Absolute Return Partners

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2 December 2019

Recession or Not?

Why bond and equity markets are sending two very different signals, and how investors should position themselves.

Part 1

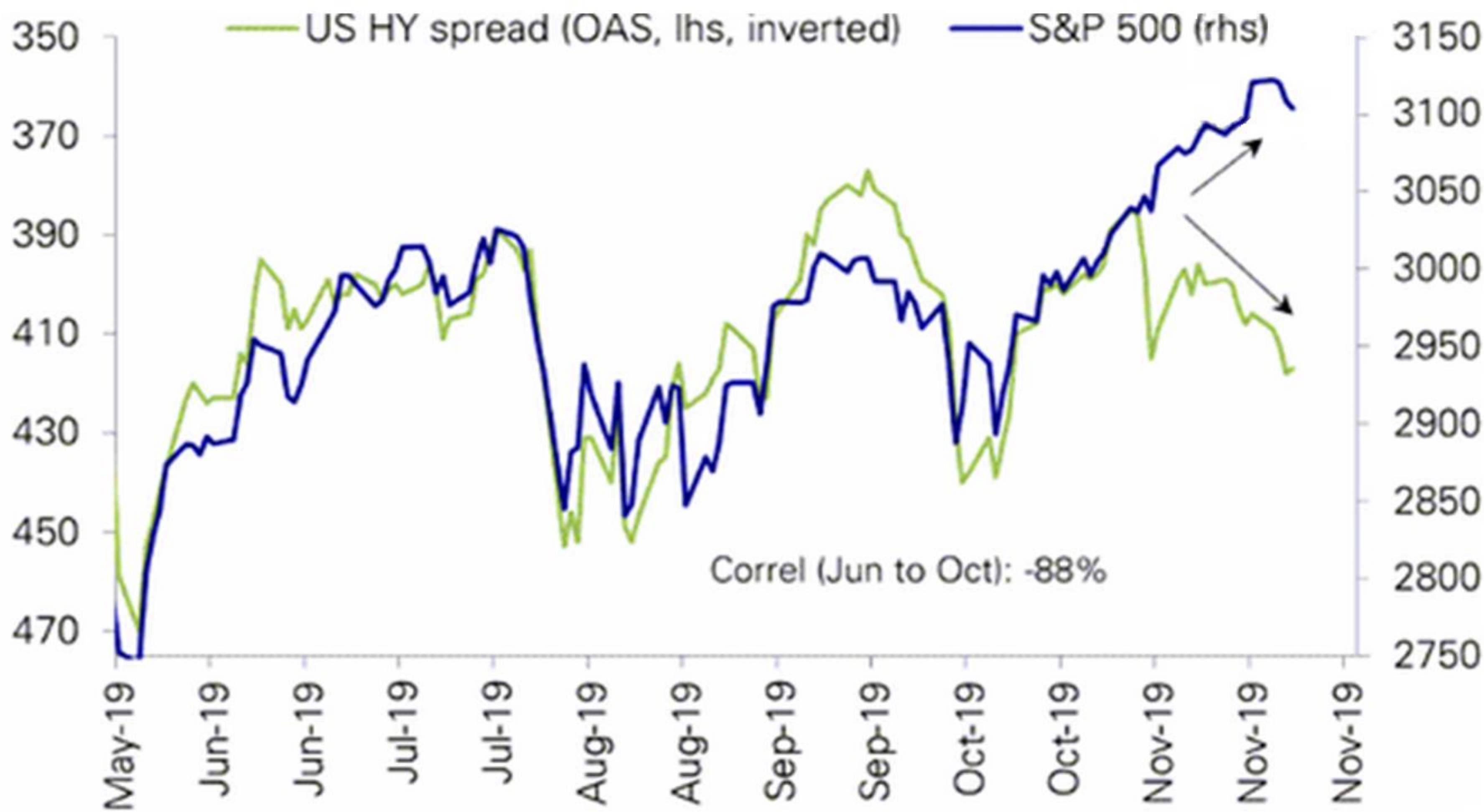
THE CONUNDRUM

Why has the correlation between the S&P 500 and government bond yields weakened recently?

S&P 500 vs. 10-Year US Bond Yields

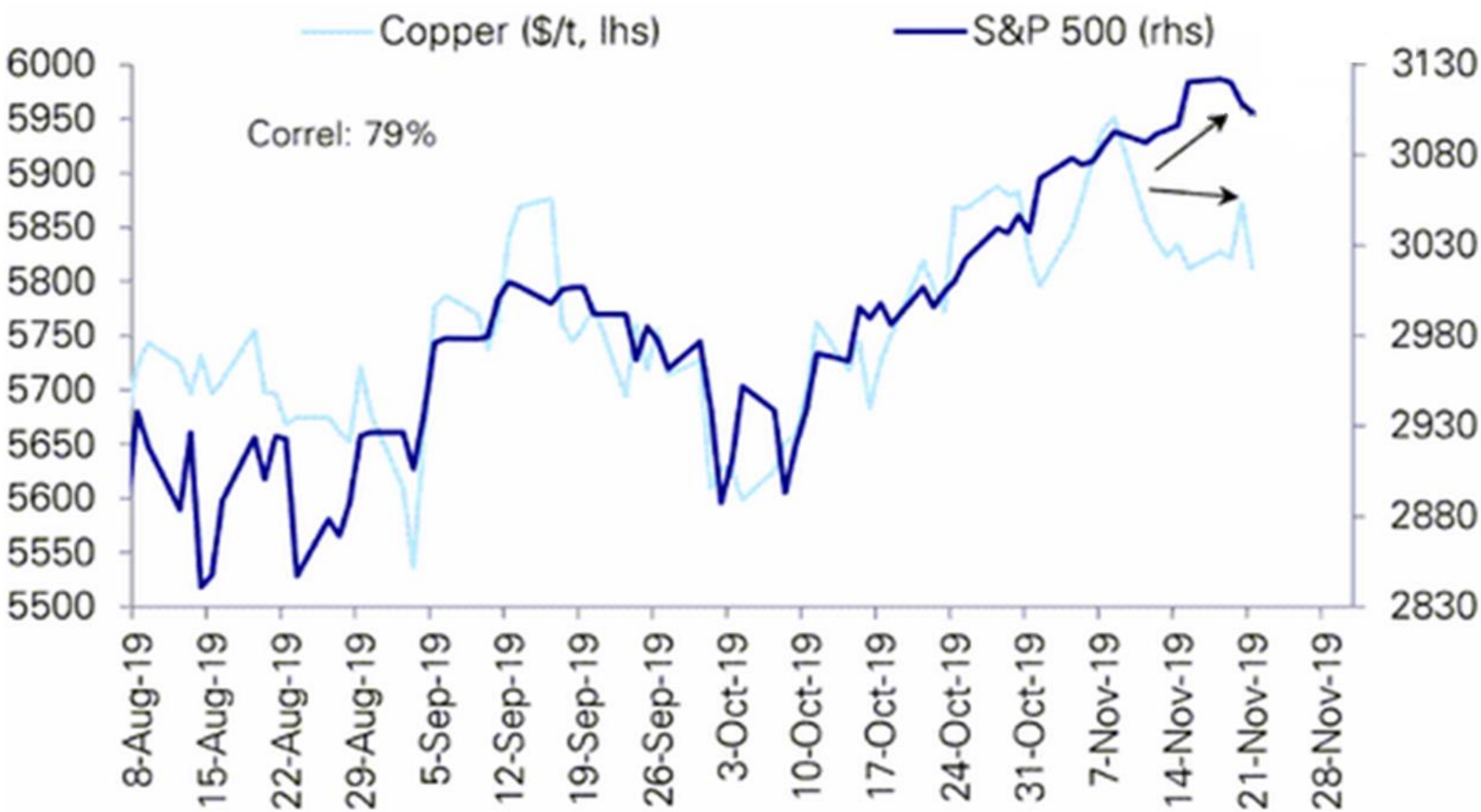
It is a phenomenon not limited to government bonds. The same picture is emerging when comparing the S&P 500 to corporate HY bonds ...

