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CEO Corner

U.S. versus Global Investments: A paradigm shift?

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While the 4th quarter of 2018 was one of the worst ones for global equity markets in a long time, the first quarter of this year was a completely different story. Despite concerns over issues such as Brexit or the trade negotiations between the U.S. and China, global equity markets had a surprisingly strong start to the year. Within just a few weeks, pretty much all the losses seen in 2018 were erased. This great reversal of fortune was something that probably not even the greatest optimists expected after the challenges of the last year. So, what are the reasons for this sharp recovery we've been seeing so far?

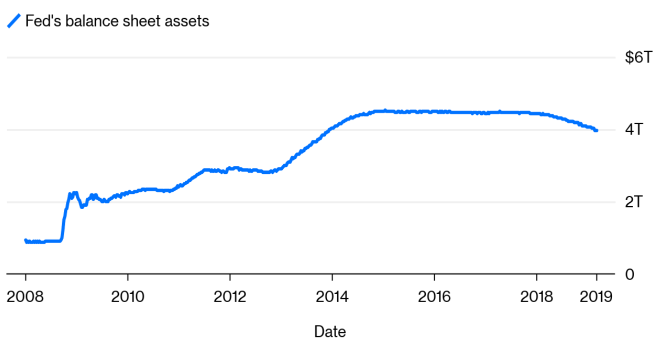
Our view is that the Brexit saga and the trade negotiations have not been as consequential as the media coverage they receive might suggest. Yes, of course, there has been a lot of talk and speculation about these two issues, but their actual impact on financial markets has been rather insignificant. The real story, however, has been developing in the bond market and more precisely in monetary policies, especially the monetary policy of the Federal Reserve in the U.S.

For the past two years, the investing environment was overall quite simple and straightforward. The U.S. was doing great, with a booming stock market and strong economic growth, so the Federal Reserve started to normalize its monetary policy by hiking rates and starting to reduce the size of its balance sheet (quantitative tightening, or "QT"). As the market already anticipated higher rates in the U.S., the Dollar got an extra boost and therefore has stayed relatively expensive, at least for now. However, the Dollar has lost some ground since the peak in the cycle at the end of 2016.

Our readers know that we have always remained sceptical about the central banks' ability to raise interest rates given the large amounts of debt in the government, corporate and consumer sector. We think that the developments and market reactions seen in Q4 2018 clearly proved that the global economic system can't deal with significantly higher levels of interest rates. Remember, all it took was a series of small rate hikes by the Federal Reserve and a slight reduction of its balance sheet to raise strong concerns about a liquidity crunch. We have always believed central banks would react more proactively in the future after the lessons learned from the 2008 crisis. Indeed, between September 2018 and early 2019, the Federal Reserve made a complete U-turn in their strategy, which was a response to the volatility seen in Q4 and/or a reaction to a global economic slowdown, the reason that was officially cited by the central bank.

So, where do we stand now? We have the Federal Reserve that has clearly signalled to the market that it will not proceed with any further rate hikes for the time being. It also announced its intentions to scale back its QT program and end it altogether in September, much earlier than widely anticipated. This shows just how fragile the global monetary system seems to have become. It also has far-reaching implications for financial markets, the U.S. Dollar and U.S. investments in general.

Fed set to stop its balance sheet reduction



Source: Bloomberg

It is not unlikely that we are witnessing a paradigm shift at this stage. For the last couple of years, the U.S. stock market, as well as the Dollar, were the place to be for global investors. The U.S. stock market has been rallying for more than 10 years now, outperforming pretty much every market in the world. A similar situation unfolded in currency markets, where the Dollar rallied by almost 35% between 2011 and 2016. Thus, for US investors who diversified outside the U.S. Dollar and outside the U.S. markets, the results have been disappointing against the U.S. performance numbers. And yet, this might now be changing.

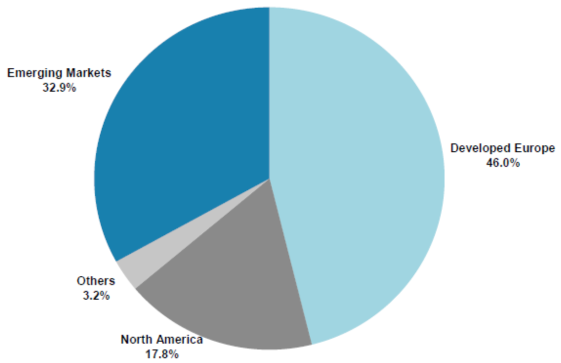
An end to the decade-long outperformance of U.S. markets?

