Market commentary October 2015

Brief overview

Since the last market commentary dated April 2015, global equities have performed poorly with most major stock markets posting sharp declines. UK equities fell -4.7%, global equities fell -8.2% and emerging market equities fell -17.3% but within the period we experienced some high levels of volatility. Since the turn of the calendar year, total returns are broadly more positive given the strong performance in the first quarter.

Investor sentiment is currently dominated by four major themes which represent the biggest risks to the global recovery namely a China economic hard landing, the U.S. Federal Reserve raising the target interest rate with the potential for collapse in emerging markets, further oil price falls and the fear from investors that the Federal Reserve is already too late in raising interest rates.

China and the emerging markets (Latin America, South Africa, Turkey, India and Russia to name a few) were under severe financial stress during the summer. After decades of double digit economic growth, China is now finding the transition from an investment led economic model, building cities and transport networks, to a domestic led model, buying cars and healthcare, somewhat problematic. Official economic growth figures from China, which are opaque at best, were reported at a lowly 6.9% per annum with independent external analysis suggesting that a figure closer to 4.0% per annum is closer to reality. Whilst the western world would be delighted with these numbers, China's share of global GDP is currently 16% compared to just 4% some 25 years ago and so investors take the downward shift very seriously. Confidence in the authority's ability to manage the economy was shaken in August when the Chinese government made a surprise announcement to devalue the Chinese Yuan (Chinese currency). In a bid to raise their exports, we can look to the well-publicised plight of the steel industry in the UK to provide some useful insight into the problem that also confronts China. The Shanghai equity market promptly dropped sharply, dragging most other major markets down with it, wiping out the tremendous gains built up in the previous year.

Since the turn of the millennium, emerging economies have been the main beneficiaries of China's growth engine, locking into a virtuous cycle of selling highly priced commodities to support China's infrastructure boom whilst rejoicing in strong capital inflows, appreciating domestic currencies, falling interest rates and falling inflation. Both the corporate and government sectors have funded this boom by raising significant levels of both external (mainly in Dollars) and internal debt which is now showing early signs of stress. Slower growth in China has led to collapsing commodity prices which has reduced government tax revenues. The Dollar has simultaneously strengthened against a basket of emerging market currencies raising the cost of the dollar denominated debt repayments heaping more pressure on EM economies. The economic cycle is now working in reverse and it is likely to get worse for the global emerging markets before it gets better.

The U.S. Federal Reserve was widely expected to raise interest rates in September for the first time in nine years but the destabilising impact of the Chinese devaluation pushed the decision back to December at the earliest. Current interest rates are set at emergency levels and need to normalise (towards 2% for arguments sake) to place the U.S. economy on a sustainable growth path. Whilst wage growth in the U.S. is starting to pick up and economic growth is stable, albeit at low levels by historical standards, deflation remains a pervasive threat and Janet Yellen, Chairwoman of the Federal Reserve will have to nuance her decision of when to raise rates and indeed, the future path of rate rises.

UK equities FTSE All-Share Index **-4.7 %**

The FTSE All-Share Index performed poorly in the period under review as the commodity heavy FTSE 100 index fell from a high of 7124 in April to a low of 5767 in late August to register a -19% fall from top to bottom. However, the strong start to April helped the FTSE 100 post a loss of only -5.6% when measured between the two review dates, the FTSE 250 Index held small gains of +0.9% and the FTSE Small Cap Index rose +1.6%.

The problems in China continued to weigh on the commodity sector as metal prices plunged towards new lows. The FTSE 350 Mining Sector which represents some of the largest primary producers in the world such as BHP Billiton and Rio Tinto lost -33% of its value. The price of a tonne of copper has halved in the last five years whilst other metals such as platinum, tin and zinc have experienced significant price falls. The FTSE 100, commodity trading company Glencore Plc is a bellwether for the sector. It traded at distressed levels in September due to its high debt levels and required a deeply discounted rights issue promising to sell some assets to raise some much needed cash.

Economic growth in 2015 for the UK has been steady at 2.3% whilst the unemployment rate of 5.4% is at a seven year low. Wages are growing in real terms at 3% per annum (including bonuses) and evidence is stacking up that there are geographic and skill mis-matches causing tight labour conditions, a pre-cursor to further wage inflation. Austerity measures on public sector wages are depressing the figures somewhat as civil servants have had the imposition of pay caps whilst retail workers are enjoying rises of 7.5% p.a. Those sectors of the economy where workers can be replaced by machines such as mining and food manufacturing are suffering from low wage rises whilst firms operating in industries renowned for labour intensive work such as administration and support services are having to pay-up for workers already holding down current jobs.

The Bank of England will be keeping a close eye on the UK current account deficit which is -6% as a percentage of GDP, the highest post war level. Ordinarily, this is a sign that the trade gap is widening (exports minus imports) and has been consistently in negative territory since the early 80's. However, income from overseas investments has been poor in recent years, depressing the number still further and would suggest that the value of the pound will come under pressure at some point raising the cost of imports. That said, the Bank of England appears relatively relaxed at this juncture and whilst the Consumer Price Index (CPI) remains below 1%, it is unlikely to raise interest rates until late 2016, early 2017.

The best performing sectors in the FTSE 350 indices were food producers, household goods, home construction and non-life insurance. UK corporate profit growth has stagnated over the last twelve months but the long-term uptrend remains intact.

