North Star Newsletter September 2016

Dear Investor,

A telescope view and a Brexit view

In this newsletter we've lifted the telescope a bit for a perspective on major economies and financial markets looking 3-5 years into the future.

In doing so, we are well aware that unforeseen events may once again upset the picture the way they have in recent years. After all, who could have predicted just two years ago that the price of crude oil would fall from above $100 per barrel to under $30 before rebounding; that the Syriza party would win in Greece giving rise to a major fiscal crisis which threatened to destabilise the whole Eurozone; or that the UK would vote in favour of Brexit, when opinion polls and betting markets had been suggesting the opposite? Still, even with this in mind, underlying trends will still eventually dominate, with or without special events.

- **Part 1 - The underlying trends**

  The first part of this newsletter takes a look at those underlying trends and what they imply for longer term asset returns.

- **Part 2 - The short term scenario and Brexit**

  The second part zooms in on the current market scenario and the economic and financial implications of Brexit.

Part 1

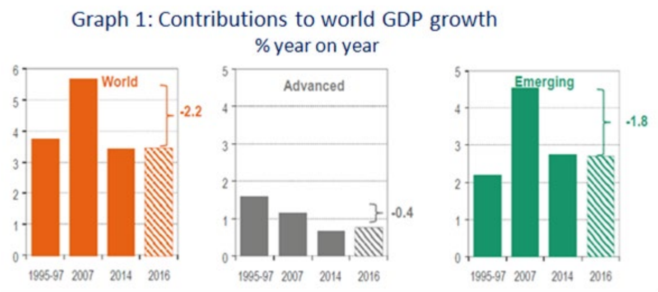
The underlying trends

Life in the slow lane

The evidence of a slowdown in the advanced economies has been with us for a while.
In *Japan*, economic growth peaked as far back as 1990 when the property bubble and subsequent problems in the banking sector created negative wealth effects and a credit crunch.

In the *US*, two bubbles burst in relatively short order: the tech bubble in the early 2000s and the housing bubble in 2007-08 during the *Great Financial Crisis* (GFC).

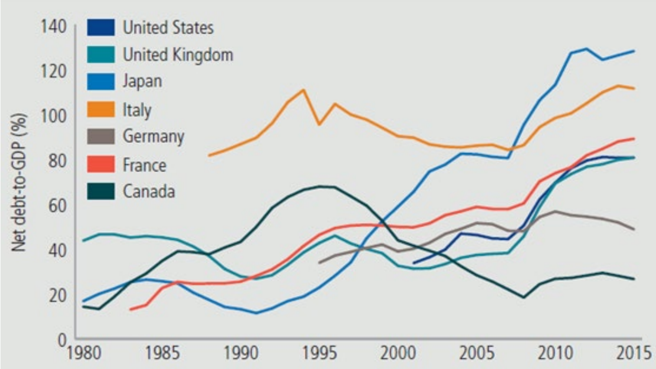
The *Eurozone* economy had its own crisis starting around 2011, stemming from indebtedness in the peripheral countries and peaking with the Greek crisis in 2015. During the GFC and in subsequent years growth in the emerging market economies compensated for the sluggish growth in the developed countries. This is no longer true to the same extent, as is illustrated in graph 1. The slowdown in the emerging markets owes in great part to the slowdown in the Chinese economy and to the drop in commodity prices.



Increase in public debt

The slower growth in the advanced economies reflects factors on both the demand and the supply side of the macro-economy. On the demand side, the growing level of indebtedness, accelerated by the crises, has given rise to a new caution, both among households, businesses and governments. Graph 2 shows net government debt to GDP among the G7 countries. With Canada and Germany as the two exceptions, the general trend among the advanced economies has been an increase in public debt to levels not seen before in the post-war period. Indebtedness in the private sector has seen a similar trend.

Graph 2: Net government debt to GDP



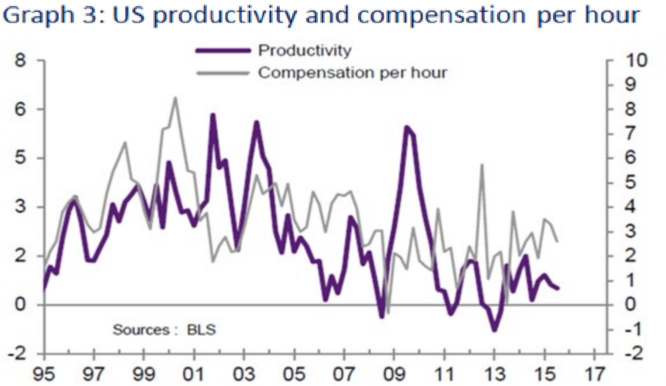
Source: International Monetary Fund, World Economic Outlook Database, April 2016. Data Jan 1980–Dec 2015.