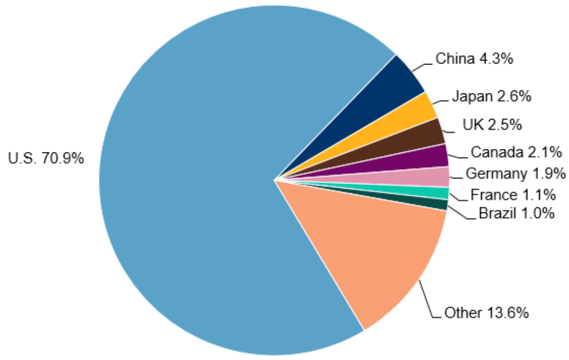
International investments and diversification, although always advisable, have been a hard sell for the past few years. Now, however, with U.S. equity markets having such high valuations and the U.S. Dollar still holding at a reasonably high level, we might finally see a shift towards international investments. Not only are valuations outside the U.S. a lot more attractive, but the long-term cycle of the U.S. Dollar (recovery phases of approx. 5 years, followed by periods of decline of approx. 10 years) is also about to reverse, a prospect that is now also boosted by the monetary U-turn of the Federal Reserve. Of course, the decline in the Dollar might not happen immediately, especially now that the global economic activity is slowing. Nevertheless, we would expect the Dollar to come under pressure in the second half of the year, when we anticipate global growth to finally accelerate again, as these conditions are typically adverse for the currency. With the renewed expansion in Chinese service PMI's, as well as an anticipated China-US trade deal, the outlook for an improving global economy is there and we could see global growth pick up again.

In our last InSights, we examined the reasons for the outperformance of U.S. markets in recent years, but we now simply feel this is not sustainable and foresee below-average returns for U.S. investments for the coming years. Given the high valuation of U.S. markets and the value of the U.S. Dollar that still remains high, the current environment offers investors a unique opportunity to reallocate funds to international investments and currencies. We are not only looking at such opportunities in Europe, but also in emerging markets, which are trading at very attractive valuations today. This does not mean that the U.S. economy will slip into a recession, but we certainly expect a slowdown of GDP growth and with it, a slowdown of earnings growth. In fact, some sectors could even see negative earnings growth this year.

With the western world continuing to grow at moderate levels, most of the world's GDP growth is now coming from emerging economies, such as China and India. This will continue as the economic power will move east in the coming 10-20 years, an inevitable shift that investors should now prepare for and position themselves accordingly. European companies, due to their significantly higher exposure to Asia and EMs than their American peers, are set to profit from this geo-economic shift. This advantage becomes apparent when one considers the limited international and EM revenue exposure of the S&P 500, in contrast to that of European companies, as seen below.

Revenue exposure to EMs, European vs U.S. companies





Source: S&P Dow Jones Indices, MSCI

Given that the Federal Reserve is already in reversal mode and most other central banks haven't even started to hike rates, what options will they have to stimulate the economy should the current slowdown prove to be longer and more extensive than expected? The answer is relatively simple. Their options are seriously limited. Rates can go negative, but even that is not a strong enough push to get the economy back on track. Low or ultra-low interest rates are hurting savers and banks, while they only offer modest support to the economy. This was of course different in the early days, when rates were at significantly higher levels to begin with. Lowering rates from 5% to 2% indeed provided a strong incentive, but a drop from 2% to 0% is not making much difference anymore.

As options run out for central banks to provide support for the economy, we see the focus shift to fiscal stimulus, with governments spending more money and injecting it directly into the economy. Italy is a prime example of this, as the new government is hoping that extensive spending programs will reenergize and jump-start the whole economy. If they don't, the already heavily indebted country will be left with even more debt and nothing to show for it. It is a dangerous approach that can create more problems than it solves. However, this shift towards fiscal stimulus can also be seen throughout the Eurozone, as well as in the U.S. and China. Does that mean that it works then? Many different studies suggest that fiscal stimulus in the form of direct government spending has a significant impact, much stronger than passive measures, such as tax cuts. So, the incentives for countries to go down that road are compelling and we have no doubt that we will see more of it.

Is the Yield Curve inversion pointing to a Recession?

Central banks and politicians have become paranoid in their fears of a recession, even though recessions are the most powerful self-correcting mechanism in modern economies. However, these days central banks and politicians are trying to create eternal growth and they try to achieve that through overspending and keeping interest rates artificially low. This is creating all sorts of problems by inflating asset prices, as can been seen in stock markets, bond markets and real estate today. Make no mistake, this process is far from over and with more debt accumulating in various sectors of the economy, liquidity will not be withdrawn. In fact, more of it is being created out of thin air. This process will continue and with it, the liquidity inflow we have been seeing in recent years. Five years ago, the Dow was trading at around 16'000 points, today it is already trading above 26'000. Again, make no mistake, liquidity inflow is here to stay, and it will probably not go away in the coming years; in fact, it might get worse.

