Summer Newsletter 2016

2016-Is that a bird, a plane or is the sky falling?

Key takeaways

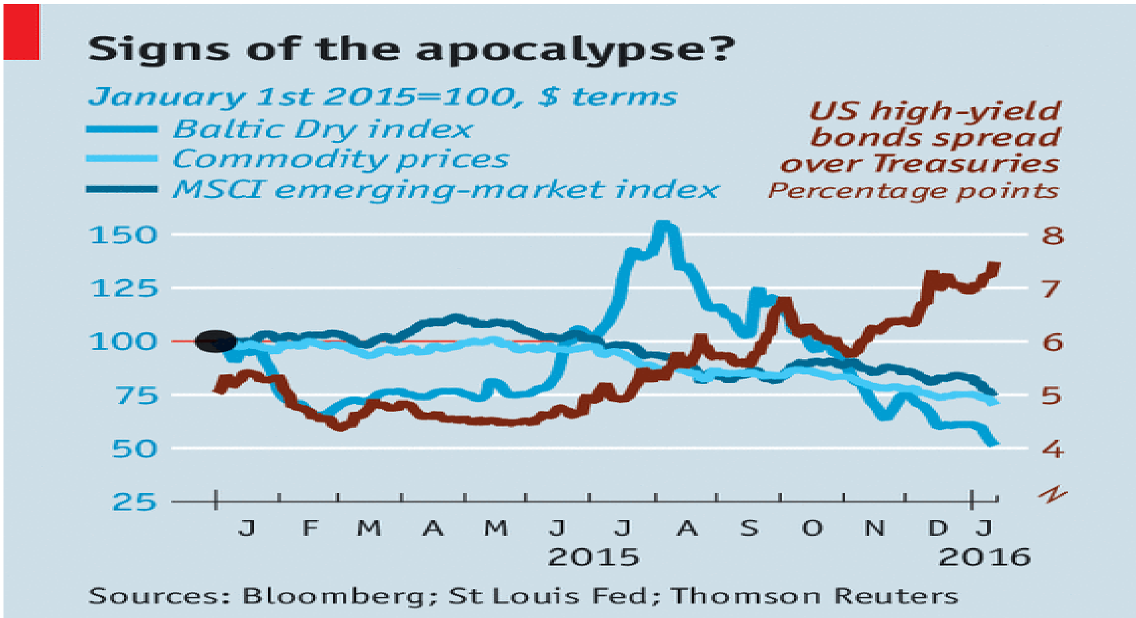
- China is moving through a painful transition, but is still growing.
- High yield bonds repriced:- easy money coming to an end.
- Asian and Aussie markets (segments) looking much more attractive.
- Risks in markets need to be considered but consensus is for no major shocks.

I hope the festive season has left you all rested and ready to face the torrid economic landscape that is 2016. I have been writing for some time about the problems that markets face and at Hudson Gore we have been expecting a correction instigated by the Fed rate hike. Markets are now adjusting to a new environment which may take some time as we have a number of issues to deal with. This makes any predictions on depth and length of the current correction near impossible, but hopefully I will enlighten you a little on what I think is happening.

Issues facing the world

- Credit excesses
- Weakening China
- European Nationalism
- Oil prices

The graph below paints the picture. Commodity prices continue to fall as demand from China slows and the world is awash with supply. The Baltic Dry index tracks bulk shipping and the declining figures are indicative of weak global demand. As one would expect the emerging market index has been heavily sold eroding all last year's heavy gains and then some. The strong USD has also weighed heavily on emerging markets which has feasted on cheap credit which is mainly denominated in USD.



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The only line going up is the US high yield bond spread over treasuries. Last year I wrote about the incorrect pricing of risk in credit markets and the possible re-pricing and liquidity issues that could arise with segments of this market. As a result we recommended the sale of specialist credit funds such as Bentham Global Income that some clients held. Our fears have been realised and we are now seeing the consequences. Of course, the root cause of "cheap money" is the unprecedented Qualitative Easing or Ultra Easy monetary policy. Much has been written about the dangers of prolonged QE. *Richard R White* (2012) wrote in his paper on QE: - "*Assets purchased with created credit, both real and financial assets, eventually yield returns that are inadequate to service the debts associated"* However, in the face of the alternative there is a fair argument that QE was better than austerity, certainly in the short-term.

