

Holland Macro Views

All hands to the Fiscal Pump

It is interesting to watch economic theories evolve over time and the advocates of each approach gradually change their view. Normally, interest rates rise and an economy slows then rates fall and it recovers. The exact drivers of each slowdown and then reacceleration are often not identifiable as the inflection point happens too fast – not this cycle it seems. Five or so years ago we were told emphatically by many right of centre, financially-well-informed politicians that we had to ‘live within our means’ and ‘move toward a more balanced budget, cutting expenditure was our ‘only option’.

In a surprisingly short period of time this mantra has been seemingly forgotten. In the current US election race the debt burden hardly gets a mention and the only policy both candidates seemingly agree on is the need for more fiscal stimulus likely by way of infrastructure spending. The UK political consensus has quickly moved in this direction also, as it seems have central banks: Mark Carney recently observing that low interest rates suggest that a ‘fiscal spending plan is justifiable’. Many Monetarists have now morphed into Keynesians.

Policy on the hoof 101?

Whilst on the one hand this gives investors a clearer sign of what direction economic policies are now moving in, it should also serve to illustrate how little those we listen to for leadership really know about the ‘economic machine’ as Ray Dalio calls it. Is this policy on the hoof 101: ‘X’ did not work, so let’s try ‘Y’? Whilst we can see reasons to worry at a global level if such a spending policy fails to stimulate growth we are still not inclined to the global longer term Armageddon view many find compelling. Indeed maybe a fiscal boost, which would consume a lot more labour and materials than a QE one, is exactly what many economies need for a little stronger growth and a little higher inflation. The bears of such a policy should remember also that it is very different building the infrastructure that a growing economy desperately needs (such as new tunnels, roads and Airports in the US), to the ‘bridges to nowhere’ policy of say Japan. Lastly, such a fiscal plan will likely keep animal spirits alive in markets and economies.

Productivity

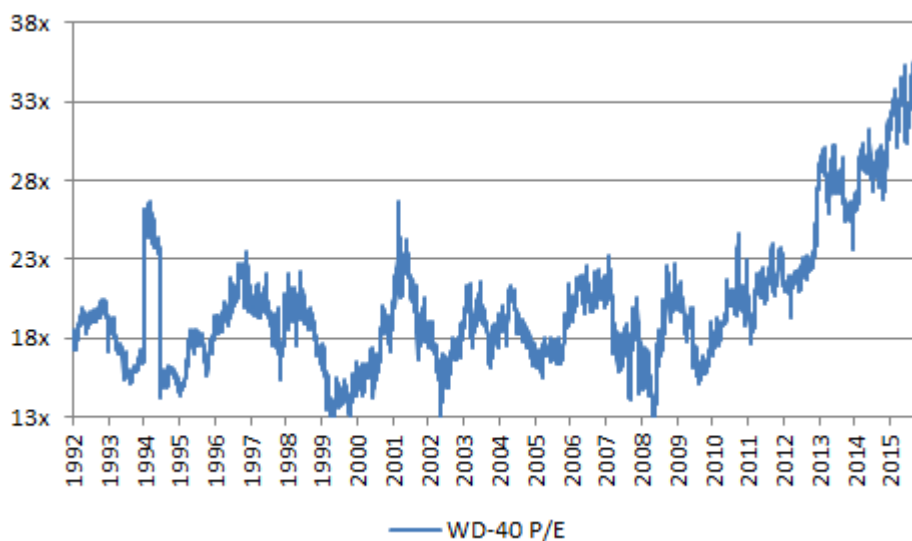
Economic productivity measured in output per head is often seen as the nirvana that all economists and finance ministers are searching for. Its current low growth rate in the US of less than 1% pa vs. the 2-3% growth rate of the 1990/2000s is something therefore that concerns and confounds many. But we find ourselves wondering if the focus on this measure misses a wider point. This being that whilst output per head might not be as high as desired, the cost of living for many vs. (more importantly) *the standard of living* this cost achieves is actually, today, falling in many areas. Thus society and economies are developing but just doing so in a different way than in the past and in ways economists find hard to model. On the face of it, a 2% wage rise in 2016 is of course worth less than a 4% one in say 2005. But the cost of living is arguably falling faster due to deflation in commodities but also in a lasting way via technology. Such changes include better time usage (iPhone) or lower transport costs (Uber) or cheaper entertainment (Spotify/WhatsApp).

