TINA – There is no alternative, or is there?

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We argue in this article that the unique interventions made by central banks globally have resulted in many traditional and alternative asset classes being overpriced. Consequently, investors are being forced to face an Antoine Lavoisier moment.

Lavoisier, an 18th century chemist, was unfairly sentenced to death by guillotine during the French revolution. He agreed to blink his eyes for as long as he remained conscious after his beheading to add knowledge to medical science. Like Antoine, most investors are being forced to choose the best out of a bad set of alternatives.

We conclude with our thoughts on risk mitigation, our answer to navigating bizarre times.

Developed market cash and bonds offer negative real yields

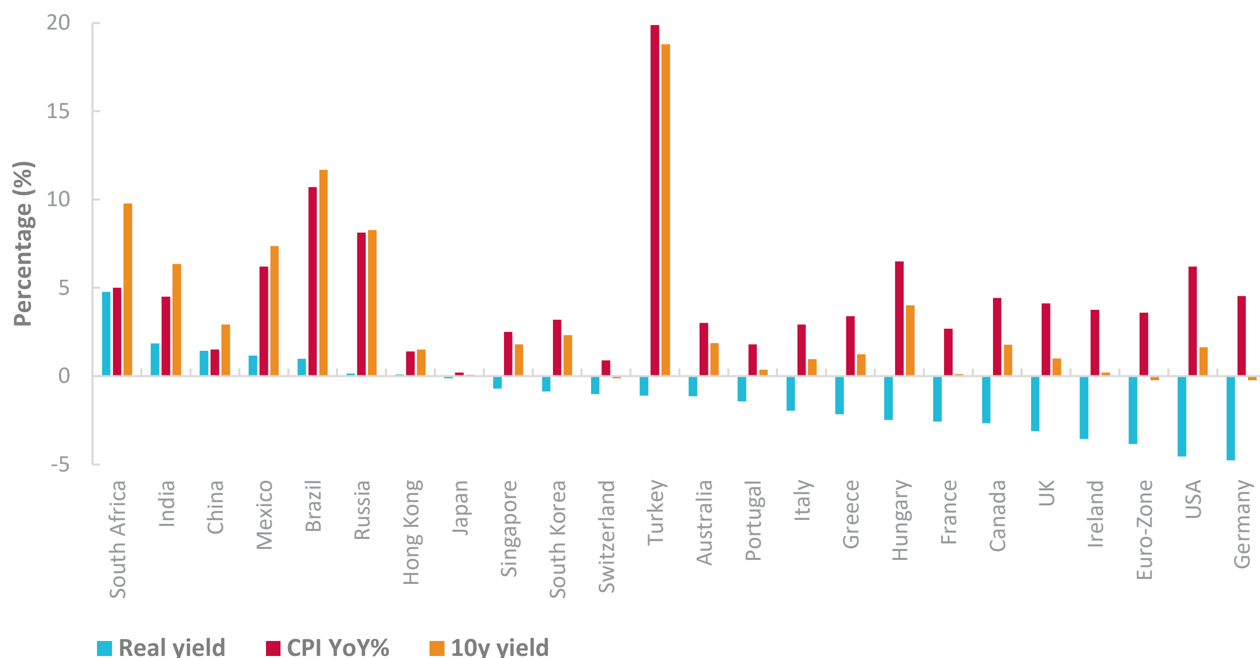
Monetary authorities have, since 2008, responded to stuttering growth by slashing interest rates in the hope of stimulating it. The robust global employment levels pre-2008 only recovered by mid-2016, while interest rates have been kept at the lowest levels in the history of the Federal Reserve (the Fed Fund's rate is 0.00% to 0.25%), of which most banks take their cue.

The chart below shows that developed bond markets currently yield negative real interest rates. Negative real rates are historically unorthodox, but more extreme is the imposition of negative absolute interest rates, where a saver pays the bank to hold their deposit. Interest rates in Switzerland have been -0.75% for 5 years now.

This amounts to a form of economic coercion, where the effect of negative returns on cash or bonds forces savers out of deposits and into other riskier asset classes such as equities, property, credit, commodities, private equity, mortgage rate securities, art, crypto and the list goes on, in search of yield. One market's loss is another's gain. Prices inflate in the beneficiary market and theoretically the losing market (cash, treasuries, bunds, JGB's) should re-price to lure back investors.

However, the various monetary authorities have stymied such conventional economics as central banks have acted as default buyers of debt instruments, thereby anchoring yields and artificially elevating prices. Look no further than the Fed, which doubled its exposure to US treasuries between 2020 and 2021, and now holds in excess of 20% of those securities. The real unanswered question is, what levels would treasury yields be at without the Fed?

