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Hedgeye, When markets chose to look through shorter term economic disturbance, 21 Feb 2020

Bubble trouble

Compared to last week, there have been few changes to the big picture narrative: Thanks to the virus containment efforts enacted by its government, China's labour force is only now slowly returning to work following an unusually extended Lunar New Year break. But most importantly, factories have restarted, even if at lower output levels than their trading partners would have banked on at the beginning of the calendar year. Because of the global supply chain interdependencies, and the temporary fall in Chinese demand, the resulting slowdown in industrial activity around the world is increasingly seen as a delay to the expected 2020 economic recovery. The upswing is unlikely to come in the first quarter, perhaps not even in the second, but after that activity levels are likely to jump up in the second half of the year.

In the UK, the new government's actions confirmed our view that austerity is not part of their vocabulary and that we can expect a significant boost in public investment. While much of this is expected to be debt financed, the March Budget may nevertheless bring direct and indirect tax increases, or the government risks losing trust and support from capital markets – which could ruin their fiscal expansion plans. For the moment, fiscal expansion is good news, as it will reduce dependence on export demand. However, alongside Home Office plans to curb "lower skilled" immigration, the fiscal expansion plans have the potential to create wage-driven inflation pressures. That is, unless the government can also coerce businesses into significantly hiking their investment levels to increase productivity, which have been severely lacking recently. Businesses' workers may well be attracted onto better pay in the government's infrastructure projects.

We discussed last week how markets appear willing to disregard the unavoidable deterioration of earnings prospects in manufacturing over the first two quarters in return for an enhanced outlook for the second half of 2020. This week continued along the same lines, with the US stock markets once again hitting new all-time highs. But this was not the whole story. So, we devote the rest of this piece to discussing the nature and dynamics of stock market bubbles.

Blowing Bubbles

On Thursday evening, there was a sudden rush to the exit in some of the highest valued stocks in the world. Those who have described current US valuations as being in bubble territory saw this as a vindication of their view. There was no obvious trigger for the sell-off. News wires might point to the rise in South Korean COVID-19 infection cases – but this sounds a bit far-fetched, given the spread is well within expectations from last week.

Current market conditions continue to be mostly about liquidity and investor capital flows – with near-term economic prospects looking sluggish. When market movements are dominated by liquidity flows, it tends to be related to asset bubbles. Bubbles are risky for investors because they eventually deflate, even if it may not feel that way when we are in the middle of one – most investors prefer to be part of a bubble when its inflating. At the same time, investors would like their active managers to use "timing" to get out at the right moment.

Bubbles inflate when most are getting in, but during this phase, some market players try to lessen the risk by "scalping": buying and then taking a quick, smallish profit. That has the effect of increasing trading volumes and lessening daily volatility. Prices squeeze upwards rather than gapping up. (There are also other reasons for low short-term volatility, related to options trading).

It does not work like that on the way down. Signs of more than expected intraday volatility, as seen on Thursday evening, can be a signal for the longer-term timers to exit. The number of buyers in this sort of market can fall quickly to virtually none.

Of course, short-term volatility is used by many as a primary measure of investment risk. So, the riskier phases in markets can seem like the least risky, which leads back to what we said above, that the riskiness of a bubble building is usually not immediately apparent during the process.

So, are the bears right that a stock market bubble is building, one that will inevitably end in another enduring market correction later in the year? We do not think so – although even we cannot be entirely sure. What we do know is that current market action is ignoring the fact that Chinese and international virus containment actions will lead to lower than anticipated growth rates during the first half of 2020. Should expectations for the virus impact prove correct, and COVID-19 follow similar patterns to flu pandemics of past decades, then a V-shaped recovery later in 2020 is a reasonable expectation. In which case, company earnings should underpin the levels stock market valuations have reached in anticipation of such an outcome.

The discomfort of this market environment is that any bouts of doubt about the benign scenario unfolding leads to potentially outsized market reactions. Such effects can be as short-lived as they were this week, but also slightly longer lasting, as experienced last year in May and August.

