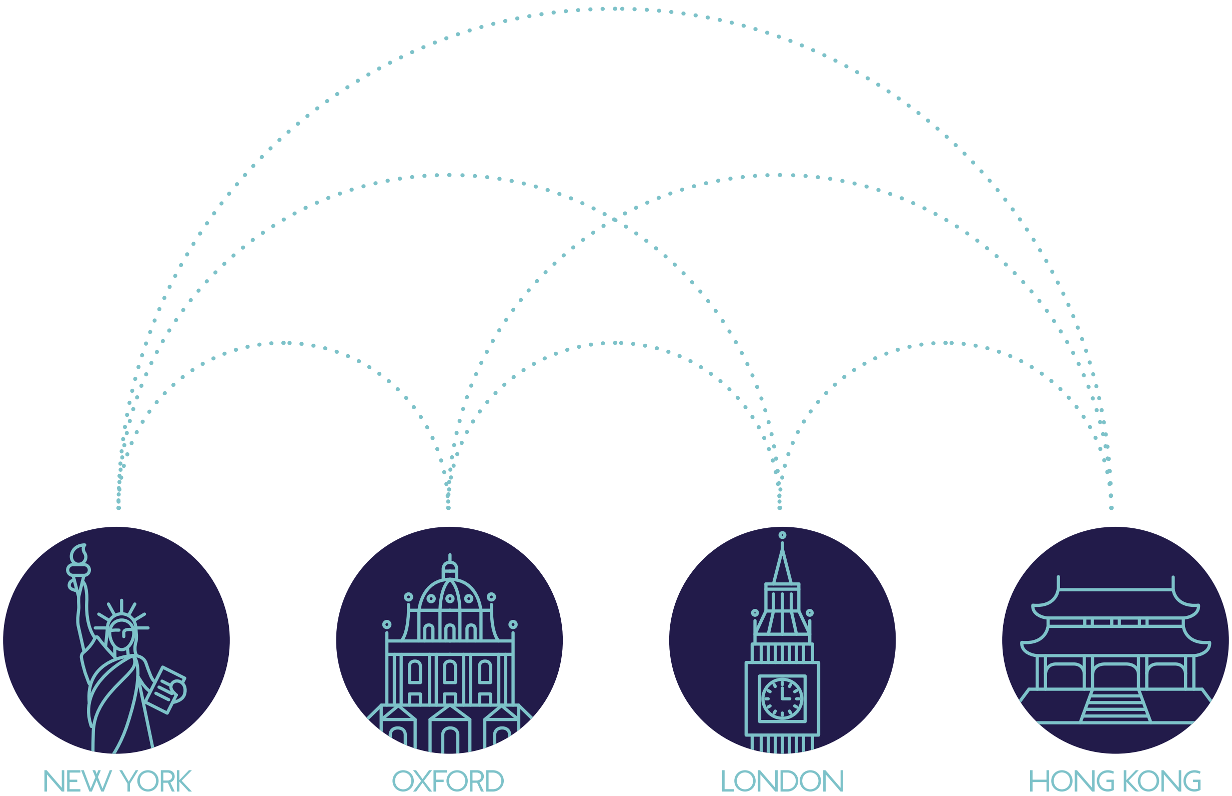
SIR JOHN TEMPLETON INVESTMENT ROUNDTABLE 2020

Global Video Conference | 11th November



JOHN TEMPLETON FOUNDATION

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Oxford Metrica is a strategic advisory firm, offering informed counsel to boards.
Our advisory services are anchored on evidence-based research in risk and financial performance.
Our work includes statistical analysis and index construction for banks and insurers, risk and performance analytics for asset managers, due diligence support in mergers and highly customised services for corporate boards.

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THE PARTICIPANTS

MODERATOR
Dr. Rory Knight, *Chairman*, Oxford Metrica & JTF IASC

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Dr King Au, *Executive Director*, **HKFSDC**

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William Priest, *Co-Founder*, Epoch Investment Partners
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MEMBERS & TRUSTEES OF THE TEMPLETON PHILANTHROPIES

FOREWORD

Dr Rory Knight is Chairman of Oxford Metrica and chairs the Investment Advisory Committee of the John Templeton Foundation. He was formerly Dean of Templeton, Oxford University's business college. Prior to that Dr Knight was the vize-direktor at the Schweizerische Nationalbank (SNB) the Swiss central bank.

NEW WORLD

We are living in doubtful and troubling times. In fact, looking back over the last thirteen Roundtables, this is surely the one presenting the greatest uncertainty. When – or if - we emerge from the shadow of Covid, what will be the new normal? Will we find ourselves in an entirely new world – a world of different values and behaviours – personal, environmental and technological? A world of shattered economies, hollowed out city centres and domestic intramural transactions? Have we bid a last hurrah to the globalization of Twentieth Century with its liberal free markets? Will long-established Western values of freedom and democracy be superseded by more authoritarian Asian models? Alternatively, will previous models prove more durable than expected and reassert themselves? As new vaccines kick in, will economies and equities soar as never before? These are the urgent questions with which we must grapple.

Let us hope that in our discussions today, we are able to identify potential opportunities and investment ideas out of this very difficult situation. We should remember the words of Sir John: 'Trouble is opportunity.' There are positive features. We have good news about new vaccines, and markets are certainly not as bad as they could be. But, to turn to 'the elephant in the room', the world economy has been dealt a severe body blow over the last year. A recent IMF report has warned that we will have a global recession this year. Certainly the GDP of the world is going to be significantly lower than it was last year. This will be accompanied by a significant amount of unemployment virtually everywhere around the world. And yet to emerge is the damage that has been done to small- and medium-sized enterprises around the world which may never recover.