Chart 1: Real yield



Source: Iress (Date: 24 November 2021)

Fortunately, markets are never an amorphous mass and opportunities always exist

In a world of overvalued fixed income assets, there are of course always exceptions. Positive real yielding bond markets do exist, mostly in emerging markets, with South Africa being a stand-out example, as evidenced in the above chart. Of course, higher yields occur to compensate for elevated risks, but in SA, yields are at extreme levels, offering investors a healthy buffer against near-term risks. Our SA bond analysis below demonstrates this attraction. Our base case annualised returns for fixed bonds over the next two years exceeds 10%, for securities with duration of more than 8 years and less than 20 years.

Table 1: South African Government Bonds

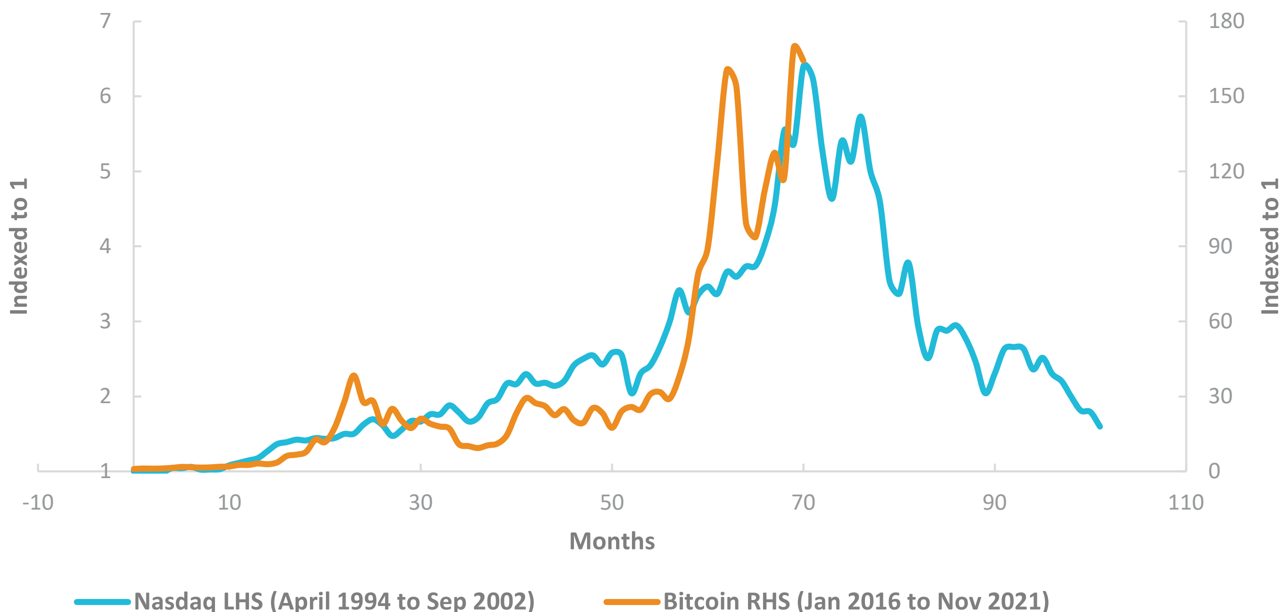
2y expected returns 15 Nov 21	Years to maturity	Bull Case	Base Case	Bear Case
R186	5.1	9.9%	8.7%	7.5%
R2030	8.2	14.0%	11.2%	8.5%
R213	9.3	14.9%	11.5%	8.3%
R2032	10.4	15.5%	11.6%	7.9%
R2035	13.3	16.6%	11.4%	6.7%
R209	14.4	16.3%	10.7%	5.6%
R2037	15.2	17.2%	11.3%	6.0%
R2040	18.2	17.3%	10.5%	4.7%
R214	19.3	17.3%	10.3%	4.3%
R2044	22.2	17.3%	9.7%	3.4%
R2048	26.3	17.1%	9.0%	2.4%
SA 30y	30.0	17.2%	8.8%	2.2%

Source: JSE and Northstar Asset Management (Date: 24 November 2021)

Risky bubble-like alternative asset classes

Equity exuberance and risk are dwarfed by the level of religious fervency that abounds in certain alternative investment securities, the 6 000 different crypto currencies being a case in point. Bitcoin, birthed in 2009 has garnered a market capitalization of US $1.3trn equating to almost 10% of all gold, a store of wealth since 500BC, valued at US $11.9trn. The chart below shows how Bitcoin's trajectory is similar to that of the IT bubble, albeit at a multiple in terms of the size of the move.

