Market Musings

July 2019

“Whoever fights monsters should see to it that he does not in the process become a monster.”

Friedrich Nietzsche, 1844-1900

Veritas Investment Management

REAL RETURN INVESTING

Meg Woods
Investment Partner

At the heart of the US-China trade war is the battle for global digital supremacy.

Who is likely to win?

The revolution in artificial intelligence (AI) is at the forefront of the digital race. The US is ahead of China in AI at present, but will it be in five years' time?

Dr. Kai-Fu Lee, former President of Google China and now a high tech venture capitalist in China, has published a 'must read' book entitled "*AI Superpowers*". He offers an insightful analysis into this question. He fully recognises that China is not leading in the big intellectual breakthroughs in this field, but notes that the work of leading AI researchers is readily available to all online – including China's AI engineers. Where China will hold the advantage is in the implementation of AI, enabling them to capture much of the economic benefit.

Silicon Valley has a reputation for hard work, but lags far behind China's internet entrepreneurs according to Dr. Lee. The latter have conquered in a cut-throat competitive environment, a world where speed is essential, copying is an accepted practice and unscrupulous competitors will stop at nothing to win. These entrepreneurs are the children who were born into poverty in the Mao Cultural Revolution, and are driven to escape it.

They have access to China's other "natural resource", scale and an over-abundance of data. This arises not just out of the size of the population, 1.4 billion to America's 325 million, but also out of the fact that China leapfrogged the US in payment systems. WeChat became a universal app, combining text and voice messaging with the facility to pay for shopping, book medical appointments, file taxes, unlock shared bikes, organise birthday parties – all without leaving the app. In the US, these functionalities are scattered across a dozen different apps and providers. WeChat thus captures a comprehensive treasure trove of users' daily habits that can be combined with deep-learning algorithms to market tailor-made products and services. This far outstrips what Silicon Valley's companies can decipher from a person's searches on Google, product review 'likes' or occasional purchases.

Another tailwind for China's AI engineers is that Chinese are not sensitive about their data being collected and analysed, whereas Americans regard it as an invasion of privacy.

In addition, China's government is providing widespread support and funding. The State Council has a national strategy for AI development. Local governments are vying to attract tech companies with tax incentives and tech-friendly infrastructure, in contrast to Washington's 'hands off' approach.

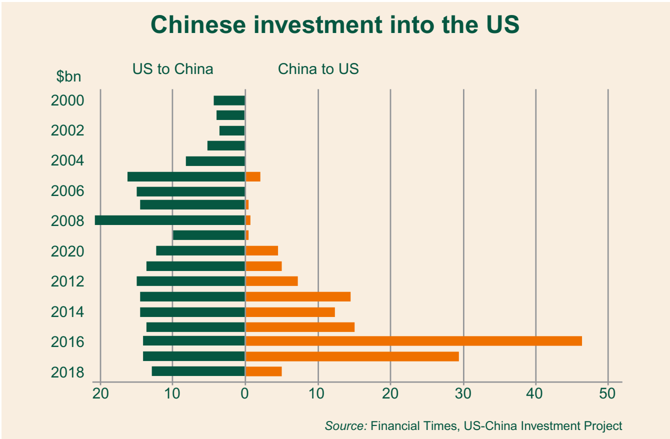
Dr. Lee believes that China will soon overtake the US in developing and deploying AI. The disruption to job markets will be very real and very large, and present huge political challenges, but it will translate into productivity gains on a scale not seen since the Industrial Revolution. PricewaterhouseCoopers predicts that AI will add $15.7 trillion to global GDP by 2030 (some 20% of global GDP in 2018), with China taking $7 trillion of that to N. America's $3.7 trillion.

As the economic balance of power tilts in China's favour, opines Dr. Lee, so too will political influence and 'soft power'.

