Weekly Digest
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Investec
Wealth & Investment

The weekly insight into world stock markets

Standing On Seth's Shoulders

I recently read the latest letter that Seth Klarman sends out to his clients. Mr Klarman is one of a select group of professional investors (alongside, for example, Warren Buffett, Howard Marks, Jeremy Grantham and Bill Gross) whose longevity in the industry and (for the most part) strong track record commands a huge amount of respect. Furthermore, he writes in a clear and engaging style which informs and educates. Like Buffett, his first paid job was delivering newspapers, which gives one pause for thought in the digital age. I note that he is four years older than me and set up his firm, Baupost, in 1982, just two years before I started in the City. Unfortunately I am unable to compete with the opening line of his Wikipedia biography which describes him as a "billionaire investor". Clearly I have underachieved.

Klarman is generally described as a "value investor". His expertise is in bonds, notably distressed debt, and so he gives interesting perspectives from an area of the market that tends to be in the shadows when it comes to media coverage (and, indeed, from investment banks).

What immediately struck me in his review of the last quarter of 2018, a period which was extremely stressful for the majority of investors, was how often the word "record" appeared. He notes (as we have done, referencing the work of Deutsche Bank's strategists) that "a record share of all investible assets – 90% - posted losses on a year-to-date basis". He also reminds us that the oil price "at one point declin[ed] a record 12 consecutive sessions", and that December's monthly fall for the S&P 500 Index was the worst since 1931. No wonder everyone was in a tizzy. It seems these days that when markets start moving they often build up inexorable momentum.

He goes on to list some of the excesses in markets that might have contributed to the moves, and more records are apparent. He notes the flood of money into private equity funds, where "fundraising has set records, with estimates of more than a trillion dollars in capital available to be put to work". That pile of cash is burning a hole in the pockets of the fund managers, who feel compelled to invest in riskier enterprises with greater leverage, leaving them extremely vulnerable in the event of higher interest rates and/or a slowing economy - which is, of course, what investors were worrying about at the end of 2018.

He is not alone in pointing out the structural risks in the corporate bond markets. There has been plenty of commentary about the lowest rung of the Investment Grade sector – bonds rated BBB. They comprise 58% of the investment grade market, up from 48% in 2011, and that's in a market where the total outstanding issuance has ballooned from $2.2 trilllion to $3.8 trillion. Again, the companies that have issued these bonds are vulnerable to a downturn. Another fear is that if some of them get downgraded to non-investment grade (the asset class currently known as "High Yield", formerly "Junk"), they will overwhelm that sector and trigger a huge sell-off.

This could in turn be exacerbated by liquidity issues. Other sources report that the primary dealers' inventory in the corporate bond market is now a mere $14 billion, down from $285bn before the financial crisis, and in a total market that has expanded from $2.8 trillion to $5.5 trillion. This is thanks to tighter regulation and tougher capital controls. It effectively means that the seller of a bond has to find a willing buyer to take it off him, as investment banks no longer act as a buffer. If sellers are in the ascendant, the process of price discovery can be quite painful.

Another esoteric corner of the bond market that Klarman discusses is the Leveraged Loan market. Leveraged loans, as one might expect from the title, are loans made to more highly leveraged companies (more than 4x net debt to earnings before interest, tax, depreciation and amortisation), but they also have floating coupons. Investors have been flocking into this market thanks to the prospect of rising interest rates, but, of course, the flip side is that if they rise too far they begin to inflict pain on the borrower – a further reason for the panic in December, when a(nother) record $3.3 billion was withdrawn from US loan funds in a single week. That record is perhaps hardly surprising, owing to the fact that 2017 saw a record (!) $788 billion issuance of leveraged loans, and 2018 wasn't far behind. He notes that this could be a happy future hunting ground for a distressed debt investor, especially owing to the lack of protection for new buyers – so called "covenant-lite" issuance. But the pain will have to come first.

I have commented in the past that bond markets send early warning signals to other asset classes, but I am beginning to wonder whether the transmission mechanism has become too sensitive. In the earlier period of my equity sales days we didn't know who the bond guys were or even where they sat. Thus it could be months before the warning signals from corporate bonds – widening spreads and rising defaults – were reflected in equities. Now, particularly after the Tech bust and the financial crisis, equity players continually monitor the credit markets. Add in the influence of computer-based trading and the smallest twitch in credit can have an almost immediate effect on equities. Furthermore, if people can't sell their bonds owing to liquidity problems, they will sell equities instead. I believe there was an element of this behavior evident in December. More constructively, it did mean that those who recognised it as an overreaction were able to pick up some bargains. I certainly don't think we have seen the last of this phenomenon.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Micro Focus Internatonal	10.6%
AstraZeneca	9.6%
Smurfit Kappa	8.9%
Melrose Industries	8.5%
Rolls-Royce Holdings	7.7%
DS Smith	7.5%
NMC Health	7.0%

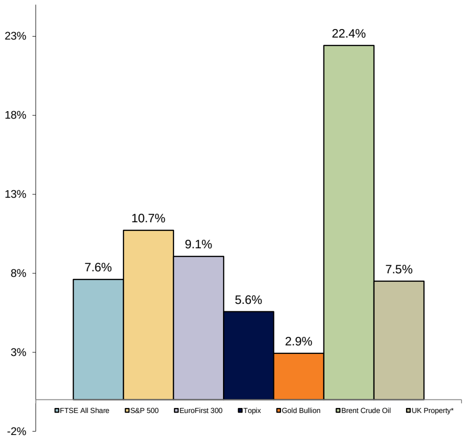
Source: FactSet

FTSE 100 Weekly Losers

TUI	-11.4%
Standard Life Aberdeen	-4.4%
Smith & Nephew	-4.2%
Paddy Power Betfair	-2.9%
Next	-2.7%
Coca-Cola	-2.2%
Severn Trent	-2.0%

Source: FactSet

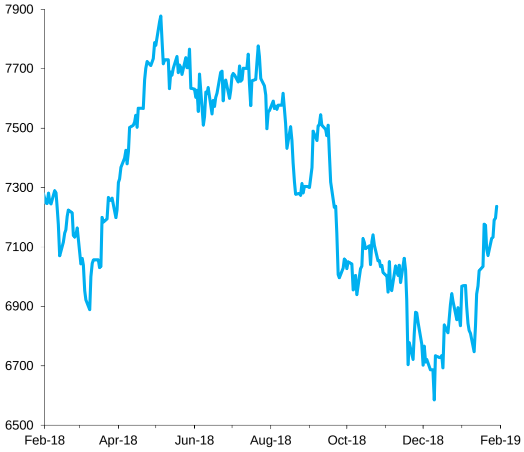
Year to Date Market Performance



Source: FactSet

*IPD Total Return to December 2018

FTSE 100 Index, Past 12 Months



Source: FactSet

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