A glass half-empty view of markets

The 20s harder than the last decade

Steve Clapham

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Executive summary

Failing to oblige on remaining upbeat…

I recently appeared on a panel on the Money stage at the FT Weekend Festival in London. Claer Barrett, the FT columnist and podcaster, was the moderator and opened by suggesting that the panel would try to stay cheerful – I failed to oblige. I thought it might be, therefore, worth repeating some of those off-the-cuff comments here and repeating the advice I gave to the attendees.

The FT Money Panel

Source: Behind the Balance Sheet

Incidentally, the FT Weekend Festival is a fantastic event and I have attended almost all of them as a paying guest (this was my first time as a speaker). Even better, you can now catch up on what you missed in person, online.

…as dire economic outlook…

I pointed out to the audience that I am a glass half empty sort of person when it comes to investing – downside protection is the number one priority in my view. I then explained that I was not around as an investor in the 1970s, but that is the only period I can recall, other than the 1929 Depression, where the circumstances were similar to today. The economic outlook has never been this bad in my experience and we start at a point of likely significant over-valuation of markets. You should be resigned to seeing your real wealth decline in the next ten years and you should have a plan to mitigate the adverse impacts.

…leads to gloomy prognosis

This is not just my view. One of my friends, who manages a billionaire's family office and has immense resources at his disposal, recently passed a similar message to his employer. Let's first look at why the prognosis is so gloomy.

Most of what I shall discuss is focused on the US and UK, the two most important markets for me and my readers, but the symptoms are generally pretty consistent globally.

Valuations

We start from high levels of valuations relative to history in most markets – equities certainly and in almost every region, but especially the US; bonds generally; and property. The three main asset classes are all pretty richly valued by historical standards. I say this first because valuation is always important. Our recent equity correction from the peak is fairly modest.

Equity valuations unlikely to see further significant gains

The S&P500 started the year at just shy of 4800 and is now at c.3900, a fall of c.19%, not great, but hardly a disaster. Five years ago, it was 2461, so it's up nearly 60% (before dividends), which is well above long-term historical averages.

The FTSE100 in the UK has fared better this year, down 4%, partly because of sterling's weakness, and partly because of the weight of energy and commodity stocks. It's down 2% over the last 5 years! Again, before dividends.

Importantly, equity valuations are generally rich on margins and returns, which are also near peaks. They may not revert to historical means, but the odds are certainly against further significant gains.

Bond yields have risen but remain low by long-term standards. And property is still close to the peak.

A look to the past supports current bear market premise

That we are likely in a bear market is borne out by comparison with past bear markets, an exercise which was conducted by Jeremy Grantham of GMO in a recent article, "Entering The Superbubble's Final Act".

> *"… the speed and scale of these bear market rallies.*
>
> *From the November low in 1929 to the April 1930 high, the market rallied 46% – a 55% recovery of the loss from the peak.*
>
> *In 1973, the summer rally after the initial decline recovered 59% of the S&P 500's total loss from the high.*
>
> *In 2000, the NASDAQ (which had been the main event of the tech bubble) recovered 60% of its initial losses in just 2 months.*
>
> *In 2022, at the intraday peak on August 16th, the S&P had made back 58% of its losses since its June low. Thus, we could say the current event, so far, is looking eerily similar to these other historic superbubbles."*

Market action since Powell talked tough at Jackson Hole supports this bear market premise. Such markets are characterised by higher volatility and sharp rallies; these make investing tricky; you therefore need a long-term plan.

Economics – Short term

In US, end-2022 inflation likely to be way ahead of Fed's 2% target

Part of the relief rally came from the hope that inflation in the US was turning with a 0% month on month CPI print in July. But, as Greed and Fear pointed out, 18 of the 36 CPI components actually accelerated, and if inflation remained at 0% until the end of the year, we would still exit 2022 at 5.4% p.a. inflation, hardly a major win and much higher than the 2% Fed target.

This remains critical – Jan Hatzius, Chief Economist at Goldman, Sachs and a cut above the average of the breed – stated in a recent Odd Lots podcast that he believes the Fed will be aggressive on rate rises until the inflation rate begins with a "3". (Incidentally, I think this is an excellent podcast and Joe Weisenthal and Tracy Alloway dig into many otherwise unexplored areas.)

Clearly, the combination of quantitative tightening (or QT) and higher rates is a reversal of the policies which fuelled the market's rise, and when you add in high inflation, and particularly rising energy prices, you have an unattractive cocktail. And that ignores the pressure on food supplies, partly related to the Ukraine situation, but also to unprecedented drought conditions globally.

In Europe, rising energy costs and food cost pressures causing pain

Europe will also suffer the food cost pressures and greater pain from rising energy costs and the availability of gas. Martin Wolf in the FT (Europe can – and must – win the energy war) discussed the IMF's assessment of the impact on Germany of cutting off Europe's gas (they predict 1.5/2.7/0.4% of GDP in 2022/23/24).

If Russia shuts off Europe's gas, it will be a disaster for Germany. I calculate the IMF's impact at c.$110-120bn in 2023. That seems much too low – BASF's revenue is just shy of $100bn, obviously not all sourced from Germany but that is a good context. If Russian gas stops, Ludwigshafen (BASF's massive chemicals complex) surely will have to close, but it's the knock-on effects which really matter – car factories will close because they will be short of components, as will large swathes of German industry. This sounds much larger than a $100bn problem – $200bn, $300bn, could it be more? A friend at a large hedge fund agreed the IMF forecasts look highly conservative.

