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Q3 Market Recap

2015

Market Commentary from Parmenion Investment Management

The third quarter of 2015 has proven to be lacklustre in stock market performance terms and the whole year may turn out to be one of lower returns than investors have become accustomed to in recent years.

Apart from Japan all major stock market indices are in negative territory in sterling terms year to date.

For the past couple of months Greece and its problems have faded from the news (although they have not gone away) and markets have focused on when or if the US would raise interest rates. In the end the Federal Reserve did not raise rates in September owing to uncertainty in emerging markets and in particular China. So why is China so important?

After enjoying growth rates of 10% per year for a number of decades, growth is now more subdued. Last year GDP was officially 7.4%, this year it's likely to be notably lower. A lower rate of growth in China causes problems for other emerging countries like Brazil and Russia (which are now both in recession) who did well out of exporting commodities to China. For example take copper, an important raw material for the construction industry, its price has fallen from US$4500/lb to just under US$2400/lb over the past 5 years. The impact on oil has been similar as demand has fallen. And the problems extend to developed countries. China is a major export market for the likes of South Korea, the United States, Japan and Germany. The knock on effects of a Chinese slowdown spread far and wide.

In order to revive the economy the Chinese devalued their currency making their exports cheaper and more competitive. Many accuse the Chinese of "exporting deflation" with cheaper goods lowering prices elsewhere in the world and making it harder for other nations to compete. It is this that poses a problem for central banks; if prices are falling, consumers hold off spending knowing that prices may fall further and consequently economies contract. Plus with interest rates at 300 year lows, reviving economies becomes problematic!

However, looking at the domestic US economy in isolation, there is an argument to raise rates. The second quarter of 2015 saw the economy expand at an annualized 3.9%. And recent comments by Janet Yellen hinted at a rate rise before the year end. However rising US interest rates may cause problems for some emerging markets.

Many governments, companies and individuals have dollar borrowings. Rising US rates will raise the borrowing costs and put pressure on their economies. The so called "taper tantrum" of 2013 occurred when the US hinted at a possible end of QE. This caused problems for some emerging markets, in particular those who depended upon dollars to finance their economies. Could the same happen again?

This also has implications for the UK as there is an expectation we will follow the US with a slight time lag. Like the US the UK economy is expanding with employment rising. However for both there is still little evidence that inflation is a problem. The question then becomes, do you raise rates before inflation rises or do you wait until it is already rising. Ahead of or behind the curve? Thankfully that is a question for central bankers!

Commentary by Simon Brett, Director & Chief Investment Officer, Parmenion Investment Management

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Market Commentary from Sanlam UK

The third quarter of 2015 was the weakest for stock markets since the so-called 'Eurozone crisis' of 2011.

Emerging markets were down around 15% since the mid-year point and the best part of 30% down from their April highs. Developed equity markets also suffered.

The cause of the falls, and especially of the late-August turbulence that gave China its very own 'Black Monday', was debated.

Two camps emerged. The first, playing out mainly in the popular press, was that the bursting of China's consumer-driven stockmarket bubble somehow 'rippled' around the world and caused falls elsewhere. The second, a more plausible narrative, was that weakening global corporate earnings growth coincided with an anticipated rise in US interest rates. The combined effect caused markets to correct downwards.

Market storytelling is always an attempt to make sense, after the fact, of the extremely complex and living entities that we call stockmarkets. Sometimes these stories are about the market as a whole (told via the movement of indices like the UK's FTSE 100), and sometimes they are about individual shares.

So it was also at end of Q3 2015 that a classic 'single stock crisis' came into view: the Volkswagen Group, one the world's largest carmakers owning many well-known brands, had apparently used sophisticated software to cheat emissions tests.

As this is written, the full details of VW's alleged offence are still emerging. We can only guess at the total cost to the company in fines, reparations and reputational damage. But share analysts have made their estimates, the market has spoken, and the share price has collapsed.

A nasty corporate secret bursting out of the ground and rampaging through the streets of the City is what portfolio theorists call 'unsystematic risk': risks unique to an individual company. It's the opposite of 'systematic risk', which is the risk of holding shares per se.

You can't really do much about systematic risk, except to hold a smaller proportion of shares in your portfolio if you don't like the risk level you're experiencing. But you can do something about unsystematic risk: diversify.

