SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

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We may yet be proved wrong but it is starting to look as if our call that we were not heading into a more pronounced period of equity market weakness was a decent one. In a yourmoney.com article on 2 October, I was quoted as saying that most bear markets begin when economies are strong or overheating. As evidence, I pointed to the IMF world output gap having been 2% in both 2000 and 2007 when the last two bear markets began, whereas the gap currently is -2%. I also noted, though it wasn't used in the article, that bear markets also normally begin when markets are overvalued, again pointing to high valuations in 2000 and 2007, and current valuations that are certainly not stretched (in fact dividend yields pretty much everywhere are above their longer term averages).

I stand by these assertions.

There is no doubt that it is very hard being an investor at the moment, let alone being an asset allocator. Negative real interest rates, bloated central bank balance sheets, a slowdown in China, weak investment across the developed world all serve to cause consternation that another 2008 is just around the corner. My view is that ultra-loose monetary policy and scope to boost fiscal policy if required will prevent growth from slipping into recession. Furthermore, the prevailing weakness will keep a lid on inflation. This is a 'Goldilocks' environment that equities tend to thrive on.

Contrarian opportunities

Thanks to Canaccord's Alan Brierley for his slides highlighting some interesting contrarian opportunities. The four he presented were MSCI World Value (having underperformed MSCI World Growth), MSCI World ex US (versus S&P Composite), MSCI Emerging Markets (versus MSCI World) and Euromoney Global Mining (versus MSCI AC World). The four had underperformed their respective comparator by 19, 39, 43 and 73% respectively in recent years.

What do we think about these opportunities?

As multi-asset value investors, we'd certainly support the assertion that value will do well, though it is hard to know when it will start outperforming growth. Since inception of the indices in November 1975, the MSCI World Value index has returned 7.4% per annum versus Growth's 6.8%. This may not sound like much until one realises that over the 40 years, Value's total excess return equates to a very decent 22%.

As for the MSCI World ex US in relation the S&P Composite, we'd also agree that the US will start to underperform (in our Income Fund we have zero exposure to US equities given paucity of yield). The US market is starting to look obviously expensive versus the rest of the world: the price to book ratio of the MSCI US index is 2.8 times versus 1.6 times for the World ex US index. While US companies may be more dynamic than those elsewhere, we think the valuation gap is too big. Furthermore, it is clear that the US is closer to its business cycle peak that other developed countries, notably Japan and many in Europe, so monetary policy tightening is also closer.

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The emerging markets versus developed markets question is a particularly intriguing one. I have for a long time held the view that emerging markets are horrible places to invest. The 'region' is stuffed full of corrupt countries and poorly-governed companies, and as a result the stronger economic growth achieved has not filtered down to shareholders. Since inception of the index in 1987, the MSCI Emerging Markets index has returned 7.7% per annum. This compares with 7.8% for the MSCI US index, pretty poor when you consider the difference in economic growth. Furthermore, when you take volatility into account, you'd wonder why anyone would invest in emerging markets: 29% versus 17% for the US. Having said all that, the current price to book ratio of the MSCI EM index of 1.4 times is getting close to the 1.2 times it reached at depths of the global financial crisis. We're still underweight emerging market equities but are starting to think there is value emerging.

Finally, what about global miners? Well, in August we made a move into Blackrock World Mining Trust, feeling that the 10% yield that was on offer was good value even if dividends were halved. So we'd agree with Alan on that one too.

Inflation watch

Inflation has such an important bearing on real and financial asset prices, that it deserves its own section.

The table below lists price data releases over the last month in various key countries and how they compare with the survey consensus, the previous month, and where central banks would like the rate to be (the last of these requires a bit of judgment). It also derives an average of the comparisons by taking the net number of up and down arrows and dividing by the number of data releases.

Country	Series	Period	YoY%	Versus			Overall
				Survey	Prior	Desired	
Europe	PPI	Aug	-2.6	↓	↓	↓	↓↓↓
Germany	WPI	Sep	-1.8	n/a	↓	↓	↓↓
Germany	CPI (EU harmonised)	Sep	-0.2	⇔	⇔	↓	↓
UK	CPI core	Sep	1.0	↓	⇔	↓	↓↓
UK	PPI output core	Sep	0.2	⇔	↑	↓	⇔
Japan	PPI	Sep	-3.9	⇔	↓	↓	↓↓
US	PPI ex food/energy	Sep	0.8	↓	↑	↓	↓
US	CPI ex food/energy	Sep	1.9	↑	↑	⇔	↑↑
Europe	CPI	Sep	-0.1	⇔	⇔	↓	↓
Germany	CPI (EU harmonised)	Oct	0.2	↑	↑	↓	↑
China	CPI	Sep	1.6	↓	↓	↓	↓↓↓
China	PPI	Sep	-5.9	⇔	⇔	↓	↓
India	WPI	Sep	-4.5	↓	↑	↓	↓

Source: Bloomberg

Overall, inflation pressures in the developed world and in key emerging markets remain very weak. This means that monetary policy will remain loose for some time to come which should be positive for equity markets and other so-called 'risky assets'.

