**John Townsend’s investment opinions September 2016**

**Against stupidity the very gods themselves contend in vain** – Friedrich Schiller, German Dramatist 1759 - 1805

There is a great deal happening in the global economic market, much is important but little has an immediate impact on the way that institutional traders think and act.

In China, the economy is moving from an infrastructure investment base to a consumer driven one. The economic growth rate is slowing and lending from mainstream and secondary banks is at very high levels. That economic growth is declining from incredibly high figures is not news. The data is widely held to be unbelievable with numbers dictated by the government. However, even with real growth of 3% instead of the official 6%, there are still many non-government sector domestic investment opportunities with good corporate governance. A good fund manager will find these and avoid the banks, many of which seem to be headed for disaster through their unskilled lending, having wrongly believed that the state would bail them out. China’s imports are also changing, with consumer demand driving imports rather than engineering or raw materials. It is not that demand for steel, energy and engineered goods will cease, far rather demand for them is declining in favour of other imports.

Brexit, having caused two days of uncertainty in the investment markets then became less of an issue and calm promptly returned. The messages from the leaders of the weaker countries and the bureaucrats nominally at the helm of the European Union, that Britain should leave quickly and quietly – in other words, to fall on its own sword – have been ignored. Europe now has the opportunity to make changes within the Union, though bearing in mind the unlikelihood of reaching any decision; it is unlikely this will happen. At the recent meeting in Bratislava where the future of Europe was discussed, a number of suggestions were made. One glares out as an example of startlingly opportunistic but depressingly unrealistic thought. France suggests there should be a united European military headquarters, (presumably in France) controlling a European military force which would act in support of the European government. This is of course an interesting suggestion from the only European country capable of fielding a modern fighting force and one of only three remaining countries, after the United Kingdom’s departure (the others being Greece and Poland), to have adhered to the 2% of GDP minimum spending on defence. The major problem with this idea is that any pan-European decision, including military action, will take so long to achieve that any war would be lost long before agreement was reached to fight one. Such a force becomes meaningless because its political leaders, each with their own policies, would never willingly agree on a coherent decision. So it is with the reform proposals put forward in outline terms in Bratislava. They are unlikely to be agreed by all the states at any time in the future and so are in practice meaningless.

There is still a marked imbalance between the economic strength of the European States. The Northern Sates led by Germany for whom the Euro as a currency is too weak and the Southern States led by France, whose internal domestic issues and ensuing economic weakness make their current value of the Euro against world currencies too strong. This cannot be muddled through over the long term and a two speed Europe with different currencies and different economic strategies has to be the outcome. If one wants swift action, rather than just a swift Brexit, there should be a clear and rapid North South split in the structure and policies of the economic union. A removal of the bureaucratic overlay could be an additional advantage.

Bureaucracy makes itself felt in Germany too. The former German health minister Andrea Fischer recognized that she had a problem with the four permanent secretaries of her ministry when she took over in 1998. She swiftly removed three of them, but in a recent speech, she reflected that the fourth one undermined her just as effectively as the other 3 would have. She left office in 2001. It is clear that the whims of an unelected bureaucracy, without reference to their elected Political masters, make the execution of German policy. This is true through the length and breadth of German society and it is then left to the German courts to decide what policy was intended and what the laws actually mean.

In the USA there is a presidential election looming. What makes this one special and interesting is that the choice is between two deeply unpopular candidates. The least disliked candidate will probably win. The suggestion is that there is so much hostility towards both candidates that many more undecided voters than normal will actually get out and vote.

Under the democratic candidate, there will probably be very few changes to current policies. The Republican candidate has promised far reaching changes, not all of which are honest, logical or feasible. It must be remembered that the US Bureaucracy as much as in Germany, can dampen or alter the reality of policies.

The US economy is gaining ground and US corporations are growing in their profitability. Now seems a very good time to switch from European equities into the US Markets. However until the result of the US election is known, there is much to be said for holding back for the time being.