Disappointing quarters happen, and they will happen often. The aim is to add value in all types of market, both good and bad.

Source: Sanlam Market Review October 2015

In August the screens were abuzz with the news that China had devalued its currency and equity markets everywhere tumbled; headlines connected the two but what is the link?

China is the second largest economy in the world and since the Global Financial Crisis has been the engine of world growth, overtaking even the US in terms of total trade.

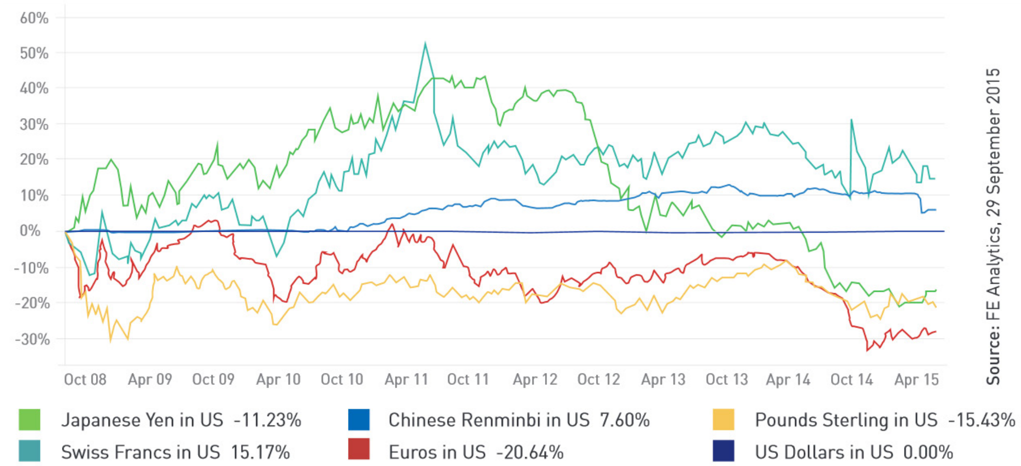
Devaluations cause the prices of imports to rise and of exports to fall. The International Monetary Fund estimates that a 10% currency devaluation adds 1.5% to a country's Gross Domestic Product[1] - attractive in a growth-constrained world. But one country's exports are another country's imports so one country boosting GDP in this way must reduce GDP elsewhere.

Until we find traders on Mars, this world is a closed system. Therefore while it may be rational for one country to pursue this "Beggar Thy Neighbour" strategy, for the world as a whole this is at best a zero sum game (HSBC have a theory that feedback mechanisms actually reduce overall growth). At the G20 summit last month, world leaders agreed that to engage in competitive currency devaluations would be detrimental to all.

As the chart shows, much bigger relative moves in US Dollar terms have occurred among other currencies since the Global Financial Crisis (China's is the dark blue line). The US and UK and belatedly Europe embarked on Quantitative Easing programmes, one impact of which was to devalue their currencies. Japan in 2001 was first to try this unorthodox method to jolt itself out of a decade-long deflationary slump. Since Abe's re-election in 2012, when he reinvigorated this policy, the Yen (green line) has fallen by about 35%.

So why should such a small change in the value of the Renminbi (albeit the biggest change in 21 years) be thought to be so important to equity markets across the globe? There are three plausible reasons.

Relative value of major world currencies in US Dollars since the collapse of Lehman Brothers and the start of the Global Financial Crisis:



Firstly, the move was a formal acknowledgement that China is struggling to maintain its economic momentum. Hopes that the Chinese economy would be rebalanced away from exports and towards a more Western-style consumerism have been punctured. This matters because it has knock-on effects for sellers of commodities to financial services, high tech industrial equipment to luxury goods from all around the world, reducing both revenue and margin projections.

Secondly, it put other developing economies in a quandary – either maintain their currency's value and lose competitiveness or devalue and pay more for their US Dollar debt. Neither would help their growth.

Thirdly, the Renminbi's fall overwhelms many of the trade tariffs the US uses to protect its own manufacturing base. US-made goods have become less competitive which could cause its exports to slow, worsening the US trade deficit. The US Federal Reserve's decision last month not to raise interest rates, despite having warned markets to expect this, shows they are concerned about this. Perhaps the Chinese authorities were not trying to boost exports after all: to do so they would surely have made a more sizeable adjustment.

