River Valley Asset Management

Reflections from the First Quarter
Newsletter for April 2017

Review of a Good Quarter

We have had the best quarterly result since inception with the portfolio up 8.4%. More importantly this was not a "reversal to mean" performance, the kind of strong performance that follows a weak streak. Q4 2016 was a flat quarter for us. Hence a desire to understand the source of these returns.

The primary drivers of this return are:

- Markets did well. Our focus market (Asia Pacific ex-japan) did well. Globally also equity markets had a strong quarter (MSCI world being up 6.6%).
- We remained well invested through this upcycle. This is something that investors tend to underestimate. One of the wise investors I knew used to always say "what makes you money is getting the right price and the right size". Getting only one of them right is not enough. Given the fear related to Trump and the sell-off in Asia in Q4 2016, remaining well invested was not the most obvious thing to do.
- Making no large mistakes. In golfing parlance, we had no "double bogeys". As we have tightened our processes over the past one year, we hope and expect such mistakes to become less likely. Historically a few of these large mistakes have cost us dearly – and a strong process discipline, like the one we have put in place now, would have helped us avoid these mistakes.

Our forward outlook remains relatively positive as we continue to see pockets of value with improving earnings outlook.

Takeaways from the Credit Suisse Asia Conference in Hong Kong

As I have done over the last twelve years, I participated in the Credit Suisse Asia conference again in March. With a great collection of speakers on topics related to macroeconomics, AI, robotics, market sentiment and corporate updates we did gain some interesting insights.

The Secular Loads on US GDP Growth

As the US enjoys a tepid cyclical recovery and the stock market gets all positively worked up about it, it makes sense to relook at some of the secular brakes on USD GDP growth.

- Fed fund rates have dropped from 5.75% in 2007 to 0.75% now. This very cheap cost of money was a tail wind supporting growth. Going forward, this is reversing.
- The Fed balance sheet has moved from USD 900 bln. in 2007 to USD 4.5 trl. now. This five-fold increase in balance sheet has further helped the availability of money. So we had a combination of cheap and easily available money – this is reversing. For the first time we are hearing the talks about the path to shrinkage of the Fed balance sheet. This will be a head wind to growth.

- Though we hear about record low employment rate, the labour force participation is at record lows – it dropped from 66% in 2007 to 62% now. Many people have just given up looking for jobs. This partly explains the slow and much delayed wage growth we are seeing now.
- The sharp drop in labour productivity growth from 2.2% in 2006 to just 0.7% now. There are various reasons why this might be happening, but it is one of the biggest drags on GDP growth. If Trump's anti-immigration policies cause labour force growth to also slow down, the negative impact on GDP growth from this front will continue.
- Consequently the US real per capita GDP has moved from USD 48.9k to USD 51.8k from 2006 to 2016 - a paltry growth of 6% over ten years. No wonder there is a feeling of secular stagnation in large parts of the US.
- Household formation has dropped from 1.46% in 2000 to 0.96% in 2016. Household formation helps economic activity on a lot of fronts – and hence its slowdown is a secular drag on growth.

The US needs a large jump in productivity growth either through large policy changes or technological breakthroughs. The market has a lot of hopes on Trump to drive the former, but time is running out as the market tends to be an impatient animal. Already the chorus of "are we there yet" has started.

On the technology front, the US is leading in some of the most disruptive technological breakthroughs. The critical mass on some of these technologies has already crept up on us and this is causing a lot of "creative destruction". As the stock market understands the power of technologies like deep learning, AI, next generation robotics, etc., a lot of the older business models will have to be thoroughly reviewed. Service industry jobs including blue collar ones like drivers, shop assistants, factory workers, etc. are clearly under stress. But, more importantly, high-end workers like doctors, lawyers, fund managers, etc. will also be under pressure and will have to evolve. The initial impact of this on GDP growth is probably going to be negative.

Asian earnings cycle

A few interesting points were highlighted on this front.

- Asia is seeing an earnings and ROE upgrade cycle for the first time since 2010. These are very powerful indicators and a primary source of our confidence in terms of asset returns over the next twelve months.
- The ROE upgrade is happening with a much higher underlying quality. Corporate leverage has moved down as ROE's have moved up. For example corporate Taiwan is in a net cash position now, while ROE's are bottoming out.

Other takeaways

- China is seeing a cyclical rebound during a secular slow down. There has been a slow rebound in exports, industrial investments and property investment. Though the long term deceleration continues, this has quietened down the "China doomsayers" for some time.
- The regional high yield bond market is looking very expensive. The big change in the past two years has been the emergence of large onshore buyers of offshore issuances. These are primarily from markets like China. Given the small and shallow nature of the Asian high yield market, such large buyers have made everything expensive. Hence our current relatively cautious stance vis-à-vis our bond portfolio.

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