For all of the reasons outlined above, investors also need to be careful how they interpret the currently inverse shape of the yield curve, which has historically been a strong indication that the economy is slipping into a recession soon. While we are already experiencing a slowdown in most major economies, it is too early to say if this will culminate into a recession. The yield curves are distorted today by the central banks' intervention in the markets and thus their predictive and signalling value is not entirely reliable. Therefore, when looking for signals pointing to an upcoming recession, we need to look beyond an isolated factor such as the yield curve. Today, this means that the overall outlook is more positive and even though most major economies are slowing, this might only be the case temporarily.

While we expect more volatility in equity markets going forward, we also believe that long-term investors need to hold investments in equities (especially global equities) and precious metals. Furthermore, the coming years will be critical and will require active investment management, as the performance differential among individual sectors will continue to widen. We do see a few challenges ahead, but we also see a lot of attractive opportunities for the active investor.

Improved outlook for the precious metal mining sector

Dirk Steinhoff
Chief Investment Officer

After many tough years of disappointing performances and investor discontent, gold mining companies now appear poised for better days ahead. As the outlook for precious metals appears increasingly positive and after a number of significant developments in the sector, mining companies could hold considerable potential going forward.

Gold price prospects

Gold's performance has historically played a key role in the gold mining sector and gold mining stocks and gold ETFs tend to move with the gold price. It therefore makes sense to first take a look at the current conditions and factors that help determine gold's outlook. To begin with, the recent U-turn of the Federal Reserve showed that, after the turbulence of the past year, the central bank capitulated on its normalization efforts. This urgent need to avoid a recession at all costs is dominant across most major central banks, that haven't even attempted to raise rates yet. In fact, given the wider economic weakness and the recession fears on the rise, interest rates are very likely to remain at ultra-low levels for some time. This, of course, is good news for gold, as it translates to very low opportunity costs for choosing the precious metal over interest-bearing assets.

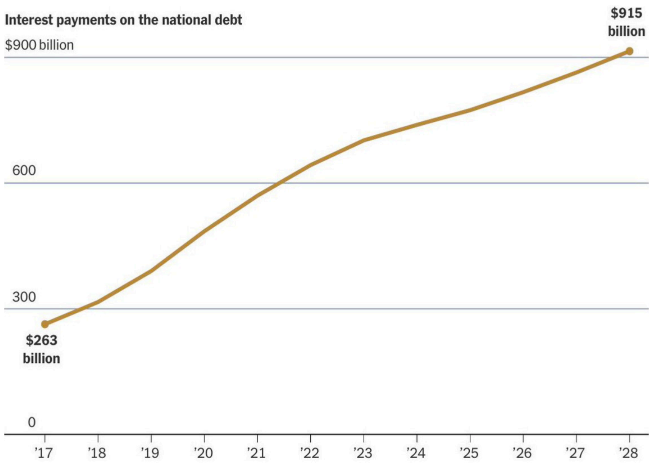
Additionally, a look at the bigger picture and especially at the extraordinarily high debt levels throughout most major economies also provides solid support for higher precious metals prices in the coming years. A great example is the runaway budget deficit in the U.S., currently at $1.1 trillion and the largest since 2012, and the country's total public debt that climbed to a record $22 trillion as of February.

Over in Europe, debt is also a major issue. Italy's government debt is in excess of 132% of its GDP, while the country has succumbed to its third recession in just a decade. Greece, despite having exited its bailout program, also remains a "problem child" in the Euro area with government debt at 180% its of GDP. Portugal carries a very heavy debt burden too, at 121% of GDP, while Belgium's stands at just over 103%. It is worth noting, however, that in the EU as whole and in many key economies in the bloc, the government debt-to-GDP ratio has been decreasing over the past few years, while the opposite is the case for the U.S.

However, it's not just governments that have a debt problem. Corporate debt has exploded as well, as we covered in our December insights. Especially in the U.S., companies have been using cheap credit to fund buy-back programs that helped push up earnings per share growth. At the same time, consumer debt has also skyrocketed. While housing debt is lower than its pre-2008 levels, auto and student loans have doubled, from $1.36 trillion to $2.73 trillion.