These developments have been attended by a significant expansion of debt, both private and public. We are in a position where the Fed with its very expansive monetary policy is driving monetary policy worldwide. It is now difficult for central banks elsewhere to go against what the Fed is doing. In the UK alone, the Bank of England announced last week a £150 billion stimulus package in support of Britain's current lockdown. This takes its cumulative spend to £800 billion pounds - more than one trillion dollars.

So the question demands our attention: when is the price going to be paid and what will its impact be? Inevitably, given this profligate monetary policy on the part of central banks, a bill will eventually need to be paid. Is this going to cause a very serious inflation-driven recession? But what could possibly go wrong, and, if so, what should we do about it?'

While emphasizing that the views expressed in the discussions are those of the attendees alone and do not necessarily reflect those of the Templeton Foundations and its trustees and officers, I am certain you will find much of common interest and shared value in these deliberations. I wish to thank all those who participated, particularly the keynote speakers, Lord O'Neill and Dr King Au.

Dr Rory Knight
Moderator

KEYNOTE ADDRESS BY LORD O'NEILL

UNCERTAINTY, INEQUALITY AND VOLATILITY

I suspect that in the next twelve months we are going to enjoy a very strong cyclical economic recovery. A whole slew of policy-making forces point in that direction. The election of Joe Biden is going to be a key factor. In essence he will be demanding even greater fiscal expansion.

Together with a possible exit from the pandemic, these forces are going to result in a recovery around the world over the next twelve months, though stronger in some places than others. However there are going to be major challenges, not just in containing the costs of the pandemic but also coming to terms with the world which the pandemic hit - that world in which Donald Trump emerged, Brexit happened and the Five Star Movement appeared in Italy not to mention many other explosions of the rise of populism and angst about the state of capitalism.

Many issues about the inequalities of modern capitalism will simply not go away and will pose significant challenges to conventional policy over the middle part of this decade, if not earlier.

The usefulness of conventional QE by central banks around the world had run its course long before the pandemic. Indeed there is a view, one to which I subscribe, that their policies indirectly contributed to both to the perception and actuality of inequality. They created a hugely positive environment for asset returns over the decade since the financial crisis, particularly in the bond markets, bringing very little benefit to the less well off, especially in Anglo-Saxon societies.

While I do not foresee any abrupt shift in fiscal and monetary policy over the next year, various forms of tax increases that have been off the agenda in the Anglo-Saxon world for some time are likely now to be seriously considered.

A related outcome may be the end of single target monetary policy. Specific focus on inflation targeting as the goal of central banks has largely lost its purpose. The Fed is moving more towards a nominal GDP target, and I suspect a number of other central banks will follow suit.

There has already been quite a sell-off in bond markets. I think central banks, given their commitment to stop any rise in bond yields. But at the same time at some point in the next couple of years if inflation picks up, they may find they have to suddenly change course. So we may be facing a very turbulent period in bond markets on a par with 1993.

The major challenge confronting business will be to achieve "profit with purpose" as opposed to profit just for the sake of profit, along with adjusting to 'market externalities' of which climate change is one of the most pressing. The challenge of antimicrobial resistance may be even more urgent.

But the lasting message that I hope the world will derive from the pandemic is that somehow or other society has to prepare far better for the future than it has done in the past.

Altogether, these developments incline me to think that the cyclical outlook for investing is far clearer than the structural outlook. I detect a possible parallel with the 1970s. The upshot will be volatility and exceptionally difficult challenges for businesses and financial markets.

Lord O'Neill is Chair of Chatham House. His previous roles include, joint head of research at Goldman Sachs (1995–2000), its chief economist (2001–10) and chairman of its asset management division (2010–13); creator of the acronym BRIC; chair of the City Growth Commission (2014); chair of the Review on Antimicrobial Resistance [AMR] (2014-16); commercial secretary to the Treasury (2015-16). He is a board member, and one of the founding trustees of educational charity SHINE. Jim recently joined a new EU/WHO Commission on COVID-19 . Lord O'Neill was created a life peer in 2015, and serves as a crossbench member of the House.

THE IMPACT OF THE 2020 US ELECTION

'President Biden will face a full inbox when he finally manages to make his way through the doors of the Oval Office on 21st January, the day after his inauguration,' Dr Knight commented. 'He will find himself operating under considerable constraints, chiefly the parlous state of the US economy. Interest rates are close to zero, and the Federal Reserve balance sheet has nearly doubled in the last twelve months. The President-elect wants to spend more than can be raised in taxes, and as a result federal debt will exceed 100% of annual GDP - low by Greek standards but unique for the custodian of the world's reserve currency. Continuing application of Modern Monetary Theory (MMT) will eventually run its course, and winding down the Fed's balance sheet could prove highly disruptive.

Several key aspects of his policies could have a major impact on investment portfolios, not all of them positive, and the actions investors take them into account in order to mitigate risk. These policies include the costs of combating Covid, tax hikes, increased social spending, tougher regulation and the costs involved in "greening America". I invite your views on these issues.'

'We may be a little more of the status quo than we might expect,' said Bill Priest, 'but we are certainly going to put up with higher corporate and individual taxes. But, reverting to Lord O'Neill's comments, had the central banks not done what they did, it would have been catastrophic. However in saving the world, they created billionaires and gave rise to issues of income and wealth inequality. We are going to have to address those issues if we want to maintain democracy. While I will be one of the people who will be paying more taxes under Biden, I think it is a necessary condition for democracy to continue to exist and prosper.'

