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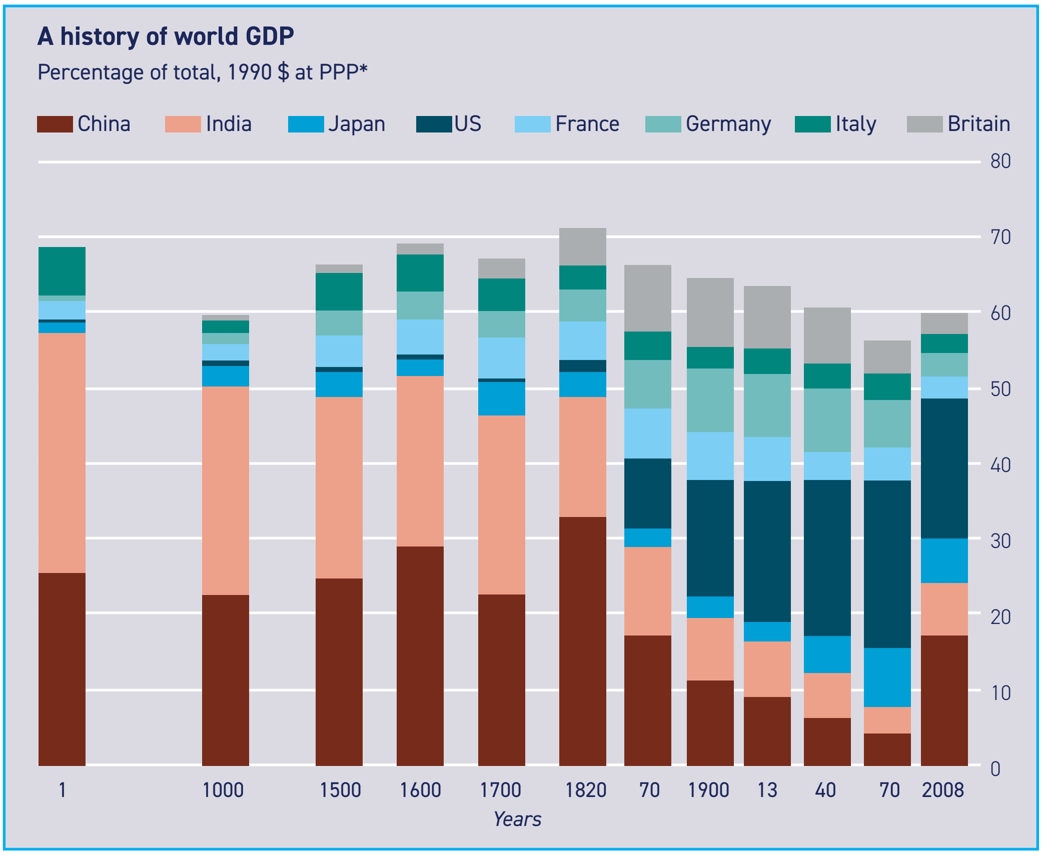
Winter 2020

THE VIEW FROM OUTSIDE

As a non-US person one of the things that has most impressed me over time is how over such a relatively short period (in big-picture historical terms) the US economy developed into one of the most important in the world.

The start of this rapid transformation can roughly be traced back to the period after the US Civil War (1870–1900), when the US economy started to become dominant and replace China and India, which between them had exerted global economic dominance for the preceding 2,000 years.[1]



**Source: Angus Maddisson, University of Groningen, The Economist; A history of world GDP, data as at December 2018. ***Purchasing-power parity*

Investments in infrastructure – railroads, the increased mechanisation of industry and inventions in applied technology (AT&T, Edison etc.) – were perhaps some of the most important contributors.
From 1869–1879 the US economy grew 6.8% per annum in real GDP terms.[2]
US GDP growth doubled in the 1880s and by 1890 the US had surpassed the UK in terms of manufacturing output.[3]