Chart 2: Nasdaq vs Bitcoin



Source: Iress (Date: 09 November 2021)

This feels uncannily like the emerging market frenzy of 1998, the Dotcom bubble of 2000, and, closer to home, the building and construction debauchery that fed off the Soccer World Cup in 2007. Finally, let us not forget the bust of the commodity cycle in 2015. In a world of "free money", radical new age ideas displace "behind the times" conventional wisdom and new asset classes devoid of cash-flow gain traction.

Bubbles exhibit two common traits, firstly they turn "early and vocal non-believers'' into public cretons or nitwits as prices escalate to unthinkable levels. Secondly, they inevitably and ultimately decimate the wealth of the ardent believers, particularly the FOMO brigade that dove in late. Right now, the first trait is playing out on cue!

Lofty markets

It is difficult to argue that the global titan equity names are cheap - they are priced with a weight of expectation. Analysts use bond yields as a key discount rate input to value equities and low bond yields result in high equity valuations. A second impact is that low borrowing costs effectively inflate company profits. Essentially these "manipulated yields" have exaggerated the numerator (profits) and depressed the denominator (discount rates) in equity valuation. Rising bond yields might not have an immediate impact on equity prices, but their relationship is inseparable and equity prices will unavoidably reduce.

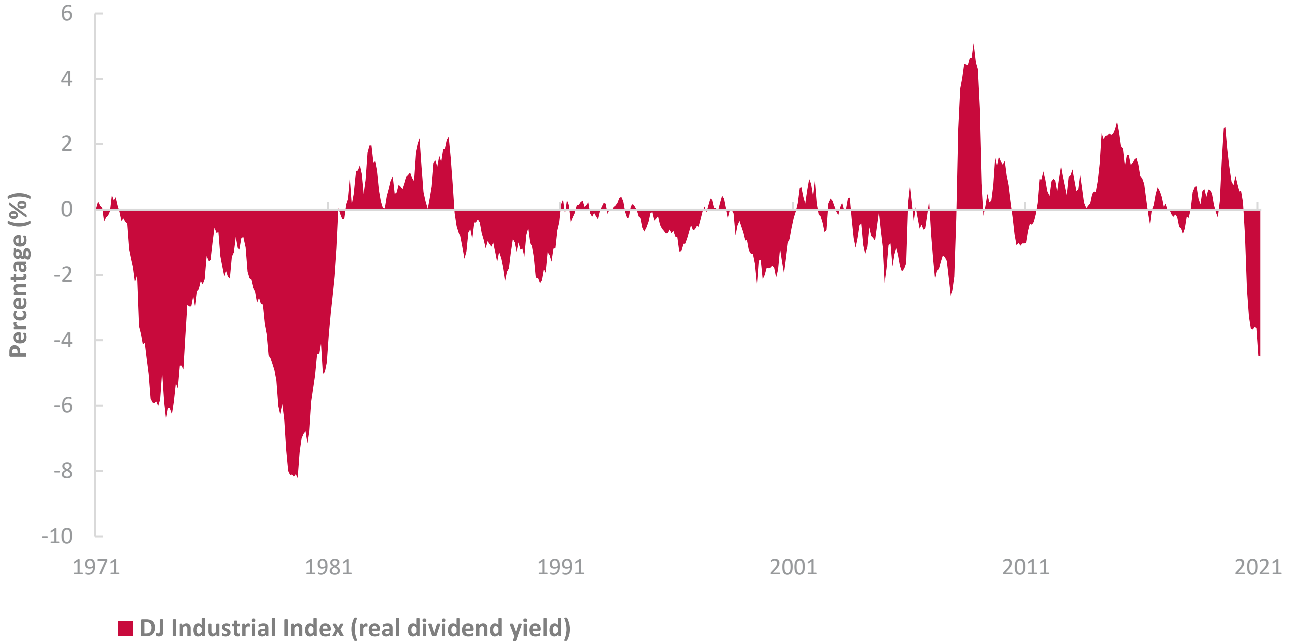
Markets move randomly over short time periods. Expensive markets can become significantly more lofty and cheap markets can get cheaper, but in the long term valuations matter.

Valuation techniques

We apply many filters to assess how expensive a market is. All have their own limitations, but collectively they tell a story.

One very rudimentary example of a filter is the real dividend yield of the Dow Jones (dividends adjusted for inflation). In the chart below we show how real dividend yields have, of late, turned negative. Historically, this has generally been a sign of poor future equity returns.

