CROSSBRIDGE CAPITAL

Market Viewpoints

Manish Singh

March 2017

You can't be for big government, big taxes, and big bureaucracy and still be for the little guy.

- Ronald Reagan, 40th US President

Over the weekend, President Trump failed to repeal and replace The Affordable Care Act also known as *Obamacare*. *Obamacare,* with a budget five times that of the UK's National Health Service (NHS), is a prickly issue, and one which will unlikely be solved to everyone's satisfaction anytime soon. Now the Republicans plan to move on to tax reform and have promised quick action. However, tax reform could be just as complicated as healthcare reform. To start with, the only actual tax plan in existence, the Ryan-Brady Border Adjustment Tax, is extremely divisive within the Republican Party and doesn't have sufficient support to pass the Senate. The economic recovery and the equity bull market, that started in March 2009 are celebrating their eighth anniversary this month. During this time the S&P 500 Index is up a staggering +246%. The economic expansion has been driven largely by record low-interest rates, the lowest since the 1800s in the US, driven by accommodative monetary policy. Going forward, given the low level of interest rates and expectations of rising inflation and bond yields, equities continue to offer better potential returns than bonds. On a valuation basis, Europe looks much more reasonably valued than the US. The European Stoxx 600 Index is still -7% below its 2007 peak, whereas the S&P500 Index is +48% above its 2007 peak.

Pension Tsunami

When it came to major financial crises, the Savings and Loans (S&L) defined the 1980s, the Dot-Com bubble the 1990s and subprime mortgages the 2000s. Are unfunded public pensions the next big crisis?

Unfunded pensions are shaping up to be a crisis that could overwhelm developed nations and challenge the social structure. Over many years, generous pensions have been promised and the price of keeping that promise is soaring. Credit rating firms have started downgrading US states and municipalities, whose pension liabilities threaten their budgets: New Jersey, Chicago, Houston and Dallas to name but a few. In the US, the unfunded public pension obligations have risen to $1.9 trillion today from $292 billion in 2007. The ongoing crisis at the Dallas Police and Fire Pension System is a cautionary tale for others.

The Dallas Pension scheme has been underfunded for many years, with the situation taking a sudden turn for worse recently. As at January 1, 2016, the pension plan had $2.68 billion of assets against $5.95 billion of liabilities, making the funding ratio a mere 45.1%. In order to pay its generous benefits, the scheme counted on an investment return of +8.5% per year, absurdly high in a world where the yield on 10-year US Treasury bonds has been hovering in a range of +1.5-2.5%. So the scheme bet on riskier private equity and real estate investments. Dallas held 68.4% of its assets in alternative and real estate investments compared to 21.8% for comparable state and local plans. But the high-risk strategy did not work and the value of its investments declined by $650 million during 2013-15. As news of losses spread, the pension fund saw a run on its assets. When some workers take out their money, they get the full value of their benefits; leaving a smaller pot to be shared among the remaining members. As in a bank run, it seems rational to withdraw your money if you worry that all the benefits won't be paid. Last year saw a withdrawal of $600m, of which almost $500m has been taken out since August. In 2015 total withdrawals were just $81m. After the withdrawals, the funded ratio has fallen further and the Mayor of Dallas is scrambling to find a solution.

What has changed with these pensions is the asset allocation, which I suspect was driven by "greed" and the influence of Wall Street. According to Bloomberg, in 1952, the average US public pension had 96% of its portfolio invested in bonds and cash equivalents. Assets matched future liabilities. However, a loosening of state laws in the 1980s opened the door to riskier investments. In 1992, fixed income and cash had fallen to an average of 47% of holdings. By 2016, these safer investments had declined to 27%. "Greed is good" may have worked for Wall Street as the seller of these riskier investments, but it has sown seeds of discontent on the Main Street.

If current returns were to prevail and more a realistic discount factor used, unfunded pension liabilities could triple to upwards of $6 trillion. This would translate into much steeper funding requirements at a time when budgets are already constrained and lead to essential public service budgets slashed to dangerous levels. The simple math of - overpriced financial markets, inadequate contributions, and overly generous pension promises - mean that what happened at GM, Chrysler, Detroit (and now Dallas) could happen nationwide in the coming decade.

According to University of California, San Diego, economists Gordon Hanson, Chen Liu and Craig McIntosh, the era of massive low-skilled migration to the US may be over. The consequences of this on US economic growth and associated liabilities (pensions included) are profound. In their paper - "Along the watchtower: The rise and fall of US low - skilled immigration," Hanson and Co. suggest that the future immigration of young low-skilled labour to the US looks is set to decline rapidly, whether or not President Trump implements more-draconian policies to control US immigration. The US baby boom that ended in the early 1960s continued for an additional two decades in Latin America, creating pressure from the 1980s onward for workers to migrate to the US from countries such as Mexico. US neighbours to the south are today experiencing much slower labour-supply growth and the 2007-09 recession "may have merely advanced forward in time an inevitable reduction in low-skilled immigration." The dilemma facing the US therefore, is not so much how to stop massive increases in the supply of foreign labour, but rather, how to prepare for a lower-immigration future.