S&P 500 vs. Corporate High Yield



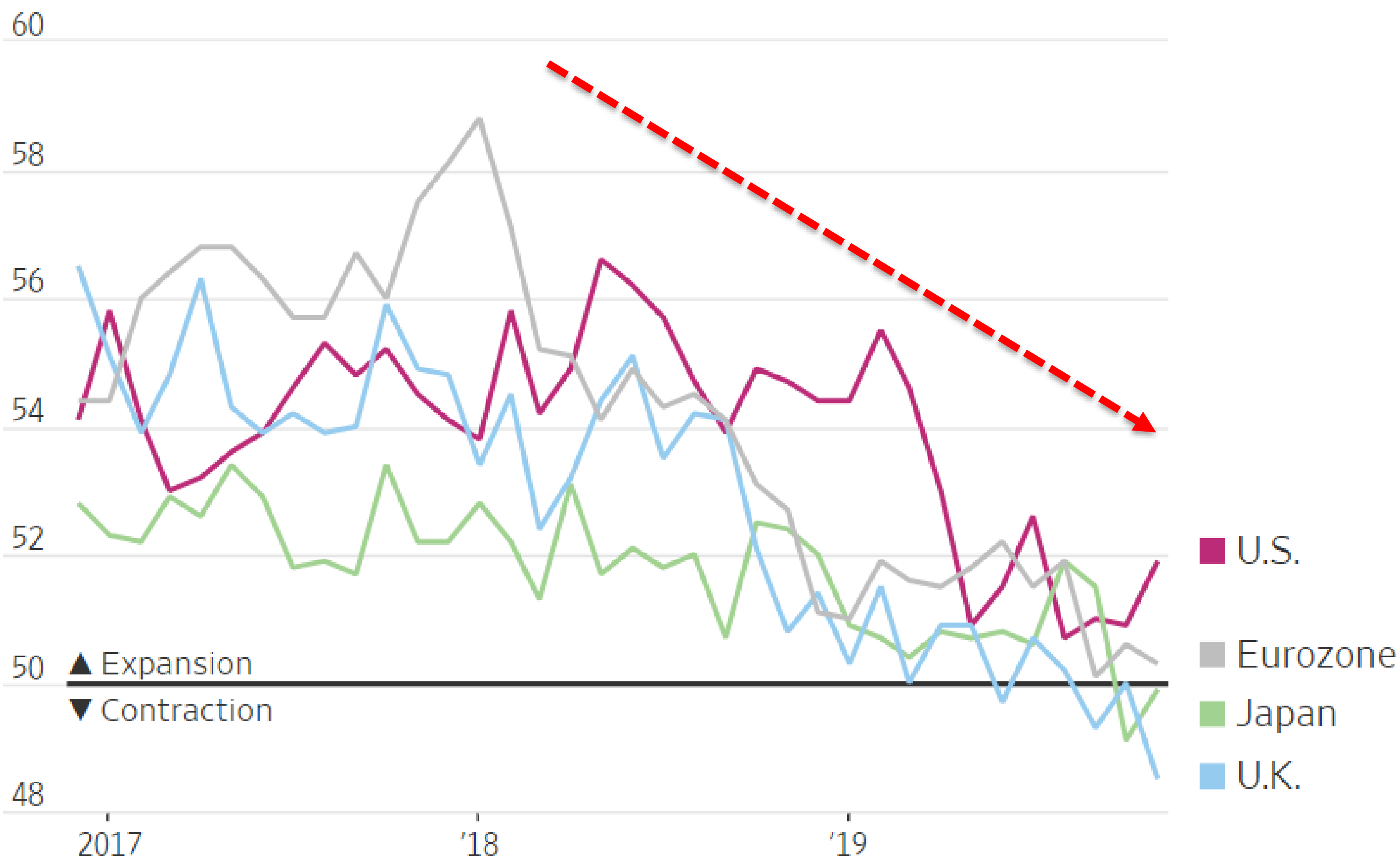
... and to copper – one of the most powerful economic indicators of them all.

