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INVESTMENT OUTLOOK

Q2 2016

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The first six weeks of 2016 saw a violent sell off in both equity markets and the oil price followed by a recovery as Central Banks sought to soothe markets with further support measures. In particular the European Central Bank and Bank of Japan announced actions to prop up their economies, and the Chinese authorities stepped in to calm markets following a serious panic in the first ten days of the year. Their actions were broadly successful in restoring calm but there were some unexpected consequences, for example, instead of the yen weakening following the Bank of Japan's statement it strengthened 8% in two days. The yen move led to a sharp squeeze on some crowded trades, particularly on short positions, as commodities, cyclical companies and commodity currencies rallied dramatically. Global economic growth remains subdued, and with interest rates low or negative, and profit growth deteriorating, the outlook for returns in all asset classes remains challenging.

The oil price has occupied the headlines throughout the quarter and as the oil price fell equity markets followed, and when oil recovered the markets rose again. This is an unusual relationship. Historically recessions have been caused by significant rises in the oil price not by dramatic falls. It seems odd that markets are so alarmed by such an important component in the costs of consumption and production falling so much. Part of the reason is the impact that the fall in price has had on oil producers. It is estimated that $110tn of oil reserve wealth has been wiped out in the last couple of years. This is a huge balance sheet hit to the owners of oil reserves. Several oil producing countries' debt has been downgraded, and many Middle East countries budgets that were made to balance at $100 a barrel of oil now have budget deficits above 10% of GDP. For example the Gulf States' fiscal deficit is running at approximately $270 billion now. In the US the fracking revolution was financed largely by debt, and servicing that debt has become increasingly problematic for marginal producers. As this debt is a significant component of the US bond market any defaults would have wide repercussions. The oil decline has also blunted Sovereign Wealth Funds buying power in markets changing them from substantial buyers to net sellers. This has a particular impact on trophy assets, for example, central London property costs considerably more barrels of oil today than it did when oil hit its peak. However lower oil prices should be viewed as a monumental positive for equity markets. A $60 a barrel drop in the oil price translates to a two trillion dollar transfer of wealth from the producer countries to the consumer worldwide. Whether this money is spent or saved it represents a gigantic stimulus for the world economy. If oil stays below $60 over a sustained period then the benefits of that will flow through for years to come.

The slowdown in the Chinese economy continues to be the most concerning issue in the world. China is now the second largest economy in the world and as the one large economy that has grown strongly since the crisis in 2008 it has become the world's largest engine. As evidence mounts of that growth spluttering, concern is increasing that instead of being a propeller of world growth its contribution may become much more modest. China is suffering from severe overcapacity in a number of industries and as a consequence the system is full of unrecognised bad debts. China is trying to keep its old economy (steel, coal, cement etc) stable while the new economy (consumption, services) grows to critical mass so that it can assume the burden of driving GDP. The two small devaluations it has made since last August were the means to keep the old economy going because otherwise the negative returns of these industries was too great. Transitioning from an industrial driven economy to a service economy is a painful process and in the early stages it damages consumption as highly paid manufacturing jobs are replaced by mundane service sector ones paying much less. Moreover the difficulties arising from this overcapacity are feeding into the banking system where non-performing loans are bound to rise. In the midst of this transition many Chinese companies are making significant foreign acquisitions. This may indicate a lack of opportunity in China or a desire to diversify out of renminbi assets. However the prices being paid are extremely high. In 2015 the median price China companies paid for this diversification was 33 times earnings. Chinese companies have been built in an environment of an economy growing at nearly 10% over the past three decades and often with the benefit of political connections. This is not an environment they will enjoy with their overseas acquisitions. China's adjustment will take time and be an uncertain feature in the world economy for some time. Closing down swathes of industrial capacity and finding employment for the resulting unemployed workers will take several years and be fraught with social complication because the legitimacy of the Communist Party depends on providing full employment for workers. None of this will be made easier by the fact that the population is rapidly ageing presenting another challenge for the government. The relevance of this to the investor is that capitalism and markets require transparency and the last year has shown that this is exactly what China's stock markets lack. As China attempts to navigate through this transition it is likely to favour workers and the State's needs above all else, and this will often hurt both domestic corporate profits and those of international companies operating there. The more alarming threat from China would be a large devaluation which would have substantial effects throughout all global financial markets. This possibility remains an outlier, but cannot be ignored.

The first quarter saw some further extreme events in bond markets. The Japanese Government ten-year bond fell into negative territory and at quarter end yielded minus 5 basis points. Approximately 30% of the world's rich sovereign bonds have a negative yield. The total of government debt that is negative is about $7tn. Given this, it is hardly surprising that investors who require income have been driven into an increasingly desperate search for yield. This creates its own dangers. As has been widely discussed money has poured into the credit markets, but they may resemble lobster pots in that they are easy to enter but hard to exit. Credit funds have mushroomed in recent years to meet the needs of those seeking yield. However with the withdrawal of investment bank trading desks from providing liquidity in these markets, who will be the buyer in the event of a panic or a reversal in markets? Holders of many of these assets will find themselves stuck. While the headlines have been full of deflationary worries there is increasing evidence of at least some inflationary pressures. Central Bank policy has relentlessly pursued inflation to ward off deflationary forces for several years now. Their efforts may finally start to pay off. The Central Bank in Europe and Japan markedly increased their stimulus in the last quarter, and China's money supply is now running at three times their GDP. The rebasing of oil at a much lower level will create inflation if oil recovers in the next year. More fundamentally the tight labour market in the US is leading to modest wage pressure. There is unlikely to be high inflation but what matters is the gap between expectation and reality, and investors are positioned for prolonged deflation. At present investors are welcoming any inflation as a sign of healthier balance. The critical test will come if markets sense that Central Banks do not have everything under control and the longer end of the bond market starts to react. At that point the sustainability of public sector deficits will come under scrutiny. The US Federal debt has tripled in the last fifteen years while the interest it pays to service this debt has fallen. This benign state of affairs will be tested if inflation creeps persistently higher, particularly if it is accompanied by low economic growth.

In this baffling environment what is an investor to do? Cash yields nothing. Bonds offer negligible or even negative returns. Property has been driven to levels where yields are unattractive and it is illiquid. In this context equities have little competition. Of course many stocks are also expensive now, and the stocks that most investors are comfortable owning for their reliable and consistent returns are particularly expensive, as Warren Buffett commented 'You pay a high price for a cheery consensus'. However some opportunities are starting to emerge. Emerging Markets have suffered a precipitous decline in the last five years both in terms of their prices and currencies. The problems are obvious – low visibility, political uncertainty, hostile market conditions and depressed sentiment. But valuations have adjusted to a level where much of the downside is priced in and the potential upside is not. A China devaluation would certainly cause a further fall in the short term but it is reaching the point where the risk is more of not owning the area which promises the greatest growth over the next thirty years. There are other areas that offer good value if confidence returns, with financials being a prominent example. Banking problems have terrified investors for several years now but if interest rates do rise then banks would be a major beneficiary. The catalogue of problems such as the ugly US Presidential battle, Brexit, the European migration crisis, limp global demand, and excessive debt mean that a cautious approach continues to be warranted but a disciplined stock picking approach continues to look the best strategy.

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