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Investment Outlook Q1 2016

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Quarterly Investment Outlook

- 2015 was a difficult year for almost all financial markets. From the dramatic unpegging of the Swiss franc in January to the unexpected devaluation of China's renminbi to the dollar, and the shocking Volkswagen scandal it was a year full of trap doors. Most equity markets were down, and many emerging markets down heavily, and even these results were flattered by a few stocks with heavy weightings in the indices performing well. Almost every currency was down against the dollar, and again many emerging market currencies fell much harder. Bond markets were more mixed but with a third of European Sovereign bonds offering negative yields and the Federal Reserve inching closer to raising rates, which they finally did in December, bonds with negative or minimal yields felt increasingly unsafe. Commodities had another brutal year as the full impact of the slowdown in China's industrial economy came through. This weak performance of financial assets was due to the economic situation. Expressed in US dollars few countries, other than the US and China, managed any growth, and in China's case growth was slowing and by year end, as a result of their currency falling about 5% against the dollar, they were barely growing at all. The large devaluations of the euro and the yen over the last couple of years meant that international companies were addressing much smaller markets in these two large areas, and the Emerging Market bloc shrank radically in US dollar terms as a result of their collapsing currencies. These contractions caused aggregate demand to shrink dramatically. In addition there was greater political unease due to a sense that politicians are struggling to come up with solutions to today's problems and peripheral political parties gained from the mainstream ones, whether it was Donald Trump high-jacking the early stages of the US Republican nominee election, or strong advances by Marine Le Pen in France. The Trump candidacy is benefiting from decades of stagnant real wages for the majority of Americans who blamed foreign competition. In Europe extremist parties have gained as anger has risen from double digit unemployment, and with much worse levels amongst the youth, further aggravated by the overwhelming influx of refugees. The inability of politicians to provide solutions is resulting in a loss of trust in the competence of established political parties.

- The outlook for 2016 remains difficult. In the past when the outlook was uncertain the cautious investor always retreated to the bond market. However quantitative easing (QE) and zero interest rates (ZIRP) have destroyed this safe haven, and the destruction of high quality yield has turned the bond market into a potentially dangerous place. QE and ZIRP have caused huge distortions. QE is like morphine. It turns the economy into a hospital with lots sick patients but with lots of doctors and nurses keeping them alive at great expense. In market terms it diverts capital away from new productive ideas to keeping old, inefficient ideas on life support. It slows down change and allows denial to persist beyond sensible time limits. QE has kept low quality capacity alive and created excess capacity in sectors like mining. Zero interest rates have had the consequence of destroying the income of savers and in particular have driven returns on pensioners' savings to nothing over the last seven years, a devastating situation for the elderly. ZIRP has also encouraged the build up of huge debt with the result that the ratio of debt to GDP is at record highs. This situation is exacerbated by slow growth. Low interest rates, justified by low inflation, have meant that people have postponed dealing with this debt mountain. Low inflation was achieved following the liberalising policies adopted from the 1980's onwards, and greatly assisted by the influx into the global labour market of a billion low cost workers from China and Eastern Europe after 1989. Some of these long term trends are starting to come to an end. The disinflationary effects of low cost labour is abating as Emerging Markets become richer and their wages rise. Chinese wages have been rising at a double digit pace for twenty years. While not explicitly inflationary the benign disinflationary effect of low wages from China is disappearing. Now employment everywhere is strong and 2016 should see more upward pressure on wages. In addition burdensome regulation and corporate reporting requirements have inhibited companies' efficiency. The expansion of bureaucracy and layers of health and safety regulation have made economies less flexible and more prone to inflation, because eventually these costs get pushed through.

The fall in the oil price has obscured some of the inflationary pressures that have been building recently as evidenced by the stronger US PMI numbers. Credit growth has also been increasing so it is possible that over the course of 2016 more inflation pressure may build. This would be problematic for a bond market starting at such low yield levels, and economies saddled with bloated debt. The rise in US rates does, however, signal a small step in the return to a more normal environment. When interest rates are at zero for an extended period it becomes impossible to allocate capital sensibly. If the Federal Reserve are correct that the US is on a path to sustainable growth then rates can rise further and the next stage of healing from the 2008 crisis can take place.