S&P 500 vs. Copper

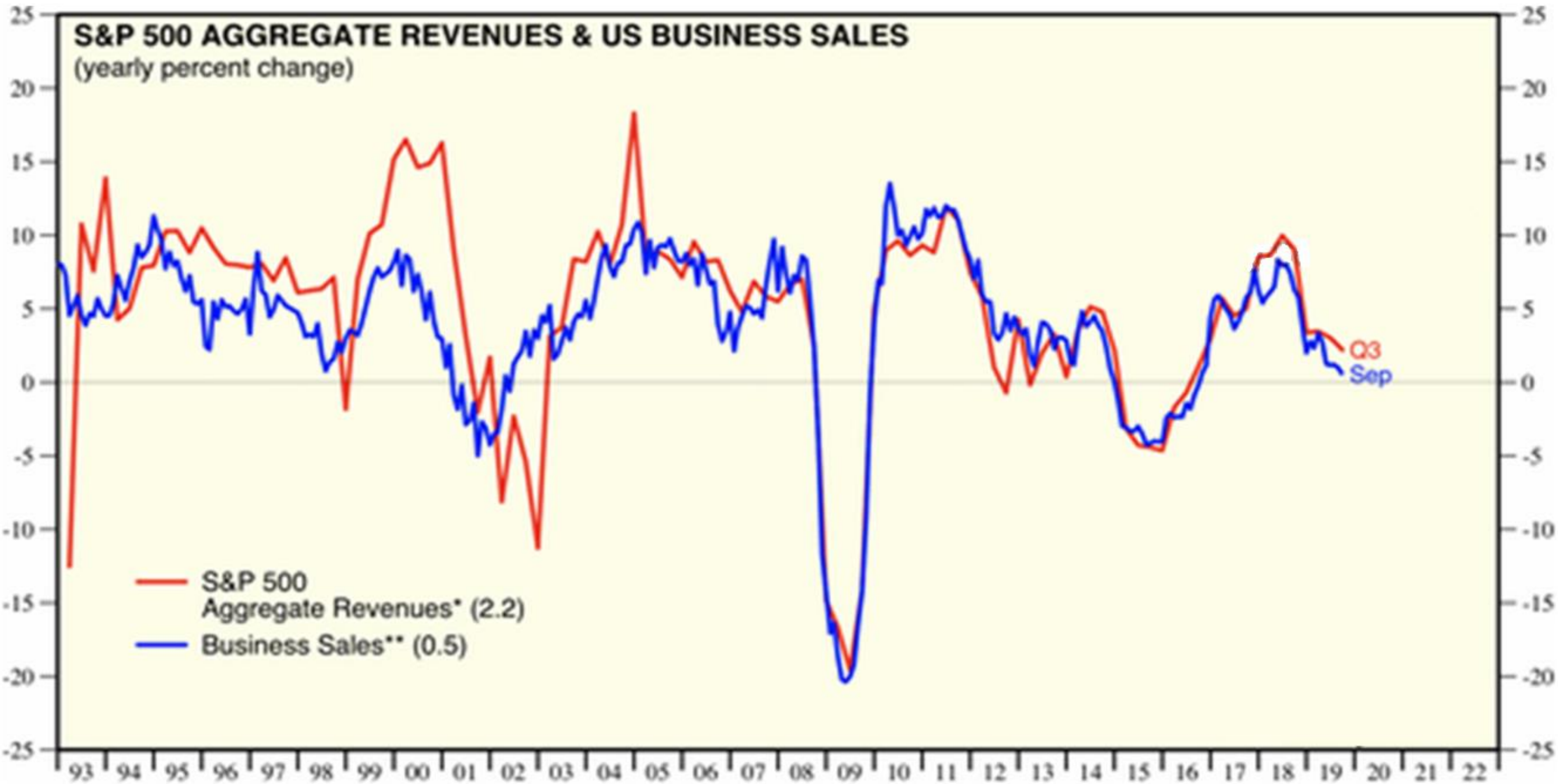


It smacks of weakening economic fundamentals, and that is precisely what is happening.

Composite Purchasing Managers' Indices
Manufacturing & Services



Even if PMI is stronger in the US than elsewhere, corporate revenue growth has come to a virtual standstill there, and that is only the topline.



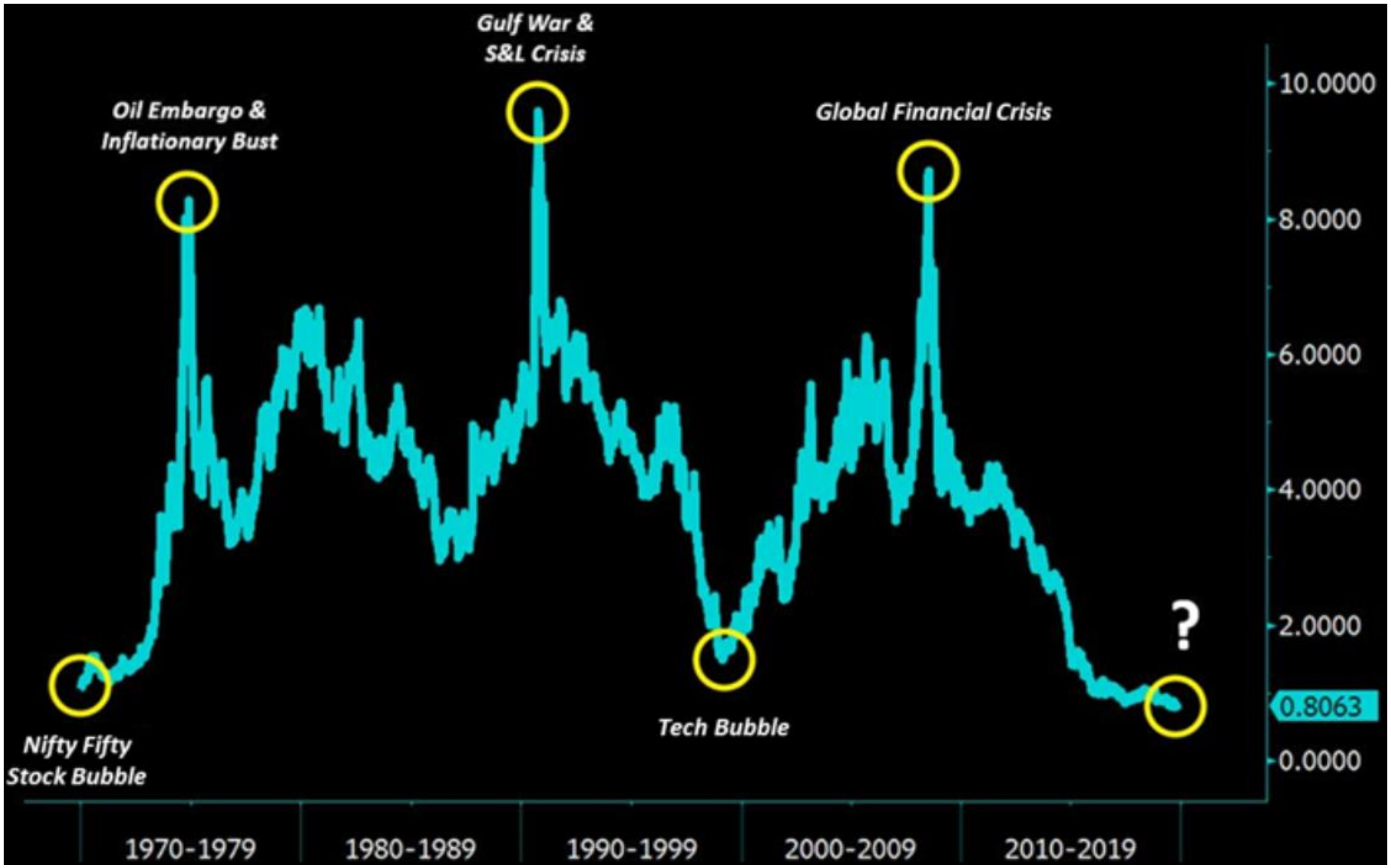
The bottom line is also under pressure. With wages rising faster than prices, labour's share of national income is rising, squeezing corporate profits.

Despite relatively poor economic fundamentals, US equities continue to do well. Storm clouds are gathering, though.

