SENECA
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Peter Elston: Investment Letter

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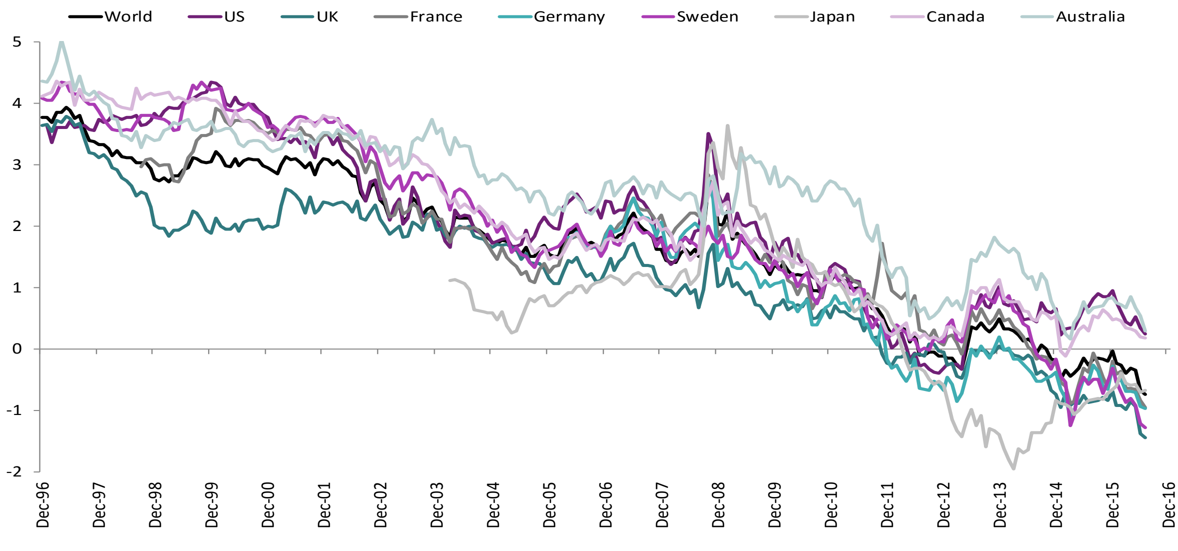
Secular stagnation and the natural rate of interest

One of the most interesting features of global financial markets over the last 20 years has been the inexorable decline in long-term real interest rates (see chart below of yields of index linked bonds of maturities over five years across various developed markets). As is evident, this is a global trend, though not all countries have 20 years of history.

Chart 1: Index linked bond yields (maturities over 5 years)



Source: Bloomberg, Seneca Investment Managers

The decline has reignited the debate about 'secular stagnation', a term coined in the late 1930s by American economist Alvin Hansen to refer to the feeble recovery in the US economy that followed the Great Depression. Hansen argued that weak trends in population growth and technological innovation meant that the low growth would continue for many years.

That there is a vibrant debate about whether global growth is stagnating or not is itself instructive, as it suggests the study of economics has not advanced much in recent decades – surely we should know the answer to this question! Earlier this year, Prospect Magazine[1] ran a series of four articles on the subject, two by proponents of the stagnation thesis and two by opponents. They were all written by well-respected economists, and consequently all were persuasive.

1 http://www.prospectmagazine.co.uk/

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The economists arguing in support of the stagnation thesis were former US Treasury secretary Larry Summers and Northwestern University professor Bob Gordon. Representing the other side of the debate were GaveKal co-founder Anatole Kaletsky and University of Illinois at Chicago professor Deirdre McCloskey.

Of the four articles, I found Anatole Kaletsky's the most convincing. Here is an excerpt:

"Cuts in public spending and tax hikes, motivated by irrational paranoia over public borrowing, have been so severe that it has not been possible to offset their effects through low interest rates. Inadequate demand, combined with labour deregulation and globalisation that would have been healthy if conditions had been normal, have squeezed wages downwards, reducing incentives for investment and aggravating inequality, which in turn has exacerbated the weakness of consumer demand.

"To make matters worse, inflation is systematically exaggerated in official figures. If the true level of inflation since 2008 has been negative, as appears quite likely, then even zero interest rates were too high to stimulate rapid growth."

In Kaletsky's world, the fall in long term real interest rates in recent years was indeed the result of lower growth but this lower growth, particularly since the Great Financial Crisis, was due to cyclical factors (poor monetary and fiscal policy) rather than structural ones.

On the subject of structural factors such as innovation, Kaletsky sees evidence of technological progress everywhere. Robert Gordon, on the other hand, "assumes that the weak economic statistics are proof that, however much new technology we see around us, progress has slowed down." I can't help but side with Kaletsky, seeing as I do the extraordinary ways in which our lives continue to be made better, whether with respect to medical advances, battery storage, energy production, car and airline safety, or online shopping.

That being said, it does not appear likely that governments are going to change course with respect to public spending policy any time soon, and instead will continue to pander to growing protectionism within their electorates. This may well mean that economic growth in the medium term continues to weaken.

In such a world, one can either accept the resulting lower returns from bonds and equities, and the lower future consumption that they imply, or one can try to achieve higher returns by investing more actively – seeking out those areas of equity markets such as smaller companies or certain emerging markets that are likely to perform better over time. We would strongly espouse the latter.

A proposal for the British government

I have a proposal for the British government. It's not complicated: sell vast quantities of 50-year debt and buy vast quantities of UK equities.