Indian slowdown

The Indian economy is going through a rough patch. That may sound odd to say about a country that has racked up high single-digit growth for a decade – and has now leapfrogged the UK to become the world's fifth largest economy. But those impressive stats mask some growing pains. Ratings agency Moody's estimates that India grew around 5% in 2019 and has now slashed its 2020 forecast to around the same figure – a marked decrease from the 6.6% predicted previously.

Of course, 5% GDP growth is not to be sniffed at. But given India's status as a world-leading growth superstar, signs of deceleration are worrying. Government officials have acknowledged as much – though have suggested the green shoots of a recovery are already visible (something forecasters don't yet agree with). Over the past two years, India has been subject to the many wider issues affecting emerging markets: trade tensions, a slowing of the Chinese powerhouse and a strong US dollar. But these issues have been coupled with what are ultimately self-induced problems.

Broad stock market development for India since 1 Jan 2018, Source: Morningstar, 21 Feb 2020

India is often grouped with China as a prime example of a growth-intensive, densely populated emerging market. But comparisons to China are somewhat misleading. China is a highly-developed (by emerging market standards) state-driven economy run by an extremely powerful central body capable of rolling out common policies across the country. India is effectively a collection of disparate states, each with their own policies, political issues and developmental worries.

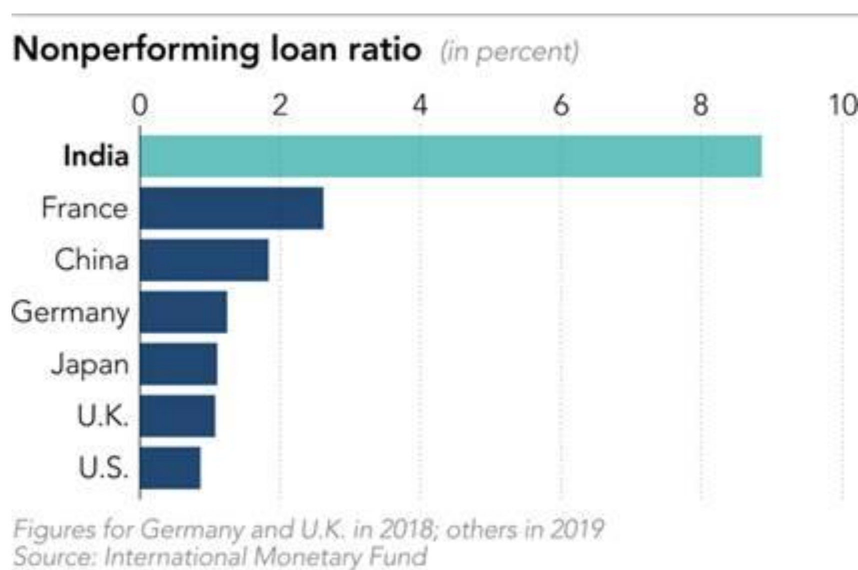
The economic reforms initiated by the Modi government are, at heart, about addressing these issues. Institutional weaknesses need to be addressed if India is to become a leading global player. But reforms have come with teething troubles, uncovering even more deep-rooted concerns.

The four major reforms of the Modi era are: insolvency and bankruptcy code; financial inclusion; goods and services tax; and the direct benefit transfers system. The changes to bankruptcy law are the most important for investors in immediate terms. They aim to unify the country under a single rule, creating big incentives for proper governance, allowing the legal system to deal more efficiently with failing companies and removing corrupt owners (by preventing them from buying back their businesses after bankruptcy).

In terms of financial inclusion, most still remember the government's hugely disruptive (some might say almost disastrous) 2016 removal from circulation of all the 500 and 1000-rupee notes. But as a result, there are now 1.1bn bank accounts in the country, and 99% of all households have access to a bank account. Similarly, the goods and services tax (GST) came in for much criticism when it was implemented in 2017, but few can deny that, while not perfect, it has improved India's old patchwork of different state tax regimes. To add to this, the direct benefit transfers system has given the country a de facto social welfare system, with benefits and subsidies being deposited directly into recipients' accounts. It is estimated to have saved the government around 0.5% of GDP in the 2018 financial year.