This widespread and unsustainable trend of rising debt levels, spread throughout the economy, presents a clear threat to future growth and renders monetary normalization and higher interest rates extremely difficult and risky, while increasing the appeal of precious metals.

Interest payments on the U.S. national debt expected to triple in a decade



Source: Congressional Budget Office

Solid demand for gold

Central banks seem to have recognized this increased appeal and arguably, they are even at the center of this new appetite, as their gold purchases last year reached the highest levels in half a century. In an attempt to diversify away from the USD, Russia, Turkey and Kazakhstan have gone on a gold buying spree, while China also resumed its purchases for the first time since 2016. Overall, central banks added over $27bn worth of gold to their reserves, with volumes climbing to 651.5 tones, an increase of 74 % on the previous year, according to the World Gold Council. Even in the EU, long-standing political tensions have contributed to a spike in gold purchases by some central banks as a way to ensure stability and hedge against the various sanction threats by Brussels. A prime example is Hungary, that after years of friction with the EU, announced a 10-fold jump in its gold holdings last October.

As for the consumer demand for gold, it also appears to hold strong, supported by major markets like India and China, where a rising middle class, broader economic growth and a long historical and cultural tradition of gold ownership has pushed demand higher. In 2018, China and India accounted for 57.75% of global gold jewelry demand, a figure that is only expected to rise in 2019, according to Bloomberg Intelligence.

As a result of all the aforementioned factors, the outlook for precious metals appears positive at this stage. The gold price has already shown an upward tendency in past months, as in late January it managed to break though the crucial $1,300 milestone. While it retreated to somewhat lower levels since, it did show signs of a rebound and the mid- and long-term expectations for the metal are encouraging. According to a survey of analysts by the London Bullion Market Association (LBMA), two-thirds of those questioned see gold reaching or surpassing $1,400 during the year.

Precious metals mining sector: Better days ahead?

The precious metals sector went through a very rough patch after the gold price peaked around $1,900 in 2011, and gold mining equities' market capitalization has halved since 2012. The industry largely fell out of favor after companies spent heavily on mines and new exploration projects that did not deliver the expected results. Government regulations and legal battles also disrupted activities for some companies, like AngloGold, and so did protracted strikes, such as the 5-month long strike that crippled production for South Africa's Sibanye Gold. Overall, in the past years the sector has underperformed in terms of returns to shareholders, while poor management decisions and extravagant exec-

Central bank gold accumulation

Source: IMF, Bloomberg

Dow Jones US gold mining index vs. gold: ratio still near decade low

Source: Bloomberg

utive bonuses contributed to the negative investor sentiment.

However, over the last couple of years, many companies in the sector have taken meaningful steps to rebuild investor trust. Through management changes, restructuring and cost-cutting, a return to strong cash generation, as well as share buyback programs and special dividends, significant progress has been made in regaining shareholder confidence.

Moreover, there is another important shift that has the potential to lift the sector. While demand for gold is well supported and expected to remain strong, supply is declining. As exploration expenditures were reduced during the aforementioned efforts to cut costs, the mining industry is today facing a resource replacement challenge. For the 10 years prior to 2016, the amount of gold discovered declined by 85%, while since 2011, reserves have dropped by 40%, according to a report by Deloitte. As new exploration projects are not only capital- and time-intensive, but can also be risky, many companies have opted for acquiring existing operations with already proven deposits instead. This urgent need to efficiently replenish resources has been a key driving force behind a considerable increase in M&A activity in the sector over the last year.

The much-publicized merger between Barrick Gold and Randgold Resources has allowed the combined group to cut costs and to forecast a double-digit jump in gold output this year. Newmont Mining is another bright example, as after the buyout of Goldcorp, it is set to overtake Barrick and become the world's largest gold producer.

Overall, consolidation seems to be the way forward for a sector that has so far been relatively fragmented, and we expect to see more of it, as the increased efficiency, operational optimization and resource replacement opportunities are largely welcomed by shareholders and investors. Furthermore, apart from the uptick in merger deals, joint ventures are also on the rise in the sector. At the end of April, Barrick and Newmont announced that a joint venture in Nevada, which will form the largest gold producing complex in the world, has cleared all the regulatory hurdles.

In light of these developments and despite the signs of a turn-around in the sector, mining stocks remain at relatively low valuations, as the potential of the consolidation wave and the structural changes within companies don't seem to be priced in yet. In fact, mining stocks are close to their lowest point in a decade compared to gold, and only recently began to gather some steam. Given the positive outlook for the sector, this represents an interesting opportunity and one certainly worth considering, while closely observing all relevant developments in the coming months.

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