Circuit breaker

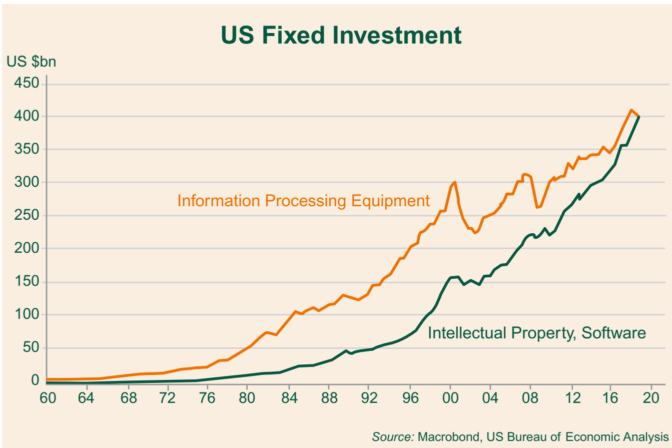
Donald Trump's approach to making his country "great again" stands in stark contrast to that of China's State Council. His persistence in erecting an economic wall between the US and China is disrupting supply chains and imposing significant costs on US manufacturers. Some tariffs are being absorbed through lower profit margins, others passed on to consumers through higher prices.

Soft damage is being done too, that will not easily be repaired. Columbia University has terminated research exchanges with 14 Chinese universities; even if Trump does pull off a trade deal, relations will not resume as before. China has warned its citizens of the dangers of travelling to the US, citing being harassed by law enforcement agencies (e.g. the arrest of Huawei's Finance Director) and frequent gun shootings! Travel from China to the U.S. fell in 2018 for the first time since 2003, down by 5.7% (source: National Tourism Office). Chinese investment into the US has slumped.



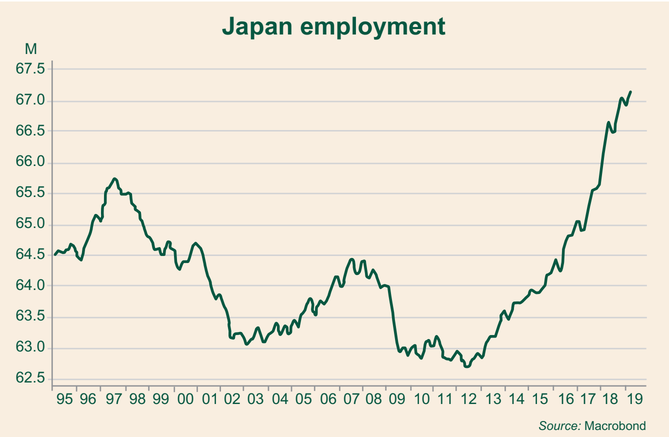
Trump's trade offensive is hitting other parts of the world too, with the €urozone hardest hit. GDP growth estimates there for 2019 have been cut from 1.8% in January to 1.1% now (source: *Consensus Forecasts*).

In contrast, US growth forecasts have been *raised*, with GDP now expected to grow by 2.6% this year compared with the 2.4% estimate in January. This has been led by a surge in investment. Inter alia, software investment was up by 12.2% year-on-year in Q1 and research & development expenditures by 9.7%: the tight labour market is prompting companies to explore productivity improvements (source: GFC Economics).



This is feeding through to costs: while wages are growing at 3.1% p.a., unit labour costs were up by just 0.32% in Q1 year-on-year for non-financial corporations – with the jobless rate at a 49 year low of 3.6%! Little wonder that the Federal Reserve's (the Fed's) favourite measure of inflation, the Core PCE Deflator, had slipped back down to 1.6% p.a. in May from 2.0% a year earlier.

Indeed, most of the West is enjoying a jobs boom. Two-thirds of OECD countries are enjoying record high employment, including Japan.



This is partly cyclical, but also reflects structural shifts – higher levels of education, efficient websites matching vacancies and applicants, more women in work.

Foolish Fed?

With close to full employment and inflation muted, it beggars belief that the Fed is reported to be considering cutting interest rates. Goldilocks on steroids? This protracted period of historically low interest rates endorses debt accumulation and condones the misallocation of capital, enabling marginally profitable companies to stay in business. It has been a prime driver of high housing prices that shut so many young people out of the housing market.

