. Inflation itself is a highly lagging indicator and, from the chart below, can be seen to not peak until a recession has begun and does not bottom until subsequent recovery is well underway.



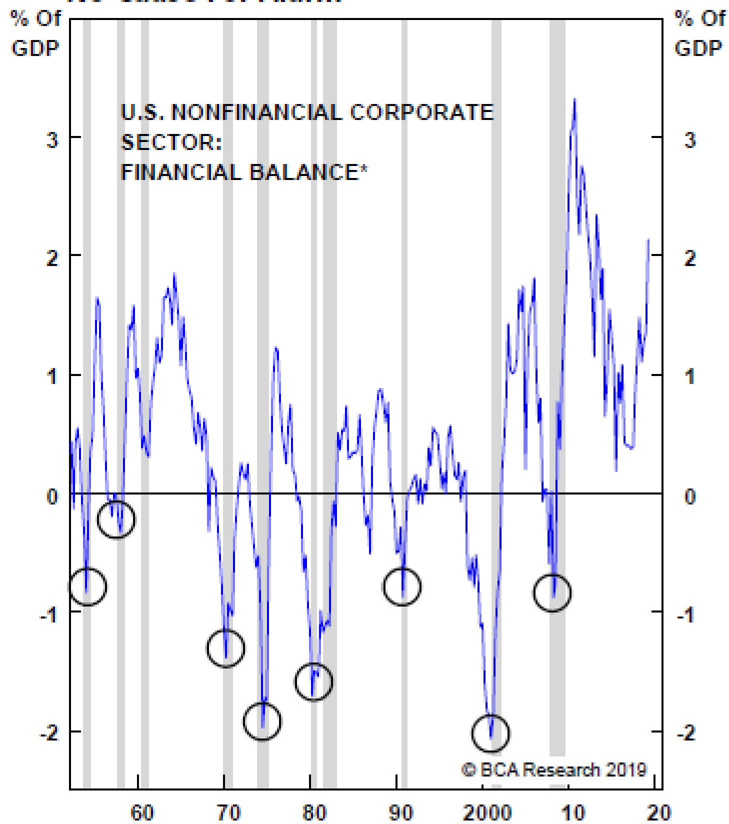
This then begs the question, is a recession looming?

If you look at the next chart below, it is very clear that every recession (in the US) in the past 50 years has begun when the corporate sector financial balance was in deficit, and it is equally clear from the same chart that it is currently nowhere near in deficit today. So, in the absence of a shock in the form of tensions blowing up (literally) in the Middle East, or an all-out Trade War, it would appear that we have some time to go before the aforementioned may come to pass.

This uncertainty is why we chose to manage all of the VT Esprit funds on a non-benchmarked basis and why they each sit in the Flexible Investment sector. Flexibility will be the key to successfully navigating the choppy waters that lay ahead and we strongly believe that being allowed to invest in virtually any asset class, without being handcuffed to a benchmark or some other restrictive parameter will give us the best opportunity to deliver returns that avoid disappointing, or even scare, our investors.

We may even get our timing spot on. But then, that'll never happen!

U.S. Corporate Debt (III): No Cause For Alarm



* FINANCIAL BALANCE IS CALCULATED AS GROSS SAVINGS LESS NET CAPITAL TRANSFERS PAID LESS CAPITAL EXPENDITURES (EXCLUDING INVENTORY CHANGE).
Q4 2017 DATA POINT EXCLUDED DUE TO THE IMPACT OF THE TAX ON FOREIGN EARNINGS RETAINED ABROAD (2017 TAX CUTS AND JOBS ACT) ON CAPITAL TRANSFERS.
SOURCE: FEDERAL RESERVE (FINANCIAL ACCOUNTS OF THE UNITED STATES).
NOTE: SHADED AREAS REPRESENT NBER-DESIGNATED RECESSIONS.

These are our views and do not constitute investment advice