But supply side factors are equally at play in the rich countries.

The first is the ageing of the populations, due to the combination of increasing longevity and declining fertility. This combination, which is particularly pronounced in countries like Japan and Germany, has led to a growing dependency ratio, meaning a greater percentage of the population in the 0-14 year and 65+ year segments compared to the 15-64 year segment. This implies a shrinking working-age population out of the total and a greater burden of supporting the less productive segment of the population in terms of social benefits, pensions, etc.

The second, and equally important, factor is the decline in the growth in productivity. This is shown in graph 3 which compares the growth in productivity with the growth in compensation per hour in the US. A higher growth in worker compensation is generally seen as necessary to support a higher growth in private consumption. But if compensation levels grow by more than productivity, and final prices don't rise to the same extent, corporate profits will suffer.

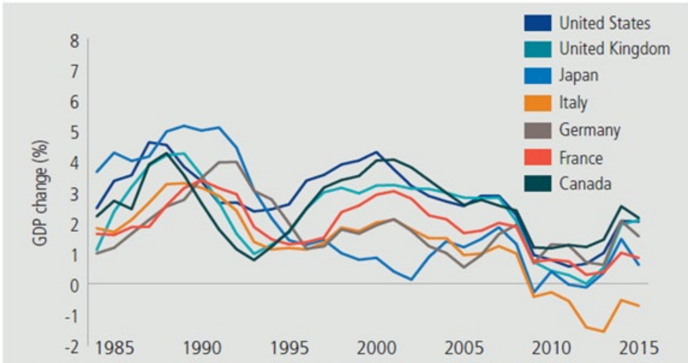
Graph 3: US productivity and compensation per hour



The evidence of slowdown

As mentioned, the evidence of a secular slowdown in growth has been with us for a while. In the US case, real GDP grew on average above 4% from the early 1980s to the beginning of the 1990s, by around 3.5% throughout the 1990s, by a little less than 3% in 2000s up until the GFC, and by around 2% after 2009. A similar situation has characterised the other G7 countries, as shown in Graph 4.

Graph 4: 5 year average growth rates of real GDP



Source: International Monetary Fund, World Economic Outlook Database, April 2016. Data Jan 1985–Dec 2015.

Lower growth - lower inflation...

Long term interest rates

The secular trend towards lower economic growth and lower inflation, combined with the periodic stress seen in risk markets like equities and credit instruments, has implied a consistent demand for long-dated bonds issued by core countries such as the US, Germany, and Japan. This is illustrated in graph 5 which shows the yield to maturity of 10 year bonds issued by G7 governments. As can be seen, Japan was well ahead in this respect, but Western markets have subsequently followed suit to reach unprecedented low levels of yields.

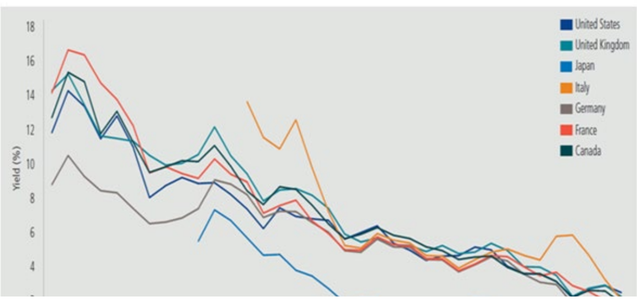
The decline in yields not only reflects the decline in growth and inflation; it confirms that the market believes this will continue and possibly get even more pronounced. As can be seen, none of the special events mentioned already has managed to materially interrupt this downtrend in yields.

The enhanced role of the Central Banks

Central banks have always seen it as part of their role to act counter-cyclically in economic downturns by cutting interest rates aggressively. But it was left to Ben

Bernanke of the US Fed to introduce unconventional policies to counter the effects of the GFC. As central bank interest rates get close to zero (or a 'lower bound'), any further stimulus would have to come from other policy sources and the Fed introduced socalled *Quantitative Easing* (QE) involving central bank purchases of government bonds and mortgage-backed securities.

