Opinion **US & Canadian companies**

Gambling on US equities is becoming more difficult

Deglobalisation should make investors think twice about betting on index tracker funds

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At the recent Berkshire Hathaway annual meeting it sometimes felt like Warren Buffett was trying to square words with actions. The Oracle of Omaha insisted, as he always has, that the best place for retail investors to be is in an S&P500 index fund. But he also told shareholders that his company had sold 16 times as much stock as it had purchased in the last month, including dumping the entire airline asset class. And he admitted that while you could still "bet on America, you are going to have to be careful how you bet".

When you look closely at his actions, he is still following the same strategy that he has employed throughout his career. It is an approach built on two things: first, value investing, which basically involves the forensic examination of corporate balance sheets; and, second, a belief not so much in America as in American companies and their ability to export their particular brand of capitalism abroad. Both of those pillars still hold much wisdom for investors who want to understand where markets — and the real economy — are heading.

Mr Buffett learnt the skill of value investing from his former Columbia Business School professors David Dodd and Benjamin Graham, whose book, *The Intelligent Investor*, he memorised. They argued that investors should buy companies that have steady profits, low price-to-earnings ratios and very little debt. Following that logic, it is no wonder that Mr Buffett isn't buying much stock. Corporate debt doubled between Mr Buffett's bullish buying spree after the 2008 financial crisis and the end of 2019.

Meanwhile, P/E ratios are not providing a true market signal when asset prices are being driven mainly by US Federal Reserve interventions. Many companies have stopped giving earnings guidance amid this historic downturn. Some people might respond that the Fed's actions are the market signal. By that they mean that share prices will from now on be driven by the supply of money that central banks pump into the economy, rather than by the relationship of stock prices to corporate earnings. But as Gavekal Research co-founder Charles Gave wrote last week, everyone in Japan in the 1980s thought the correlation between the Topix and the country's supply of cash and cash equivalents would last forever, too. But the value of equities there stopped tracking the money supply in 1990.

We will continue to see plenty of companies and stocks flourish in the post-Covid-19 era, even after the Fed turns off the spigots of its recent interventions. But investors will need to conduct a new kind of forensic study to discover who the winners will be.

Mr Buffett's second pillar of betting on US blue-chips, as a way to wager on global growth, no longer works as well in an era of localisation. The US, China and parts of Europe are all developing national champions in sectors such as technology, which holds a disproportionate weight within the S&P 500. It is impossible to know yet how deglobalisation will play out in the long term. But in the short term, the increased competition will surely dampen US share prices.

Some industries will be safer investments than others. Travel — and anything related to it — is unlikely to rebound soon. As bond investor Jeffrey Gundlach noted last week, Mr Buffett bailing out of airlines was the negative equivalent of his doubling down on banking stocks in the wake of 2008. He was making a bet that the long-term fortunes of an entire sector will change. In retail, it is hard to imagine that many big brands won't follow J Crew into bankruptcy. Banking faces increased risk as corporate insolvencies rise, so the sector's share prices will probably stay depressed. So, too, for small and midsized companies that don't have teams of lawyers to push them to the front of the bailout queue. Many will surely be gobbled up by larger competitors as they flounder.

Even within seemingly Teflon-like sectors, such as technology, there will be divergence by company. Microsoft is booming amid coronavirus, while Apple chief executive Tim Cook says the company is in "the most challenging environment" it has ever seen.

All US companies will have to live with a new level of political risk that will make it difficult to predict returns — or their regulatory future. Not only is there growing tech nationalism among both Republicans and Democrats. There is also rising concern about corporate concentration, which Democrat Joe Biden is making a central issue of his presidential campaign.

Amazon is the perfect case in point here. The company has become totally essential during the lockdown. Yet it is under more attack than ever from labour and antitrust activists. It is possible that Big Tech behemoths will come out of the current crisis stronger, only to have their wings clipped in the end via regulation and higher taxes. They could be very much in the crosshairs as the politics of unequal wealth distribution and nationalism play out.

In this environment, buying the S&P 500 as a whole only makes sense if investors believe that the Fed can continue to lift all boats indefinitely.

I believe the US is moving from a consumer liquidity crisis to a corporate solvency crisis. When that happens, it is unclear whether the central bank can continue to save everyone. For a generation brought up to buy and hold US blue-chips, betting on America has become a lot trickier.

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