In late July, the Treasury sold £2.5 billion of debt for £5.1 billion. During the lifetime of the bond it will have to pay a total of £0.2 billion in interest but this isn't much in the grand scheme of things. Let's say the Treasury sensibly puts this to one side and is left with £4.9 billion. Surely it can find something to do with this over the fifty years. If it can make a return on investment of at least -1.4%, then it will have the funds to repay the £2.5 billion par value.

You may have realised that I am referring to the most recent tranche of the 0.125% 2065 inflation linked Gilt that was sold on 26 July for 201.335% of par. In other words, the aforementioned return of -1.4% required to pay back the bond at maturity is a real return. You could just as easily use a nominal bond and a nominal required return. However, using the inflation linked Gilt makes it easier to understand the point at hand, namely that current yields imply the government cannot make a real return on investment of even -1.4%. (At this point I am reminded of economist Paul Samuelson's famous remark that at a permanently zero or subzero real interest rate it would make sense to invest any amount to level a hill for the resulting saving in transportation costs.)

Back to my proposal: surely a basket of UK equities will return more than -1.4% per annum over the next fifty years?

They are already yielding 4.1%, so you'd need corporate earnings - and thus dividends - ***to fall 5.5% per annum in real terms*** over the long term for total annual real returns to equate to -1.4% (note: this derives from a mathematical truism that says that total return is equal to the dividend yield plus the growth in dividends, otherwise known as the Gordon growth formula). Even if we say that dividends are currently twice the sustainable level, and start with a 2% yield, we'd still be left needing earnings growth of just -3.4% per annum.

Now, earnings and dividend growth over time tend to be around two percentage points per annum less than GDP growth (note: this is because listed companies are generally the larger ones and thus have less propensity to grow than the average company). So, even if we assume an immediate and permanent 50% cut in dividends, GDP growth for the next 50 years could shrink 1.4% per annum and the British government would still break even.

Can economic prospects really be that bad? It's possible, I suppose, but unlikely.

Current fund targets

The target weights in the table below are where funds should be positioned currently. Actual positions may deviate slightly from these target weights as a result of market movements or ongoing trades for example.

Table 1: Current fund tactical asset allocation (TAA) target weights (as of 31 July 2016, prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	26.5 (26.5)	24.0 (24.0)	33.0 (33.0)
	North America	0.0 (0.0)	4.0 (4.0)	2.5 (2.5)
	Europe ex UK	10.0 (10.0)	13.0 (13.0)	12.0 (12.0)
	Japan	1.0 (1.0)	8.0 (8.0)	4.5 (4.5)
	Asia Pacific ex Japan	5.5 (5.5)	10.5 (10.5)	9.5 (9.5)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.0 (2.0)	2.0 (2.0)	1.5 (1.5)
	Equities Subtotal	**46.0 (46.0)**	**66.0 (66.0)**	**66.0 (66.0)**
Fixed income	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.6 (5.6)	2.0 (2.0)	1.5 (1.5)
	Corporate	25.4 (25.4)	8.0 (8.0)	5.5 (5.5)
	Fixed income Subtotal	**31.0 (31.0)**	**10.0 (10.0)**	**7.0 (7.0)**
Specialist assets	Property	5.0 (5.0)	4.0 (4.0)	5.2 (5.2)
	Private equity	2.9 (2.9)	2.9 (2.9)	5.7 (5.7)
	Specialist financial	9.5 (9.5)	12.7 (12.7)	10.4 (10.4)
	Infrastructure	4.6 (4.6)	3.4 (3.4)	4.7 (4.7)
	Specialist Subtotal	**22.0 (22.0)**	**23.0 (23.0)**	**26.0 (26.0)**
Cash		1.0 (1.0)	1.0 (1.0)	1.0 (1.0)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 31 July 2016

Increased *Decreased*

- No changes to tactical asset allocation during the month.
- Both Sterling and Gilt yields stabilised, following June's sharp falls.
- Equity markets around the world performed well, with markets responding well to strong July payrolls in the US that suggested the US economy was still growing at a moderate pace.
- It is becoming clear that Brexit has impacted household and business confidence that will likely merit a response from the Bank of England.

SDIF

- The holding in the AXA US Short Duration High Yield Bond Fund was sold to further consolidate holdings, with the yield on the fund having fallen to a less attractive level.
- The fund's position in the TwentyFour Dynamic Bond Fund was reduced to provide funding for an increase in the TwentyFour Select Monthly Income Fund, which offers a higher yield.

SIGT

- Royal Dutch Shell was exited following a significant re-rating which led to a premium PE and yield compression.
- New investment in IShares FTSE UK Dividend Plus which maintains UK equity weighting pending further work being carried out on a new direct investment.
- Added to position in Polypipe following Brexit related sell-off.
- Top sliced Asian equity holdings to maintain weighting following strong performance this year.
- New investment in International Public Partnerships in order to broaden the exposure across a range of infrastructure sectors. This was funded with a managed exit from Bluefield Solar Income Fund which has a narrower mandate.

SDGF

- Initiated a position in Intermediate Capital, manager of alternative credit strategies. Strong growth in permanent capital AUM. Yield over 4%.
- New investment in Dairy Crest. Cathedral City increasing market share. Yield over 4%, improving cash flow and returns, post disposal of dairy business. Premier Foods being exited.
- Royal Dutch Shell exited. Significant re-rating - premium to NAV and yield compression.
- Atlantis China Healthcare Fund exited, favouring regional manager, Stewart Investors.
- New investment in Aberdeen Private Equity Fund on unwarranted discount to NAV as well as strong NAV growth.