It has been far from smooth sailing, however. Financial reforms have exposed just how weak India's financial system is, which was highlighted by the fallout from demonetisation. The ban on high-value notes was intended to flush out the country's black market, but the main effect was that cash, previously held physically in households, flooded into the banking system. Unfortunately, the banks did not know what to do with the sudden surplus funds. Shoddy lending standards encouraged the money to flow to shadow banks, which then lent it on in an even less controlled way.

By 2018, regulators were tightening oversight on shadow lenders, but were unaware of the fragility of these institutions. India's non-performing loan ratio then spiked, leaving it at an uncomfortable level – as shown in the chart below.



This led to increased defaults, such as the high-profile case of Infrastructure Leasing & Financial Services. That shook India's bond market back in 2018 and abruptly stopped the flow of easy money. Individual borrowers in rural villages suddenly found themselves without access to finance. A credit crunch ensued, and is still ongoing, in large part causing the economic slowdown.

Growth in loans to the nonbank sector has now fallen to half of its 2018 peak, according to data from India's central bank. Srei Infrastructure Finance, a listed non-bank lender, is planning to halt its lending for infrastructure projects. This has only exacerbated bad debt problems following years of careless lending. The amount of debt at listed companies struggling to make interest payments has doubled over the past decade to more than one-fifth of the total, according to a report from Nikkei. This suggests there may be

more non-performing loans lurking below the surface. For example, nearly 300 auto dealerships have closed since 2018.

Non-performing loans accounted for 8.9% of overall bank lending in India last year – and the ratio has risen more than 5% in five years. That is the biggest increase of any G20 countries, according to the IMF. The discretion for banks and authorities to judge what counts as a performing loan makes it difficult to tell the real ratio of non-performing loans, but Nikkei's analysis suggests it could be as high as 21% of all the debt of listed Indian companies – against a global average of 4.3%.

India stands at a crucial juncture. There is some truth to the government's optimistic message – especially if the global economy picks up around it. Last month's rise in both manufacturing and services Purchasing Manager Surveys (polled in January) suggests that 2020 could be strong. But the expected pick-up in domestic and external demand now needs to materialise. If it does, the outlook for India and its stock market will brighten. In which case, there would be a lot of upside in both the stock market and currency.

Despite frequent appeals, India's government has been rather flat-footed in getting to grips with financial system problems, preferring to address issues that please Hindu nationalists (like Kashmir) rather than the economy. Meanwhile, tax revenues that had been expected to improve following the 2016 "demonetisation" have disappointed, leaving less room than hoped-for government investment stimulus. Lastly, consumer goods inflation has reappeared, hampering the Reserve Bank's ability for monetary stimulus to move rates lower after cuts during 2019.

At present, the crucial second phase of the reforms that Modi introduced last term seem to be lacking. COVID-19 related activity restrictions are not helping any emerging market economy in the near-term. Investors appear to be side-lined for the moment, leaving India seeming too heavily handicapped to feature among potential emerging market winners this season.

Are trackers 'killing' the active management stars?

This year has already seen a flurry of mergers and acquisitions in the asset management industry. In the UK, following the Q4 2019 merger of Premier Asset Management and Miton, this week we learned Jupiter intends to buy Richard Buxton's Merian. In the US, a much larger deal was announced with the friendly takeover approach of Legg Mason by Franklin Templeton, which will have combined assets under management of around $1.5tn.

Active managers have been swimming against the current for some time, as mounting regulatory burdens have increased costs, while passive investment funds have been chipping away at client bases. Low-cost index tracker funds are becoming increasingly popular, for several reasons.