US Equities vs. Equities in the Rest of the World

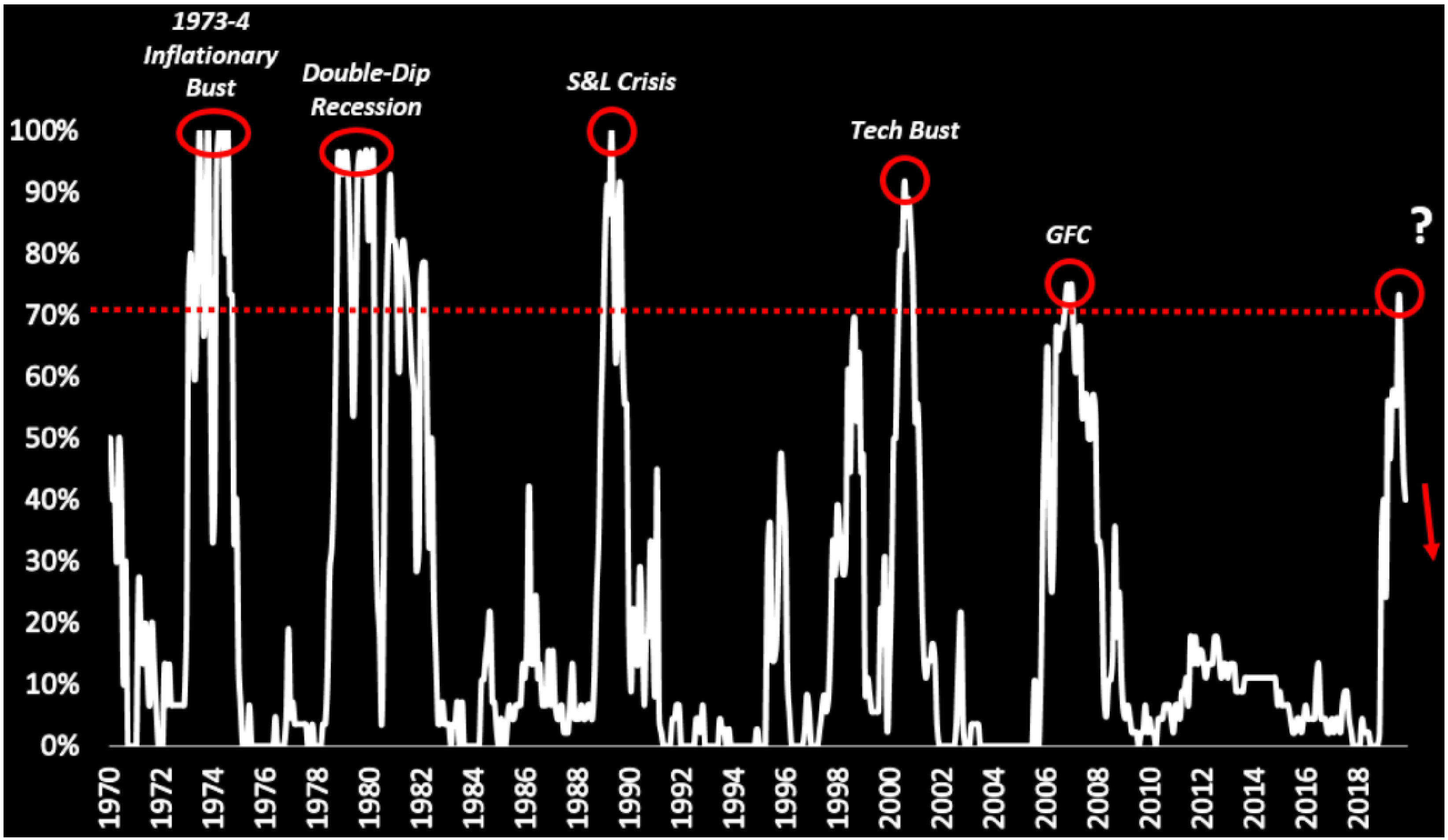
Commodities-to-equities valuation ratios are at 50-year lows ...

Commodities-to-Equities Valuation Ratio



... and 73% of the US yield curve has inverted. In the past, when more than 70% of the yield curve has inverted, a recession has always followed.

Yield Curve Inversions vs Recessions in the US



Why do US equities continue to perform so well on the back of all this bad news? I think there are (at least) four reasons.

1. **Trade war misconceptions**
2. **The antics of President Trump**
3. **ETF craze**
4. **Lack of alternative investment opportunities**

The US dollar has performed exceptionally well in the post crisis environment, making it less attractive for US investors to diversify abroad.