All these services put more power in the consumers' hands for often less money, but little of it feeds into national statistics. These just capture that less DVD's are sold, or lower taxi company taxes paid. The money consumers are saving is measured as a worrying economic line item (deflation) not a positive one. We make the above observation just to show that for all of the economic uncertainty that many love to highlight there is much progress in non-economic items and improved quality in many people lives, even if economists find it hard to measure.

Markets – Bubbles or just logical pricing?

Many an investment bear believes that the rise in markets of the last 5+ years has been in some way false, with higher market levels solely a result (directly or indirectly) of money printing. We can see this point of view, but do not see market prices as in any way false or manipulated. All that has really occurred is a repricing of all related assets to today's record low global risk free rate (Global Long Bonds). Corporate bonds, Property and Equities have all performed royally as a result with the best gains handed out to those seen to be the lowest risk (prime property, investment grade bonds and top quality companies). As we observed in the Spring those investors wanting cheap absolute starting prices for a company's shares, rather than paying up for quality, have been finding life tough.

We recently came across a chart that we thought put this 're-rating of quality equities' theme into perspective. It is the PE rating attached to the shares of WD-40 over the last 30 years.



Source: Capital IQ

WD40 is an interesting example for a variety of reasons not least that it sells one product worldwide and has done so for decades. It is also well run with modest annual top line growth but a good Return on Equity. Of note however its expected growth rates in earnings are no greater than those achieved in the past 20 years. The re-pricing of its shares therefore is arguably merely the function of predictable growth being harder to find. We looked closely at WD40 about 4 years ago as a possible investment (PE was then c.18x) and found many of the traits we like. We did not rate the shares a 'buy' however. Why? Because, we assessed them as being fairly priced. In the four years since, the group earnings per share have risen a healthy 50%. Its shares however are up 140%. What we thought as prudence four years ago looks like folly today.

As we observed in our research note of the summer (*Holland Views - What would Billy Beane (or Ranieri) do? – May 2016*), franchise companies have in recent years received a once in a lifetime re-rating as

the market rewarded their quality and resilience in spades. As interest rates and global growth have stayed low this is arguably a logical sequence of events. However this is not a trick that can be repeated in these same companies again. History shows however that it is possible to be reversed.

Digging for value

With many a market commentator wanting to point out the extreme valuation of Bonds (we agree, seeing much of the bond market as offering return-free risk) and the toppy look of equity indices (the charts do not lie) it is easy to be bearish. Indeed were our job asset allocation rather than stock ideas it would be fiendishly difficult to find value today amongst the range of standard assets classes offered. This is why so many have the ‘It all looks pretty toppy to me, own some gold’ conclusion to their commentaries. However with Brexit headwinds to some companies and others punished if they show themselves to be fallible rather than smoothly predictable pockets of value are on offer for those prepared to dig and trust their own analysis.