Risk is now started to be priced in by investors. The problems is that easy money has been available for years and inevitably as White infers there will be a price to pay. Fortunately, since the GFC, there are safe guards and I do not foresee a credit crisis as we had in 2009 but we are now seeing a sizable re-adjustment.

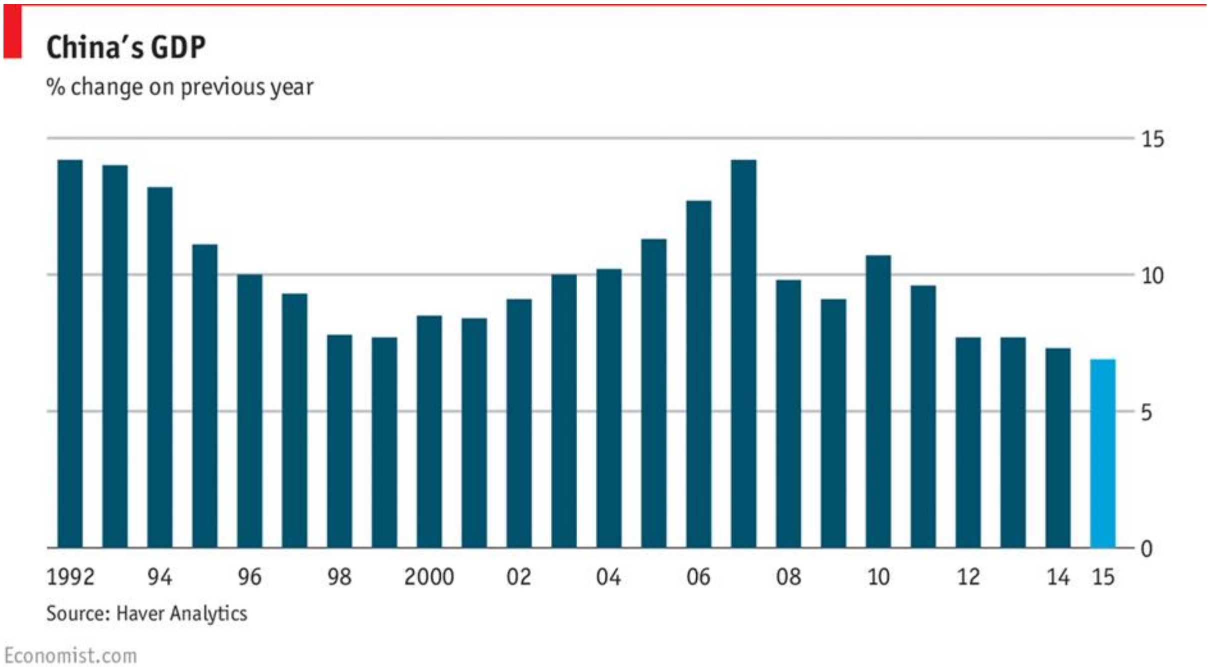
Interestingly, and history will be the decider, the Fed may have timed the rise nicely. There are arguments arising that the Fed moved too soon and they risk derailing the US recovery. My alternative argument is that the Fed has sent a clear signal that we are returning to the norm and risk must be priced correctly. We have seen what easy money can do (GFC) and market participators will always find ways to leverage to ensure their bonuses keep ticking over. Cheap money multiplies the excesses and we have already had years of credit incorrectly pricing risk. The adjustment may hurt but it may well deliver a return to growth in the future.

China was the world's saviour during the GFC and is now facing several issues as it moves away from investment driving its growth, to growth being derived by greater private consumption. Kerr Neilsen (Platinum) had this to say on China and its current transformation:-

To assist in this transformation, the Chinese Government is reducing the cost of money and increasing its expenditure (currently running a deficit of 4.4%) and is also allowing the Rmb to find a market cleared price. This is common enough and has been the path of the Yen, Euro and indeed the Australian dollar. The problem with a system steeped in government intervention is that there is a lack of faith in allowing market mechanisms to deal with quantity and price - too often planners will o try to control both! Tampering creates other distortions.

The past high investment was internally funded through abnormally high savings. This pattern is likely to change slowly and hence the conversion of the economy cannot occur overnight. The consequence is that under-utilised factories will try to find markets abroad with deflationary effects on prices and this will wash across broad categories of products (companies) via weaker profits and in pure commodities, weak demand and prices.