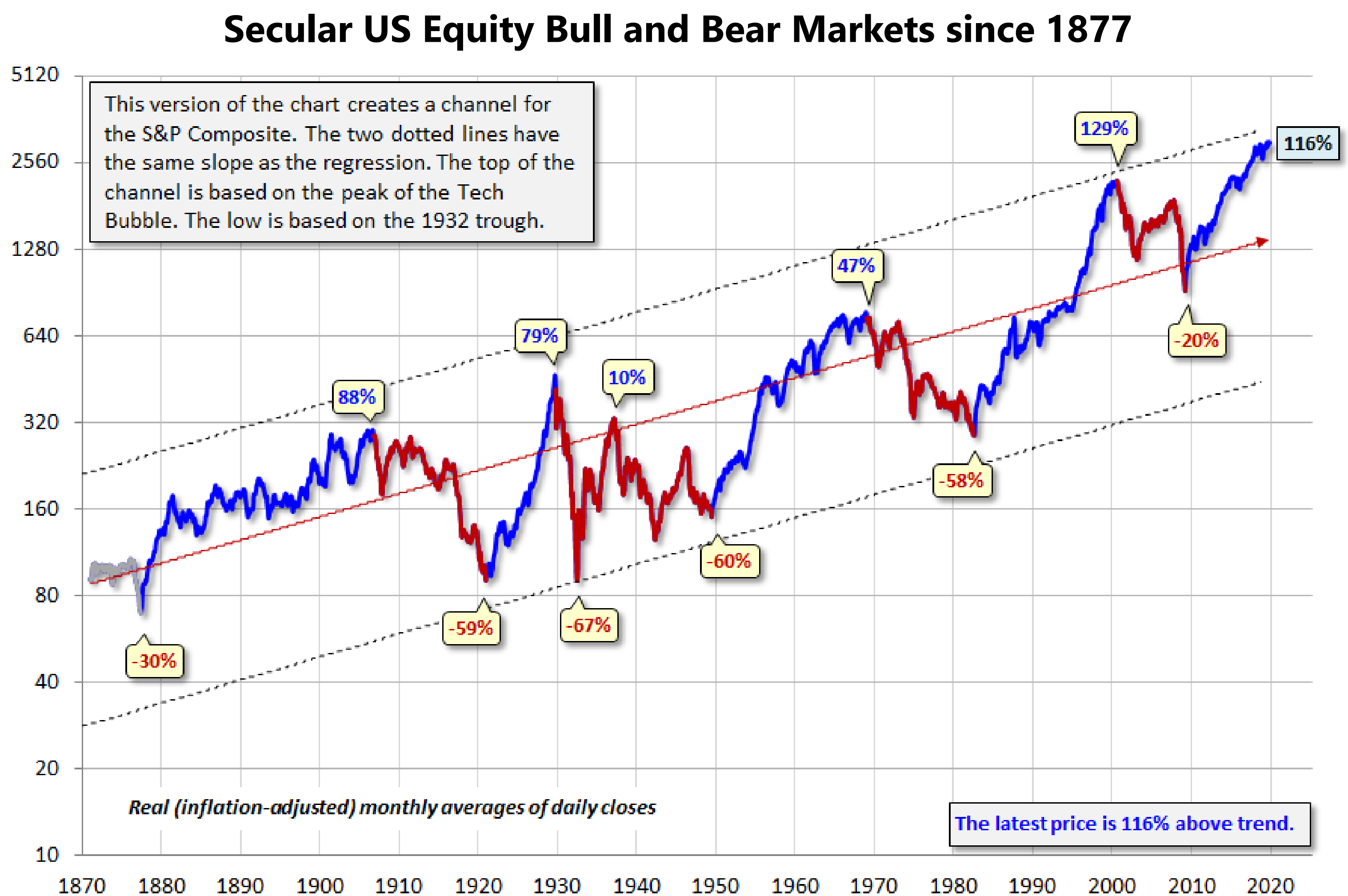
US Dollar vs. Other Currencies

Part 2

WHAT SHOULD YOU DO?

Recommendation #1: Reduce your equity beta exposure.

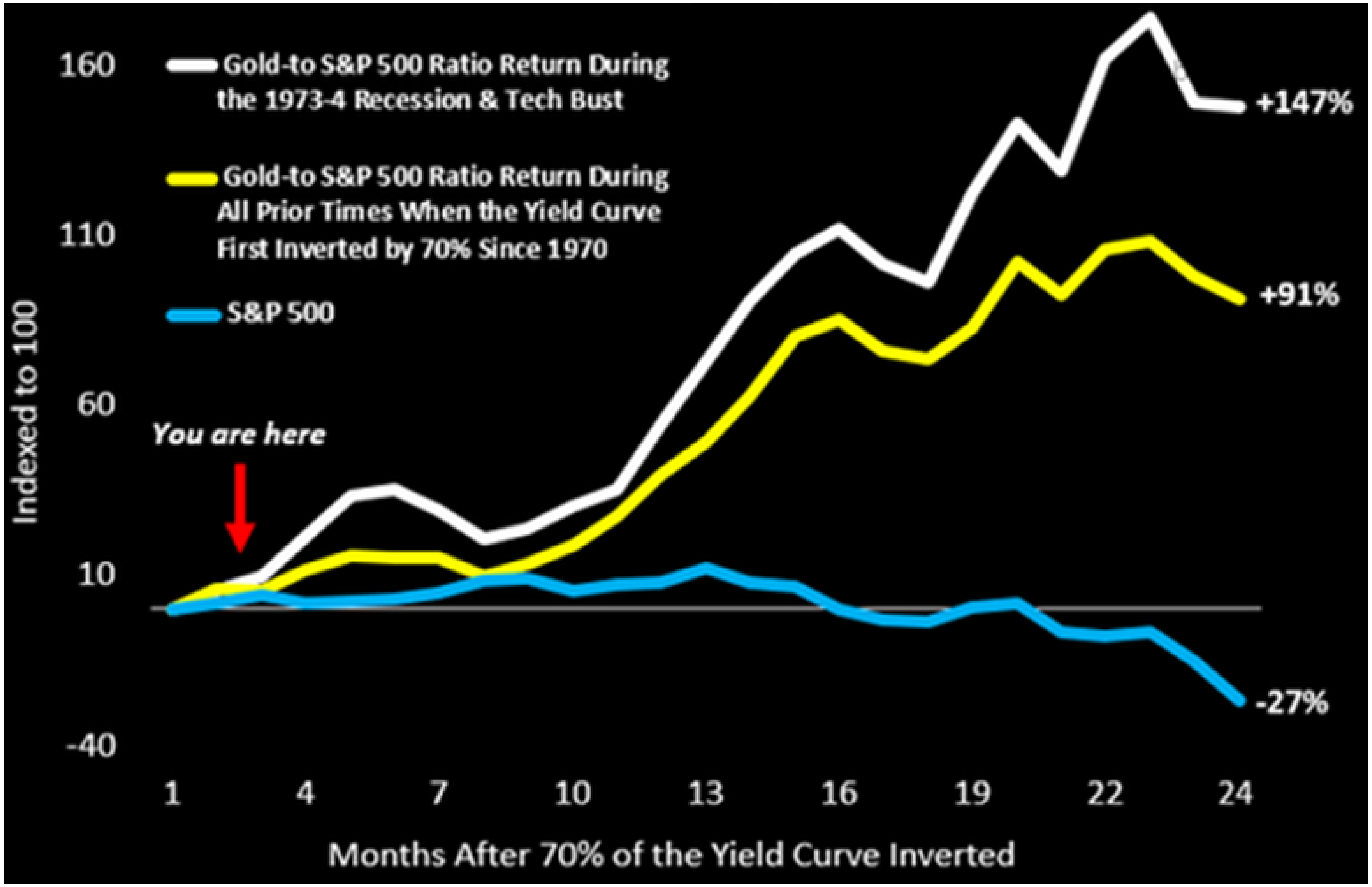
We are in dangerous territory and could soon be entering a secular bear market.



Recommendation #2: Add gold to your portfolio.

Gold almost always does well once the yield curve has inverted.

Gold-to-S&P 100 after Yield Curve Inversions



Recommendation #3: Invest in robust income-generating strategies. They always outperform in bear markets.

Megatrend

THE AGE OF DISRUPTION

Sub-trend

THE DIGITAL REVOLUTION

Investment Opportunity

MUSIC ROYALTIES

Recommendation #4: Structure your portfolio on the basis of megatrends. We have, over the years, identified no less than eight of those.

The End of the Debt Supercycle	60 years of debt accumulation is about to come to the end of the road.
Retirement of the Baby Boomers	More than 150 million people in the OECD will retire in the next 15 years.
Declining Spending Powers of the Middle Classes	Many countries have not experienced any meaningful growth in real wages for many years.
Rise of the East	In PPP terms, China has more middle class families, and is a larger economy, now than the U.S.
The Age of Disruption	The number of years to fully disrupt a business is falling as the use of digital technology spreads across society.
Running Out of Freshwater	More people in the world have a mobile phone than have access to clean water.
Electrification of Everything	New technologies combined with a war against climate change will eventually electrify all heating and transportation.
Mean Reversion of Wealth-to-GDP	The aggregate result of the other seven mega-trends and why we keep the equity beta in our portfolios to a minimum.

