LHV Portfolio Management

Monthly review of investments

October 2019

LHV

Monthly review
October 2019

Years long low interest rate environment has flooded the market with cheap funding.

Government deficit spending is on the rise and it will play a crucial role for investors.

Most important thing for an investor is to be conservative while others are greedy, and on the other hand, to be greedy when others are conservative.

A lot of optimism in the markets

In general, we can see in the financial markets that too large amount of money is chasing too small number of investments. It is reflected by the very high share of unprofitable companies listing themselves in the stock market, which is back at the 90s tech boom levels. This year, out of all companies doing IPO in the US stock market, 81% are not earning any profit.

As they say, *if you want a deal really badly, you get a really bad deal!* Supply and demand are crucial when managing investments. When there is too much money in the economy the forward looking yields are low as there is oversupply in terms of money. On the other hand, when economy cools down and investors are keen to hold cash leaving little liquidity in the system, the yields are high. Therefore, the **most important thing for an investor is to be conservative while others are greedy, and on the other hand, to be greedy when others are conservative.**

Too much money in the economy brings us back to central banks monetary policy. Interests have been close to zero for already a decade, meaning the cost of credit should not have been an obstacle when financing projects. It could be argued that all the projects that have needed financing, have received it. Therefore**, in the case of economic downturn, the central banks role will be way smaller than it has been so far in the history as it is not possible to increase demand for credit and therefore boost the economy by just lowering interest rates even further.**

Governments' deficit spending set to increase

As central banks effect is limited, the main tool to keep economy from cooling down will be government spending. In case private sector slows down, only the public sector can support the falling demand and create balance. In order to do that, simply put, the government must print money (nevertheless, by essence, government issues bonds to the market but in reality central banks purchase them back in large amount).

The US deficit spending is already around 1 trillion dollars (approx. 5% of GDP) even though we are at the peak of economic cycle. It is realistic to expect those numbers to go up considerably as the economy slows down – up to several trillions. But as countries start issuing bonds and to print money, it creates a pressure to devaluate currencies, which is in turn inflationary. That does not mean hyper-inflation but rather a change in the paradigm that has dominated the last decade where inflation has been low and decreasing even further.

If we should see continuously low but somewhat accelerating inflation, it would clearly have an effect on investors portfolios as it disrupts the trends dominating this decade and at the same time bring several new opportunities for active investors who can be flexible and adapt quickly.

Monthly review
October 2019

Going ahead, deficit spending increases faster than we are used to in the past.

In current environment, gold and commodities have a risk reducing and at the same time return enhancing component, therefore they should definitely be included in investors' portfolio.

We continue to be rather conservatively positioned and focus on protecting the capital.

Deficit spending increases fast

To conclude on the governments' deficit topic, we see that if the economy should slow down in current zero-interest environment, the local governments have several projects they could finance through budget deficit in order to promote economic activity. To bring examples, we could start off with investments in renewable energy, climate neutrality, education, infrastructure and defence spending – all of which have recently gained popularity.

We see that in current environment, gold and commodities have a risk reducing and at the same time return enhancing component, therefore they should definitely be included in investors' portfolio. Gold works as insurance policy against larger political changes when populist movements are increasing budget deficits.

We believe that we are in the middle of a great change where central banks role is diminishing and government spending is gaining grounds rapidly. When previously central banks asset purchase programs raised the prices of financial instruments and the asset owners were better off, then government spending will have clearly different effect on the economy. It could bring a change in inflation environment and that in turn alters the familiar trends among different asset classes.

In low and slowing inflation environment, the best investments were cash, bonds and growth stocks. In low but accelerating inflation environment those trends reverse and upside potential lies in the assets that are exposed to inflation, such as value stocks and commodities.

Exposure to risks remains low

Our portfolios are least exposed to risks than they have ever been in this growth cycle. **We have reduced the risk levels by 40% over the last couple of months, sticking only with the cheaper value stocks that are well positioned to the changing environment. Regarding price levels, they could be compared with inflated baloons under water – they are eventually forced to go up.**

Forward looking, we continue with rather low risk profile as the positions we are currently holding have great upside potential in the 2-3 year perspective while earning strong cash flow. At the same time, we are willing to add investments that reduce the overall risk level of our portfolios.

Onwards from here, our focus will be first and foremost on protecting capital, at the same time being open and ready to react to changes in the economy where we could benefit from.

Wishing you the best,
Kaius Kiivramees and Mikk Taras