Market Update – March 2016

This is a brief market update given the noteworthy rebound in asset prices that has taken place since we dispatched our last investment thought-piece in early February *'Enter The Dragon'*. At the time, although stock markets had sold off very quickly in recognition of risks related to a strong US dollar and a slowdown in China/emerging economies, we noted that:

"This shift may itself lead to a short term relief rally because quite a lot of exuberance has quickly been taken out of equity valuations. Ideally, though, we need to see some stability in the oil price and a change in the Federal Reserve's rhetoric which will allow the US dollar to pull back from its current strength. As volatility subsides, there is no reason that equities cannot retrace a reasonable portion of the recent losses, but if a negative cycle has indeed begun then it is likely that this rally will fade as investors start to position their portfolios for recessionary conditions."

Since then, both the US dollar and indeed the oil price stabilised and started to reverse direction. True to form, the academics at the Federal Reserve have also capitulated on their attempts to push through multiple interest rate hikes this year.

In the case of oil, both US and European crude oil prices put in a bottom in early February and then rallied by around 50%. Other raw materials such as copper, gold and iron ore also rallied. As one might expect, currencies that are strongly correlated such as the Canadian, Australian dollars, Russian ruble and Brazilian real have also bounced, and with that, emerging market equities have rallied around 20%. Elsewhere, the bounce has been less pronounced (UK and US markets both up around 10%), but then the initial falls were less severe also.

From our side, *given that we see no change to the structural problems of over-indebtedness and excess capacity* (underwritten by seven years of low interest rates and quantitative easing), we are not taking this opportunity to launch back into a pro-risk investment posture. Instead, we have used this rally to reduce our exposure to equities further.

Oil and the US Dollar

It has been difficult to quantify the leading driver of this rally but essentially, at present, the US dollar and the oil price are moving in lock-step and have become the primary driver of asset prices. Lower oil prices means shrinking petrodollar reserves and is an indicator of weak industrial activity globally, and particularly in China. As the world's reserve currency, a stronger US dollar means tightening liquidity conditions globally and increased pressure on emerging economies that are heavily laden with dollar debt. As soon as the US dollar and oil started to reverse, analysts have commenced the process of calling a bottom in commodities and also an end to the bear market in emerging market equities.

Central Banks Painted into a Corner

For some time we have taken the view that central banks will continue to pull the same policy levers repeatedly as long as they see the correct reaction from the markets. But in the last few months we have seen some worrying developments.

The Bank of Japan surprised markets in January by adopting a negative interest rates policy (NIRP), despite stating just days earlier that it had no intention of doing so. The result was the opposite of what they were seeking: the Japanese yen has strengthened substantially and the stock market has fallen, with the shares of Japanese banks getting hammered. It should be noted that the performance of the Japanese stock market has been inextricably linked to yen weakness. Needless to say, we judge the success or failure of Japan's policy to be a key leading indicator for the success of central bank intervention (and hence the effectiveness of currency wars) everywhere, and, *the current path of the USD/JPY exchange rate is a concern*.

The European Central Bank initially adopted NIRP back in 2014, and has repeatedly moved more and more into negative territory. But since December, not only has the euro currency rallied substantially but the shares of European banks have basically crashed (down as much as 50% in some cases). Given that one of the key aims of lowering interest rates is to stimulate lending, creating a crash in the equity value of banks does not seem to be a powerful way to achieve it. The banks themselves have said that NIRPs are destroying their business models, forcing them to shrink their balance sheets and, if anything, forcing them even farther out on the risk spectrum in order to generate any return at all on their capital.

In short, we appear to have reached the end of the road in terms of NIRP because it is now serving to undermine an economic system that was never built to accommodate it. Yet central banks have painted themselves into a corner because how can they now unwind this corrosive policy without signalling to markets that they are out of ammunition?

Finally, the US Federal Reserve (Fed) is probably the one central bank that is not out of firepower. In recent days the Fed issued their latest interest rate decision and substantially backtracked on their previously stated objective of raising interest rates to at least 1.0% by the end of 2016. This was taken very positively by the market because it served to further weaken the US dollar and hence provide support for oil and emerging markets. It leads us to believe that any return to quantitative easing by the Fed could probably provide another significant leg up for stock markets, although there is no evidence that the Fed will consider this in the near future.

GBP Weakness Has Lifted Our Overseas Positions

The threat of 'Brexit' has been weighing on sterling for some time, to the extent that GBP has fallen by as much as 10% against the US dollar and the euro since last September. Since we have been structurally underweight sterling for some time, this trend has provided a fillip to our overseas investment positons, to the extent that, despite the fall in stock markets, some of our holdings in US and global equities are actually hitting new highs! We are selectively clipping these positions and we are also sensitive to the prospect of a rapid reversal if it becomes apparent that Brexit is unlikely (since institutional 'hedging' of GBP positions is at record levels).

Volatility

Price volatility in most assets, but particularly the stock market, is becoming alarming, with stocks crashing to the downside on (legitimate) concerns about economic issues, but then turning on a dime and ramping to the upside in response to commodities, currencies, or policy announcements.

One might conclude that, logically, these extreme moves reflect an increasingly schizophrenic market that is awash with the trillions of dollars of cheap liquidity that has been injected into the system since 2008. But at some point central banks will have to step back from continually spiking the punchbowl and from this policy of constantly try to micro-manage asset prices, in the same way they will have to step back from this destructive policy of negative interest rates.

These volatile moves can be dramatic and *no-one wants to catch these shifts for clients more than we do*. However, it is extraordinarily difficult to judge the strength and duration of these moves and, increasingly, as noted above, we have grown concerned that the conditioning setting into markets could eventually lead to the opposite of what one might expect. Also, arguably it is the hedge funds in this industry that are in prime position to take advantage of this volatility but currently the industry is littered with billionaire hedge fund managers that have seen their performance decimated by these whipsaw moves.

Summary

Overall, we continue to adopt the view that there are times in the investment cycle when it is correct to hold your nerve and significantly embrace risk in pursuit of very clear upside potential. Conversely, there are times when it is prudent to tread cautiously and focus on preserving capital because downside risks prevail. Our current thinking and strategy is very much focused on the latter, and hence we are using this rally in equities to lighten our positions further whilst maintaining our portfolio hedges in the form of gold, property and long-dated government bonds.

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