The Long Sanity Clause Rally Begins (10/12/18)

“A man who has seen only a rising tide fears only drowning”
Old Ulster Proverb (well, not so old)

Within days of publication of the new quarterly (What The Hell Is Water?: Why January 2018 Marks a Generational Peak for US Equity Valuations), your analyst woke to news that there was to be a Santa Clause rally. That was last Monday but by Tuesday that ‘strategy’ it seems had been rejected. There are many reasons given for the ups and downs, mainly downs, over the past ten days but few, if any, mention the supply and demand for Treasury securities as the key driver. Subscribers can read about the structural forces that the shift in supply and demand for Treasury securities has unleashed which will reduce equity valuations in what will be a major bear market.

Meanwhile the battle for quarterly investment performance continues. A few years ago I was having a drink with Charles Gave, (beer for me, wine for Charles), when he told me something important that his father had told him when he was a boy. Gave Senior had remarked, ‘What you have to remember about the English is that they lose every battle and win every war.’ Whatever the historical accuracy of that statement, and its usual French looseness in mis-naming of the United Kingdom, it very accurately describes what has been happening in finance for nigh on three decades.

There is perhaps no better example than GE. For many, many years the stewards of capital, your analyst prefers agents of capital in this case, at GE won every battle by beating their earnings forecasts. However, it turns out they have lost the war - ask anyone who has held the shares for the past thirty years. The agents won, through higher pay and good bonuses, as they won every battle and the principals lost out as the share price attests. GE is just an example of how the agents sacrifice the balance sheet on the altar of growth because, rather unbelievably, that is what they are paid to do.

Alarmingly central bankers have a similar incentive structure. Paid to keep inflation low, they have won almost every battle for almost thirty years. But in the process they have lost the war. The war is lost because every intervention, particularly those to defeat the forces of deflation, has led to ever higher debt to GDP ratios. Global non-financial debt is now 242% of GDP, up from 210% when the last business cycle peaked in 2007. While market practitioners praise the success of these particular agents, they criticize the agents who brought GE to grief.

Of course, the key difference is that whoever was running GE could not create their own liabilities. This is not the case with central bankers: it is their very ability to create such liabilities that allows them to go ever further in winning every battle, but ultimately losing the war. For those unfamiliar with what defeat looks like, it is either gross inflation or a deflation shock. Your analyst continues to believe that the deflation shock is the greater of those risks and, as we saw in the last Newsletter, the rapid decline in real money growth in the past year suggests defeat is nearer than most think. Subscribers are more than well briefed on the other catalysts that signal that this particular defeat is now close at hand.

If the debt-to-cash flow fundamentals were not worrying enough, now comes the politicisation of capital or what some prefer to call the ‘weaponisation of
the dollar’. Investors can bandy about this phrase and talk glibly about the ‘weaponisation of the dollar’ because it allows them to believe that this is somebody else’s problem. By simply renaming this phenomenon as the ‘weaponisation of capital’ perhaps we can all see that it is us, the stewards of capital, who are the frontline weapon in this particular form of economic/political warfare.

Perhaps the arrest of the Huawei CFO brought a bit closer to home the message that, as a new Cold War erupts between the US and China, capital is on the front line. The last Iron Curtain descended with almost no foreign capital behind it and no trading relations crossing it. What foreign capital there had been east of the Rhine had already been confiscated by fascists and communists or destroyed in warfare. So we did not have an issue of how to sever the capital ties that bind China to the rest of the world. Now every day we get another piece of evidence that some, perhaps many, but let’s hope not all, the capital ties that bind China to the rest of the world are under strain.

For the avoidance of doubt, in case it is not already clear enough, this means that you are on the frontline. Even if you never invest a penny in China, it is clear in the salvoes already fired in this Cold War that corporations across the planet are not just collateral damage - they are the targets. Still unconvinced that a Cold War is not bad for capital?

How likely do you think it is that the President Trump will allow US pension funds to buy the government debt of the People’s Republic of China when they enter the global bond indices? The PRC has long financed US military spending, through their purchase of Treasury securities, but it is not conceivable that US pensioners will be permitted to finance the Chinese Communist Party’s bid for dominance in the Pacific Rim, their aim according to the US VP Mike Pence.