BUT ARE WE FACING A ONE-TERM PRESIDENCY?

'Joe Biden will be 78 years old on inauguration day and the oldest person ever to take up the office of president,' Dr Knight remarked. 'In 2024 he will be 82. Even if he does not retire early it is unlikely that he will run for a second term. This has great significance for the way Biden tackles his agenda. Will he be 'Slow Joe' or 'Old Man in a Hurry'? If the latter, he is likely to focus more on legacy issues and risk pursuing unpopular policies which will not come back to haunt him. Whatever path he opts for, there is likely to be a sharp change of course as he attempts to reverse Trump's policies. The resultant discontinuity is highly likely to add further financial and investment uncertainty. That said, since the end of the first Cold War the world no longer banks on policy consistency from one presidency to another. Whatever Biden reverses in the course of his term is just as likely to be reversed by any incoming Republican president in 2024. Witness the Paris accord: Obama in, Trump out, Biden in and then who know's...'

TODAY'S INVESTMENT CONUNDRUM

Dr Knight invited Lew Sanders to share his thoughts on what he called the 'Post-Covid Investment Conundrum'.

'Over the last decade there've been a number of technological and demographic forces that have been deflationary,' said Sanders. 'Perhaps the changes brought about by the pandemic are going to reverse those trends. But what will be the investment implications?

As investment managers we have to acknowledge we are operating in an investment universe that is being reshaped by technological and demographic forces for which there is no historical precedent.

Consider: cash yields are near zero in the US, and if the Federal Reserve lives up its promises, they're likely to stay there for many years. Negative yields on sovereign bonds outside this country are common at maturities as long as ten years - something unthinkable in any modern-day context.

Compensation for taking on credit risk is at a historic low in absolute terms. Investment-grade corporate bonds, for example, have yields in the 2s and have never been of lower quality, with 65% having BBB ratings. The so-called high-yield universe – almost a contradiction in terms these days – has a coupon yield of less than 5%. Adjusted for loss, the associated expected returns are barely better than investment grade.

Not surprisingly capitalization rates for real estate have also declined sharply. Rates are now below 4% even for properties that are perceived to have reliable cash flows – an unprecedented feature these days. Real estate used to be about location but it is now all about technology - which is disruptive to some property types while benefitting others. Equities reflect a similar trend. They are clearly dramatically up in valuation but at the expense of future returns, which now promise to be far lower than ever before.

Of course, many of these trends predate the pandemic. They derive from the interplay of deflationary demographic and technological forces. They both created a world increasingly driven by intellectual as opposed to financial and physical capital. It's a shift that among other things has reduced demand for savings, putting additional pressure, therefore, on the available returns.

The pandemic simply added fuel to the fire by exacerbating the excess supply of cash savings. The central banks also bought huge quantities of tradeable assets that would otherwise be in private hands. In addition the pandemic spawned a sharp acceleration in the substitution of virtual forms of economic interaction for physical forms. In fact, it rendered obsolete many of the assets associated with the latter – a feature that will probably continue into the post-pandemic world.

Valuations have adjusted accordingly, producing a bifurcation in returns on equities without prior precedent. And the pandemic has sparked another even more profound change. It has legitimized money printing to finance fiscal deficits on a scale without parallel.'

THE SPECTRE OF INFLATION?

Should monetized debt continue to grow at anything like the current pace – and it promises to do so at least in the nearer term – history would suggest inflation will ultimately re-surface. That would be a profound change, reversing some forty years of deflationary demographic and technological trends.

Whether this will happen is probably the single-most important investment question facing us as investors. We need therefore to ask ourselves: do we need to take steps now to protect ourselves, and if so, what?

Some have turned to gold. Its dynamics are favorable when you consider that the physical stock of gold is increasing about 2% annually, while the stock of fiat currencies these days is growing at ten times that figure and with nearly no cash yield to favor it. However, the history of investing in commodities priced at twice the cost of production - which is the case with gold - is not good. Others have turned to inflation-protected bonds. But here too the picture is problematic. The real interest rate on such investments is now well below zero and, as such, represents assured wealth destruction.'

Amit Wadhwaney agreed with much of this analysis while others like Dan Strickberger strongly resisted it. 'I have heard about the threat of inflation for a long time,' he argued. 'Central banks are printing money and therefore we are going to have inflation. Interest rates are going to go up and valuations down. I will believe that when I see it. It may happen, but I'm not making any investment decisions based on it until I see some evidence, and there is no real evidence of it, right here, right now.'

HIGH VALUATIONS, LOW YIELDS

Dr Knight asked about the link between the high market valuation of equities and the low yields on long-term bonds.

'Current valuations are certainly high,' Dan Strickberger commented, 'especially in technology-related industries and companies but not only there. In other sectors of the marketplace valuation extremes reflect very low interest rates or negative interest rates with dividend yields that are still uncertain. A lot of consumer stocks have had high dividend yields, trading at 25 times earnings and P/E ratios sometimes higher than Facebook, Google, Alibaba, and Tencent. At the same time they do not have a fraction of the same growth potential and indeed are under attack from the digital world. So, in going forward, the digital world would seem to be the place to be in.

But my view of uncertainty is its inverse: predictability. When investing in an uncertain environment – and the world is always uncertain though probably more now than before – one should focus on companies with very predictable outcomes. But of course one has to be careful about their valuations. Returns are basically driven by the entry level. You can overpay going in. You don't want to overpay and find yourself swallowing a 50, 100 or 200 times P/E ratio. The company may succeed, but your stock may not do as well.

