

## Holland Macro Views

### Met many bulls lately? (Revisited)

The above was the title of a note we penned last autumn when, like now, an all pervading gloom seemed to surround equities and markets. In an effort to even up today's debate we make a few positive observations and try to offer a little perspective. Your author sums up by finding himself in the most unusual position of his career – i.e. For the first time in almost 20 years realising that he is more bullish than many others he speaks to about the prospects for many equity investments.

#### Dare to think bullish thoughts

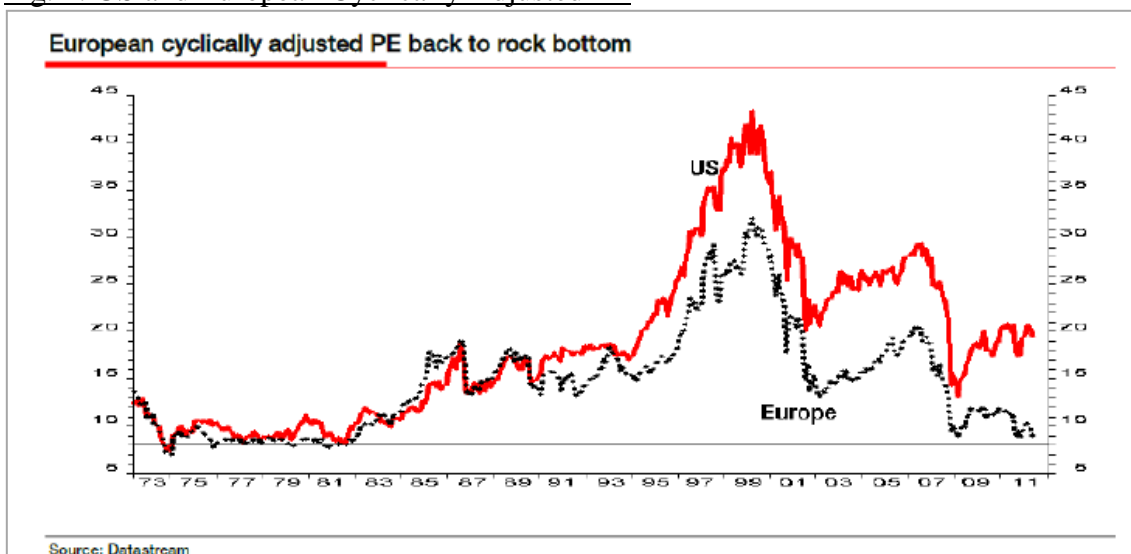
*“Panic of the Headline writers: When 2 year German Bunds are priced to yield less than nothing and Martin Wolf, the cerebral financial Times columnist counsels panic (as he did only last Wednesday) an enlightened opportunist may begin to allow himself to think of the upside”* – This is was how Grants, a publication that has helped us and many others see the economic wood from the trees in the last 10 years, put it 2 weeks ago - we are strongly inclined to agree.

#### Reasons to be Cheerful: 1, 2, 3

Below we list a just a few things that might cause encouragement:

- The Chinese stock market is on its lowest price book ratio for 20 years. This market also looks very cheap when measured against GDP/GNP - A guide to market valuation Buffett and others have used in the past.
- The European stock market Cyclically adjusted PE is the lowest it has been since 1981

Fig. 1: US and European Cyclically Adjusted PE



Source: Societe Generale

## Reasons to be Cheerful: Continued

- US Housing :
  - 25% of US housing transactions are now bought for cash (likely by investors)
  - In 2009, 2010, 2011 35-40% of housing transactions were classified as ‘distressed’
  - US house prices are down 35% from their peak
  - In some cases these houses can now be bought for less than half replacement cost - they also again look cheap when judged against multiples of average income
- The US stock market cyclically adjusted PE suggests stocks are averagely priced
- Pension fund allocations to Equities as an asset class are back to where they were in the 1950’s (Towers Watson)
- US Equities yield more than 10 year bonds for only the second time since 1955 (Robert Shiller)
- ‘The Death of Equities’ is being widely discussed again not just in a contrarian way, but it seems with real feeling from many observers
- Flows into Equity funds are back to the low levels seen during 1990s and are a fraction (10-20%) of the flows into Bond funds (FT)
- Equity issuance is at multi decade lows across the world (Citigroup/FT)

## Some perspective

- The great John Templeton said: *“A sign of the coming bull market in 1980s was corporate M+A activity and company buy backs”* - We are seeing plenty of both today
- This spring Buffett wrote: *“if the S&P 500 should put together a five-year winning streak (which it may well be on its way to doing as I write this)”* No one expressed surprise at this comment...Why? Because markets were then rising steadily - but is the world so different only 3 months hence.
- Recently a well respect US PM said *“you can either have stable, predictable markets or you can have cheap share prices , you don’t get both”*
- Templeton: *“Buy at point of maximum pessimism, when there is blood on the street.”* He never mentioned the need to second guess policy makers in far flung countries like Greece!

The Death of Equity type talk must be fun for the likes of Buffet, Rothschild and other older investors to listen to as they have seen it all so many times before, and yet in the last 100 years the capital structure of companies and the split of who legally gets what of a company’s spoils, between bonds and equities, has not changed a jot. This we reflect on as the FT concludes its ‘capitalism in crisis’ series. We observe capitalism as resiliently unchanged. There is also concern expressed at the weak markets for IPOs and that this is in some way a sign of poor health for Equities - as non IPO buyers we see it as a sign that clearing prices are too low (i.e. cheap) for sellers to want to sell and buying appetite is low - i.e. Markets might be cheap and low in confidence, rather than concerning.

