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INVESTMENT POLICY NOTES

NOTZ STUCKI INVESTMENT MEETING APRIL 12TH 2016

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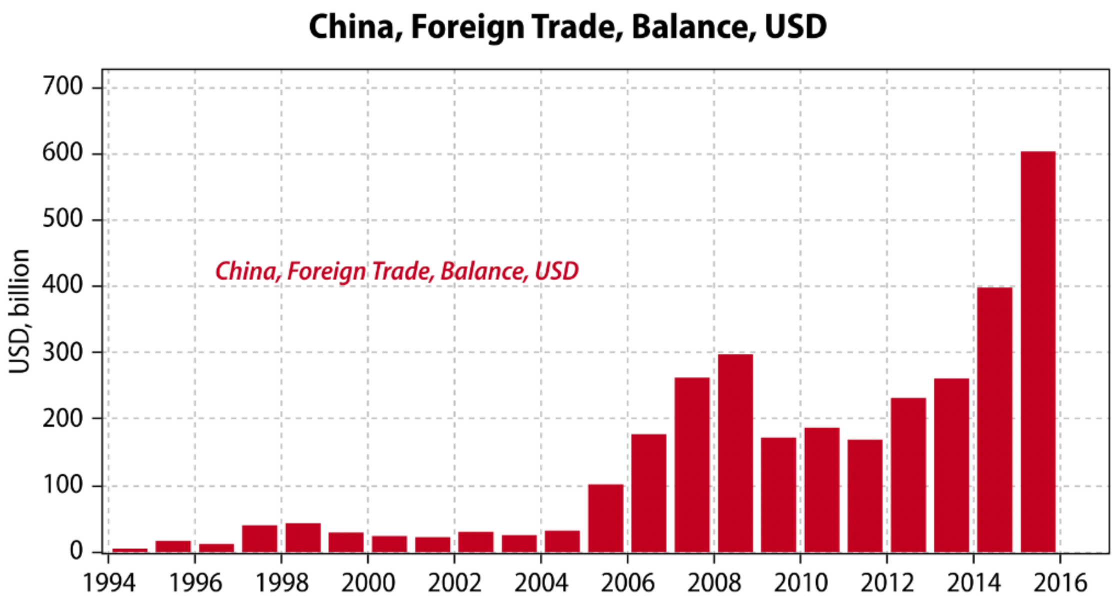
The first quarter witnessed volatility on a scale not seen since the height of the 2011/12 European crisis. While the World Equity Index was only slightly down for the quarter this masked a plunge of over 10%, followed by a steep recovery. Delving further into what happened showed some particularly odd features. For example equities and the oil price moved in lockstep. This is highly unusual and the opposite of what their relationship has been historically. At the end of January the Bank of Japan took interest rates into negative territory and increased their QE program. This was taken badly by the markets, and Japanese bank shares quickly fell 25%. Even more surprising was the yen rally which was the exact opposite of what was intended. The principal concerns for markets in the world currently are what is happening in China, the effects of monetary policy, and the political sphere where there is a trend towards the rejection of the establishment and a move towards the fringe. In this meeting Gavekal focused on China and considered a number of worries that investors have on the Chinese economy. Their conclusion is that China is in much better shape than the western media indicate.

The western press paint China as the number one concern for the world. While the economy continues to grow at 6-7% the fear is that something bad is lurking under the surface which will capsize the fragile growth in the rest of the world. Many analysts seem to extrapolate what has happened in the commodity market following the slowdown in China's heavy industry to the whole economy. But the weakness in commodity prices is partly caused by the supply side, and to most people's surprise the volume of China's imports of oil, copper and iron ore is at a record high. Oil and copper imports each grew 11% in the last year. The point is that China's economy is slowing but at a different pace in different areas. The heavy industry-intensive northern provinces are slowing markedly but other areas of the country are growing steadily. The slowdown of heavy industry is being controlled by the Government. The overcapacity in areas like steel and coal will take time to be absorbed. Yet even in these provinces growth is about 2%, and critically there have been no signs of social unrest. Visits to these areas show restaurants are full, and shopping malls reasonably busy.one reason for this is that locals have moved to faster growing areas and they send remittances home which helps the adjustment process.

Another concern is the banks. But in the Chinese banking system loans are roughly equal to deposits so it is hard to see a full blown crisis unless deposits are withdrawn. It is not like the situation in the West before the crisis where much of the banks funding came from the inter-bank market. There is also the shadow banking system to consider but even here there is little leverage, and this area should be viewed as a positive as it is helping to liberalise interest rates.

Since the small but unexpected devaluation of the renminbi last year the potential for a much larger devaluation has hung over the market. This too seems unlikely. First while the renminbi has declined against the dollar it has been stable when measured against a broader basket of currencies. Second China has a huge trade surplus which is hardly consistent with a country needing to devalue (see **Exhibit 1**). Indeed in spite of wage growth China has maintained its share in export markets as it has moved from basic manufacturing to more sophisticated areas like technology. China has a strong desire to establish the renminbi as an alternative to the US dollar and a devaluation would undermine that project. Wider usage of the renminbi ties in with China's more assertive geo-political ambitions. China aim is to overtake the US as the world's leading superpower by 2049, the 100th anniversary of the Communist Party's ascent to power. They will want to exert their power through financial strength as much as through their industrial and military power, and this will require them to build up their capital markets. Given all this the only reason left for China to devalue would be if they ran out of reserves. In the past year their reserves have declined by about $1tn. This is a big number. However usually a capital flight of this size leaves big footprints. The natural beneficiaries of Chinese capital flight – HK property, Macao, high-end property in London, Sydney and Vancouver – do not seem to have registered that big a change. A more likely explanation is that Chinese companies that were borrowing in dollars during the period that the renminbi was rising have repaid this debt to avoid a currency mismatch. This process is almost complete and once completed the reserves can grow and the renminbi will stabilise, or even start rising again. Once the renminbi is stable the PBOC will be able to cut interest rates without upsetting the currency. This will ease the pressure on the economy. It also presents a major investment opportunity. Slow growth and lower interest rates makes for an excellent fixed interest environment. Renminbi bonds with a three year maturity yield 6%. The next ten years is likely to see a boom in RMB bonds. Absent a devaluation these look compelling in a low growth world.

Exhibit 1



Gavekal looked briefly at why the US dollar had been weak. In 2015 it was the strongest currency and few people challenged the idea that this would continue this year. Dollar strength was underpinned by the US's greater growth and interest rate differential. These remain. Yet the yen with no growth and negative interest rates has been the strongest currency this year. The reasons are not yet clear. However it could be that currencies are now being driven more by inflation. With the whole world trying to generate inflation fixed income investors will look to areas where inflation is most subdued, that is Europe and Japan. Their currencies can become the safe havens. Equally what would be the catalyst to push the dollar higher from here? Its politics are messy, the Fed have become less hawkish, and most investors are already overweight the US.

This is not an easy environment for investors. The root cause of concerns is that QE and zero interest rates have maintained overcapacity in many industries. We have not seen the capital destruction that a normal recession cycle brings, which allows for a strong rebound. As the effects of Central Banks stimulus becomes less effective, and their own credibility starts to be questioned, the potential for a significant market dislocation remains. It is also possible that the Central Banks gigantic efforts to create inflation finally pay off. That would be devastating for bond markets. So equities remain the asset of choice, not least because there is little alternative. Companies that offer a sustainable yield of 3% or so may be driven to even higher valuations by investors desperate for income.