So what other forms of funding of China, whether public or private, will be considered to be beyond the limits of what is acceptable for foreign capital investment? As the list grows, almost by the day, investors will realise that a Cold War is not compatible with hot commerce. In particular, all those countries in Asia will no longer have the privilege of trading and investing freely in China while demanding the right to US military protection. That is a challenge to government spending and private capital that will now last a generation at least.

So, what can you do about it? Beyond the advice in the quarterly reports, your analyst recommends siding with the principals and shunning agents. As we have seen with GE, it can be quite a ride with the agents but it’s not been a ride for the ultimate benefit of the principals. There are, of course, many corporations where the revolution of the agents did not take place and the principals, either directly or through their board control, insisted that capital was invested for their benefit and not the agents. These tend to be companies with large family ownerships or where the family has left behind a strong credo, as at Johnson & Johnson, that keeps the incentives of the agents much more aligned with the returns to the principals.

There are many differences between how agents and principals operate, but key for investors today is that agents look at the profit and loss while principals focus more on balance sheets. This is a good time to side with those who have not sacrificed balance sheet strength for gains in quarterly profit. Your analyst is all too aware that all the rewards for the stewards of capital reading this newsletter have pushed them to back the agents. That symbiotic relationship is now changing, and if not because of a debt deflation, then ultimately because society cannot live with the consequences of corporate capital directed by the agents. (No better an explanation of the consequences of the damage caused by this form of capitalism can be found in a new book by Jonathan Tepper and Denise Hearn - The Myth of Capitalism: Monopolies and the Death of Competition).
There comes a time when all tyrannies must end and the tyranny of the agent is ending. Investors need to recognise this shift and side with the principals by becoming the principals they are paid to be or at least will be paid to be. So, apart from looking to invest in more principal-run companies and looking for sound balance sheets, what else can investors do now that the tyranny of the agent is ending?

Your analyst is not unbiased on that subject and strongly recommends that investors seek to invest fixed pools of capital, thus massively increasing their own ability to behave like principals. A fixed pool of capital can hugely reduce the pressure for short-term performance that can retain or perhaps even attract more funds to manage. By way of illustration of how permanent a fixed pool of capital can be your analyst spent time last week, as a director, approving the 131st Annual Report & Accounts of The Scottish Investment Trust.

Whether in the field of politics, or in the field of finance, the principals are fighting back to take power from the agents. In politics some chose to call that move back towards a more representative democracy as populism. I’m not sure what it will be called when it comes to finance, but this analyst thinks ‘real active investment’ is a reasonable label to start with. In finance your analyst believes a debt deflation is a large enough catalyst to massively accelerate the process away from agents to principals and, of course, passive investors will be lumbered with the capital still involved in winning every battle but losing the war. If Smith’s invisible hand is to be saved, then ultimately only the stewards of capital can do so. ‘Real active investment’ is one of the few forces that can free that hand before socio-political forces determine a different diagnosis of the problem and amputate.

In the interests of balance one cannot mention Smith without mentioning Marx - that’s Groucho and not Karl. One was a bad economist but a good historian, and the other a damn bad investor but a blessed comedian. In A Night At The Opera this exchange between Groucho and Chico explains why the Santa Clause rally is not what investors really have to be looking at:

Fiorello: Hey wait! What does this say here, this thing here?
Driftwood: Oh that? Oh that’s the usual clause in every contract. That just says, uh, it says, uh, if any of the parties participating in this contract are shown not to be in their right mind, the entire agreement is automatically nullified.

Fiorello: Well, I don’t know…
Driftwood: It’s all right. That’s, that’s in every contract. That’s, that’s what they call a sanity clause.

Fiorello: Ha-ha-ha-ha! You can’t fool me. There ain’t no sanity clause.

So, for a generation those who steered capital were incentivised to win every battle but, through destroying the balance sheet and destroying the balance in society, they have lost the war. Now we will have a long, long 'sanity clause' rally. It’s a rally when the sanity of managing money for principals will have to be done by people behaving like principals, and the insanity of the revolution of the agents is overturned. Not everyone will, or even can, change but when it comes to sanity investors always need to bear in mind the remarkable words of Charles Mackay from 1842:

*Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one.*

Charles Mackay (Extraordinary Popular Delusions and the Madness of Crowds, new Harriman edition with a Foreword by Russell Napier)
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Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220