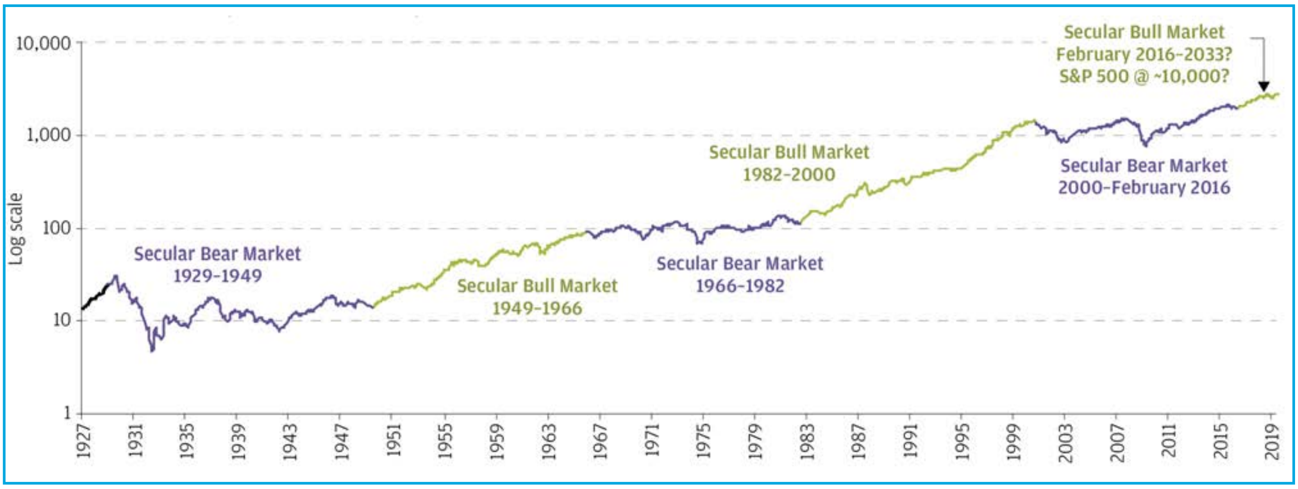
BUT WHAT WAS MORE IMPORTANT THAN ANYTHING ELSE WAS THAT AFTER A BRUISING AND BLOODY CIVIL WAR THE COUNTRY WAS PULLING TOGETHER IN THE SAME DIRECTION TO ACHIEVE SOME TRULY INCREDIBLE ACCOMPLISHMENTS.

We are now looking forward to the next decade and beyond, and the US lead has already narrowed. But perhaps it is still not too late for the country to achieve further significant progress.
As we approach the New Year and a new decade, surely understanding is better than aggression, listening better than shouting, fellowship better than isolation and mutual respect better than hate? It is not too late for Americans to rediscover their solidarity for the mutually beneficial goal of economic prosperity.

THE REALLY, REALLY, REALLY BIG PICTURE SHOW

Taking a few steps back – a few million, in fact – I tried to research a time or civilisation that did not engage in trade. The result was a big fat zero. From the Stone Age and before to the modern age, trade and the exchange of ideas have perhaps been among the most important driving forces for the development of human society. Whether it was the historic ancient empires of China or India or more recent empires such as those of the UK, Spain or Portugal, trade was one of the key drivers of their advancement and prosperity.
Of course, there have been some mistakes along the way such as the Smoot-Hawley Act, which erected strong tariffs and barriers (until it had to be rescinded) and was commonly believed to be one of the key contributors to prolonging the depression of the 1930s.[4]
The simple solution to all these current trade disputes would be for nations to become more patriotic and the consumers within them to only buy domestic goods. This would, however, be completely undemocratic, no fun and set civilisation back to an immeasurable extent.