Overall, inflation data is coming in slightly below expectations but slightly above prior periods. The big discrepancy is between current rates of inflation and desirable rates of inflation – in most countries other than the US, inflation is much lower than central banks would like.

Employment watch

Most if not all central banks are tasked with maintaining price stability and full employment. This section looks at recent employment trends and what they might mean for monetary policy around the world.

Country	Series	Period	YoY%	Versus			Overall
				Survey	Prior	Desired	
Japan	Jobless rate	Aug	3.4	↑	↑	↑	↑↑↑
US	Unemployment rate	Sep	5.1	⇔	⇔	↑	↑
Canada	Unemployment rate	Sep	7.1	↑	↑	↑	↑↑↑
UK	ILO unemployment rate 3m	Aug	5.4	↓	↓	↑	↓
Russia	Unemployment rate	Sep	5.2	↓	↓	↑	↓
Germany	Unemployment claims rate	Oct	6.4	⇔	⇔	↑	↑
Australia	Unemployment rate	Sep	6.2	⇔	⇔	↑	↑
Europe	Unemployment rate	Sep	10.8	↓	↓	↑	↓

Source: Bloomberg

Unsurprisingly, given the weak inflation pressures, unemployment rates around the world are still in general above the level that central banks would consider full employment. Furthermore, while the rate in the US may be getting quite close to the NAIRU (non-accelerating inflation rate of unemployment), it should be remembered that many have left the workforce over the last few years. A better job market may tempt them back in the coming months and years, thus keeping wage pressures lower than would otherwise be the case.

Captain Murphy's diary

Murphy's Law says that what can go wrong, will go wrong. It is thought to be named after Captain Ed Murphy, an aircraft engineer who, frustrated with the work of an incompetent colleague, is alleged to have remarked, "If there is any way to do it wrong, he will." This section is dedicated to combing the financial markets for risks that are lurking out there, preparing to pounce.

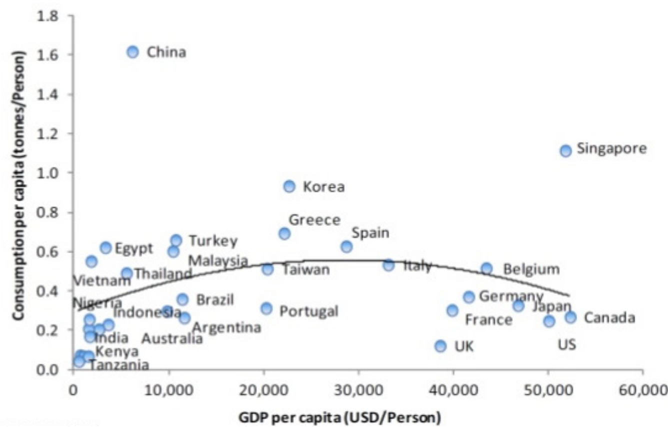
Question: is China a slow motion train wreck or has the Communist Party found the secret to generating high and stable growth?

China has the potential to cause global markets serious problems. Its economy is huge and has been growing at a relentless pace for a number of years. Furthermore, its growth has been one-dimensional, based on building and making 'stuff' using bank credit. This is evident from the below two charts.

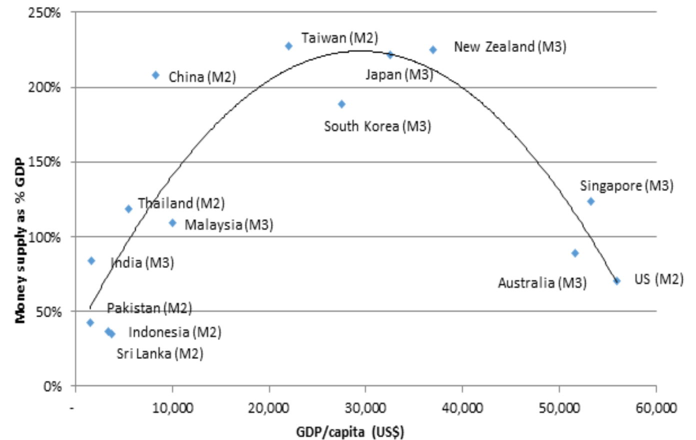
The first chart illustrates the extent to which China has consumed vastly more cement per person per year than any other country on the planet, particularly when GDP/capita is taken into account. Even Bill Gates was moved to tweet a few months ago about what he thought was the most mind-blowing fact he had learned in 2014, namely that China used more cement in the three years from 2011 to 2013 than the US used in the entire 20th century (6.6 gigatons versus 4.5 gigatons).

The second chart shows the extent to which China's use of bank credit is also off the scale in relation to its GDP/capita. Given the best fit line, China's money supply as a % of GDP should be 125% given its GDP per capita of $8,280. In fact, it's 208%.