- The US stock market was one of the few markets to record a positive return in 2015 when measured in US dollars. This result was helped by approximately $500 billion worth of share buybacks. As well as supporting the share price share buybacks improve earnings as could be seen in Microsoft's third quarter earnings where a buyback of the company's stock improved earnings from a decline of 1.3% to a rise of 3.1%. The strong dollar has proved a significant headwind to US earnings, and by the end of the year the market as a whole was showing negative sales and earnings. The lower oil price is an undoubted boost for the consumer but for the stock market it has been more problematic. The large amount of energy debt that was raised to support the fracking revolution was dependent on an oil price considerably higher than the current level. As this debt comes to maturity if the oil price does not recover the borrowers may default. In addition there is over a trillion dollars of auto loans outstanding that have been extended on terms reminiscent of the sub prime market prior to the 2008 crisis when anyone who had a pulse could get a mortgage loan. Trouble in either of these segments in the bond market or from emerging market borrowers could spill over into the equity markets because equities are always more liquid than corporate bonds. However the crowding into the big names that has taken place in the US, and many other, markets in the past year or two has left these big stocks trading on high valuations and vulnerable to any disappointment. Meanwhile smaller companies have been left behind and many trade at attractive valuations. The positive surprise of last year was the steady strength in the US jobs market. Robust employment, and some signs of wage pressure and the full benefits of the lower oil price mean the US consumer should be strong. Having contended with the strong dollar in 2015 if the dollar declines then this will also boost profits for American companies helped by easier comparisons. Selectively there should be plenty of opportunities, though most of them are likely to be midcaps. Much the same can be said for Europe though given the stimulating effects of lower oil, QE, and a much lower euro it is disappointing that the European markets did not perform better, and underperformed the US when measured in dollars. Europe is experiencing many crises which the political class seem unprepared to deal with: refugees, Russian aggression, unresolved sovereign debt, and Britain's future status in the EU. 2016 seems unlikely to offer hope of this changing. However European stock markets may fare better this year as the full impact of the weaker euro, lower oil and QE come through. The specific oil affected bonds aside, the power of the oil price, if it remains at current levels, will be tremendous. A drop from $100 a barrel to $40 represents a $2 trillion transfer from the world's oil producers to its consumers. This is a mighty boost to the consumer globally.

- After years of discussion the rise in US interest rates was well discounted by markets and therefore not a surprise, but the de-pegging of the Chinese renminbi in August, the first equivalent move for twenty years, was shocking and has yet to be fully digested by markets, not least because it remains uncertain where the Chinese currency will settle. China has grown to be the world's second largest economy but more importantly it has been the growth engine of the world since the 2008 crisis. Much of this growth was driven by a massive industrial and investment cycle which created significant overcapacity leaving several sectors nursing heavy losses as demand has slowed down. Exports remain an important part of China's economy and the devaluation was probably prompted by the fact that it made no sense for the largest industrial economy to operate a dollar peg in a world awash with overcapacity. Another sign of this overcapacity is the fact that China has had 45 consecutive months of decline in its producer prices. What this means is that if volumes are the same then sales decline and profitability shrinks. As China battles to transition its economy to one based more on consumption it is wrestling with obdurate legacy issues. The currency has fallen 5-6% so far which has upset all the other emerging markets. Until the worries over China's currency have settled down, Emerging Markets' stocks are likely to be under pressure even though they are beginning to show attractive values following several years of poor performance. Emerging Markets are now half of global GDP so what happens to them matters. The bigger risk they pose may be in Developed Markets because the large cap stocks that have propped up the US and European indices have significant exposure to them. Their slowdown and particularly the falls in their currencies will impact the earnings of the big multinationals with operations there.

- Japan remains an attractive market, although after five consecutive years of gains some caution must be warranted, though all the gains have been matched by earnings growth. Japan's financial year ends in March and it looks as though earnings should rise 21% this year, followed by approximately 9% for the year to March 2017. These estimates are softer than they were a year ago but still competitive on an international basis. The unemployment rate has fallen to 3% which augers well for wage rises which would be unambiguously positive for Japan following twenty years of deflation. Much of the positive sentiment focuses on the structural improvements in the way that Japanese companies are being run with far more emphasis on shareholder returns, and both dividends and share buy backs rising strongly. Up to 2008 the Japanese market traded at about 15 times earnings and currently it trades at about 13 times. Given the corporate improvements this seems undemanding. One definition of a bull market is that PEs expand as earnings are valued at a richer level. The potential remains for this to happen in Japan.

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