‘Price’ is what you pay – ‘Value’ is what you get

We present General Motors as an example of this and as a contrast to WD40 above. For the full thesis for why we like the shares please see our notes. We only state here that we believe, due to the restructuring it went through in 2009 that GM is a far better business today than many other investors do. We think it will make higher margins for longer than many believe. As a result we have liked the shares for c.3 years. When we first wrote on them the shares were priced at \$32 and trading on a PE of around 8x earnings. Since then profits have risen faster than the market has expected, but pretty much in line with our and the company management projections. The share price today...? It is \$32. How is this possible? Because today it trades on <5x current earnings as Mr Market seemingly believes the cyclical peak in its profits are likely now even nearer and/or Tesla will soon have revolutionised the car market resulting in lower profits for the incumbent operators. These cyclical and structural threats we believe to be overstated, but as the saying goes, we ‘have to remain solvent longer than the market can remain irrational’. Consider that in the last 4 years GM profits are up 80%, but its shares are unchanged. In contrast WD40’s earnings are up c.50% and its shares up almost three times as much over the same period. (NB. GM investors have received an annual dividend income of c.4% during this period – it also now yields 4.7%, and the Dividend cover is 4x. Yes you did read that right!).

There’s never been a better time to have a currency crisis!

We see Sterling’s currently depressed level as likely offering very good value. The resilience of the UK economy has surprised all this summer. Equally it is logical that future open trade between the EU and UK is in all parties’ best interests. Thus the recent drop in Sterling maybe just reflects the entrenched positions that each side must present before negotiations can maybe start in earnest.

We also observe that perhaps there has never been a better point in recent history to have a currency crisis. Many global economies have worked hard in recent years to depress their exchange rate to steal a little global growth for themselves – the UK then achieves this almost by accident. The price we pay for this accident? Sky-rocketing UK Government borrowing costs; 10y money costs have risen 35% in the last 6 weeks as UK Government credibility has fallen. It now stands at a whopping 1.1%! There has never been a better time to have a currency crisis.

Brexit – Entrenched positions

Our June/July commentaries on Brexit could best be summarised as ‘in time normality will return’ and ‘in the meantime markets are confusing high uncertainty with high risk, thus you are mostly being offered bargains’. Clearly since then events have moved on a little, with Political stability achieved, Sterling falling (as discussed) and a harder line on Brexit being taken by the Prime Minister and her team.

Debating back and forth the economic logic for open borders and free trade (for the record we favour both) we think gets us nowhere fast as few are listening to a balanced argument. In June we highlighted the following piece (from an Irishman) which briefly articulated the route the UK should take and why. It is a sound logical argument for the Norwegian model. Our concern today is that ‘sound logic’ might be trumped by ‘consistency bias’ – i.e. entrenched positions.

<http://www.independent.ie/opinion/columnists/david-mcwilliams/calm-down-the-brexit-referendum-result-is-not-a-21stcentury-sarajevo-34842130.html>

The ‘Brexit means Brexit’ rhetoric is hard to peddle back from and the Europeans will not like to be dictated to. Of interest we thought were the following points:

- Switzerland had a referendum that wanted to limit immigration 3 years ago. It was passed (i.e. instructed its parliament to address the issue). However it has been ignored, why? Because delivering this requirement whilst keeping free trade routes open has been impossible for its politicians to achieve.
- A German industrialist was interviewed and the point put to him about seeking a deal with the UK to secure German car exports. His answer was telling, he suggested that German’s indeed do like their exports but they are also heavily wedded to the European project in a way the British cannot fathom. Thus if a stand-off occurs and exports suffer for while they are quite capable of coping with a little economic hardship (he just shrugged his shoulders)...hmm these are not people you want to play hard ball with.

We are used to our female Prime Ministers being hard as nails. I find myself hoping this one is just a little more malleable in the next 12-24 months. We need to accept an amount of immigration (probably large) and we will likely have to pay into the EU budget. In return, we will get free trade and to set our own laws. The longer the saga goes on the deeper entrenched each side get and the more likely something unpleasant happens (either to us, or to wider Europe). A resolution along the simple lines we (or the Irish Times piece) outline is sadly looking more and more unlikely.