With the advent of the Pfizer, Moderna and other vaccines it can be predicted that an economic recovery may take off. But we may find ourselves returning to a post-2008 economic environment of low growth and low inflation. And in that kind of environment, cyclical businesses, value businesses and emerging markets other than those in China and Korea, Taiwan will underperform.'

‘Tracking bond yields relative to equity valuations has been very profitable for our company for over thirty years,’ Nick Train added. ‘But today’s extremes in valuations, both in the bond market and in their implications for equities, are truly extraordinary. Only two conclusions can be drawn from this. The first is that with regard to truly secular growth industries and businesses, their high valuation may be warranted. To a degree, therefore, maybe we should not be so concerned about apparent excesses in those parts of equity markets where there is truly secular growth.

Secondly, however, I’ve never felt more revolted by the idea of committing long-term capital to fixed interest assets, whether conventional or Treasury Inflation-protected Securities (TIPS) than I do today. That convinces me that sound, common equities - however great a cliché that is – are of extraordinary appeal in the current environment from an asset allocator’s perspective. By that I don’t mean the prices of such stocks will not be volatile. They may well go down but at least they will not be threatened with the same financial oblivion that overtook fixed interest government paper back in the Twentieth Century.’

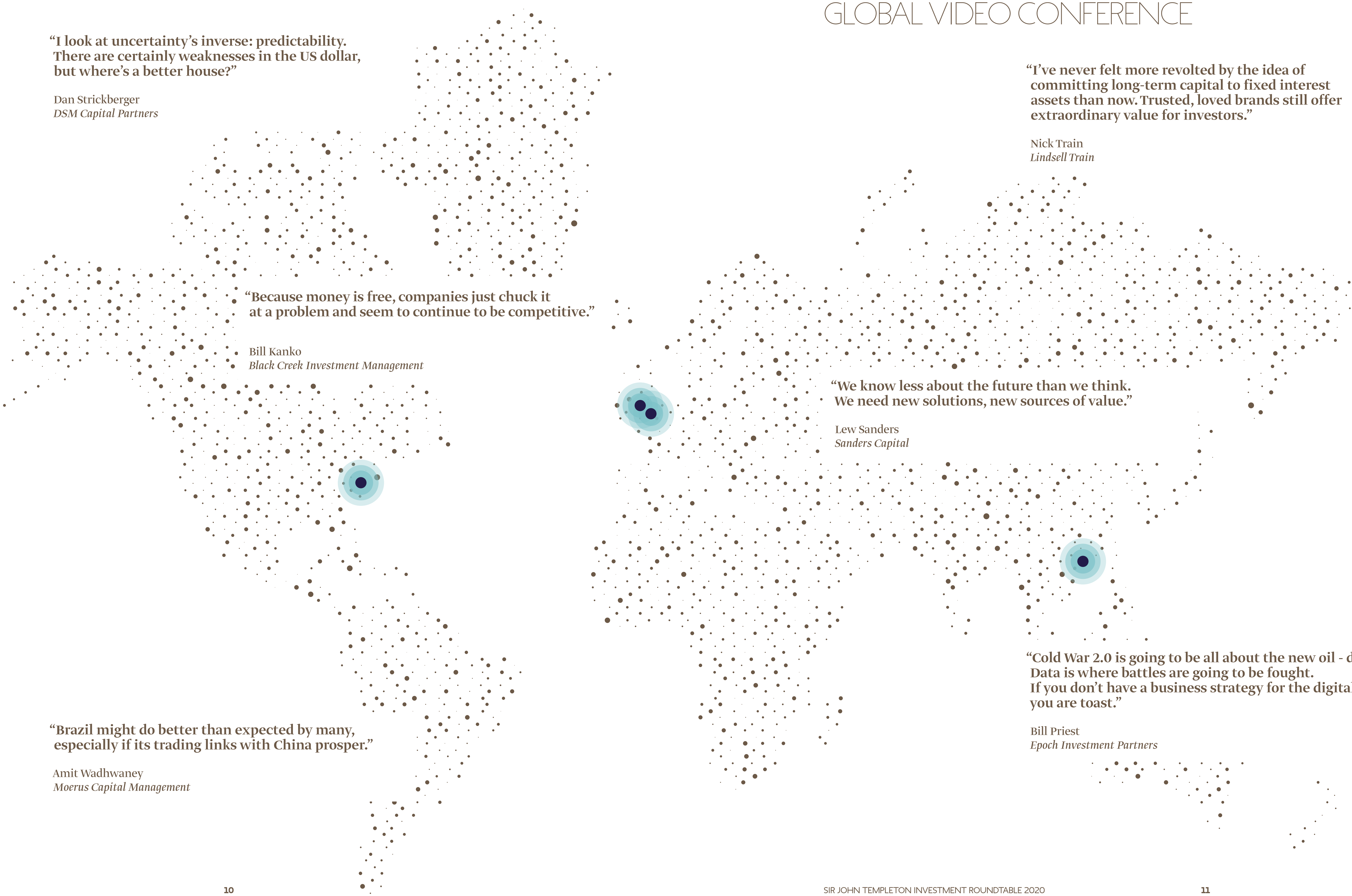
‘There is certainly a lot of uncertainty out there’ said Bill Kanko. ‘It is something we have all been aware of for some time. The reason is free money. Interest rates are zero or negative and as a result money is free. At the end of the day that is bound to have an impact on the price you pay in the financial markets. In terms of risks and opportunities right now, I think there is great risk involved in passive investing because there is no price discovery there. Some of these stocks or sectors taken up there have been taken up by the indices just because they are going up.