THE SLIGHTLY LESS BIG PICTURE SHOW

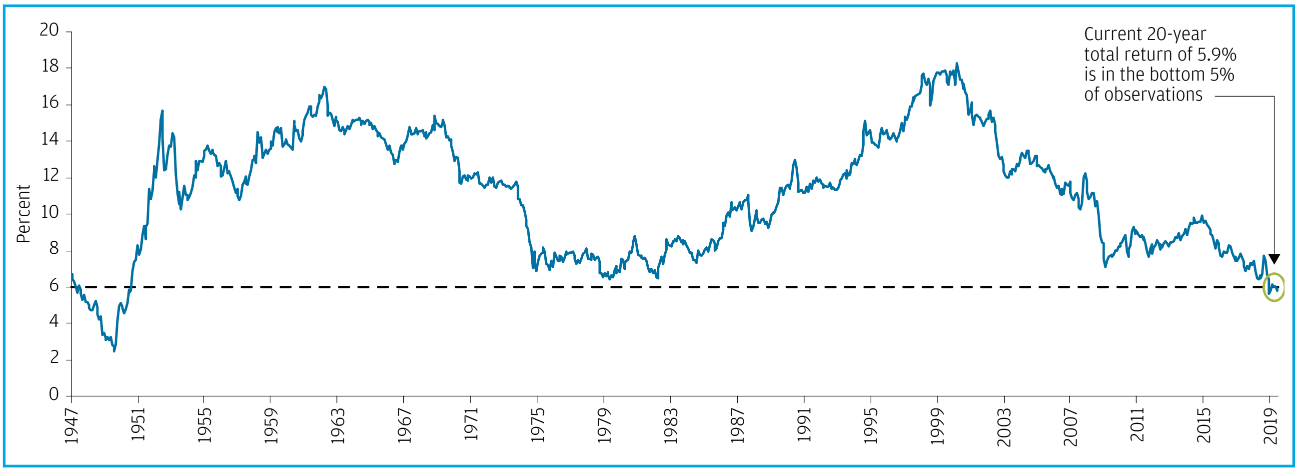


Source: Robert Shiller, FactSet; S&P 500 Index, logarithmic scale, 1927-June 2019. Data shown in log scale to best illustrate long-term index patterns.
The performance quoted is past performance and is not a guarantee of future results.

As we have stressed many times before in this publication, we have been in a secular – not a cyclical – bull market for over five years now. We originally thought that this new secular bull market (a long-term uptrend in markets) started in 2013; however, it could also be argued that the bull market only started in 2016 given the very large correction in 2011, which exceeded 20% on a peak to trough basis.[5] The exact timing is not that crucial as we expect the longer-term trend for markets to be upwards over the next three to four presidential cycles (over a decade). Indices could perhaps rise 300% or more over this period. Of course, there will not be a linear, straight upward line and there will be negative years (some of which will see double-digit declines, perhaps by as much as 20%) and probably a recession or maybe two; however, these will just be great buying opportunities in a much longer-term uptrend.