[Brexit Franchises opportunities thrown up](#)

Over the last 6-9 months a number of individual company wobbles or market events, like Brexit, have again presented some really interesting franchise opportunities. This has resulted in a number of companies that we know /have researched for a long while being offered compelling prices. **JD Wetherspoon, Ryanair, SportsDirect and Next** all we think have either good or very good franchise characteristics, but importantly still offer us compelling value at the today’s entry price (less-so JDW now). All four companies have single trait in common also; they are run by a determined and experienced manager who owns a significant stake in the business and has extensive experience of running these cherished operations.

US Financials: Blind spot- or becoming sweet spot?

We have believed for some time that the only sector that looked notably undervalued in the US stock market was the US financials; particularly the largest banks deemed ultra-safe by regulators, but assessed as un-investable by many an equity manager. The difficulty of competing with JP Morgan in just a single line of business, let alone across its whole scale of operations and fortress balance sheet is daunting and likely impossible. As such surely such a business has a sizable moat, but its share price suggests otherwise trading at c.10-11x earnings (post a 20% run up!) vs. a market PE nearer 20x.

This difference is justified by many due to how hard it is for banks to make money in a low interest rate environment. However despite this significant headwind the best US banks are still making acceptable (10-15%) ROE's achieved by constant product repricing and efficiency drives, whilst building the capital regulators desire. In short, the world's best banking franchises are being run very efficiently at what may well be the trough of the interest rate cycle. As such the operational gearing into any 'recovery' could be very significant. Equally regulators are running out of reasons for them to hold onto further capital, thus greater percentages are now being paid out to income starved investors.

Imagine if due to fiscal spending boost or maybe some economies finally gathering steam post US Election blues (when polling, politicians paradoxically actually love to talk the country down) that US growth picks up just a tad. Then imagine an outline agreement on Brexit. Alongside this, US rates rise just a tad and money returns to the UK faster than it left. At which point what price do you think Lloyds banks shares might be? Still yielding c.5% on a 3x covered dividend (at 53p)? We think not.

What on earth to own?

So what should investors own in a world where most asset classes, on average, look fully priced. We reiterate the four categories we highlighted in May and would not change any of the stock names we gave at the time. These areas all offered value then and despite in aggregate the group performing well, many still do - albeit in different forms.

The 'Hate it, never going to own it sector'

- **US banks** (we favour the biggest and best ones).
- Autos: **General Motors** more specifically.
- **Suncor**, a shale Oil digger. It has a reserve life of 35 years and a good FCF Yield.

'Beat the Fade' Franchises

These companies may not slow or fail at the speed Mr Market expects.

- In May we suggested **Apple, Burberry, Next and SportsDirect** all fitted this bill. Now we might add **Ryanair** too.

Well run asset owners dismissed due to their complexity

- We highlight again **EXOR, Melrose, Jardine Strategic and Leucadia**. All we still favour. **Bolloré** intrigues us also but we have yet to do the work.

'Blood on the streets' investing Templeton style

- In the summer we highlighted two Greek stock which we know well: **Eurobank and Terna Energy** (Wind farm owner). There are others.

In Conclusion

We conclude as we often do to be pragmatic searchers for value. In some assets classes there is clearly little (Government Bonds) but our chosen asset class (Equities) continues to throw-up the odd mispricing, a few of which are oddly excellent companies well run by owner managers. The risk that bothers us far more than the macro ones all voice daily is that which we commented on it in our 'Iceberg Watch' piece in January (*Holland Views – Iceberg Watch – January 2016*) - namely obsolescence risk. Are the companies and franchises we own or recommend, being or about to be, undercut by new competitive forces and new business models bringing in new more efficient capacity? This is where we think investors should be spending their 'worrying' time.

For those that made it this far we offer a prize. It is a link to an excellent recent interview with Jamie Dimon. In it he addresses a number of the issues above and many more. He also suggests something all investors should try; take an annual report, block out all references to the share price. Now try to value to company.... We highly recommend this interview.

<https://uk.finance.yahoo.com/news/warren-buffett-called-this-jamie-dimon-interview-off-the-charts-122945995.html>

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