But we are also ignoring the impact on the real economy. Because money is free, companies can just chuck it at a problem and still seem to be continue to be competitive. That again is going to reduce margins and returns for all sorts of businesses.

Overall, the market right now reminds me a lot of the tech bubble of 1999-2000. We are getting sectors like electric vehicles and solar and other parts of technology with multiples of 10-20 times revenues. Again, that’s a function of low interest rates. While their basic business propositions might be valid, a lot of these companies are not going to be around ten years from now.

But then again I think back to the early 1970s when the US went off the gold standard and there was an oil embargo. The indexes went down a great deal to begin with, most by a lot. But while the larger stocks tended to do very little through the 1970s as inflation and interest rates rose, the vast majority of stocks did quite well. Of course by that time, the public had lost interest in equities, but throughout the 1970s, after the initial shock, most equities actually did quite well.’

GLOBAL VIDEO CONFERENCE



"I look at uncertainty's inverse: predictability. There are certainly weaknesses in the US dollar, but where's a better house?"

Dan Strickberger
DSM Capital Partners

"Because money is free, companies just chuck it at a problem and seem to continue to be competitive."

Bill Kanko
Black Creek Investment Management

"Brazil might do better than expected by many, especially if its trading links with China prosper."

Amit Wadhwaney
Moerus Capital Management

"I've never felt more revolted by the idea of committing long-term capital to fixed interest assets than now. Trusted, loved brands still offer extraordinary value for investors."

Nick Train
Lindsell Train

"We know less about the future than we think. We need new solutions, new sources of value."

Lew Sanders
Sanders Capital

"Cold War 2.0 is going to be all about the new oil - data. Data is where battles are going to be fought. If you don't have a business strategy for the digital age you are toast."

Bill Priest
Epoch Investment Partners

KEYNOTE ADDRESS
DR KING AU

Dr King Au, a 30+ years asset management industry veteran, is Executive Director of Financial Services Development Council (FSDC). Dr Au was named CEO of the Year in HK by Asia Asset Management in 2012 and 2014. He was awarded the Medal of Honor by the HKSAR Government in 2008 for his valuable contributions to the securities and asset management industry. He was also the Chairman of the HK Securities and Investment Institute from 2006 to 2008 and the Chairman of the HK Investment Funds Association in 2004/2005.Dr Au is an Index Advisory Committee member of China Securities Index Co., Limited among other public services. Dr Au received his BA in Physics from the University of Oxford and PhD in Theoretical Particle Physics from Durham University.

CHINA IN HIS HAND

'The biggest single foreign policy issue confronting the incoming president', Dr Knight has written, 'is the relationship with China. Under Trump, relations with China hit rock bottom, with mutual tariff impositions, the sanctioning of Chinese companies and sabre rattling in the South China Sea. Both contenders for the White House promised tough policies on China. But once in office, Biden might not be so aggressive. He will be in a position to reverse these tariff policies and thus send a positive message to the world that the US is open for business - which in turn would boost the US economy. His dilemma is that there is bipartisan support for curbing China's path to economic dominance. Reversing tariffs too quickly might be perceived as weakness.

On balance, the international investor should probably view the Biden ascendency as potentially improving the US relationship with regard to world trade. But what Biden does is less important that how China views the relationship. After all US foreign policy is no longer the constant it once was, and China may have decided to play a waiting game.'

'China has emerged strongly from the pandemic,' Dr Knight continued. 'At the half-year mark, it was the only stock market in positive territory. The MSCI China Index has added 25% in the year to date. A recent IMF report indicated it will probably be the only country that has a positive growth in GDP this year. How therefore do you view the opportunities and risks for investors in China and Hong Kong?'

'While the rest of the world is still struggling to contain Covid-19,' said Dr. King Au, 'the Chinese economy is well on the way to recovering from the pandemic. The Asian market has shown significant momentum, providing sizeable returns compared to many other major markets. A lot of investments in Asia have been made through Hong Kong and its Stock Connect Scheme, through which more than 35% of the $151 billion foreign investments in the Chinese bond market have been traded since the beginning of 2019.

Why do the weightings of Asia, as in Chinese bonds, continue to increase in various global indices? The answer may lie in China's Dual Circulation strategy laid out at the fourteenth plenary session of the Chinese government last month. It is a two-pronged development strategy which, while continuing to encourage exports, also seeks to spur Chinese domestic demand. This is a notable break with the past and makes sense given the sheer size of China's domestic economy.

As well as fostering domestic consumption, China is developing strategic industries, such as chip technology, but global investors should consider are other technology sectors such as biotechnology and new energy. China is also promoting the integrated development of online and offline distribution with the aim of opening up rural consumer markets. The introduction of the digital renminbi may fast-track this important market transformation.

Despite talk of technology decoupling between US and China, global technology companies cannot afford to ignore China. It represents a huge and fast-growing market. China has 904 million internet users - three times more than the US and 1.6 billion phone subscriptions. Chinese consumption represents some 25% of global demand in the server, networking, PC and smartphone product markets. Consumption growth in China is at least twice the global average. China also has an enormous homegrown technology sector. Four of the top six smartphone companies worldwide are Chinese. Huawei has become the global market leader in telecommunication. Alibaba Cloud is now the world's third largest infrastructure service (IaaS) provider.