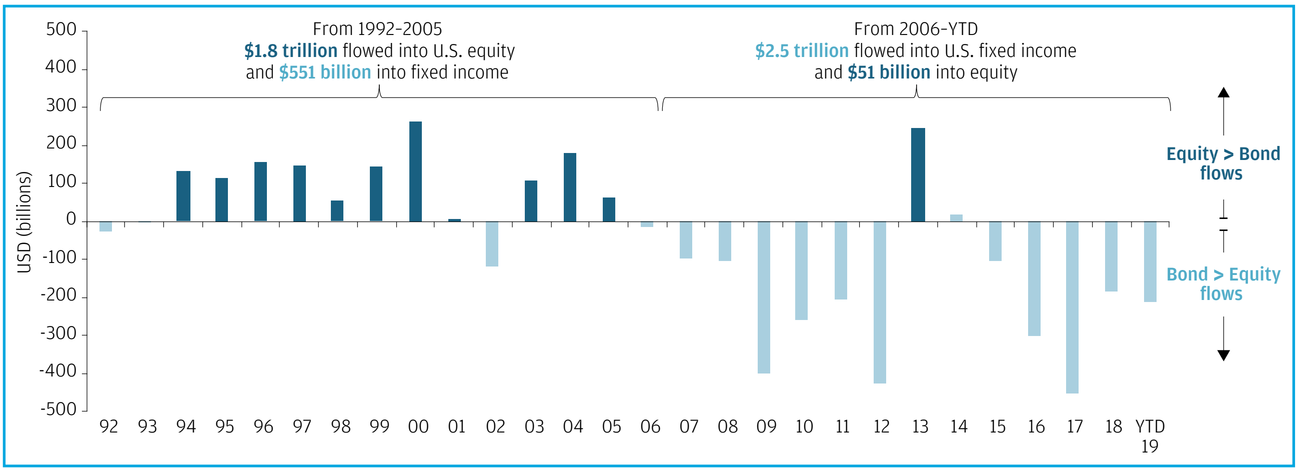
The return from the S&P 500 was just 1% per annum over the period from March 2000 to February 2016, and following the cumulative total return paths of the two previous secular bull markets of +525% (from 1952 to the peak of the secular bull market in 1966) and +992% (from 1985 to the peak in 2000), an annualised (not linear) double-digit return does not seem unfeasible.[6]

We acknowledge that many have concerns about the increase in markets since 2009. But we would once again politely point out that over the period from 2000 to 2013 markets were essentially flat.
Looking at 20-year rolling market returns, we are in the bottom 5% of returns since 1927.[7]



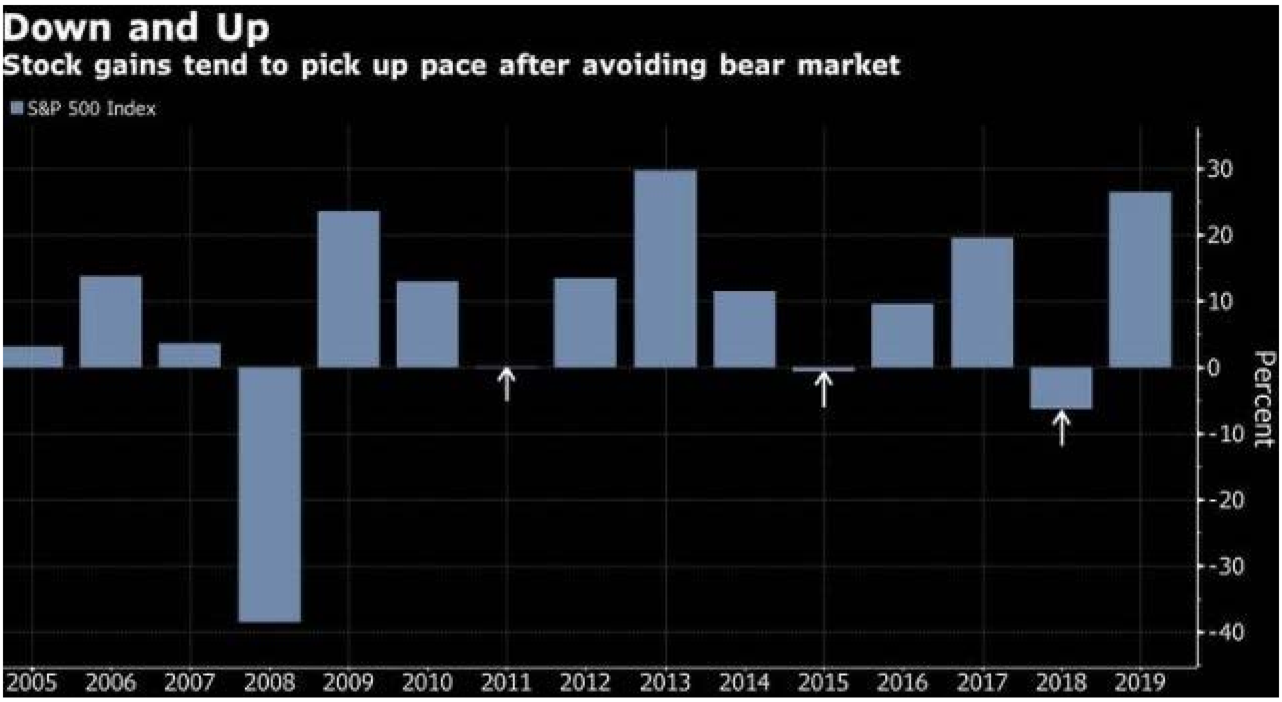
Source: Ibbotson, Empirical Research Partners Analysis, J.P. Morgan Asset Management, Bloomberg L.P., as at 30 June 2019; annualised S&P 500 20-year total returns, 1947 through June 2019. *The performance quoted is past performance and is not a guarantee of future results.*