One alternative interpretation of their actions is that they were mimicking the typical free market response to slowing growth in a country: to sell its currency. As such, their tip-toeing towards market liberalisation continues but their reluctance to let markets find their own level makes this seem a long road. However, one day we may look back on this summer's market gyrations as an early sign of the growing importance of the Renminbi on the world stage. Might it even take over from the Dollar as the main currency of exchange one day?

[1] GDP is the sum of consumption, investment, government spending and exports minus imports, ie the total economic activity within a country's borders.

First published by Emily Booth, Senior Investment Manager, Parmenion Investment Management in their Q3 Investment Review.

The theme of monetary policy divergence between the US Federal Reserve (Fed) and the European Central Bank (ECB) came to the fore in October. In its September meeting, the Fed referred to China and emerging markets (EM) as key reasons for leaving monetary policy on hold.

In October, the Fed adopted a surprisingly hawkish tone as it removed the sentence on external risks from its statement. The Fed also downplayed weaker industrial data and focused instead on solid growth in consumer spending. Explicitly, it will be assessing whether to hike or not "at the next meeting", firmly putting December on the table. The shift in tone led financial markets to refocus on the very real possibility of a rate increase in December and, more significantly, the start of a tightening cycle.

Conversely, the ECB sent a very dovish signal following its October meeting, thereby raising expectations for further easing measures in December. The ECB signalled that it is considering amendments to the current quantitative easing (QE) program and a cut to deposit rates.

The "shadow"[1] policy rates suggest that monetary policies in the US and the eurozone have been diverging since the start of 2014. This is due to the conclusion of QE in the US and the start of QE in the eurozone. December will be an interesting month as we are likely to see the first interest rate rise in the US since 2006 and, possibly, the first negative refinancing rate in the eurozone.

US – stronger services versus weaker manufacturing activity

It is now almost 18 months since oil prices began to slide and the US dollar

"Shadow" policy rates

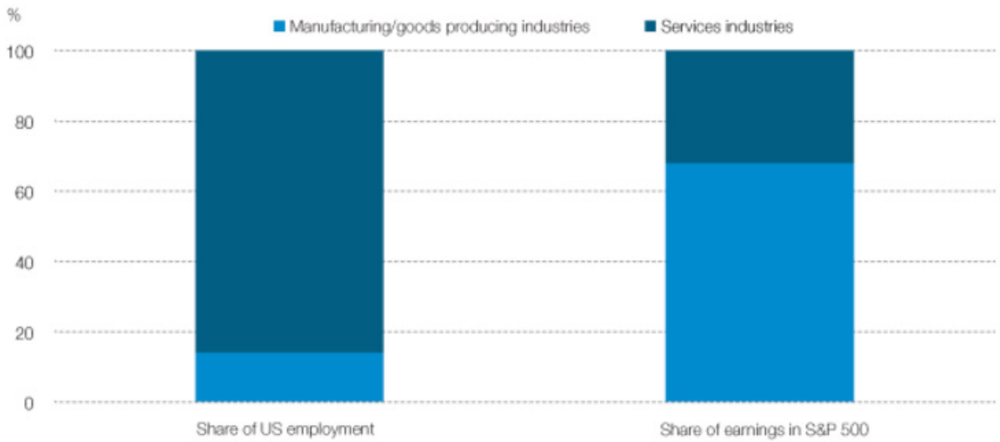
Source: Fathom Consulting. The arrows indicate our expected direction, but not magnitude, of the shadow rates.

embarked on a now very substantial appreciation. Consequently, the US energy and manufacturing sectors, especially multinational exporters, have encountered strong headwinds. The negative narrative in financial markets in August and September was a reflection of the fact that energy and multinational companies make up a significant portion of the S&P 500 Index.

According to Deutsche Bank's estimates, the share of earnings in the S&P 500 coming from manufacturing industries is a whopping 68%. However, the composition of the index is very different from that of the US economy.

While capital expenditure in the energy sector has plunged and manufacturing activity has slowed, the two sectors only account for 15% of the US economy. But these hard-hit sectors are dwarfed by the service sector, which represents 85% of the US economy, as well as 86% of employment creation.

US services vs manufacturing industries



Source: Deutsche Bank.

US personal spending vs manufacturing production

Source: Datastream.