In the UK, I spent time with the management of John Lewis this week. It's a well-run business and the team is sensible and not afraid to talk. This was prior to new PM Truss making any policy announcements and the team were all expressing concern about the next two years. I expect that the news of fuel price caps will have been a great relief, although clearly there will be a price to pay at some point. It made me think that survival is the most important goal in any consumer facing enterprise – conservative financing and a quality management team will count for a lot, going forward.

Chinese real estate sector, a major component of Chinese household wealth, in dire straits…

An area which has gone relatively uncovered, which is a surprise to me, is China. Obviously the zero-Covid policy is a disaster (although it is helping depress Chinese oil demand, which is down 6-7m b/d and capping oil price rises). But the Chinese real estate sector is one of the largest asset classes in the world and it's in dire straits. This is important as it's a major component of Chinese household wealth; the middle class often invest in second and third properties.

Since the scale of Evergrande's problems surfaced, confidence in the sector has been receding. Sales are now running down 30% (by floor space), and starts are down 35%. Home prices are in decline and unless this is reversed, volumes may not pick up. Recent initiatives to relax interest rates and deposit requirements may not be enough to persuade speculative investors. They clearly form a large part of incremental demand, although I have never seen any good estimates of the degree.

The problem for China is that residential real estate is an engine of economic growth. It's not just the 20-25% of GDP it represents. Local municipalities often rely on land sales for 30-40% of their revenues and this is already drying up with sales at 2000 levels, according to Greed and Fear. Megan Greene in a recent article in the FT stated that 30 real estate companies there have now defaulted. She puts real estate at 60% of local government revenues and 70% of household wealth.

…putting short-term Chinese growth outlook in crisis

This looks to be a real crisis. Chinese growth may not even hit the 3.5% consensus level for 2022. Major US companies like Tesla and Apple rely heavily on China sales. I would be worried about Apple, which is on a consensus P/E of 25.5x for the year to 9/22, falling to 24.1x next year. With the strength of the dollar, the impact of inflation, the lack of an exciting new phone and general economic weakness, I wouldn't be in a hurry to add – forecasts are surely at risk.

To be fair, not everyone views the short term as negatively as I do. There is hope that Government support, like the new UK Prime Minister's initiative to cap energy bills, will limit the damage. Here is a take from one wag on Fintwit.

View from Fintwit

We went through a Pandemic & 2 years of lockdowns, yet Fintwit expects the world to end this winter, whereas the problem is solved if you drop your heating by 2 degrees & wear a sweater indoors instead of a T-Shirt.

And we will bail out utilities like we did with banks in '08
🌳

Source: https://twitter.com/agnostoxxx/status/1567465888009306112

Somehow, I doubt it will be that easy.

Economics – Longer term

Climate and workforce availability longer-term red flags

Grantham's piece flags a number of longer-term issues, which I also think are important.

Labour force availability – demographics are now working against us. More pensioners and fewer workers, when we already have full employment and are struggling to fill vacancies.

Climate – drought conditions are affecting not only farming. Waterways for transport are being affected, notably the Rhine. My recent visits to the Boulder and Glen Canyon Dams highlighted low water levels and the risk of electricity supply to LA. Grantham writes:

> *"French nuclear power stations have had to reduce production because rivers are too hot to be used for cooling; China has had to halve its hydropower (18% of its electricity), which has also been reduced in Canada, Norway, India, and elsewhere by low water levels."*

And high temperatures are affecting agriculture.

Moreover, the issue of food availability which he cites as a short-term issue could also become a longer-term problem with population growth, higher energy costs inflating the cost of fertiliser and climate impacts.

Meanwhile, productivity growth has been very slow; we have the longer-term issue of de-globalisation, which is inherently inflationary (and likely to be accelerated by the weakness of the RMB); and financial repression is possible or even likely with Russell Napier arguing that Government will force savers to buy their bonds, which means a reduction in equity exposure.

The solution

Look to UK small cap space for some individual performers, even against gloomy backdrop

Even in the 1970s, it was possible to make a real return by buying the right equities. I know this all sounds terribly gloomy, but the good news is I am finding lots of interesting stocks at valuations which look sensible even with a gloomy economic backdrop. I don't expect the market to repeat its performance of the last decade, but there are lots of individual stocks which will make you money in the next 10 years, especially in the UK and particularly in the small cap space, where Hardman & Co can help.

About the author

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Stephen (Steve) Clapham is an equity analyst at Hardman & Co. Steve is also the founder of Behind the Balance Sheet, an investor training consultancy. He has been an investment analyst for the last 25 years, working on the sell side for a number of investment banks covering the transport, utilities and conglomerates sectors. In 2005, he moved to the buy side, where he was a partner at Toscafund Asset Management LLP, and then Head of Research at Altima Partners LLP. Steve was part of the group of investors that acquired Hardman & Co in late 2012. He holds a degree in Technology and Business Studies, and is a member of the Institute of Chartered Accountants of Scotland.

Steve Clapham, Founder, Behind the Balance Sheet. Visit Steve's *website* to sign up for his free newsletter.

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