Investors who have been highly sceptical of market performance since 2009 have missed out significantly as a result. Rather than blindly believing investor surveys, fund flows paint a less than positive picture showing that more money has flowed into bonds than equities over the last 13 years – a great contrarian indicator (see graph next page).



Source: Strategic Insight, Empirical Research Partners Analysis; annual spread of US equity net flows and fixed income net flows 1992–2019, data as at May 2019

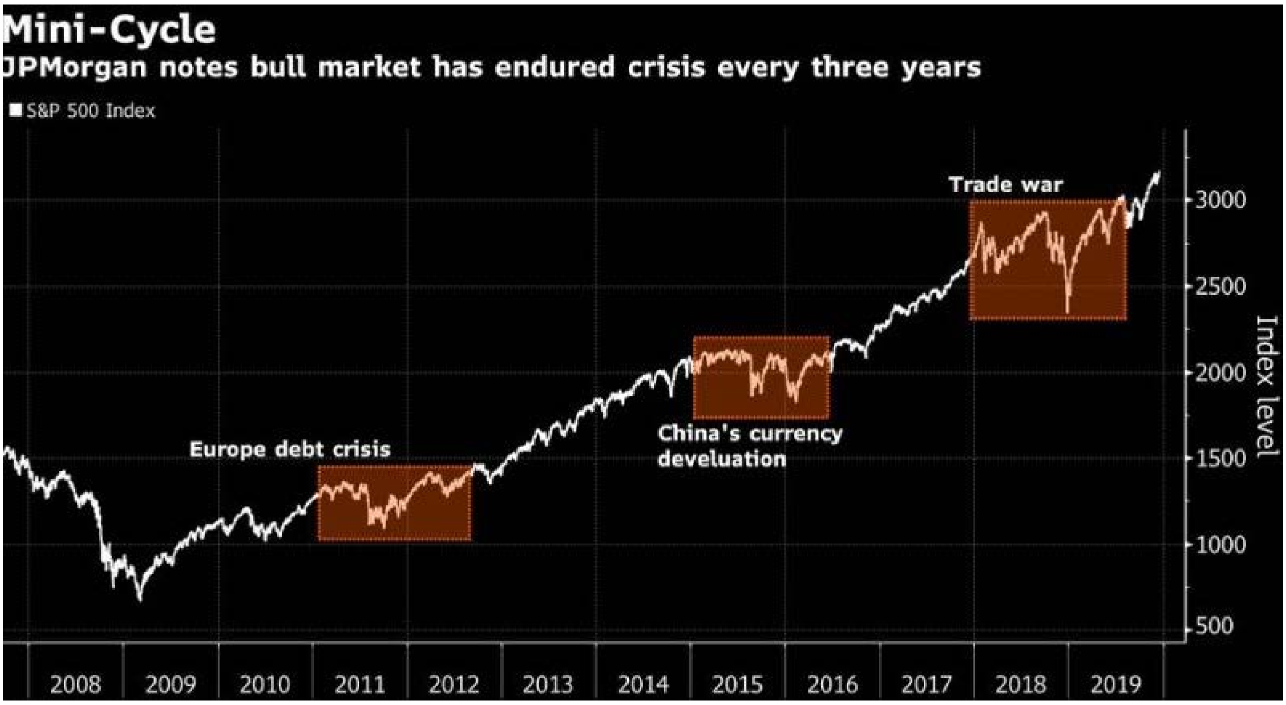
The same argument applies to those looking at the performance of markets in 2019 in isolation –when you look at two-year returns things do not appear quite so rosy. In fact, historically when stocks have risen 20% or more over a calendar year, the returns in the next 12 months have been positive two-thirds of the time.[8]



