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Investment Outlook Q4 2015

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- The third quarter was an eventful one in global markets. At the start of the quarter the Greek crisis was in full flow which led to the Athens stock exchange being closed for the whole of July. On the other side of the world the Chinese stock market suffered a rout, with over 1400 shares suspended at one point, and then in August the Chinese currency dropped the most in twenty years. In the middle of this turmoil Puerto Rico defaulted on its debt, and the Saudis raised $27 billion from the bond market, a visible sign that the stresses the decline of oil is causing the producer nations. On top of all this at the end of the quarter a major scandal broke when Volkswagen disclosed that they had falsified the way their emissions were tested. All these issues rattled markets. The closure or suspension of large parts of a market reminded investors of the importance of continuous liquidity. The collapse of the oil and commodity prices is pressuring credit markets. China's slowdown is perhaps the most significant concern for investors as it has been the world's motor for the past six years, so any indication that this motor is spluttering unnerves them. This backdrop led to some heavy falls in stock markets and the S&P in the US suffered its worst quarter for four years. Emerging market stocks also fell, a decline exacerbated by the fall in their currencies.

- Predicting the future on China has become more difficult this year but the implications of what happens in China are profound. Since the 2008 crisis China's powerful growth rate of well over 7% per year, accompanied by an appreciating currency, has provided a large part of global growth. Thirty years of near 10% growth have led to China becoming the second largest economy in the world and on a number of measures the most significant. For a whole range of commodities and consumer items China is the largest importer, for example, in cars and smart phones. As much as 25% of the world's industrial production is in China. Chinese supply chains are so integrated into the world economy that their influence reaches almost everywhere. As China's importance has grown for more than a decade businesses have been built on the basis that China will continue to routinely grow at 7% a year and that the renminbi will remain strong. If these assumptions turn out to be wrong then many business plans could be in trouble and many prices would need to adjust. On official numbers China is still growing at close to 7% per year but many analysts think the true figure is more like 4%. Of equal importance many expect that China will weaken the renminbi further. The combination of slowing growth and a declining currency could mean that China's growth approaches zero if measured in US dollars over the next two years.

- China concerns have been exacerbated by the poor communication and poor execution in their handling of markets this year. The government had encouraged the stock market bubble as they hoped to use the market to raise equity to help repair company balance sheets and reduce debt. Unfortunately this led to a lot of speculation on margin rather than engendering an equity culture in solid names. When the markets started to unravel the authorities were late in reining in the excesses, and then became draconian in their attempts to get the situation under control. The rout was dramatic. In a few weeks the Chinese market lost the equivalent of the French and Spanish markets combined. This episode raises questions. First the government's credibility has been damaged. They puffed the market up and as a result many investors got hurt. This is not in keeping with the image of firm control that the Chinese government has always encouraged. Second the government has been talking for several years about increasing the role of market pricing in the economy. It was disappointing to see the instinctive reaction to trouble was to step in and try and control prices, particularly as the market wasn't even in negative territory for the year. It was against the reform spirit that the authorities have been trying to promote. Moreover the impact of the stock market crash will be less in China than most other places as the stock market is relatively under developed. While it will have a hit some individuals hard, for the Chinese consumer the much more important asset is housing. Housing prices have fallen but are now stabilising, and it is vital for consumer confidence that this stability is maintained. It should also be stressed that the Chinese government retains considerable powers to support the economy. They can cut interest rates, and they have a substantial war chest. A meltdown of the Chinese economy is unlikely, but the larger risk and one that would have many negative effects for the rest of the world, would be that the Chinese lower the renminbi further to alleviate the stresses in their economy and in doing so push more deflation into the rest of the world. It should be noted that since the August move the Chinese have been making determined and successful efforts to support their currency. The impact of China's slowdown may start to be seen more in western markets from here. The majority of many multinationals' growth in the last few years has come from China and other Emerging Markets. If China's growth becomes more subdued these companies will struggle to maintain the growth that their share prices are assuming.

- The Federal Reserve has not raised interest rates since 2006 and at the end of the third quarter they again kept rates on hold despite mounting expectations that an upward move might start. They cited the international turmoil as a reason to wait. This long period of near zero rates may have stored up problems in the corporate and high yield debt markets. Together with QE such low interest rates have allowed impoverished countries and low grade companies to issue debt at absurdly low yields. Investors have bought these poorer quality names in a desperate hunt for slightly higher yields, and in so doing have sacrificed quality. The Federal Reserve's $4tn QE program supercharged this process following a three decade bond bull market as flows into bond mutual funds have boomed. The danger lies not only in the poorer credit quality of these holdings but also their illiquidity. The size of the bond market has increased while, largely because of regulation, dealing capacity has shrunk. If there is a serious problem in these markets then large parts could be suspended because of their size. Only governments could easily provide the liquidity in a crisis and they would be reluctant to do so. Moreover the effectiveness of QE and low rates are being questioned. By propping up marginal producers and consumers these policies may have led to weaker growth rather than stronger because there is an oversupply of everything, and consumers have been encouraged to take on ever more debt. Increasingly the view is growing that the sogginess of global demand is being caused by the overcapacity of production and meagre yields that low rates has engendered. It is not healthy when a dysfunctional, left wing government like Brazil which is embroiled in a major crisis and corruption charge scandals can issue bonds at 5%. It seems equally extraordinary that Russian bonds are selling at a higher price than a year ago despite the crash in the rouble and the oil price. The longer these anomalies persist the greater the risk of a nasty denouement.

- The last quarter shows how skittish the investor community feels but the many positive points around the world should not be overlooked. The US economy continues to recover steadily. The latest jobs data was slightly disappointing but over the past few years employment has grown to the point that the unemployment level is down to about 5% which is close to full employment as the recovery broadens. Companies in the US have continued to buy back shares and pay strong dividends. While corporate profits have suffered from the strength of the dollar US companies are performing well operationally. The dividend yield of the S&P is about the same as the yield on the US 10-year bond, but the S&P has the advantage of the enormous human enterprise of 500 of the world's best companies. Improvements in technology and advances in many fields continue. The crash in oil and other commodities is a substantial transfer of wealth to the western consumer, maybe as much as two trillion dollars. Effectively a large part of their spending has received a discount which can be saved or spent. Either way the consumer is in better shape. Elsewhere in the world Japanese companies continue to improve their returns to shareholders and earnings growth is strong. Europe is slowly healing and the benefits of the lower euro and oil prices will start to kick in from here. If China can stabilise that would put a significant floor under global confidence. On top of all this there is a global merger and acquisition boom going on that is supportive to equity prices. It is not an easy environment given how soggy global demand is but companies can grow, and the value of this growth is all the greater in a low growth world.

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