Persistently low interest rates also ease the cost of servicing public debt and encourage government borrowing. Trump's policies are set to push the US into the deepest fiscal deficits on record outside wars and recessions, despite the economy being near full employment.

Similar stories are playing out elsewhere. Japan has not worried about budgetary strictures for two decades. Its fiscal deficit this year will be 2.5% of GDP despite the current expansion being the longest in the country's post-war history. Gross government debt is now an astonishing 226% of GDP.

The reason central banks are again pivoting towards easier monetary policy is their blinkered pursuit of the elusive inflation target of 2% p.a., ignoring the economic distortions that are building. Bonds with *negative* yields now exceed $13 trillion, equal to 26% of global sovereign debt and 15.3% of 2018's nominal global GDP!

However, in an era of the disinflation of technology, the 2% target has outlived its usefulness. Protracted easy money has exhausted central banks' flexibility to react to shocks or recessions. Monetary policy should offer a counterweight to deficit spending governments, not enable them. There was a crash and depression in 1920/1, but we never read about it because President Harding simply did nothing, let prices and markets clear, and it was all over by 1921 – to be followed by the *Roaring 20s*.

Central bankers should heed Nietzsche's warning, as per our front cover quote. In their quest to avoid the monster of deflation, they should take care not to become the monster of debt and deficits.

SPOTLIGHT

Circular economy

In the film The Day the Earth Stood Still, aliens arrive to save Earth from destruction with inter-galactic superpowers despairing of humans' ability to manage the planet's resources sustainably. Far-fetched? Absolutely… but many people are now reaching the same depths of despondency.

Little wonder given the numbers involved. For example, the UN has warned we have 12 years to change our behaviour or irreversibly damage the planet. We now consume 5gm of plastic per week (equivalent to a credit card) through waste particles in our food and drink.

One possible solution involves a fundamental shift in the structure of our economy. The idea is to move from a linear approach of "take, make, waste" to a so-called circular economy, in which we design out waste and pollution, keep materials in use, regenerate natural systems and switch to renewable energy. This would require changes from governments, consumers and companies, and a rethinking of business practices.

With environmental and social pressure set to increase, companies failing to act could find themselves sitting on the wrong side of regulation and potentially losing their social licence to operate. Clearly, this puts the long-term success of business models at risk and we expect investee companies to recognise this.

But we also want companies to consider the opportunities. The World Economic Forum believes plastic packaging waste represents $80-120 billion lost to the global economy every year, so moving to a sustainable model makes good business - as well as environmental - sense.

Google, for example, has re-used components from 2.1 million old servers in new units, saving hundreds of millions of dollars and raw materials. Packaging innovations across multiple brands at Unilever reduced the company's use of plastic by thousands of tonnes in 2018, thus decreasing costs.

Such changes seem small but the cumulative effect could be immense. The Ellen MacArthur Foundation estimates moving to a circular economy could save $700 million in material costs across consumer goods industries and reduce carbon dioxide emissions by 48% by 2030. Perhaps we can move to a sustainable future without the need for extra-terrestrial intervention.

Philippa Bliss, Assistant Investment Manager

Progressive returns

At Veritas, our quest for our clients is for real returns, ahead of inflation, both protecting and growing the purchasing power of their capital on a rolling five year view.

We are mindful of the monetary bubble that central banks have engineered with easy monetary policy and that is now being underpinned in some countries by rising fiscal deficits. March saw the 10th anniversary of the start of the current bull market and the S&P 500 Index has been hitting record highs. However, we remain firmly wedded to our philosophy of *not* trying to time markets. Few do it well consistently.

Over time, a company's share price will always reflect the underlying progress in earnings and free cash flows. We therefore strive to ferret out companies that are growing predictably and sustainably, established businesses run by proven management, financially sound with robust cash flows, a moat against competitors, all at a sensible price. We run focused portfolios, investing in some 25-40 equities.

Our cash levels are higher than usual at present reflecting our caution over full valuations, but our search for companies that will deliver real returns over the longer term continues undaunted.