Source: Bloomberg; S&P 500 Index, stock gains 2005-2019.

THE IMMEDIATE FUTURE AND BEYOND

Our prognosis for 2020 is GSGG: Global Synchronised Goldilocks Growth.
We see global economies recovering at a moderate pace – enough to embolden investors, increase corporate profits and make people generally feel better that we are heading in the right direction. It will not, however, be so hot as to prompt central banks to hit the panic button and rein in the record amounts of stimulus that are currently in the system.
Our best guess is that markets will perform much better than most participants expect. Think double digits (albeit not without volatility), as just like an elastic band whenever this bull market appears too stretched, we seem to hit the reset button every three years or so (see graph below).[9]



Source: Bloomberg; S&P 500 Index, 3-Year mini cycles in markets, 2008–2019.

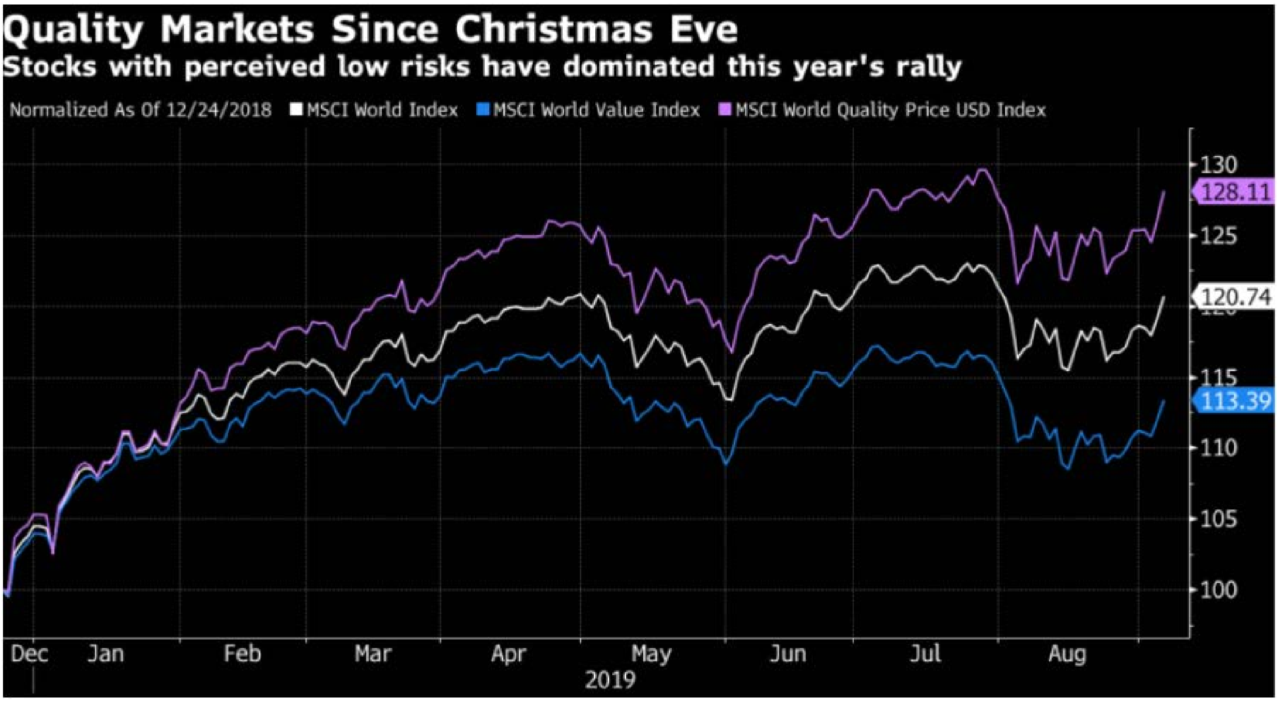
The phase 1 trade deal represents an important psychological step for both the US and China in terms of trust and should not be underestimated. We fully expect it to be signed, sealed and delivered shortly.
A phase 2 deal in 2020 is quite possible and indeed likely now that this first hurdle has been overcome. Don't be surprised if a US/Europe trade deal is also done. We really like the overall market scepticism regarding progress on trade as this shows that not everything is priced in, thus providing upside opportunities.

