Warner Matthews Diaries – Third Quarter 2020

Asset Allocation Musings:

This quarter's dispatch focuses on parallels, and to what extent one country's experiences are replayed elsewhere; in this case Japan. With that in mind, an apt song title that fits the mould wasn't too demanding – the obvious being *Turning Japanese* by The Vapors. However, the editor decreed a more subtle attempt was required. A quick look on a search engine for songs that reference Japan highlighted the most popular English music hits in Japanese Karaoke Bars. *A Whole New World*, the theme tune for the Disney blockbuster Aladdin, maintaining its top ten position. To try and complete the circle back into today's backdrop, I guess central bankers could all do with their own Genie in a bottle…

Having highlighted the various recovery trajectories in the last quarterly ("V", "W", "L", "U" or even Nike logo shaped), it appears as if stock market participants have decided a perfect V-shaped recovery is under way. This may be as a result of FOMO (fear of missing out) or TINA (there is no alternative). However, it feels somewhat removed from the fact that the world is in the midst of the worst pandemic in a century and the worst economic contraction of a few generations. We do recognise that with interest rates at close to zero, the paltry return on low risk assets necessitates the need to add risk to generate any kind of return. On one extreme we struggled to understand how Hertz, the US auto rental company, which filed for bankruptcy last quarter, would see its share price surge 3-fold after it announced it could no longer stay afloat. We do however remain confident that the funds selected for you have been able to cherry pick some bargains in the last quarter's early sales season.

A History Lesson:

Japan – is there a lesson to be learnt or is the World heading down the same rabbit hole?

It is referred to as the lost decade, however in reality it has been 20yrs since Japan's economic juggernaut ground to a sudden halt. Prior to this, the economic miracle was built on loose monetary policies developed by the Central Bank, undertaken by the banks, and aimed at borrowers, many of who would not have surpassed the basic credit checks in a "normalised" environment. This helped inflate the economy and create asset price bubbles. Sound familiar? Reality dawned as huge amounts of policy support (including money market rates turning negative) failed to generate growth which in turn created persistent low rates of inflation. Sound familiar? The banking system struggled to operate efficiently as their profit margins were eroded by low interest rates. Bank management were encouraged to promote debt forgiveness allowing a generation of zombie companies to survive, arguing some were too big to fail. Sound familiar?

Deflation can cause people to stop spending, in the expectation that prices will continue to fall in the future, and therefore consumers are better putting off purchases hoping everything will probably be cheaper tomorrow. The problems in Japan were exacerbated by an ageing population. The labour force participation rate began to decline as a growing swathe of the population were over 65. This created a structural shift towards higher savings and lower demand for goods and investment, the feedback loop impacting economic growth and inflation expectations. This dynamic hasn't materially altered for the last 10yrs as different Japanese leaders have tried a varying array of policy tools in an attempt to stimulate growth and generate inflation. The effects have been somewhat nebulous but the growth in the country's debt pile has been significant. Expressed as a percentage of GDP, Japan has the highest level of debt in the world.

There are several parallels across the globe which imply Japan's phenomenon may not be unique to the Land of the Rising Sun. In Europe for instance, headline consumer price inflation (CPI) has stubbornly stayed around 1%; a long way below the target rate. Ultra-loose monetary policies are now set in stone across the world, with leading Central Banks finding novel ways to bolster growth (including negative rate issuances). GDP rates were contracting in places like Germany/France/UK/China and India prior to Covid-19, the pandemic making this data point momentarily redundant as growth disappeared in the second quarter. The glue that bound Japan's predicament, ageing demographics, is starting to blight several European countries such as Italy, Germany, Greece and Sweden. China will face this problem further down the line, as a consequence of its one child policy, which only ceased in 2016. The over-65's cohort has doubled in the last 20yrs and now represents well over 10% of the population which makes it an old society by normal convention. Even the US birth rate has been declining for years, a precursor of what is to come.

Can anything be done to avoid a repeat of Japan's lost decade(s)? What has become clear is that monetary policy alone cannot "encourage" inflation. Western Governments are learning these lessons rapidly. Recently Boris Johnson has spoken about a New Deal – large fiscal stimulus packages aimed at improving infrastructure (green orientated), education and training, which should create jobs. New jobs should encourage spending which should in turn nurture consumption and hence inflation. Europe appears to be finally getting its act together to combine fiscal and monetary policy.

And what about Japan? Although growth has been tepid, it has not been non-existent, averaging 1.3% growth p.a. on average over the last decade. Despite the notion that Japanese employees no longer have a job for life, overall employment has never looked better. Combined with little price inflation, standards of living continue to improve. Companies continue to thrive and prosper, always prepared to change and adapt, fostering innovation (ageing demographics has led to investment in robotics etc.) in autos/chemical/pharma and technology to name a few. Management have embraced governance codes, improving total shareholder returns and acting as better custodians of capital. Income inequality which is becoming a more significant issue in the western world is declining in a society where values are upheld and enhanced. We seek assiduously for keenly priced opportunities. They will emerge and we will take advantage – perhaps Japan may form a part of this fair value strategy given the equity market is 50% below its 1990 peak, with valuations that reflect much of the bad news.

What's on our Minds?

Halfway through the year – a chance to take stock of the UK

March and April were unique months for many startling reasons. It feels like a long time ago that the headlines were pierced with a run on loo rolls, the supermarket shelves looking like a communist government owned rationing store and our daily government Covid update. The UK lockdown data points are, I think, fascinating, as it underscores how we all coped. Apologies if you have digested this data already, however, I have summarised the more fascinating elements for you to examine: According to a range of leading retailers we all became expert bakers as flour sales rose 2000% in March, alcohol sales rose 31% as our love of hooch remained undiminished, and wine sales grew 50% year-on-year, perhaps as a result of the benefit of the warm lockdown climate. With that in mind maybe it wasn't so surprising that eBay's sales of hot tubs grew almost 5-fold in April. The Royal Horticultural Society stated that traffic to compost websites also grew 5-fold (some coincidence). It seems we all became fitness fanatics as well as sport shoe sales rose 72%. There was a 160% increase in the sales of men's hair clippers in April (I suspect this would have been higher but for the lack of supply. Note to self: it is time to call up my barber).

Some of the data points reflect short term benefits to individuals – petrol consumption fell 70% in March, consumer credit dropped £7.6bn in April as cash withdrawals slumped by 60% and, consequently, household savings rose £16.2bn in April. As an aside, for those living in urban areas, there was a 59% drop in robberies in London in April month-on-month and a 32% fall in household burglaries.

Perhaps the most notable change was the improvement in the climate, as planet earth appeared to heal. Air pollution in some UK cities dropped 60% year-on-year. Less flights meant cleaner air as airplane travel accounts for 5% of global warming. Venice's famous canals welcomed back fish, thanks to a reduction in water transportation thereby improving the water quality. Citizens in Northern India were surprised to finally see a view of the Himalayan mountain range for the first time in a generation. The list goes on. However, a study that highlighted that cleaner air led to 11,000 fewer deaths from pollution in the UK and Europe was a minor respite against the negative Covid related health data points.

On the flip side, the consequences of locking us all down for the best part of 3 months is significant for any economy and will continue to be. For now the figures paint a gloomy picture – GDP fell 20% in April, retail sales collapsed, almost 900,000 people began claiming unemployment benefits in April along with a rise of 450,000 claiming Universal Credit. Over 9m people took advantage of the government's furlough scheme which will now run until October. We were told this was an indiscriminate pandemic, however it appears to have affected those worst off and from certain ethnic backgrounds.