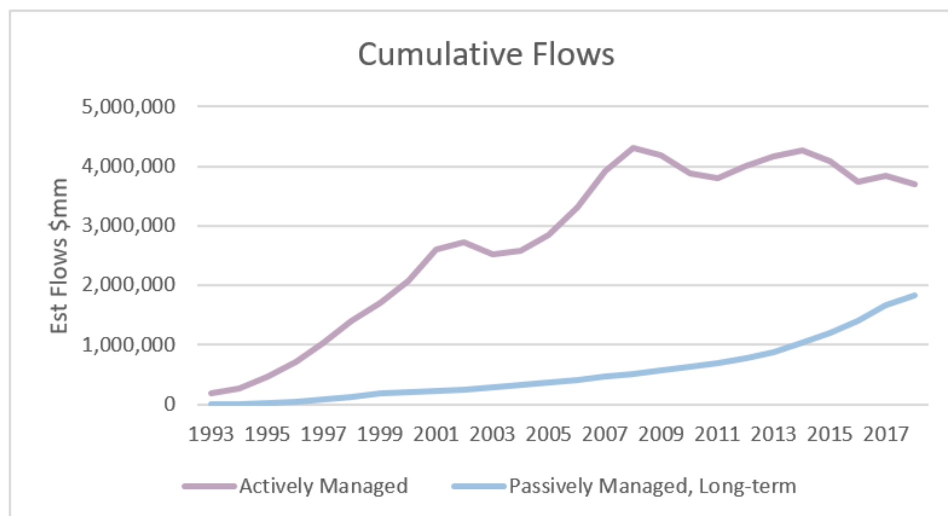
As discussed before, active management is potentially a zero-sum game. Since the bulk of stock markets are dominated by institutional investment managers, a passive tracker fund effectively mimics the average performance of all active managers combined. So, if one active manager is outperforming, there must be another underperforming – and that's before fees. Market and cost-beating investment strategies that are fund based are therefore just as dependent on skilled (paid) manager selection as success in individual asset classes is dependent on skilled (paid) stock picking. Over the past two decades, a lot of DIY and low-cost investors have reduced the fees required by switching to lower cost passive options. The switch has also

eliminated the risk of picking managers that deliver "market-minus", rather than "market-plus" returns – by being satisfied with market-minus just the fees of the investment.

This has been exacerbated by the creation of passive or near passive "smart beta" and other factor-based products. As investors have grown more sophisticated in their analysis, and begun decomposing returns of popular managers, they have learned that a lot of claimed outperformance (alpha) was down to persistent style tilts in portfolios, such as small cap, quality, value etc. (style beta). Armed with that knowledge, they have flocked to cheaper vehicles that replicate the headline-style characteristics of such portfolios (hence smart beta), without the nuance of the individual stock-picking.

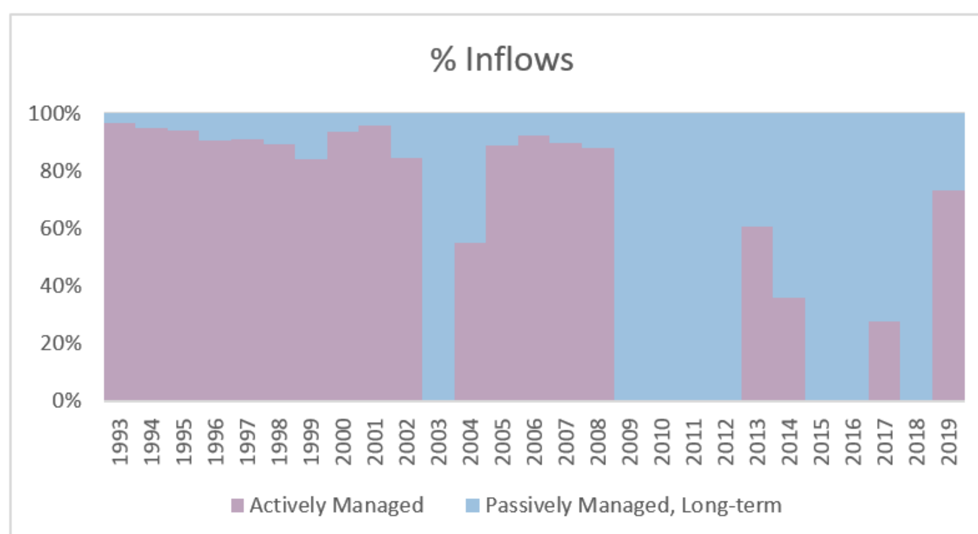
This alone would be enough to keep many asset managers awake at night, but there is more. When large enough, these flows, can drive performance and overwhelm rational investment decision dynamics at the individual stock level. Basically, the largest companies around get bought most, almost regardless of what a qualitative assessment might tell traditional investors with less of a blanket-style approach. This performance can then drive further flows, and so on. This is not the death knell for active management, but any managers whose investment processes didn't lend them towards the characteristics of the very largest companies in the world will have struggled in broad terms.