Risk and its management is now all-important. Where the traditional fixed income markets are showing negative returns, there is a temptation to diversify into hitherto unknown areas such as the Emerging Markets and corporate debt with much lower risk ratings than most investors had previously experienced or understood. Indeed many companies are capable of issuing debt at effectively no cost and are steadfastly doing so. Investors in such bonds are not being rewarded for the risks they are taking. Yet there is a danger of believing that these conditions will last forever and therefore acting, or not acting, accordingly. They won’t; the ancient dictum “These times will change” will inevitably make itself felt. Fund managers with analysts who are capable of assessing lower quality risk and taking coherent decisions will be able to avoid the inevitable future problems with debt from companies that fall by the wayside.

There is however now much to be said for investing in the Equities of the same high quality companies, where the yields, made up by equity market price increases and dividends, at least provide a passable return. Once again the skill of a management team and a wide distribution of risk will play key roles.

Looking into the future, there are industries that are once again flourishing after a longer term global economic downturn. Examples here are efficient oil and raw material producers. Increased consumer confidence also means an increased demand for the so-called next generation resources, such as lithium, battery storage production, renewable energy and coatings and packaging companies. These are detailed operations and need thorough competent analysis. They do however have a very strong future.

The major victims of the economic changes and zero or negative interest rates are the banks, which cannot make a profit with their lending when competition from other lenders is driving interest rates to effectively zero. Many funds from the major fund management companies had and still have a cushion of bank equities. These are now suffering badly and the entire sector is in urgent need of a substantial review. There is already a rescue scheme being organized for at least one Italian bank, even if this goes against European regulations. In Italy, regulations which would normally be adhered to rigidly in the Northern States are adjusted – almost with impunity- to meet specific political and economic needs.

Japanese and Western central banks have kept their interest rates - the rate at which the Central bank lends to commercial banks, at zero for a considerable length of time. The policy began in Japan in 1992 and was then taken up by the US Federal Reserve in 2008 to stave off economic collapse. In Europe, the ECB followed suit in March 2016. A zero interest Rate Policy was originally intended as an emergency measure to provide liquidity to the banks. As happens so often with emergency measures, they are clasped very tightly even when the need for them has disappeared. At the same time, the Fed, the ECB, Switzerland, Sweden and the Bank of England have Quantitative Easing Programs by which they buy high quality debt from the commercial banks to inject more money into their respective economies. Such cash injections were intended to increase investment demand and lift inflation rates from near to zero at present to a more normal two percent. This has not happened and has left the central banks with inflated balance sheets and often questionable assets, but without ammunition, other than the fear of uncertainty amongst investors, to steer their economies. The emergency measures have continued and will continue unabated until someone, somewhere, comes up with a better idea.

The outcome is that fixed income investments, needed by so many institutions to secure their obligations in the future, now have a zero and sometimes negative yield. Insurance companies have to incur costs to manage and meet their obligations and cannot now do so with the present low and indeed negative yields in their investments, The result is that investors, both institutional and retail have to increase the risk of their investments in order to achieve a higher yield. The concern once again is that many investors really do not understand what it means to take higher risks. Their nervous reactions to bad market news means that suddenly bonds and to a lesser extent equities will be dumped wholescale into the markets, almost at any price when the computers, who are not programmed to understand risk, signal a sell order.

Where does this leave the private investor? The safe investment havens of the past have disappeared. Not only will some life insurance companies no longer be able to meet their guaranteed payments and may be threatened with having to avoid making payments under their policies with guaranteed interest rates, but the wholesale stampede into previously unknown investment markets, such as the Emerging Markets in an attempt to improve returns, has dropped many bond prices in this sector. Some well managed funds, such as those from Nordea have seen a massive influx of institutional and other fund of fund money and have had to close their doors to further new investment. The fact that this is hot money and can just as quickly disappear as happened with the property funds in Germany in 2011, should be clear.

There is no realistic alternative to investing in Equities, either through equity funds or as part of mixed strategy strategies. The aim has to be to build up a carefully diversified portfolio of well-managed funds and be prepared for the many changes that will inevitably happen in the near and medium future.

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