Green finance in China represents another opportunity for international investors. China has pledged to become carbon-neutral by 2060. That means that China will be putting at least $450 to $600 billion US into green investments every year. China already has the second largest green bond market in the world after the US, which has quadrupled from $29 billion in 2016 to $120 billion last year. However, participation by foreign investor still remains tiny: just 1.6%. This is where Hong Kong can again play a key role by bridging the gap between Chinese and more stringent European standards.

Another promising opportunity for international investors in Hong Kong is the Greater Bay Area initiative (GBA). It comprises Hong Kong, Macau, and the other nine municipal cities in the Guangdong Province. Its total area is three times the size of the San Francisco Bay area with a combined population more than the UK's - 72 million - and a GDP equal to Canada's - $1.7 trillion. A Wealth Management Connect Scheme is being introduced to allow eligible financial products to be sold between Hong Kong and other GBA cities. All this reinforces the role of Hong Kong as a superconnector between mainland China and the rest of the world. So, international investors should definitely not overlook Hong Kong when considering China!'

However Dr. Knight raised several contentious issues: the sanctioning by the US of Huawei and TikTok and WeChat, which is owned by Hong Kong-listed Tencent, the recent thwarting of the Ant Financial IPO by Beijing and, not least, the imposition of China's National Security Laws on Hong Kong. 'Hong Kong has been the world's top IPO center for seven of the last eleven years.' he noted. 'Can we be confident that Beijing is really committed to Hong Kong and wants it to continue to flourish as an international financial centre?'

'US-China relations have certainly caused concern among investors in Chinese technology companies,' Dr King agreed. 'However, there is a Chinese proverb that says, 'Risk and opportunity go hand in hand', and this is especially true of Hong Kong. Despite current tensions, the Hong Kong Stock Exchange has welcomed a number of Chinese stocks back to Hong Kong as well as others from the US into China. Up to September of this year, Hong Kong had 92 IPOs raising $26 billion with about 60% for new economy companies, making it the world's number two biotech fundraising centre this year. It is also the second-largest private equity and venture capital market in Asia after mainland China.

Regarding the Ant Group, it must be understood China refuses to tolerate a "too big to fail" situation. The Ant Group had become very big in terms of peer group lending, and the government wanted to regulate it as a normal bank. Incidentally, just again to highlight how efficient the Hong Kong market is, the Ant Group IPO subscriptions of $170 billion were refunded to investors within 48 hours without a single hitch.

As to the National Security Law, many ordinary people feel relief that you can go to malls or restaurants without fear of protests or personal attacks. For business people stability is very important. In business there is no restriction on what can be said or written so long as it does not touch on Hong Kong's independence.We have every expectation that Hong Kong will continue to flourish as an international financial centre.'

THE EMERGING WORLD

'You are famous for originating the BRIC acronym,' Dr Knight commented to Lord O'Neill. 'But times are quite different now. Two question therefore: how relevant are the BRICs today in terms of asset allocation and how well are they likely to perform in the wake of Covid?'

HALF A BRIC BETTER THAN NONE

'It is nineteen years since I dreamt up that acronym, which for my sins will forever remain stamped on my forehead,' Lord O'Neill replied. 'Many people refer to the BRIC concept as some kind of investment category, which it was never intended to be. Rather it was an economic observation, one that that simply tried to describe the changing economic environment in which we lived. I never thought of the BRICs as a single asset class or investment category. That said, emerging markets still look relatively attractive compared to many developed markets, especially the US. But maybe I should also have missed out the B and R in BRIC because the decade has certainly not been kind to Brazil or Russia.

However, nineteen years on China - which is twice the size of the other BRIC countries put together - has virtually reached the point we predicted it would in 2050. Which in itself is quite remarkable. The Chinese economy is now a major world economy, and the Chinese handled the pandemic remarkably well compared to all the other BRICs, not to mention everybody else. We can be confident that in 2021 China's economy is going to be considerably bigger than in 2019.

If I am right about the initial cyclical rebound that I already mentioned, both Russia and Brazil may enjoy a better 2021 than for many years because the rise in commodity prices will boost their economies. That said, I see little evidence of either country really tackling their underlying structural challenges, which involve excessive dependence on commodities and a lack of non-commodity private sector opportunities.

India as always is a contradiction in itself. Its demographics and scope for gains in productivity make it almost unique in the emerging world, possibly alongside Indonesia and maybe some African countries. But at the same time its inability to undertake positive structural reforms will hold it back.'

'Brazil occupies a very odd, fragile position, added Amit Wadhwaney. 'The government came into power intending to reduce indebtedness and balance budgets but has made only limited progress. Since then, of course, Covid has made further demands on government spending. Brazil spends as high a percentage of its GDP as the UK - a staggering proportion for a country like Brazil. The upshot has been that Brazil's economy has done very well initially, though the bill that is going to have to be paid in the years ahead will be quite monumental.

So, there is a problematic situation in Brazil. It could be lucky, just as it has been in the past. It could somehow muddle through. It could have a good year based upon a resurgence of commodities. Brazil for many years offered limited value for us. But in the last couple of years it has become for the first time relatively cheap for investors. So Brazil might do better than expected, especially if its trading links with China prosper.'

THE END OF THE DOLLAR'S DOMINANCE

'The dollar's status as the world's reserve currency is by no means guaranteed,' Dr Knight has written. 'It has lost 9% against the euro since March, pushing it down to levels last seen at the start of the millennium. The current slide in the dollar may not be the end but may be the beginning of the end. However it is unclear how exactly the dollar will be replaced and over what period. A number of alternatives are emerging.