The resulting redrawing of the investment landscape has been ugly for the stock-picking industry. Passive funds have captured an increasing amount of inflows. Below are some data from the US Open Ended fund market. As you can see from the chart showing cumulative inflows to active and passively managed funds, as active managers have seen assets stagnate, passive flows have ramped up.



Source: Morningstar Direct

This next chart shows the % of inflows taken by passive strategies. A handful of "100% passive" years are a result of net outflows from active managers in that year.



Source: Morningstar Direct

Is it any wonder when faced with these types of pressures that active investment management companies have been looking to consolidate? Or that private equity funds have seized on an opportunity for a 'buy and build' strategy in an environment more likely to drive smaller companies out of business, or at least compress margins?

The logic here is that almost all asset managers can share operational platforms and benefit from economies of scale with service providers. There are also major opportunities for cross-selling of a wider range of products to a broader range of clients across more regions. These large integration and operational rationalisation projects are obviously far more easily said than done. Much depends on whether there are disparate operations for "multi-boutique" managers, or a smaller number of much larger systems. And as ever, mergers bring uncertainty for some employees.

We hope these and future mergers are well-executed, providing stability for teams that matter to investors, and ideally cost savings at the end of the road for clients. However, it is also possible that consolidation and increasing efficiency is the only way to make the asset management business viable at current fee levels. Fees have been steadily decreasing under the pressure of passive products and the bundling of purchasing power, particularly following the rise of model portfolio managers – like Cambridge. Perhaps we are coming to the end of the era of standalone, yet fully-formed boutique managers.

CAMBRIDGE INVESTMENTS LIMITED

24th February 2020

Global Equity Markets

Market	FRI 14:30	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7421.3	0.2	12.1	⬂	→
FTSE 250	21844	0.2	54.2	→	➚
FTSE AS	4142.5	0.2	7.5	⬂	→
FTSE Small	5999.2	0.2	14.2	→	⬀
CAC	6048.7	-0.3	-20.7	→	➚
DAX	13655.5	-0.6	-88.7	⬀	➚
Dow	29104	-1.1	-319.1	→	➚
S&P 500	3373.2	-0.0	-0.7	➚	➚
Nasdaq	9580.4	-0.2	-15.3	➚	➚
Nikkei	23386.7	-1.3	-300.8	→	➚
MSCI World	2420.2	-0.5	-11.2	⬀	➚
MSCI EM	1095.3	-1.0	-11.0	⬂	⬀

Top 5 Gainers

Company	%
Centrica	11.7
NMC Health	11.2
Flutter Ents	7.4
Fresnillo	6.3
InterCont'l Hotels	6.1

Top 5 Decliners

Company	%
Burberry	-6.0
Imperial Brands	-5.8
TUI	-5.2
British Land	-4.9
HSBC	-4.1

Currencies

Pair	last	%1W
USD/GBP	1.294	-0.9
GBP/EUR	0.836	-0.7
USD/EUR	1.08	-0.2
JPY/USD	111.91	-1.9
CNY/USD	7.03	-0.6

Commodities

Cmdty	last	%1W
Oil	58.08	1.3
Gold	1641.1	3.6
Silver	18.50	4.3
Copper	259.4	-0.7
Aluminium	1711.0	-2.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.7	20.0	13.5	13.3
FTSE 250	3.6	24.6	15.3	14.3
FTSE AS	4.5	20.9	13.7	13.4
FTSE Small	3.4	353.4	-	13.9
CAC	3.0	22.5	15.1	13.5
DAX	2.9	25.7	14.8	12.5
Dow	2.2	20.7	18.4	15.0
S&P 500	1.8	22.3	19.4	16.0
Nasdaq	0.9	29.3	24.3	18.1
Nikkei	1.9	20.6	18.3	17.1
MSCI World	2.3	21.1	17.9	15.3
MSCI EM	2.7	15.2	13.2	11.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.58	-0.05
UK 15-Yr	0.79	-0.07
US 10-Yr	1.49	-0.10
French 10-Yr	-0.21	-0.06
German 10-Yr	-0.44	-0.04
Japanese 10-Yr	-0.06	-0.03

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	4.27	4.27

* 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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