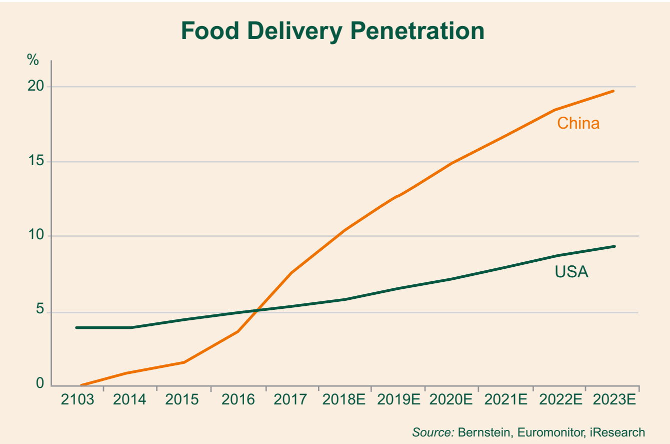
We approach stock selection by identifying tectonic structural shifts. These trends form the basis of our global growth themes, in turn a funnel to narrow the investable universe and focus on attractive sectors and stocks that are likely beneficiaries.

Our current high conviction themes are:

- online life
- demographic dynamics
- regulation, and
- all change: wire & re-wire.

Reflecting their long term nature, our themes have not changed in a while. However, the pace of change within them keeps them relevant and vibrant, and continues to excite and tantalise us.

Take online life. The rise of online food delivery is causing structural changes to global food consumption, disrupting restaurants and grocery retailers. It is driven by the convenience of food delivery and the rise in the singles population. Bernstein reports that in China, 35% of the population are now willing to give up cooking altogether and rent an apartment without a kitchen!



Thanks to ride-sharing and car-sharing services, fewer Chinese who live in urban areas are buying cars. There are demographic dynamics here too: young people cite not being able to text while driving as a reason not to own a car ...

In Bee Cave in Texas, the Hill County Galleria bought their shoppers' mobile data and analysis showed that many owned pets. Management installed water fountains, dog sitting stations and 'Santa Paws' photo opportunities. The time customers spent in the mall rose by 40% (source: Bloomberg). Also based on mobile phone data, a shopping centre in Chicago found that it was attracting Asian customers, so filled a retail vacancy with a high end Asian specialty grocer.

Innovating for children

A new addition to client portfolios (where appropriate to the mandate) has been Hasbro, long known as a toys and games company for such board games as *Monopoly*. However, management have been diligent in adapting the product offering to the evolving global consumer landscape and shopping behaviour. They have continually re-imagined and re-invented their products and brands through innovation and by embracing technology. From toys and games to TV, movies, digital gaming and other forms of digital entertainment, Hasbro strives to fulfil the global fundamental need for play and for connecting families and friends. Card games that can be played on a mobile device can be played by a child in London with a child in New York.

Hasbro's industry leading portfolio of toy brands, including *My Little Pony, Play-Doh, Nerf, Transformers* and *Magic: The Gathering* to name but a few, is a key asset to deliver sustainable long-term growth. Management build these brands through entertainment-based storytelling, understanding the importance of digital content to drive fan engagement, including in gaming.

Management are also deeply committed to Corporate Social Responsibility across the four areas of product safety, environmental sustainability, human rights & ethical sourcing, and diversity & inclusion. Another tick in our Quality of Business checklist.

Hasbro is a successful example of our '*all change: wire & re-wire*' theme. We firmly believe our investment in their shares will deliver the real returns for clients that are our objective.

Meg Woods
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Market Musings is an expression of our current views. It is for information only and must not be interpreted as investment advice. If you no longer wish to receive *Market Musings*, please contact us at one of the numbers below.

VERITAS INVESTMENT MANAGEMENT LLP 90 Long Acre, London WC2E 9RA. Tel +44 (0) 20 3740 8350
VERITAS INVESTMENT MANAGEMENT AG Genferstrasse 21, 8002 Zürich, Switzerland. Tel +41 (0) 44 206 2660 www.veritasinvestment.co.uk