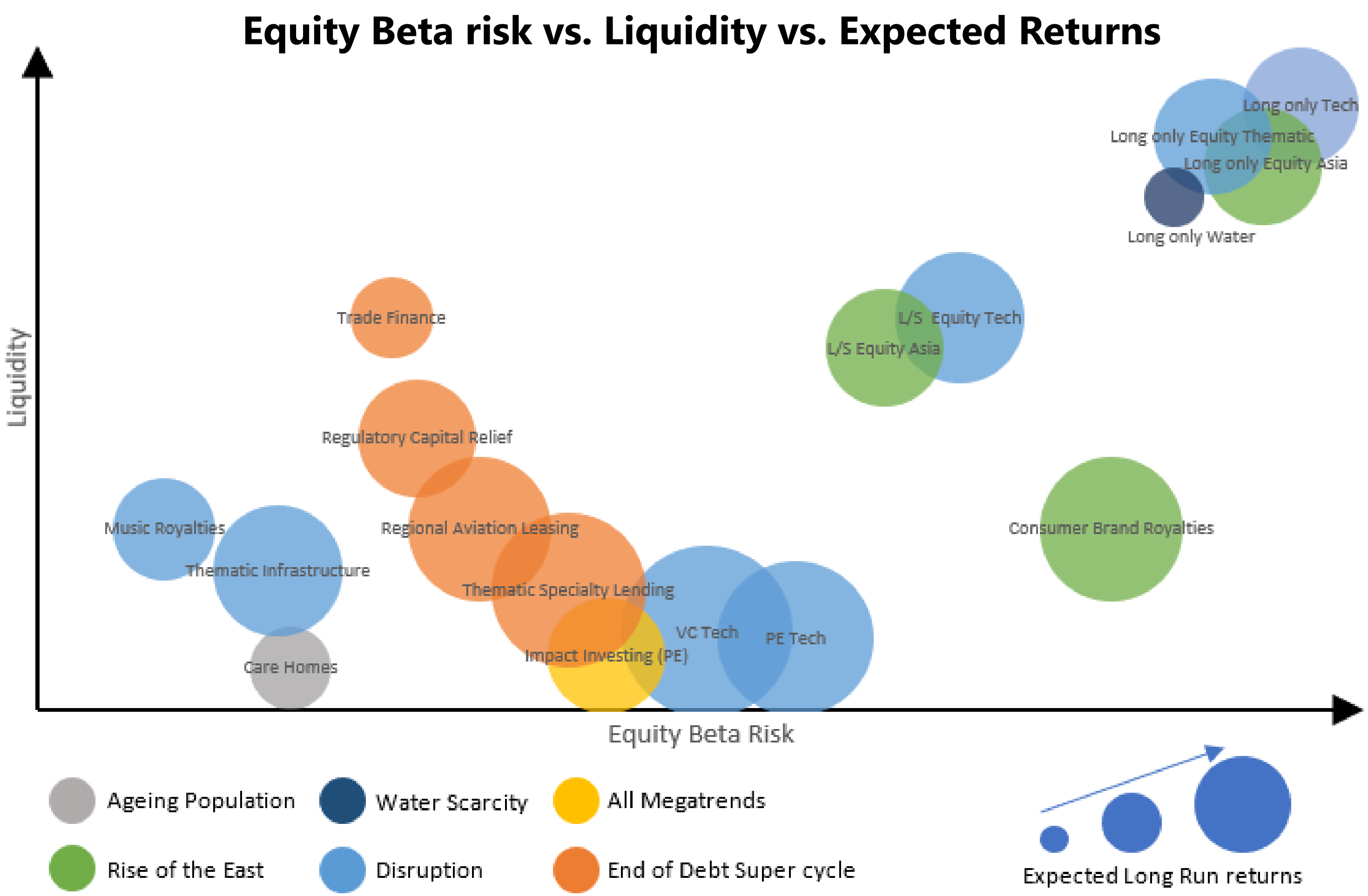
Megatrends are highly predicable, structural long-term trends. Why invest in megatrends? Because …

Megatrends are virtually set in stone, i.e. the forecasting risk normally associated with investing is greatly reduced and consists predominantly of timing risk.

Megatrend investing is about structural winners which is why it is a consistent source of alpha.

Investing in megatrends can capture behavioural biases.

Think out of the box when investing in megatrends. Not all investment opportunities offer the same efficient mix between risk, liquidity and returns.



1. *Each strategy will offer exposure to more than one megatrend. In this illustration, they key megatrend is highlighted.*

One specific investment idea:
An Equity L/S fund, targeting both winners and losers in the digital revolution.

Investment Overview

- This approach allows you to capture disruption without taking meaningful equity beta risk.
- Disruption creates dispersion and that leads to opportunities (top chart below).
- ARP has identified a manager who is long the disruptors and short the incumbents.

Expected Returns

- Our base case is for annual returns net of all fees to average at least 10%.
- Our base case is *not* contingent on strong equity markets. As you can see below (bottom charts), this investment manager has performed very well in adverse market conditions.

Average Monthly Dispersion of Sector Indices

Sector	S&P 500 (%)	S&P MidCap 400 (%)	S&P SmallCap 600 (%)
Information Technology	7.91	10.86	12.31
Consumer Discretionary	6.92	9.08	10.82
Materials	6.51	7.39	9.82
Financials	5.92	6.56	7.60
Healthcare	5.85	9.90	11.91
Industrials	5.66	8.45	9.47
Telecommunications	5.13	5.70	8.48
Consumer Staples	5.03	7.51	9.54
Utilities	4.86	4.70	4.51
Energy	4.56	7.33	9.06

Source: S&P Dow Jones Indices LLC. Data from 1995 to 2014. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.

	# Months	Market Return	Fund Return	Capture
Market Up	30	100.7%	11.3%	11.2%
Market Down	6	-26.2%	16.2%	-62.0%

	Mar-17	Feb-18	Mar-18	Oct-18	Dec-18	May-19	Total
S&P 500 Return	-0.04%	-3.89%	-2.69%	-6.94%	-9.18%	-6.58%	-29.32%
Fund Net Return	-0.80%	2.57%	3.76%	-0.22%	4.00%	6.10%	15.41%