The slower pace of labour force growth has numerous implications. For workers, it means slow growth in average wages and living standards and for businesses, it implies relatively modest growth in sales. For policymakers, it suggests relatively modest growth in tax revenues. It also suggests a lower neutral rate of interest and higher unfunded level of pension schemes. So look out for this Pension Tsunami when it makes a landfall.

Where to invest?

Apparently, at their meeting last week, President Trump handed German Chancellor Angela Merkel a bill for more than £300bn for money Germany "owed" NATO for its defence. Using 2002 as a starting point — the year Merkel's predecessor Gerhard Schröder pledged to increase defence spending — US officials allegedly calculated the extent to which German defence spending had fallen short of the 2% of GDP target that NATO required, and added the interest on top of the amount. Trump has also reportedly asked his staff to prepare similar calculations for all other NATO members who are below the 2% target.

Well if there ever was one answer to - where to invest? It has to be in defence and industrial companies. You can be certain that the peace of the last 60 years is a minor aberration in the otherwise long history of a world fraught with conflict. A world based on paper money which can almost be printed at will, has led to ever-increasing sovereign debt. Not all these debts are internal which can be easily defaulted or re-profiled with little consequence. Creditors will ask for their money back and debtors better be in a position to pay or defend. Either way defence spending will again play a central role in the years to come. Defence spending is going up in both the US and Europe, as the latter can no longer count on the protective US umbrella without making itself more vulnerable.

Over the weekend, President Trump failed to repeal and replace *Obamacare*. I never understood why he even went with repealing *Obamacare* before legislating tax reforms. Surely, if *Obamacare* were as bad as the Republicans say, they should just wait for it to implode and then repeal and replace it. Perhaps unwittingly they had a lucky escape now that *Obamacare* will be left to its own devices. *Obamacare* with a budget five times that of the UK's National Health Service (NHS), is a prickly issue, and one which will unlikely be solved to everyone's satisfaction anytime soon. Healthcare stocks are breathing a sigh of relief.

Now the Republicans plan to move on to tax reform and have promised quick action. However, taxes could be just as complicated as healthcare reform. To start with, the only actual tax plan in existence, the Ryan-Brady Border Adjustment Tax, is extremely divisive within the Republican Party and it doesn't have sufficent support in the Senate.

The economic recovery and the equity bull market that started in March 2009 are celebrating their eighth anniversary this month. While President Trump ran on the idea of "America First", in terms of global equities, "America First" has been the case for several years now. Since the lows in March 2009, the S&P500 (SPX) is up +246%, the MSCI Developed World Ex-US (MSDUWXUS) +92%, the MSCI Emerging Market (MXEF) +113%, and the Europe's Stoxx 600 (SXXP) +140%. Somewhat worryingly, these gains have occurred with very little in the way of earnings growth. Therefore, what we have seen is record price/earnings multiple expansions in the hope of future earnings growth. The expansion has been driven largely by record low interest rates - UK interest rates are the lowest since 1700, and in the US, the lowest since the 1800s - due to accomodative monetary policy.

Having said that, given the low level of interest rates and expectations of rising yields in the bond market, equities continue to offer better potential returns than bonds. Recently, the non-US markets seems to be performing well on the back of a weaker US dollar. More specifically Europe looks to be in a good recovery mode, month after month. Friday's flash Purchasing Managers' Indexes (PMI) for France, Germany and the Eurozone all beat consensus expectations. Indeed, the composite Eurozone PMI hit a 71-month high in March. Among the impressive details of the survey, were the best employment growth for almost a decade and increasing signs of inflationary pressures.

On a valuation basis, Europe looks much more reasonably valued than the US. The SXXP remains -7% below its 2007 peak, whereby the SPX level is +48% above its 2007 peak. If there were a concern in the equity market it would be that US equity valuations are elevated and volatility is low. There is a growing risk that real bond yields will rise as the US Fed is seen to be behind the curve on policy tightening. However, I remain constructive on equities and suggest increasing allocation to European equities while maintaining the US overweight. My sector preferences – Financials, Technology, Healthcare and Industrials.

Enough of history, politics and market commentary for now. I want to draw your attention and elaborate on something I briefly touched on in my November newsletter. We have now upgraded the functionality of our digital investment platform CONNECT by Crossbridge. It is an easy and transparent way for you to set your investment goals and invest in a balanced or aggressive strategy which target +6.8% and +10.3% p.a. returns respectively. If you think active asset management is not for you and you are happy to take a more passive view and invest to achieve a given level of return with reduced volatility, then you may want to take a closer look at CONNECT. Like you, we don't like high fees. Investors around the world are benefiting from the savings that technology and new ideas can bring to investment portfolios. CONNECT now brings these savings to investors, along with a hassle-free, and easy-to-use offering. I will be pleased to hear from you and get your feedback on this offering that brings together the human investment talent that we have in-house with the latest technology, in order to enhance our service offering to you.

Best wishes,

Manish Singh

Manish Singh, CFA

United Kingdom
9 South Street
London W1K 2XA
United Kingdom

Singapore
One Temasek Avenue
23-05 Millenia Tower
Singapore 039192

Monaco
Le Park Palace,
Bloc A, 8ème Etage
5, Impasse de la Fontaine
98000 Monaco

Visit our website:
crossbridgecapital.com

CROSSBRIDGE CAPITAL