## Maybe Baby

We offer a few thoughts on what might be for those inclined to consider that the glass could be half full rather than half empty:

### China

China we suggest is not the basket case many in the west are so concerned of. Many who are more local to that market seem far less concerned for it’s’ prospects than do western observers, who in truth have always mis-trusted the Chinese economic miracle. The attached links offer a

contrary view which we continue to consider valid. These suggest amongst other points that the over reliance on capital spending for growth may be miscalculated. We also observe that many Chinese policy actions of late were just the sort of ones the US/UK could have done with c.1997 or 2004 (i.e. trying to slow excessive behaviour). It is ironic that we see these as failings. <http://www.economist.com/node/21552555>; <http://www.economist.com/node/21555915>

#### [Maybe the US recovers slowly but surely?](#)

We are unapologetic bulls on the US, its stock market, housing market and even financial sector – Ray Dalio offers an interesting view as to the ‘*perfect*’(his word not ours) deleveraging we have seen so far in the US - <http://tinyurl.com/87y78h2>

#### [Size Matters](#)

Take a look at the following link if you want a reminder of the world biggest economies: <http://tinyurl.com/87y78h2>. It shows that the top 4 economies today are still: US, China, Japan and Germany. Which one do we think austerity is going to badly damage or which one looks vulnerable from this level of economic activity or asset prices? We suggest either few, or none. Two of these economies are in surplus suggesting cuts are not required and two are at or near lows be they cyclical (US) or structural (Japan). Now consider the sentiment amongst those investing in these countries equity markets - all are arguably in a bear market.

### **But it all looks so bad!**

Or does it? The headlines do, the share prices do and the news wires do. But remember with the exception of a Royal Wedding or Jubilee bad news sells really really well. Euro crisis coverage has become as wall to wall globally as once was the Credit Crunch. These days many UK or European politicians, when asked their view of the world, seem inclined to check a Bloomberg screen before they respond. Contrast these times to 2005-7 when all looked so good, share prices, headlines, consumers and politicians were all happy and spending like there was no tomorrow. Some sensible commentators (!?!) saw signs of trouble in a few issues such as:

- US and UK saving ratios at unprecedented lows
- Roaring asset prices, particularly housing
- The unsuitability of tying different speed economies together within a single currency

The difference from then to now is that 6 years ago you could not pay or beg anyone to cover one of these stories. In short, bears were dismissed as some sort of freak show in the same way bulls might be today.

Each of these issues has now come to the front and centre of the stage, but the logic as to what made someone with a long term view worry about them in the first place has not changed. So ask yourself, before you get too down about the investing world, why are so many people who never gave a thought to all these problems before so worried about them now? The reason is simple - because everyone else is. Call it herd mentality if you like or momentum investing. Either way the result is the same. When all are thinking alike the price of assets reflects this view. As an aside I found myself in deepest Yorkshire a few weeks ago where a teenager told me the financial system would collapse and he is buying gold coins when he can afford them! The bad news has travelled a long, long way it seems.

More simply put by the great man:

*“It is not that we like bear markets but we like the prices they bring”(WB)*

## Sidestep macro and create your own margins of safety

Via sensible stock selection we can avoid some of the pitfalls that come with risks such as peak profit margins or worries about financial leverage. As an example we can opt for companies that have stable margins, sell a utility like product, and who operate with prudent balance sheets. It is no coincidence that these items are on the checklists we use when seeking franchise companies. Our approach is unapologetically stolen from the great investors of the past. Each of which had to find a way to cope with all the *'this time is different'* crises that emerged in their long investing careers. They had to develop checklists too, looking for traits that would hold up against the inflationary 70's or deflationary 30's and 40's. As you read this you may respond; 'but there are no such companies left like this that are cheap enough anymore'. In some ways this is true, but each time the market worries a different list of companies are presented as cheap to us. If it were the same list every time the job would be easy.

Two summers ago we were offered Coke at a PE of less than 15x, last summer we could buy Amex & Wal-Mart for under 12x earnings and Diaego for less than 15x. Now, dare I say it, Tesco and Morrison are both offered to us for PE's of less than 10x and Greggs, JD Wetherspoon and Albemarle and Bond can all be bought for not much more. In the US Direct TV and the world largest custodian (Bank of New York Mellon) are both offered at c.10x earnings too. The other bargains we see are the safer, longer in the tooth bear market, financials. Many of these in the US are offered at the same discount to tangible book or PE's that was thought crazy cheap at the bottom of the market in 2009. Finally what about a US house?

## The reluctant optimist

And so it is your author finds himself a reluctant optimist. Remaining mindful of the global deflationary threat as he has been for years, and worried that long held fears of EU break up become real before our eyes. Worried too, of course, by the seemingly never ending money printing that arrives with every bump in the road. Other facts encourage us however. We live in a world where the big economic powers that matter don't want war with each other; where large developing countries nearly all want democracy and capitalism, where some of the biggest excesses of speculation have now been purged. We have also stress-tested capitalism in the last 5 years and yet importantly none in the battered US economy suggest any other system - an impressive feat. Finally we see an investment world where some assets that we like and understand look very cheap not just relative to others but in absolute. In sentiment terms, unlike nearly all the other times in authors investing career where he found himself seemingly the perma bear, now he is more 'bullish' than many others he speaks or listens too.

A warning....said author was years too early in his warnings of a US housing and consumer collapse, years too early in worrying about Spain and the EU and 10 years too early (and still counting!) in warnings of the UK housing bust that never came (yet). His only hope is that markets take less time to bottom than bubbles do to burst.

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