While growth in US manufacturing output has slowed to just +0.4% year-on-year (YoY), household spending growth strengthened to +3.2% YoY in September. There is no evidence that either financial market volatility or a Chinese slowdown has negatively impacted US consumer demand. In terms of outlook, leading indicators, such as the Institute of Supply Management (ISM) Non-Manufacturing New Orders Index and the National Federation of Independent Business' (NFIB) Small Business Optimism Index, continue to suggest robust activity in the services sector.

It is worth noting that the divergence in the performance of services and manufacturing is not confined to the US. Services, which comprise the lion's share of activity in most developed-market economies, are less heavily traded and less subject to the vagaries of the international economic cycle. Hence, they have benefited more from the stimulus to domestic demand in those economies provided by lower energy prices, higher disposable income and better employment prospects.

Europe – manufacturing activity stabilises

In the eurozone, the Purchasing Managers' Index (PMI), a survey-based measure of business activity, suggested that manufacturing sector regained some momentum in October. Against the backdrop of continuing weakness in manufacturing activity in Asia, industrial output in the eurozone appears to have stabilised. As we have commented previously, the marked deceleration in the Chinese economy is unlikely to derail the eurozone's ongoing recovery, as China accounts for a mere 3% of eurozone exports. Within this, Germany is one of the more exposed economies, as it exports more to China (5.4% of total exports) and partly reflecting this, factory orders dropped throughout the third quarter. Even so, business surveys have held up well and the German manufacturing PMI showed good growth in orders in October. In addition, despite the Volkswagen scandal, the IFO business confidence index[2] was more resilient than expected in October, with the expectations index strengthening for the second month.

Closer to home, the UK manufacturing PMI has bounced to the highest level since mid-2014. Output, new orders (including exports) and employment all recorded robust rates of growth in October. Given the reliability of PMI surveys and strong historical correlation with actual GDP growth, it is reasonable to anticipate an improvement in industrial and trade data in coming months.

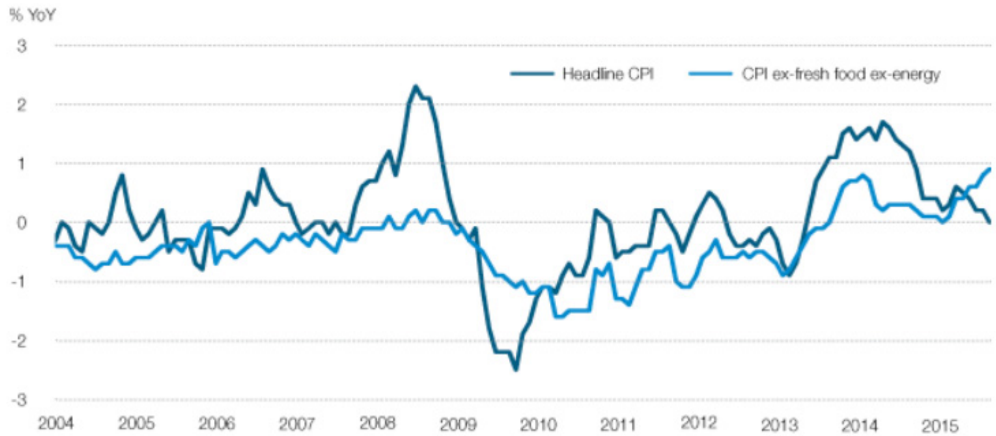
Manufacturing Purchasing Managers' Indices

Source: Datastream.

Japan – Diverging headline and core inflation kept the Bank of Japan on hold

In Japan, continuing weak domestic activity has resulted in growing pressure on the central bank to step up its QE programme. Nonetheless, with tentative signs of a pick up in inflation, the Bank of Japan seems content to leave monetary policy on hold for the moment. Although the annual rate of increase in the headline Consumer Price Index fell to zero in September, a measure of prices that excludes fresh food and energy, showed inflation of 1.2% - the highest rate since 1998. As a result, further monetary easing seems unlikely unless economic data deteriorate substantially.

Japan consumer price index (CPI)



Source: Bloomberg. Data adjusted for consumption tax hike in April 14

[1]Model-based measure of the stance of monetary policy when policy interest rates reach the zero lower bound. Source: Fathom Consulting.

[2]The German IFO (Institute for Economic Research) Business Climate Index - an index that rates the current German business climate and measures expectations for the next six months.

First published on 11th November 2015 by Janet Mui, Economist, Cazenove Capital.

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