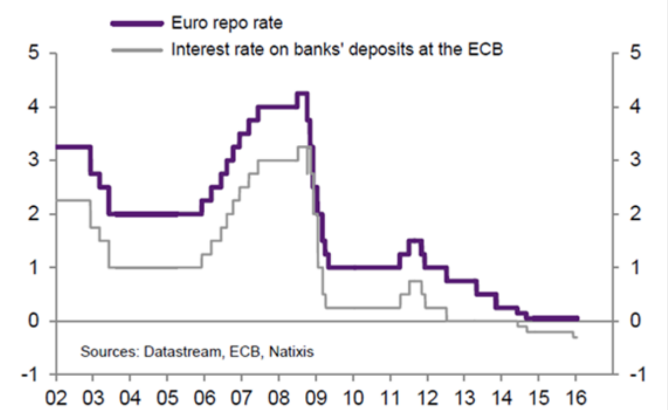
Graph 5: Yields on 10 year government bonds



The purchases would be 'non-sterilized', meaning that any positive effect on the money supply would be not be neutralised. By gradually reducing the yield available on risk free instruments like government bonds, the Fed would effectively force investors looking for yield to accept the risk on credit instruments with a lower rating and ultimately on stocks.

Other central banks such as the Bank of England, the Bank of Japan, and the European Central Bank followed suit, the latter beginning as late as 2015. But the ECB didn't stop at QE. It introduced *negative interest rates* on the deposits held by commercial banks at the central bank to induce them to lend more to the public. This is shown in graph 6.

Graph 6: Euro repo rate and interest rate on deposits at the ECB



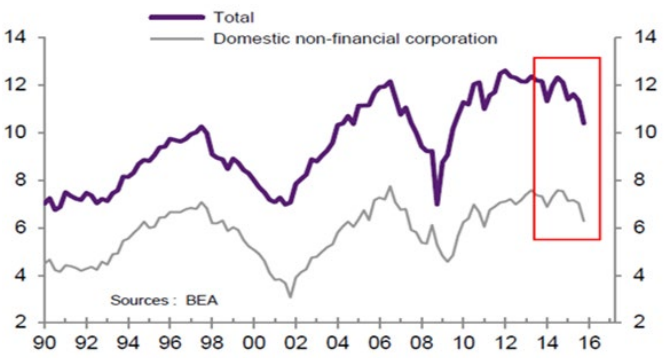
How much leeway do central banks have left to counter deflationary pressures and stimulate economic activity? The jury is still out on this question. 'QE' is generally seen to have worked in the desirable way on the financial markets, creating a positive wealth effect which has countered some of the gloominess of consumers. It is more dubious that it has affected corporate investment decisions. And the experience of the ECB seems to indicate that the negative effect on banks's profitability created by the negative deposit rate likely outweighs the benefits. Even though all central bank options are clearly not exhausted yet (see further below), it seems probable that we have seen most of the positive effect on asset prices from monetary policy.

The longer term outlook for asset returns

A secular slowdown in growth ultimately translates to low expected returns. In the case of *core government bonds*, this conclusion follows directly from the level of yields to maturity currently available, whereas in the case of riskier *corporate bonds* the risk premium currently offered by the market is at a minimum.

In the case of the stock market, the relationship with GDP growth is more subtle. Graph 7 shows the share of profits in US GDP, and as can be seen the trend has generally been upward since the beginning of the 1990s.

Graph 7: Share of profits in US GDP



A major factor at play has been *globalisation* which has allowed large corporates to outsource production to low cost countries like China. This has brought about direct cost savings and has also had the effect of keeping domestic wage growth low. As mentioned earlier, this is beginning to change. Even though wage growth has increased only moderately in the US, the combination with the slow growth in productivity has implied an increase in unit labor costs which is not matched by the increase in final prices. At the same time, the benefits of outsourcing are waning, in part because of high wage increases in the key emerging markets. The net result is that the ratio of profits to GPD peaked around 2012 and now looks like it has entered a downtrend. *The stock market can still go higher*, but this will imply ever higher P/E ratios which are already somewhat above the historical average.

3-5 years view - a summary

Our view of the next 3-5 years follows from all these considerations.

Starting with *bonds*, around 35% of the Citi World Government Bond Index is now exhibiting negative yields, in great part due to the QE programs. Starting from their generally ultra-low levels of yields, G7 government bonds will probably return somewhere between 0.5% and 2% on average depending on country of issuance and time to maturity, whereas investment grade corporate bonds will probably be in the range of 1% - 3%.

Returns on G7 *equity markets* will probably be in the range of 4%-7% on average but with considerable volatility.