Billionaire George Soros sees a parallel with 2008 in the rapid credit growth in China and other emerging markets. If growth slows, borrowers may be unable to repay their debts. Similarly, emerging-market companies that have borrowed in dollars may be in trouble if their currencies depreciate. Asian nations might be forced to devalue if China lets the yuan fall sharply. Neilsen too sees issues “we have long anticipated a considerable rise in non- performing loans in China, even though reporting them will be retarded”



This is not a new phenomenon, the market has been well aware of the credit bubble in China for some years. What the market is losing faith in is the Chinese government's ability to manage the economy and the transition. China's economy is not on the brink of collapse. The economy is predicted by their government to grow at 6.8% this year. While this is likely to be overstated, growth is still strong compared to western economies. China also has a range of policies it can implement to lift the economy. The challenge will be to convince doubters that a misfiring hybrid of market control and state control can really function efficiently. Certainly investors will be steering clear of manufacturing and looking at the opportunities that a consumer based economy will create. (think insurance, health, IT etc)

Rising Nationalism

Angela Merkel enters the New Year as the political colossus holding Europe together. Among Merkel's feats to appease the German electorate, she has preserved the euro, imposed austerity, sacrificed Cyprus as a lesson to others and won games of brinkmanship with Greece. But now close to a majority of Germans want Merkel gone. Rather than inspiring awe, Merkel is triggering growing protests in Germany, revolts within her cabinet and undermining by her finance minister.

Merkel's political fortune is just one of the political and economic developments that could upend the core presumptions that investors are making as 2016 begins. **The consensus is that Europe will keep muddling through its crisis intact and that, as tempting as it might be to leave, the UK will stay in the EU and the US will lift rates slowly and their economy will be able to adjust nicely**.

It is worth examining the risks to this mainstream view. The US is the world's only super-power. The US stock market is over half the world index, the US armed forces are by far the most potent in the world. It is quite sobering to think that in 2016 we may inaugurate President Donald Trump! Over Christmas, most afternoons after tramping the streets on our daily adventures of New York (with my two young sons) I would sit down and read the NY times over a Guinness. Only once in 10 days was there no mention of Donald Trump on the front page. No matter how outrageous his comments on Mexicans, Muslims, immigrants, women or the disabled or how stupid or absent are his policies, Trump appears immune from damage. Interestingly the press was all negative but I am guessing the readers of the NY Times are not his key constituency. In general Trump is given very little chance of reaching the Oval office but the rise of his populist, media savvy politics is a concerning to say the least.

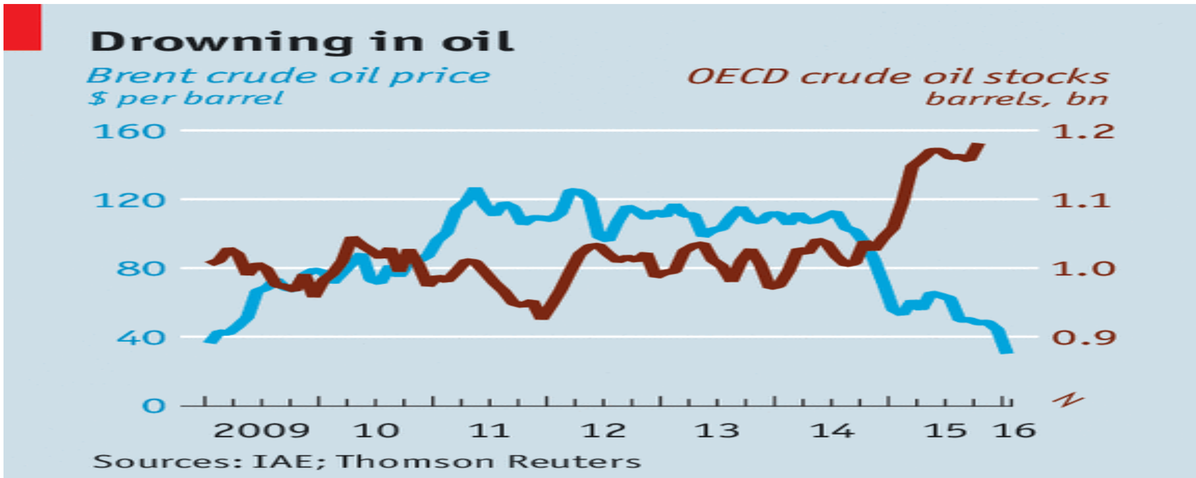
Michael Collins of Fidelity believes that politics are even more troubling for investors in the Eurozone, because populists are already grasping power and shaping policy. The seven-year-and-counting depression in the Eurozone is nourishing anti-elite populist nationalistic parties that generally reside on the right side of politics. In 2015 in national or state elections in Austria, Denmark, Finland, France, Italy, Poland, Switzerland and the UK, anti-immigration, nationalistic right-wing parties achieved the biggest gains and sometimes made or helped form national governments (Finland, Poland and Switzerland). In other elections, anti-austerity leftist governments came to power in Greece and Portugal and the emergence of a leftist, anti-austerity and another more-centrist party cost Spain's ruling pro-austerity right-wing party its parliamentary majority, left parliament paralysed and is likely to lead to a fresh election in coming months. Noteworthy too is that a Danish referendum unexpectedly rejected closer EU integration on justice legislation, an unelectable leftist populist (Jeremy Corbyn) became leader of the UK's Labour Party, secessionist movements persisted in Catalan and Scotland, the UK's push to leave the EU gained strength and Hungary's right-wing government became more autocratic. The immigration crisis and the terrorist attacks in Paris in November prompted countries including Denmark and Sweden to reintroduce border controls and in the case of Hungary and Slovakia to build border fences. Basically the political consequences of economic hardship, spiced with terrorism, are remaking Europe to the disadvantage of investors.