Appendix

THE EIGHT MEGATRENDS

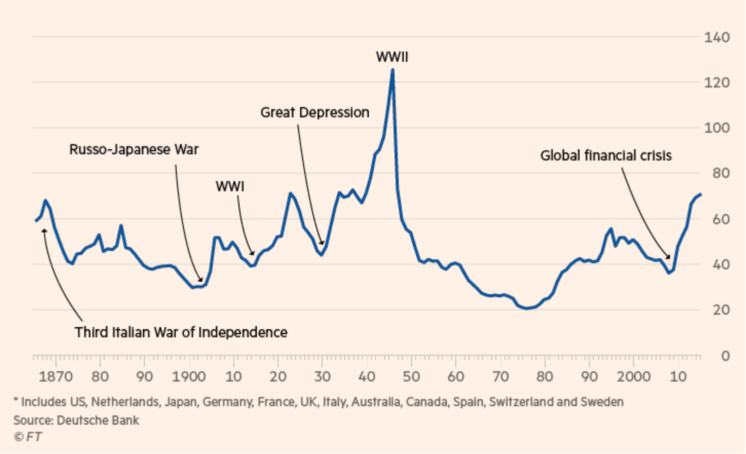
The End of the Debt Supercycle

Megatrend 1

- In the early stages of a typical debt supercycle, GDP and debt grows 1:1, but that ratio deteriorates as the cycle matures. All prior debt supercycles have come to an end when GDP grows only £0.20-0.25 for every pound of added debt. China is now at 0.21 and the US at 0.28.
- The fact that ΔProductivity and ΔGDP are both struggling to gain momentum at present are powerful indications that we are fast approaching the end of the current debt supercycle.

As is evident from this chart, the world has never been more indebted during peacetime than it is now.

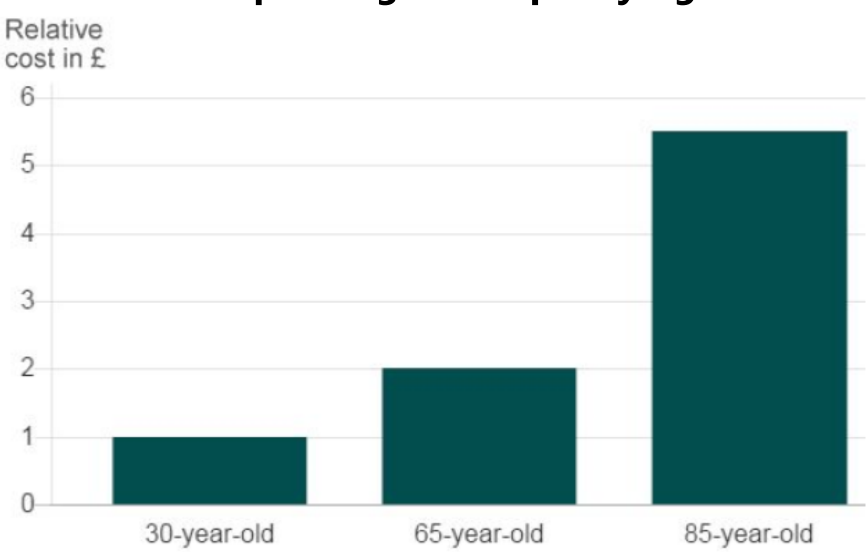
Median Govt. Debt as % of GDP



Megatrend 2

- 150 million OECD workers will retire between now and 2050.
- Servicing the elderly is extremely costly. According to the NHS, servicing a man in his mid-80s is 5-6 times more expensive than servicing a man at the age of 30 (see below).

NHS Spending on People by Age

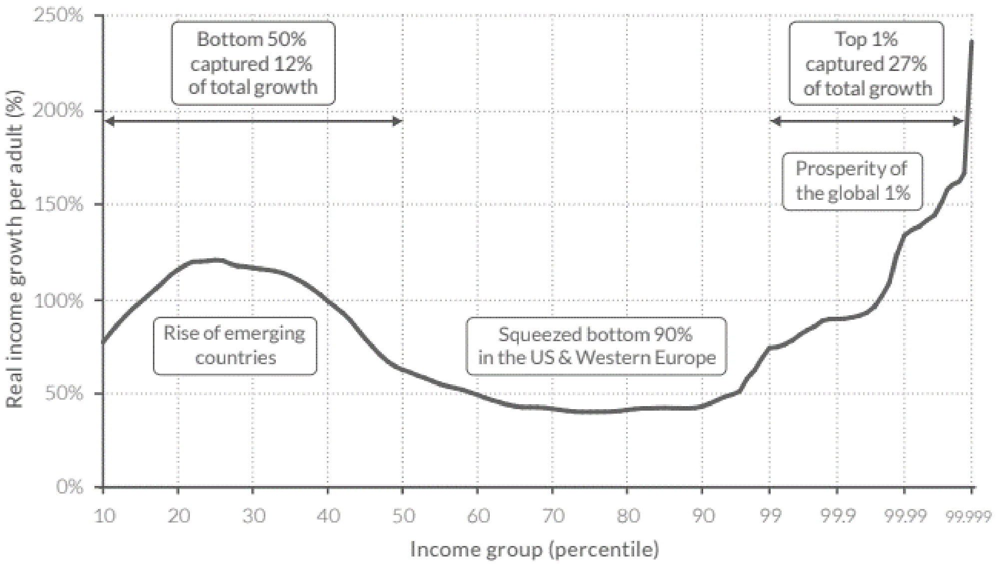


Declining Spending Powers of the Middle Classes

Megatrend 3

- Workers in many countries have not experienced any meaningful growth in real wages for years.
- Low or no real wage growth negatively affects aggregate demand and partly explains why GDP growth is so low everywhere.

Global Inequality



Megatrend 4

- In PPP terms, China has more middle class families now than the US.
- The first thing people spend more money on when living standards rise is more and better quality food – almost always more protein-rich food.
- One should seek exposure to the phenomenal growth in the Chinese economy without being exposed to the over-leveraged financial system in China.

Chinese GDP Catch-Up under Various Assumptions

		Annual Chinese GDP Growth		
		3.00%	5.00%	7.00%
Annual US GDP Growth	1.00%	2047	2032	2027
	1.50%	2057	2034	2028
	2.50%	n/a	2041	2030

