Creating Value through Innovative Financial Solutions

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Investors should be prepared for an impending shift in the economic landscape. In an article on the Financial Times, economist Russell Napier caught our attention by claiming that *"politicians had gained control of money supply and will not give up this instrument anymore".* Since inflation is the only way out of mushrooming debts, Napier anticipates a new era of financial repression where market-determined rates of interest are abolished and the yield curve is controlled by forcing savings institutions such as life insurers and mutual funds to buy government debt at yields below the rate of inflation. According to this scenario, *"savers will have to bear the burden of capped yields and will watch a portion of their savings eaten away through inflation".* While it is difficult to truly gauge the likelihood of such a scenario, the sustainability of the indebtedness (households, companies, and governments alike) should clearly be a source of concern in the medium term. This explains why interest rates keep sliding lower. As illustrated by Chart 1, the 30-year US mortgage rate now trading at the record low level of 3.0% and is likely to decrease even further in the coming years.

Chart 1: Freddie Mac US Mortgage 30 Year (%)

Source: Bloomberg

According to Napier, gold will remain the best way to retain the purchasing power of savings. While we agree with this approach and believe that gold will remain supported by Central Banks money supply, we are also cognisant that the recent sharp spike in gold may be a result of investors' flight to safety over negative headlines.

Chart 2: Gold price (USD/oz)

Source: Bloomberg

In our view, the movement in rates, gold and real economies seem to indicate a bearish sentiment and we continue to think that equity valuations globally are too optimistic. The fact that real rates have now turned deeply negative (US 10Y real rates at -0.90%) is forcing institutional money out of bonds and into equities. TINA ("There is no Alternative") and FOMO ("Fear of Missing Out") are terms often thrown around as the main reasons backing the recent upward trend in equities. Since neither of these alone is a good reason to invest into equities, we have started to exit out of and take profit on the most overstretched valuations.

An example of a grossly mispriced stock is Tesla. The stock which briefly surged to $1,794 on July 13th, implying a paltry return on equity of 0.6% (based on a very optimistic EPS of $11.9 for FY2021), is far lower than the 4.7% yield that investors would get for the less risky bond (TSLA 5.3 08/15/25). In the CDS space, the surprising fact that 30% of Investment Grade (IG) names now quote as tight as non-IG names, is also a source of potential arbitrage.

Moreover, according to NYU professor Edward Altman, who developed one of the best-known formulae for predicting corporate insolvencies (the Altman Z-Score), the spate of defaults and bankruptcies is unlikely to abate soon. Consequently, finding opportunities in these markets has become increasingly harder. With yields on IG bonds back to 70 bps and S&P500 EV/EBITDA ratio higher today than during the 2000s tech bubble (as per Chart 3 below), it would appear that investors are walking on thin ice.

Chart 3: S&P 500 EV / Trailing 12M EBITDA ratio

Source: Bloomberg

Way Forward for Us

As mentioned, we are seeing potentially larger downside than the upside offering, and thus have made the call to weed out our most speculative ideas. As an example, names in disruptive technologies have been removed from our equity portfolios, as we become increasingly uncomfortable with its inflated valuations backed by the recent outperformance of the stocks – without convincing fundamental support.

We continue to see tremendous value in niche or specialised strategies such as relative value and re-insurance which focus on capturing opportunities outside of the equity space. The low correlation to the equity markets remains valuable in providing diversification benefits to a portfolio. Within the equity space, manager selection is key where the portfolio manager's stock picking skills with strong focus on earnings and fundamentals, and disciplined risk management are crucial in downside management during a market correction.

We believe there are also opportunities within the structured credit space – especially the US mortgage-backed securities (MBS) sector as well as the AAA tranche of TALF 2.0 program which present very attractive risk-adjusted returns.

Given what we observe in the global equity markets, we believe it is prudent to have the investor's portfolio be as lowly correlated to the markets. At this junction, we would recommend our clients to reduce beta by including alternatives and market neutral strategies to their portfolio in order to earn a stable income, without incurring undue risk.

Yours Faithfully,

The Lighthouse Canton Team