In this environment the strong outperformance of US stocks versus their overseas peers is likely to dwindle as it already looked to have reached unsustainable levels. But no, this does not signal a disaster for the US market as a whole, just that there will be better-performing opportunities elsewhere.

Source: Bloomberg; performance of global equity markets versus the USA before the GFC ("Great Financial Crisis"), 2003–2008

Source: Bloomberg; performance of global equity markets versus the USA after the GFC, 2009–2019

Amidst a recovering global economy, the trend of quality growth stocks[10] outperforming is now likely to reverse.[11] After all, a year like 2019, when the Swiss SMI was one of the best performers, hardly smacks of unbridled animal spirits.



Source: Bloomberg Data; performance of MSCI's factor indexes for stocks in its World developed market index from 24 December 2018 until mid-September 2019

Especially given their stretched valuations …

Source: Bloomberg Data; prospective P/E multiple for the MSCI World Quality index and the main World index, 2013–2019

US bond investors will probably have a few panic attacks over inflation fears, but drags on the economy and bouts of equity volatility will help them get through such scares.

As we head into the new decade having only just recovered from the millennium hangover, we expect the next ten years to provide significantly better returns for risk assets, and not just because of the longer-term chart and market set-up.
We are now about to see some key technological advancements – mainly in transportation – the like of which have not been witnessed for over 100 years.
Autonomous driving will increase productivity, lower fatalities and broaden people's horizons and mutual understanding.

Urban air mobility – pilotless (eventually) drones transporting people quickly and efficiently will again increase productivity and help ease congestion on our overburdened roads. It will also lead to the rejuvenation of inner cities in terms of construction – think of the film *The Fifth Element*.

Hyperloop will enable super-fast travel in a fraction of the time in an environmentally sensitive way.

New jet engine technology (already in development) will allow transatlantic travel in as little as one hour.

Off-planet mining and eventually colonisation will ease pressure on our finite resources.

We honestly cannot remember a time when we were more excited about the future prospects.

The Navigator
has been written by:
Peter Ahluwalia, Partner
Chief Investment Officer

[1] https://www.quora.com/Economic-History-At-what-point-did-the-US-become-the-biggest-economy-in-the-world
[2] See above (i)
[3] See above (i)
[4] https://www.britannica.com/topic/Smoot-Hawley-Tariff-Act
[5] J.P. Morgan Asset Management, Portfolio Insights, Why we're in the early innings of the secular bull market, G. Devulapally, August 2019.
[6] See above (v)
[7] See above (v)
[8] Bloomberg, Recession Gets Priced Out in a Stock Rally for the Record Books, S. Ponczek and V. Hajric, 28 December 2019
[9] Bloomberg, The Three-Year Crisis Cycle and a Case for a Reborn Bull Market, L. Wang, 13 December 2019
[10] MSCI World Quality Net Total Return USD Index FIGI BBG003Q182S9: The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage.
[11] Bloomberg, Quality Street is Becoming a Very Crowded Place, J. Authers, 6 September 2019

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