A RESERVE CURRENCY ONLY AT THE PLEASURE OF CHINA

The dollar's status as the world's reserve currency will only last as long as China and other creditor countries are prepared to hold their foreign reserves in US dollar securities. These reserves have ballooned in the last twenty years from around $2 trillion at the start of the millennium to close to $12 trillion today - a six-fold increase!

Much of this rise has been due to the expanding reserves of emerging economies, with China at the head of the field. China now has foreign reserves of over $3 trillion, with the People's Bank of China holding over $1.2 trillion in US government securities, making it the US's largest creditor. Meanwhile the US dollar's share of global reserves is slipping, dropping from around 70% in 2000 to a little over 60% today. China recently announced its intention to reduce its US dollar holdings by 20% possibly in favour of the euro. It is not therefore, surprising that the euro is strengthening against the dollar.

The US dollar is now perceived to be destabilising the world economy. Deep concerns were expressed at the recent Jackson Hole Economic Policy Symposium. Given that emerging markets have an increasing share of world trade and most invoicing is in US dollars, many economies are now exposed to adverse swings in the US economy. The concern is that there may be a liquidity trap involving ultra-low interest rates combined with slow growth.

In other words, the global economy is now disproportionately at risk to a US recession. The world has effectively outsourced its monetary policy to the US Federal Reserve. Central banks around the word are unable to implement effective monetary policies tighter than those adopted by the US Federal Reserve without their currency becoming too strong.

The US derives considerable economic and political benefits from the dollar's status as the world's reserve currency. It has experienced a balance of payment deficit consistently since the early 1980s, with US citizens' consumption being paid for by foreigners. The willingness of creditor countries to hold US securities has also resulted in the US benefiting from extremely cheap money - reflected in today's almost zero interest rates. But all that could, and probably will, change.

But the factors undermining confidence in the US are legion: protectionism, indiscipline in public finances reflected in growing deficits and debt, the politicisation of finance seen in the banning of Huawei, TikTok and WePay and threats to de-list many Chinese companies from US markets. Trump's handling of the pandemic only deepened these concerns, triggering social and political unrest which in turn accelerates the process. Not surprisingly, other safe havens are being sought.

It is instructive to consider the fortunes of the previous reserve currency, sterling. Sterling was the world's reserve currency from 1860. Its demise began rather gradually in 1945 but by the mid-fifties the US share of foreign reserves overtook sterling's, and by 1971 its demise was complete along with the collapse of the 1944 Bretton Woods Agreement. Change this time could be much faster as politics and technology hand-in-hand with economics are playing a part in hastening the dollar's demise.

But maybe the process will not be so rapid after all. Sterling's replacement took at least two decades and for the whole of that period there were effectively two reserve currencies. Evidently there is no need for one currency to dominate, and it is possible that the retirement of the dollar will follow in the gradual footsteps of sterling meanwhile co-existing with other rivals.

Against this background do you believe that the dollar is weakening,' asked Dr Knight, 'and, if so, what might replace it?'

In response Lord O'Neill offered three comments. 'First of all I can guarantee the dollar is not going to remain stable. Secondly, there is a big difference between the cyclical performance of the dollar and its structural performance, although the two are connected. I am in the camp that believes that, cyclically, the dollar is going to weaken. The Fed's early shift towards de facto nominal GDP targeting has coincided when the dollar's starting to decline in the summer. I expect that that to continue in the coming weeks and months.

Thirdly on the structural issue, it is pretty clear that if the world continues to evolve in the way that it has been that the dollar will not be able to maintain the dominance it still enjoys in financial markets given the US's continuing slow decline in its share of global GDP. It has declined not only in terms of the US share of global trade but also as a consequence of Trump's policies, which have made the world more sharply aware than before of the costs of allowing the dollar to be a dominant international currency. So, at some point in the coming decades, irrespective of its cyclical performance, the dollar is going to face some serious challenges to its dominance.'

'If you look at the dollar versus the euro,' Dan Strickberger added, 'the euro is the more stable currency. That said, the dollar is still right in the middle of its forty to fifty year range, neither high nor low. Its performance remains pretty average. There are certainly a lot of weaknesses in the US, but the question is: is there a better house in the neighborhood? I do not think it is the euro. The Swiss franc is a really good house and has moved up quite a bit. Sterling could follow that once it has emerged from Brexit. Why should the UK not evolve into a Switzerland over time? But I think the only real rival to the dollar - not because the US is so great but because the other alternatives are relatively weak – is China, which from every perspective is a very serious rival.'

Dr King Au agreed. 'There has been much talk about the launch of the digital renminbi. This has a great deal to do with the internationalization of the renminbi. Like others, I don't think renminbi will rival the US dollar in the foreseeable future, but the dynamic of the reserve currency basket will certainly change over time. And with China being the largest trading partner of many countries, the importance of renminbi will become increasingly obvious and prominent.'

THE IMPACT OF TECHNOLOGY

'Both contenders in the presidential election promised to break up the Big Tech companies.' Dr Knight commented. 'Whether this is sound policy is moot but it will certainly reduce the value of some of the most valuable companies in the world. If Biden makes good on his campaign promises, underweighting high tech stocks, which have provided formidable returns to date, might now be advisable. However these same companies provided support to the Biden campaign and perhaps Biden's response will be more nuanced. Either way, many investors will be considering their exposure to technology stocks. What are your views?'