As far as *emerging markets* are concerned we see a greater intrinsic value than in developed markets. Returns in local currency on both bonds and equities look likely to outperform those of developed markets, but the currency risk will need to be managed and volatility will be higher than in the developed countries.

All in all, the environment will continue to be one in which we would favour income over capital gains (emphasising fixed income and high dividend stocks), seek some exposure to emerging markets, and hedge against economic downturns with long positions in core government bonds.

Part 2

The short term scenario and Brexit

Resilience

Financial markets have generally been more resilient to Brexit than expected. By far the biggest reaction was seen in the value of the British pound which fell over 10% against the dollar after the vote. However, this worked to the benefit of the FTSE100 which ended up more than 5% above the pre-Brexit level, justified by the fact that over 60% of the profits of the leading British companies comes from abroad. Other equity market initially sold off, but subsequently recovered. Core bond markets at first reacted with higher prices and lower yields, but this was subsequently corrected, whereas credit has generally been quite stable.

3 factors

What are the reasons for this market resilience? We believe there are three factors, of which the latter is the most important.

- Firstly, Brexit happened to coincide with relatively strong US figures, prominent among which was a much better than expected jobs report for June.
- Secondly, optimism began to grow that perhaps the overall economic effect of Brexit would be much smaller than expected.
- And thirdly, markets began to revise their forecasts for monetary policy to imply more laxitude going forward.

To begin with the first point, we believe the US economy continues more or less on the same growth path as before Brexit, with a growth in GDP for this year slightly below 2%. More optimism than this seems unwarranted to us.

The exit procedure

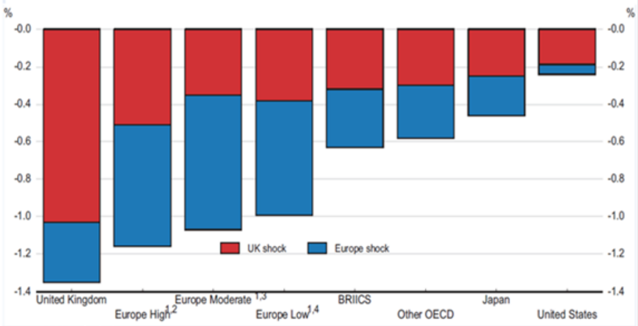
With respect to Brexit, the economic effect on both the UK and the rest of the EU will arrive both via a trade channel and through investment flows. As has been much discussed in the press, a country leaving the EU must first trigger an exit via Article 50 of the Lisbon Treaty. Once this has been done a minimum period of two years is stipulated to arrive at a new trade arrangement or adhere to the general rules of the WTO. This implies that UK trade with the rest of the EU will continue under the same framework for at least two years, starting from sometime late 2016 or early 2017. What follows thereafter will be depend on the negotiation process.

It is clear that both sides have an interest in continuing trade under some format, but realistically the UK will likely have to accept a more limited access to the EU markets in return for ceasing to comply with the free movement of people clause. A particularly thorny issue is whether UK-based banks will be able to retain their 'EU passport' allowing them to operate in the rest of the EU.

In the short run, however, the most important channel is likely to be *investment*. The longer the negotiation process with the EU drags on, the deeper the sense of uncertainty will be, and corporates look likely to hold back on major investment decisions under such circumstances.

A rough first estimate of the impact of Brexit provided by the OECD is shown in graph 8. Aside from these estimates, markets are so far neither justified in being more optimistic or more pessimistic than right after the vote; the fact is that most of the important post-Brexit economic reports have yet to be published.

Graph 8: The impact from Brexit on real GDP by 2018



Source: OECD calculations.

Helicopter money - ?

The third and most important factor behind the recent resilience of risk markets in general are expectations regarding the policy response, with central banks once again at the forefront of market sentiment. Brexit led to a flight to quality which pushed up the value of the Japanese yen to the frustration of Japanese policy-makers.

A subsequent visit to Japan by former Fed chair Ben Bernanke has prompted speculation about the possible implementation of socalled '*helicopter money*' to re-ignite economic activity and counter deflationary forces. This type of policy could take different forms but in essence it amounts to some sort of monetisation of government spending which, in different times, would have been looked upon with great concern.

- and where?

How likely is it? To our mind, it constitutes a possibility, on a relatively modest scale, in both Japan and the UK, is much less likely for the US and is even further from being realistic in the case of the ECB. From this perspective we do indeed see risk markets as somewhat too euforic given the objective negative economic forces currently at play.

Yours sincerely,

North Star International Services Limited

Mogens Kjøller-Petersen
Chairman