The Age of Disruption

Megatrend 5

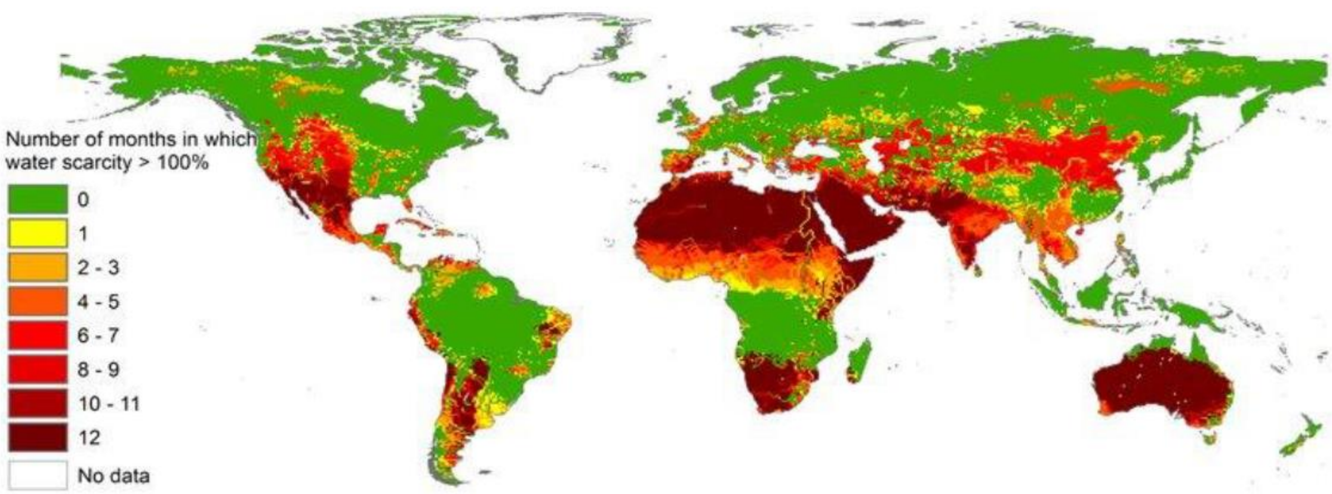
No. of Years to Disrupt Incumbent's Businesses

- Some disruptive businesses succeed whereas others don't; it is a misconception that entrants are disruptive by virtue of their success.
- Disruption has accelerated as a result of digitisation, but it is not at all limited to the technology industry.

Running Out of Freshwater

Megatrend 6

Water Scarcity

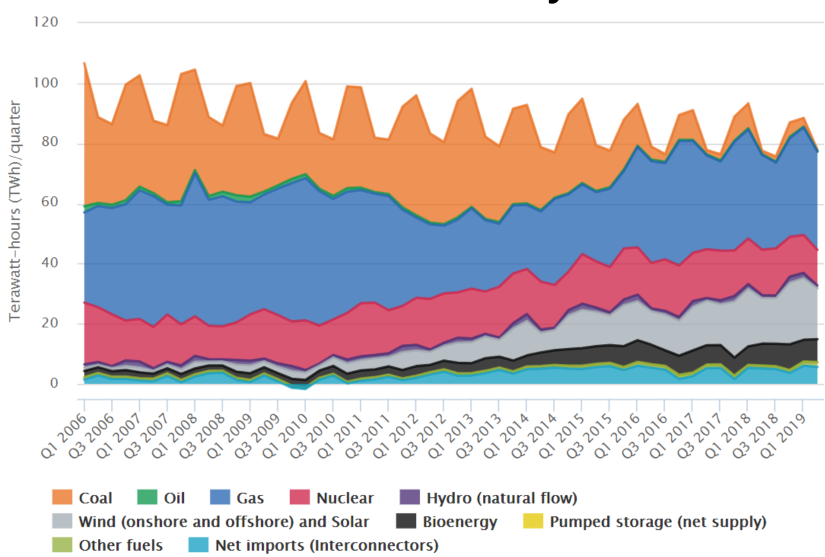


- Water scarcity is widely perceived only to be a major problem in North Africa, Australia and the Middle East but, in reality, it is fast becoming a worldwide problem.
- Food production must rise 60% in the next 20 years, and food production accounts for nearly 70% of all freshwater consumption globally. In other words, the problem can only get worse.

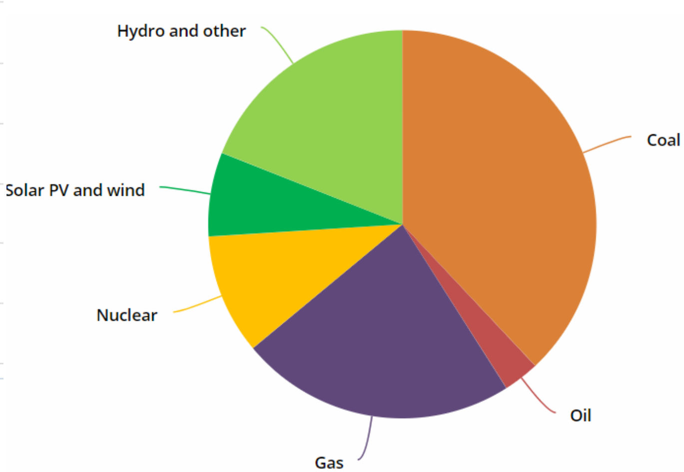
Megatrend 7

- The fight against global warming will drive governments all over the world to electrify virtually all transportation and heating, which will dramatically reduce demand for fossil fuels.
- The digital revolution will further accelerate the move towards electrification.

UK Fuel Mix in Electricity Generation



Global Fuel Mix (2018)

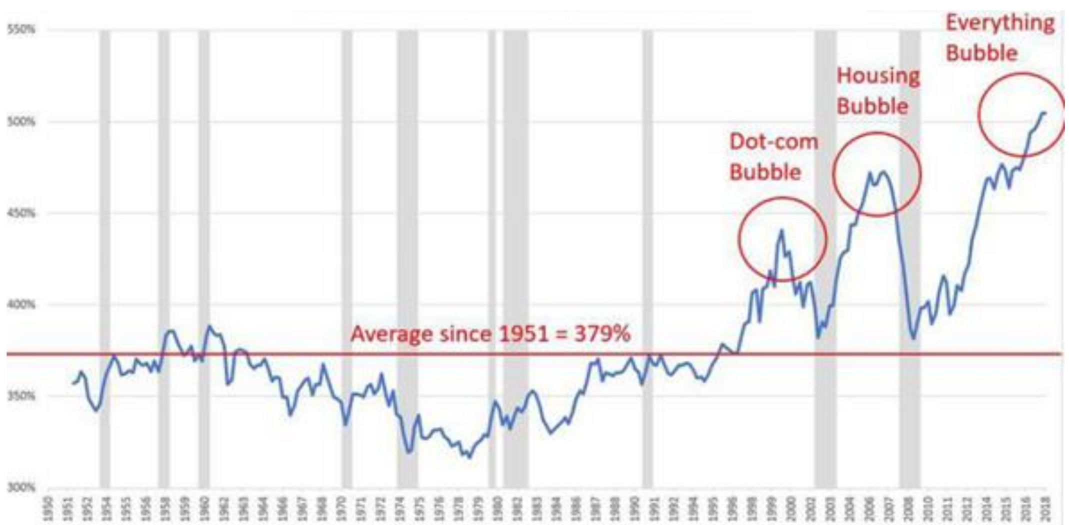


Mean Reversion of Wealth-to-GDP

Megatrend 8

- Asset prices have grown much faster than GDP since the mid 1980s and, in the long run, one *cannot* outgrow the other.
- *Every single time* wealth has deviated meaningfully from its long-term average, it has regressed to the mean, and US wealth is now a tad above 500% of US GDP against a long-term mean value of 379%.

Total US Household Wealth as % of GDP since 1950



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