Bill Priest framed the question in a larger context. 'A year ago I wrote an op-ed piece for *Barron's* on the subject of Cold War 2.0. If you look at history and why wars happened, it was because somebody wanted more land or resources. Today no-one wants hot wars; they just want to get rich. Cold War 2.0 which is all about ideas and values. It's about our bill of rights as opposed to the way China wants to run its country. And Cold War 2.0 is also going to be all about the new oil - data. Data is where the battles of Cold War 2.0 are going to be fought.'

'Technology is incredibly deflationary,' he added. 'It started with Moore's Law and the doubling of the productivity of a chip per dollar. But the Digital Age proper only really took off in 2007 with the launch of the iPhone as well as many other developments described in Friedman's book *Thank You for Being Late*.

Very often in talking to companies, we used to ask, "What is your digital strategy?" Our question should have been: "What is your business strategy for the digital age?" If you don't have a business strategy for the digital age you are toast.

A former way to measure financial performance was the so-called "DuPont return on equity formula": profit margins times asset turnover times leverage gives you ROE. But that 'E' is no more than an investment number. Essentially, if you substitute technology for labor, you substitute physical atoms for virtual bits. Bits have three characteristics: they are free, instant and perfect. Freely and instantly available through the internet, bits can be perfectly replicated. Substituting technology for labour means margins automatically go up if revenues remain constant. There is not a company in the world that is not trying to achieve this capital- and labour-lite model.

So we favour those companies that truly have a business strategy for the digital age. We own a lot of these kinds of tech companies. That said, you should buy real businesses that generate free cash flow and are good capital allocators - and not overpay for them.'

SEEKING NEW STORES OF VALUE

'We need to find a better solution,' Lew Sanders concluded, 'to locate new stores of value. But the risks associated with almost any choice nowadays are higher because the duration of all financial assets has lengthened as prices have risen, particularly in the case of equities, with a corresponding increase in latent volatility. Portfolios need to take account of these heightened risks but also have to contend with the fact that traditional low-volatility assets now typically only offer negative real yields. The cost of reducing volatility by conventional asset allocation has therefore never been higher.

I cannot offer any magic pills. There are, however, three time-tested investment principles. Look for businesses that create differentiated value for their customers, are differentiated from their competitors and have a durable history of producing good returns on their financial and intellectual capital. Such businesses will continue to produce good returns as long as you do not overpay for them. At the same time we have to accept we know less about the future than we think. Therefore, diversification and resiliency will remain key imperatives in portfolio construction.

If the current situation ultimately generates inflation - if money printing really matters this time - all long-duration assets are going to need higher real-rate nominal returns in future. There is a huge potential headwind blowing through the state of the capital markets today. But those companies that have control of their destiny will survive and will offer the best chance of being a reliable stores of value.'

'I continue to stick with predictability,' said Strickberger, 'companies in terms of their revenues and earnings and without high P/Es. If inflation does not come back, then the return potential will be better than people expect. It will, however, be bifurcated. Stocks that have growth and reasonable valuations have particularly strong potential, especially with recent moves into value and out of growth. In the digital world, where you have reasonable valuations, low interest rates will continue to exercise extremely powerful control over valuations. But I'm not advocating buying stocks on the basis of 100 or even 50 times P/Es. It is possible to operate on the basis of predictability while avoiding those.'

Bill Kanko agreed: 'We focus on companies that add value to the customers, have a competitive edge, and where you don't have to pay a whole lot for them. The risks now are largely in over-priced technology areas and stocks and sectors driven purely by passive investing.'

THE ENDURING VALUE OF BRANDS

'Trusted and loved consumer brands have protected consumers' wealth against inflation for many decades,' said Nick Train, 'even if they have not massively enhanced their wealth. Take a business like Unilever. Almost by default it has become the UK's biggest company by market capitalization, and the stock continues to compound. There is a good reason for this. Over the last five years the value of its biggest subsidiary Hindustan Lever, the biggest consumer franchise in India, has increased in dollar terms at twice the return on the S&P 500. In certain geographies, therefore, trusted beloved consumer brands that offer value for consumers can also still offer extraordinary value for investors.'

SECTOR SELECTIONS FOR 2021

Dr Knight concluded the conference by asking participants what they thought would be the best performing sectors in 2021.

'I was going to go with oil but on reflection I will go with agricultural' said Bill Kanko.

Bill Priest felt the opportunities were in 5G, and that T-Mobile offered a particularly attractive opportunity.

Lew Sanders cited universal banks.

Amit Wayhwaney also opted for the banking sector, especially European banks and in particular one that is actually more Asian than European: Standard Chartered. 'Standard Chartered has a British valuation with Asian exposure and is developing one of the larger digital footprints in Asia right now.'

Dan Strickberger made a somewhat contrarian choice: communications. 'This sector includes a lot of digital companies that are communications oriented. Many of them are not unreasonably priced. In fact, four or five still offer a discount - which is just plain crazy.'

Nick Train for his part picked the Japanese video game sector. 'This represents a major strategic valuation opportunity from a global perspective today and is led by the mighty Nintendo, which is an exceptionally undervalued franchise.'

STOCK	MARKET: SYMBOL	SECTOR
STANDARD CHARTERED BANK	LSE: SCBFY (SADR)	BANKING: UNITED KINGDOM
N/A	N/A	UNIVERSAL BANKING
NINTENDO	TSE: NTDOY (SADR)	LEISURE: JAPAN
N/A	N/A	COMMUNICATIONS
T-MOBILE	NYSE: TMUS	COMMUNICATIONS: US
N/A	N/A	AGRICULTURE

TABLE 1. Sector selections

NOTES

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