Cement consumption per capita vs. 2012 GDP per capita



Money supply as % GDP vs. GDP/Capita



Source: Deutsche Bank (2014)

What these observations mean for China's future growth prospects is very hard to say. China has far too much cement capacity and the same goes for other commodities too, steel being a good example. Shutting much of the capacity (an inevitability) would be deeply painful for banks and employees alike, but perhaps not terminal. Laid off employees would eventually be rehired in more value added activities and the banks would be recapitalised as they have been in the past. The problem is that the numbers are so far off the scale that there is no precedent, and no precedent means a lack of predictability.

Another measure on which China scores highly is average GDP growth adjusted for the volatility of GDP growth (think of it like a Sharpe Ratio for economies, the higher the better). As can be seen in the table below, China has achieved high and stable growth. The only country that comes close is India, with an "Economic Sharpe" of 3.1 times versus China's 4.6. Perhaps it has been learning a few tricks from its bigger emerging cousin. Whether these are accounting tricks or some sort of growth miracle is of course the big question.

Country	GDP YoY% (1997 to 2015 average)	Standard deviations (%)	Average/STDev
China	9.4	2.0	4.6
India	6.7	2.1	3.1
South Africa	2.9	1.8	1.6
US	2.3	1.9	1.2
South Korea	4.2	3.7	1.1
UK	2.1	2.0	1.1
Taiwan	4.2	4.0	1.1
Singapore	5.2	5.1	1.0
Brazil	2.8	2.8	1.0
Mexico	2.7	2.8	1.0
Indonesia	4.0	4.7	0.9
Czech Republic	2.3	3.0	0.8
Russia	3.7	5.2	0.7
Thailand	3.2	4.4	0.7
Europe	1.4	2.0	0.7
Japan	0.6	2.4	0.3

Source: Bloomberg

Current fund targets as at 2nd Nov (previous month's targets in brackets)

The targets in the table below are where our 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.

Target Weights (%) (previous month in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	23.5 (22.5)	21.0 (20.0)	28.0 (28.0)
	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	0.0 (0.0)	8.0 (8.0)	4.5 (4.5)
	Asia Pacific ex Japan	5.0 (5.0)	10.0 (10.0)	9.0 (9.0)
	Emerging Markets	1.2 (1.2)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.3 (2.3)	1.5 (1.5)	1.0 (1.0)
	Equities Subtotal	42.0 (41.0)	62.0 (61.0)	60.0 (60.0)
Fixed Interest	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.1 (5.1)	2.0 (2.0)	0.0 (0.0)
	Corporate	25.9 (26.9)	10.0 (10.0)	11.0 (11.0)
	Fixed Interest Subtotal	31.0 (32.0)	12.0 (12.0)	11.0 (11.0)
Alternatives	Property	8.2 (8.5)	5.0 (4.9)	8.9 (8.9)
	Private Equity	2.9 (2.9)	2.9 (4.4)	5.7 (5.7)
	Specialist Financial	10.2 (10.2)	12.7 (13.4)	8.6 (8.9)
	Infrastructure	4.7 (4.4)	2.9 (1.8)	4.8 (4.5)
	Commodities	0.0 (0.0)	1.5 (1.5)	0.0 (0.0)
	Alternatives Subtotal	26.0 (26.0)	25.0 (26.0)	28.0 (28.0)
Cash		1.0 (1.0)	1.0 (1.0)	1.0 (1.0)
Total		100.0	100.0	100.0

- We increased the equities weighting in the OEICs by 1 percentage point each in October, taking them to 2 percentage points overweights relative to the respective strategic asset allocation
- We did this predominantly because we felt markets were looking slightly cheap, with dividend yields generally above long-term averages
- We also think that monetary policy will remain on the whole loose, with inflation pressures still muted in many countries
- We did not increase the equity weight for the investment trust, which because of its closed-end structure has a higher weighting in less liquid alternatives
- The aforementioned 1 percentage point increases in equities targets came out of fixed interest in the Income Fund (reduction in corporate bonds target) and alternatives in the Growth Fund (Exit from Woodford Patient Capital which was only held in the Growth Fund)
- We continue to avoid developed market government bonds which we still think are very overvalued

- Within fixed interest, we have a focus on global high yield; this segment of the fixed interest market was hurt along with equities during the August sell off but we held firm in the belief that while spreads were lower than they were five or so years ago, they were still well above historic lows and thus offered good value
- We retain exposure to emerging market local currency debt in the OEICs but have not increased it; frankly, we had not expected the selloff that we have seen this year in emerging market currencies
- Our alternatives exposure seeks to target investments that offer something interesting in relation to equities and bonds; in the case of equities this is more stable income streams and in the case of bonds it is income streams that are index-linked
- Our private equity exposure in each of the three funds is largely in AJ Bell, a private company in which we are one of three outside shareholders
- Elsewhere in alternatives, we like non-core REITs, asset leasing and renewable energy

Important Information

Past performance is not a guide to future returns. The value of investments and any income may fluctuate and investors may not get back the full amount invested. This document is provided for the purpose of information only and if you are unsure of the suitability of these investments you should take independent advice.

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