While the UK vote on EU membership is to be watched as it's now deadlocked, perhaps the biggest menace to monitor is Marine Le Pen's National Front. In the first round of voting in French regional elections in December, the anti-immigration, anti-EU but pro-welfare-state party came first in six of the 13 regions and won the largest share of the national vote (28%). The party failed to win any provinces in the second round but this might be to its advantage – governing is the antidote for populist parties for it usually exposes them as charlatans and fools. Le Pen's goal is to win France's presidential elections in 2017 and the polls say she will make it to the second round of two contenders and lose. It would prove devastating for the Eurozone if such a nationalist and protectionist were to win. Le Pen presents almost all the ills of France as being tied to the euro. She has pledged to make reintroducing the franc her top priority, a decision that could shatter the EU as well as the Eurozone.

Had enough yet! Well let's get started on commodities.

Oil

I have to admit, I am shocked by the depth of the selloff in oil, which may still get worse. The graph below shows the reason why:-supply. We are simply awash. Motorists are relishing the cheaper petrol and oil importers such as Eurozone, China, Japan and India are enjoying healthier trade balances from the drop in prices.



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As I wrote last year the prices are unsustainable for many oil producers. Why then are they not limiting supply? I have speculated that previously that the end game may be to derail the credit market awash with shale oil junk bonds. This has effectively been achieved with many bonds now not paying their coupons. When will we see a return to normal range prices? According to the Economist, Saudi officials privately say that they expect the price of oil to rebound late this year or early in 2017 as global output begins to lag behind demand. The natural decline as fields are depleted saps production by at least 5% a year, they argue, even before accounting for the effects of reductions in new drilling by embattled oil firms.

Making Sense of all the bad news

There are a number of concerns in the world that we will be keeping a close eye on. In reality though, we have been facing similar concerns for some time. Perhaps we should be looking at the good news:- the US has finally lifted rates signalling an end to easy money. A significant step to addressing imbalances in how risk is being priced. Domestically we continuing to grow (albeit slowly) and employment is steadily rising. The lower AUD should be a boon to our exporters and large employment groups and the new Prime Minister has lifted business confidence.

Share valuations are now attractive in a number of areas. It does not mean that they won't become more "attractive" (markets do not behave rationally in the short term!) As Kerr Neilsen said we are likely *"to cast China as the centre of the current instability in markets, the point will be lost that the dice was long cast when it doubled outstanding credit in the three years after the GFC, and by so doing, provided respite for all. With prices having already declined 40% across emerging markets since 2011, current poor sentiment has already been well, if not fully, expressed in their share prices."*

Its 2016 and the year is ahead and we are looking forward to it. Please feel free to give Michael, Ian or myself a call to discuss your affairs and the opportunities that 2016 brings.