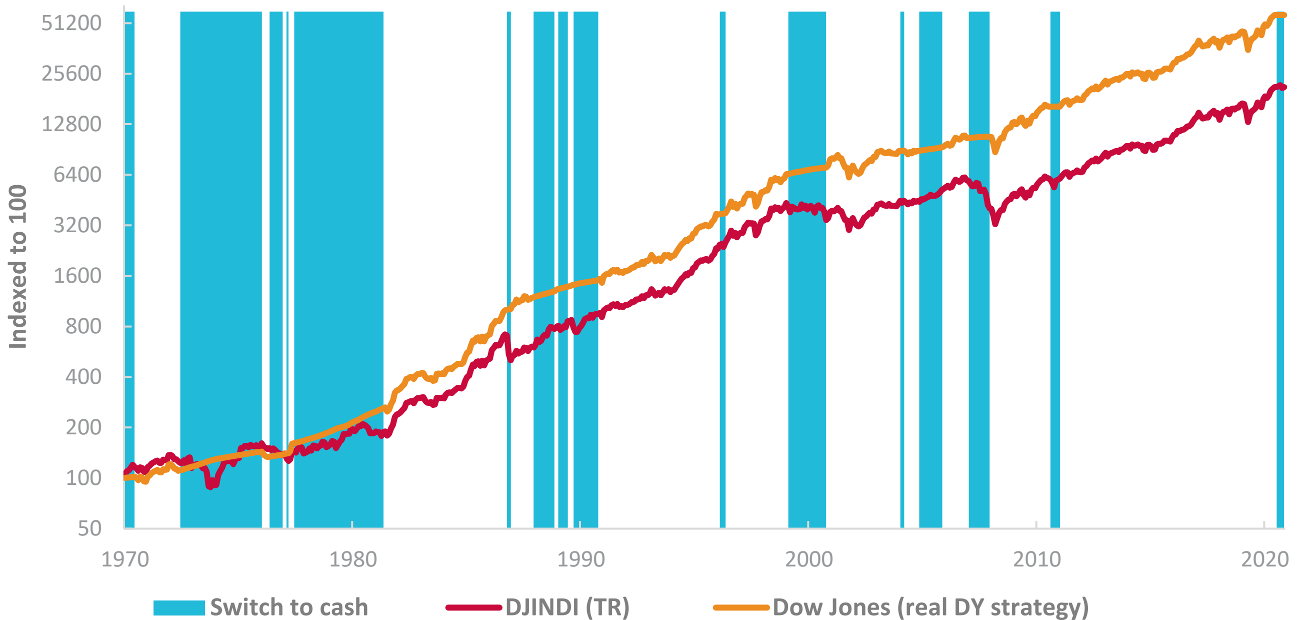
Chart 3: Dow Jones Industrial Index (real dividend yield: DY – US Inflation)



Source: Iress and Northstar Asset Management (Date: 24 November 2021)

Had an investor exited the equity market each time the real yield turned negative and hid in cash, long-term returns would have been significantly higher. We show this in the next chart, depicted by the orange line that represents the investor that times the market based on this real dividend yield signal versus staying permanently invested.

Chart 4: Real dividend yield strategy (DY <-1% real then switch to cash)



Source: Iress and Northstar Asset Management (Date: 24 November 2021)

NORTHSTAR

Risk mitigation – flexibility and time are key

We have no idea when the weight of overvaluation in alternative investments, bond markets and equities will force prices lower. What we do know is that we are suitably equipped to grow clients capital over time.

The first mechanism is to find mispriced opportunities. As previously mentioned, markets are not homogenous and South African bonds in particular appear currently undervalued. SA equities offered value this past year and we continue to feel that they are still relatively inexpensive.

The second mechanism is diversification. Blending asset classes, particularly those that act differently under varying market conditions, normally creates natural buffers to market adversity. As we argue throughout this article however, in a broadly expensive world, diversification benefits have diminished and investors relying on this lever might be facing an Antoine Lavoisier moment.

Thirdly, flexibility through exposure to products that allow investors (our clients) to adjust asset exposures in accordance with asset valuations. This demands an understanding of which asset classes are expensive and down-weighting those while upweighting areas that are undervalued with higher future potential returns. Northstar has chosen to manage products which allow us this flexibility, being our income, managed and global flexible strategies.

Lastly, understanding the power of time. Yes, it is true that maintaining a long-term time horizon can nullify the bumps in markets. Smart investors ride out market cycles. But it is equally true that investing in highly overvalued securities or entire asset classes can lead to long-lasting and even permanent capital depletion. In this case, time talks to avoiding these traps, to have the patience to accept a period of underperformance (which might take a few years) and in so doing, protect wealth from a possible moment of permanent capital decay.

Northstar will have no hesitation deploying every possible tool at our disposal to protect our clients' capital as we navigate these interesting times.

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