International equities FTSE World (excl. UK) Index **-8.2 %**

In the U.S., the S&P 500 fell by -7.9 %. The U.S. economy is still outperforming the EU with an annualised growth rate of 2.5%, however, growth remains structurally low and uneven compared to pre-financial crisis levels and the recovery is showing signs of strain after six years. Asset prices are booming but the wealth effect is not translating into consumer spending and credit growth remains subdued due to elevated debt levels. There is evidence of a tightening labour market with wages and inflationary pressures starting to accelerate and this will pressurise frothy corporate profit margins. The global economy is still reliant upon the health of U.S. consumers who represent a substantial 26% of global consumption with the EU contributing 17%.

Janet Yellen, the Chairwoman of the U.S. Federal Reserve is searching for the perfect opportunity to raise interest rates although the anticipation of the timing and trajectory of the future path of interest rates is subject to much conjecture. Volatility is sure to follow as market strategists digest the implications of a move off the zero-bound range.

FTSE Europe (excl. UK) returned -8.2% in Euro terms. The Euro against the pound was virtually unchanged. It has been another summer where Europe has lurched from one crisis to another with Greece eventually accepting the terms of its creditors to unlock additional funds and avoid leaving the Euro. There was some positive news with growth in the Euro region revised up to 1.5% for the first half of the year. There is evidence of some positive momentum with solid growth in household and government expenditure and exports are up a creditable 5.2% helped by a weak Euro. The European Union (EU) has 9.5% of its non–EU trade heading to China, Hong Kong, Brazil, Russia, India, Turkey and South Africa which are all emerging countries experiencing significant economic stress. Exports should hold up, particularly out of Germany, on the proviso that China avoids a hard landing.

The outlook for China can be summarised by a quote from Tom Orlik, the Chief Economist at Bloomberg. He stated that "investors suffer from Sinophrenia, a condition where sufferers believe China is both about to collapse and about to take over the world". Global emerging market equities bore the brunt of the latest China syndrome and equities measured by MSCI (a composition of EM countries) declined by -17.3%.

As a consequence of slower growth in China, emerging market exports have been hammered since the financial crisis and are down -20% over the last year in Dollar terms. The softening of global trade over the last five years has not been supportive due to lower demand from the heavily indebted U.S. and European consumer. Oil and industrial metals have lost half their value since 2014 and many emerging economies are primary exporters of these commodities. Since 2010, emerging currencies have substantially weakened against the Dollar with the Turkish Lira losing -49% of its value, Russian Ruble -49%, the South African Rand -49% and the Brazilian Real -54%. These countries are now importing inflation, interest rates are rising and capital is flowing out. Tax revenues are declining and incumbent governments are struggling to structurally reform their economies and to hold on to power.

In Japan, the Topix 500 declined by -7.9%. The Yen is trading at a 40 year low against the Dollar in real terms following Prime Minister Shinzo Abe's 'shock and awe' programme of Quantitative Easing (QE). His suite of 'three arrows' policies which starts with expanding the monetary base to unprecedented levels is having some effects. Inflation has risen to above zero following two decades of deflation. Corporate profits are at an all-time high, domestic investors are starting to buy shares again following years of buying bonds and companies appear to be in rude health with low levels of debt, high levels of investment in research and development and rising dividend pay-out ratios. Valuations look compelling but economic growth still looks stubbornly anaemic and is a concern. Shinzo Abe has bet the house and the consequences of failure are unthinkable.

Fixed interest securities FTSE British Government All-Stocks Index **-0.7%**

The ten year UK Gilt yield is anchored at 2.0%, the U.S. trades at 2.3%, Germany 0.6% and Japan 0.3%. The UK remains firmly behind the U.S. economic cycle and is signalling that it is unlikely to raise interest rates any time soon and certainly, well after the Federal Reserve initiates its policy tightening cycle. Government bonds offer poor projected returns over ten years although clearly provide security of capital. Low yields are symptomatic of central bank driven QE policies designed to drive down interest rates, forcing income hungry and ordinarily, risk averse investors into riskier asset classes such as equities.

Investment grade corporate bonds offer some additional yield at approximately 3.6% but with downside credit risk and potential liquidity issues down the line (difficulty selling stock in a downturn), they offer limited value in our view.

Long US Treasury Bonds (20 years +) which are interest rate sensitive returned -6.8% in the period under review but would offer substantial upside returns if global deflation became endemic. Whilst deflation has periodically threatened to materialise, it is clear that the central banks are mandated to do whatever it takes to avoid such a scenario. We are constantly surprised by the amount of both political and central bank intervention in markets and indeed, by the degree that markets react to well-placed comments by high ranking banking officials.

Commercial property	IPD UK All Property Index	**+7.2%**

Industrial properties returned +9.2%, offices +9.7% and retail +4.5%. Commercial property returns have remained resilient in the period since 5th April given the volatility in other financial markets. Strong underlying fundamentals remain in place and there is evidence that investors are moving along the risk curve by substituting commercial property for some of their fixed interest investments. Income yields are relatively high compared to other asset classes and steady property revaluations are providing some capital upside. The trophy assets in Central London are starting to look fully valued. In mainland Europe, real estate companies are able to access cheap finance given very low interest rates and relatively low property valuations are providing plenty of opportunities for innovative property companies to operate.

Alternative assets

Crude oil has remained in the doldrums following last year's precipitous declines and trades at levels ($45 a barrel) that would be unsustainable in the long run for most of the global oil majors to generate positive returns and maintain their higher than average dividends. Commodity prices are hitting 16 year lows as measured by the Bloomberg Commodity Index and highly indebted producer companies are struggling for survival. At these basement levels, the pressure on global emerging markets will persist with no obvious sign of a catalyst to reverse the trend.

Paul Farrant, Chartered Financial Analyst

Indices performance statistics are for the period 5th April 2015 to 5th October 2015, total return with income reinvested. Source of statistics: Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.