Investor Insight 78 – August 2019

Each year we attend the world's largest global industry conference, FundForum International, held this year in Copenhagen, Denmark.

In addition to this we met with fund managers, wealth managers and our economic consultants *Capital Economics* in London.

The 2019 conference was dominated by two key themes: Environmental, Social and Governance ("ESG") investing - an area which has become mainstream in Europe in recent years - and interest rates.

We have mentioned in these pages on numerous occasions that investment markets depend on the direction of interest rates. In that context, negative yielding government bonds are going to be a troubling feature of the investment horizon.

Mario Draghi, Governor of the European Central Bank ("ECB") has opened the door to lower interest rates in Europe - and to Quantitative Easing ("QE") continuing in Europe. The ECB may potentially be buying more bonds - many are saying up to another EUR1 Trillion. At the same time, both German and French government bonds are now trading on negative yields.

It was recently reported that the quantum of negative yielding debt globally is now more than USD12.5 Trillion.

It is interesting to note that QE was originally referred to as "non-conventional" monetary policy yet it is now considered conventional, hence the recent announcements by the ECB.

ECB governor Draghi said in 2015, just before Europe commenced QE, that "we will do whatever it takes" and he repeated this comment last year. The US Federal Reserve ("Fed") chairman Jerome Powell said in May this year that the Fed "will act as appropriate to sustain the current expansion".

In Copenhagen, we heard predictions of cuts of 0.50 per cent or as much as a full 1.0 per cent in the Fed Funds Rate. Market analysts are now expecting cuts of this magnitude by the Fed over the next twelve months.

The first step occurred just this week, with the Fed cutting its benchmark rate by a quarter of a percentage point or 0.25 per cent to a range of between 2.00 per cent and 2.25 per cent but, notably, Fed chairman Powell stated that this is an "insurance" cut and not necessarily the start of a series of rate cuts. Further cuts will continue to depend on the economic data. The Fed did however also announce that it will cease the rundown of its balance sheet from August 1, effectively adding some further "insurance" to the market.

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Why? Expectations for the US Q2 earnings season were quite low and so far the results have been somewhat better than anticipated but, when coupled with ongoing concerns over the China-US trade dispute, the Fed is showing a willingness to get ahead of a further slowing in growth. The result has been further strength in equity markets, extending what will soon be the longest post World War Two rally, with the S&P500 now near or above 52-week highs.

Our concern is that the US economy could not handle 2.5 per cent interest rates.

Many are referring to this as the "Japanisation" of the European and the US economies i.e. falling interest rates and slowing growth.

These "premature" interest rate cuts are the first since 1995, the last time when the Fed cut interest rates while there was still positive growth. Note that the Fed has never cut interest rates by 1.0 per cent without there being a recession.

In 1995 the Fed's actions saw equities rise and a push up in the real economy. Today we may see both global and Australian equities rise further but we question the extent of any push up in the economy.

The overall effect of rate cuts in both Europe and the US is to extend the cycle and, by the very nature of central banks buying bonds, increase leverage in the system.

One area of disagreement in discussions at the Copenhagen Conference was over inflation. There were those who feared continued disinflation and hence held concerns around further Japanisation of economies as central banks continue to cut interest rates.

Others argued that the danger was of much higher inflation than the central banks are targeting, the evidence being:

- Cyclical - tight US labour markets, having surpassed their previous peaks, tight immigration policies and industrial strikes in the US at their highest levels since the 1980s signals where the pricing power lies.

- Structural - the US is importing higher prices through their tariff war as they increase consumer prices via their own policy actions.

Further cuts in interest rates, especially in the US, will create a rush towards equities as investors chase positive yields. The result might be a melt up in global equity markets. As equity markets in the US are at record highs, the boost for demand on the back of bond yields will further distort valuations, which are already high.

To this point, an article in London's *Sunday Times* in late June highlighted the fact that stock markets such as those in Australia, China, South Korea, Malaysia and Singapore have "discovered the discipline of distributing income" or dividends.

Let's be clear - equity markets are risk-based asset classes. Investing in equities is about investing for capital returns balanced with income, not for income alone. Investing in equities for dividends alone risks a capital shock at some stage when the cycle does eventually turn.

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Author Michael O'Sullivan in Copenhagen was concerned that the S&P500 five-year returns have been 11-12 per cent per annum, twice the 100-year average. With bonds at negative yields there is only one direction for these to go and higher recent equity market returns have eaten up medium term returns for the future.

We do see where O'Sullivan is coming from. We caution more against complacency whilst acknowledging that lower interest rates must inevitably lead to lower longer-term returns.

We are late cycle. Copenhagen conference goers kept reminding themselves of this as well as the fact that we are in the longest bull market ever. There is the added concern of the unpredictability of the trade wars. It is worth remembering that the best returns are always late in the cycle and for now central banks are helping this via their accommodative monetary policies.

For those considering these important themes in the context of Australian investments, the key way to manage through is to have a strategy built around diversification. Acknowledge that we are late cycle. We will be looking to fade equity markets in any rally.

As stated at the start of this note, ESG or Environment, Social and Governance was a huge theme at Copenhagen and this has become mainstream in Europe.

Over the last four years, we have watched as ESG has gone from being a niche issue to one that now attracts high levels of interest.

Essentially, ESG takes two forms. There is the negative angle about filtering to exclude "harm" stocks in industries such as tobacco, gambling, weapons, alcohol and coal; and there is the positive angle - biasing towards companies that positively promote their credentials in the areas of environment, social practices, and corporate governance.

Notably, Governor of the Bank of England, Mark Carney recently said that ESG is crucial to the pressing need to manage between risk, reporting, and returns.

We would add that in active funds management in the UK and Europe, the allocation of capital by the funds management industry has taken on a societal view. Whilst we agree that ESG is a crucial component of an investment process, we believe that it is struggling between hopeful ambition and real action.

One argument we have often heard is that there is no clear consensus on a definition for ESG. At the conference it was highlighted that there have been more than 2,000 studies completed on ESG, yet none agree in a way that allows comparing "apples with apples". We think that's because there are values-based screens that are negative; there is impact investing which is positive; and then there are ESG qualities (some social objectives, some financial objectives - and no agreement whether it is constraint versus an objective).

I believe this will never be resolved and we will not see a practical "one-size fits all" style definition or approach with ESG as ESG is values based and what is a value for one person does not necessarily mean it is for another.

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Why has ESG become mainstream in the UK and Europe? There are several key reasons:

- better data is available.
- the focus is investor led and therefore the care factor has increased. For instance, VW fell 30 per cent in September 2015 as did BP in April 2010 on the back of their negative announcements.
- Climate change is widely accepted in Europe and it is no longer a left versus right political issue.

We have been watching trends globally and noticed a time lag in many mainstream UK/EU investment issues coming to Australia. Four years ago, the hot topic in the northern hemisphere was funds management fees or MERs. We would say that issue took three years to become an issue of the same magnitude in Australia.

We have no doubt that ESG will become as big an issue in Australia but not just yet. Meanwhile, there are some risk issues that need to be considered:

- Greenwashing - or managers claiming they implement ESG but in practice it is in words only.
- Many managers are using ESG to justify increased fees. When it is part of a process this cannot be justified.
- You cannot access ESG parameters through Index products.

On the other hand, there are also some positives;

- Constraining an index should lead to increased risk however including best in class ratings has shown this decreases the portfolio risk.
- ESG therefore enhances risk controls.
- In Europe, demand is outpacing supply. We have found this to also be the case in domestic asset classes.
- ESG leads to stewardship and therefore increased engagement and influence with companies. It is having the result of lowering portfolio turnover.

We have seen increased demand from clients to invest with “do no harm” mandates, as is the case in Europe. We can only see this trend growing. Interestingly, wealth managers we spoke to in Europe say the number one age bracket where this demand is initiating is 60-75 years.

Whilst some have asked the question “why not millennials”, it must be considered that this cohort is only growing as an age bracket for investing.

Some areas such as climate change go beyond ESG and are now touching everyone. As climate change is forcing countries to transform, so too will it force companies to transform.

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In the end, ESG is about moral capitalism. We believe that in this era, moral capitalism is about how to maximise the long term.

Where we believe many critics lose focus on ESG and sustainable investing is that understanding it is about responsible investing with increased risk criteria. It is not and should never be treated as a donation. It is about investing that does good, yet it is still firmly “in market”.

Hamilton Wealth Management is a Fee for Service, Wealth Management business and as such our advice is built around the conviction to our process and philosophy and our strong belief in diversification.

We would be happy to discuss this further with you, please don’t hesitate to contact us.

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