NBAD

From West to East

Weekly Investment View

11th January, 2016

The new 'January Effect'

Our readers will be aware that it has been the worst start for asset markets since many records began, with the exception of quality government bonds, and gold. US Treasuries have been supported in true 'safe-haven' fashion. Having hit the interim 5% and 7% circuit-breakers twice last week, Chinese equities spooked global markets as memories of last summer's Chinese equity markets' disaster rushed back, but in reality the real pressure in sentiment terms came from the fear that renminbi weakness very much exceeding expectations will usher in a new bout of competitive currency depreciation. It is just as well that to date it has been difficult for global investors to make direct Chinese investments.

Investors were shocked by last week's offshore renminbi fall, even though it stabilized at the end of the week. The way we see the renminbi situation is as follows: now the IMF has recently indicated the renminbi will join the SDR basket this year after all, the Chinese authorities want their currency lower, and will try to smooth the fall beforehand. For them, it's better to have depreciation now (which helps the beleaguered manufacturing sector), prior to SDR basket entry, after which they know prospective renminbi buyers will need stability in that currency if it is to become the true reserve currency they desire. Chinese foreign exchange reserves may have fallen by a record $108 billion last week, but they still remain very large indeed, at $3.33 trillion.

`Market increasingly worried about Chinese hard landing'

While the Chinese equity markets are as yet not important in a 'weight of money' sense (i.e. that in relation to its underlying GDP the market is 'under-capitalized', and that *de facto* Chinese equities are under-owned) international investors are worried that the authorities there simply don't know what they are doing - and why should they, actually? They are still learning how to be capitalists. The recent Chinese manufacturing PMI numbers (not so the services sector) have been registering continued weakness, and the evidence of this in global commodity prices has gone from bad to worse. Although the official real GDP target remains close to 7%, most sensible economists and market participants have tended to mentally knock about 2% off this figure when discussing what is actually being achieved, but without publishing their true thoughts. In a few conference calls last year we suggested it could easily be another couple of percent lower than that, and we suspect that such a new lower growth range is now becoming plumbed into expectations. Further than this, a so-called 'hard landing' in the world's second largest economy is becoming a distinct possibility, so *this* is also what the market is really worried about, with the prospect of more exported deflation.

So what is now likely to happen in Chinese markets? We need to have a view on this because if they got the blame for widespread downside across world markets last week, the same could easily happen again. As we go to print, Shanghai and Shenzhen are both down a further 1% or so. The consensus for corporate earnings growth on the Shanghai Composite index suggests a fall of 1.4%, and a rise of 8.7% on the (more tech-weighted) Shenzhen index for 2015, vs. 2014. These Bloomberg-sourced estimates indicate forward P/E ratios of 13.7 x and 32.9 x on the two markets respectively. Can we believe these numbers? Meanwhile, in the real world of demand and supply for stocks, the six month share sale ban by large shareholders was supposed to expire in the middle of last week, but was extended. So of course the potential selling pressure remains, and will still have to be dealt with one way or another.

`Our tip-toe into China via Hong Kong hasn't worked'

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

Late last year we had thought a relatively safety-first entry into Chinese equities could be via the 'H-shares' quoted in Hong Kong, especially as the forward P/E was thought to be in the region of only 7.7 x earnings. That number has fallen to 6.0 x. There are times when 'safety first' investments turn out not to be so safe. While we expected some further downwards creep in the renminbi over time, this has not been smooth as we (and many others) would have hoped, and the corporate earnings numbers will now have more downside risk under a lower growth scenario.

In the US, the Non-Farm Payrolls showed that 292,000 jobs were added in December, far exceeding the consensus estimate of 200,000. The unemployment rate remained at 5.0%, and average earnings grew by 2.5%, up from 2.3%, with a slightly higher labour participation rate. Also, the revisions for the previous two months were positive, to the tune of a total of an extra 50,000 jobs. While the implication of all this is - on the face of it - quite good news for the US economy, it is in line with the picture painted by the Fed in terms of why they expect to be able to increase rates, and to get further away from near-zero rates. So just as equity traders were expecting a market bounce after a number of down days, the market once again closed down. Investors had not believed that the Fed will raise four times

(of 25 bps each) this year, and the Chinese-led mayhem of last week reminded them of how similar factors caused the Fed to stall after last summer's similar episode.

`Oil prices shrugged aside regional tensions'

The fall in oil prices was also quite extreme last week (by a further 10%, to sub-$33 on WTI), although without any obvious new factors entering the equation, apart from the worry that if Chinese growth is continuing to slacken then of course their oil demand will be lower. Sure, we all know about the huge physical stock overhang, yet one would have expected the growing foreign policy ructions between Saudi Arabia (and the GCC) and Iran might have increased the political premium. Maybe it did! Either way, the latter is an example of a 'bearish divergence', in which seemingly bullish news doesn't register or is cancelled out by bearish factors. Lastly, the mooted IPO of Saudi Aramco might enable Saudi Arabia to sustain fiscal deficits for a few more years, and thus could be bearish for oil prices as they could pump heavily for even longer.

Gold had a very good week, rising by just under 5%, and is currently trading at $1,105/oz, and this occurred during dollar firmness. Gold has had a bad press in recent months, although we believe the lows (in the region of $1,040) have now been seen. So what has happened, you might ask? The short answer is that until recently the number of trouble-spots and adverse economic and political occurrences happening at the same time were insufficient to worry investors. Well, now it seems they are, and in all likelihood gold is once again being bought as the 'hedge' against negative events just as it used to be.

`We remain bearish on US equities - be careful'

So what are our interim conclusions in terms of likely market action? In equities, a logical place to start is always the S&P500. Readers will be aware that we have been bearish of US equities (last explored in the 21st December, 2015, edition of this report), and this is unfortunately being borne out. Brokers' bottom-up forecasts for S&P500 earnings this year currently suggest earnings growth of 11%, after a small estimated fall for 2015. Analysts as a group tend to be too bullish, and listen too slavishly to the companies they follow for fear of upsetting them and wrecking corporate relationships. The prospective P/E for 2016 is 15.4 x, a number that is likely to be compressed as the US Presidential election gets nearer. We remain very underweight in US equities in our model portfolios (counterbalanced by full positions in quality sovereign bonds), and although this has been correct it looks as though this trend has further to fall. As we go to print, the technical condition of the S&P500 is now such that it is very close to a major breakdown point, with a very bearish configuration taking shape in our favoured long-term moving averages.

We currently have eurozone and Japanese equities under review. Just as 'when New York sneezes, London catches a cold', other developed equity markets cannot be immune to any downside risk emanating from the US. We haven't seen any wholesale dumping of quality assets as yet, but we expect this to occur in time as the US gradually raises rates. Although purchasing managers' data has been weak in China and the US we appreciate that it has been good or improving in France, Spain, Italy, and Germany - off low levels in many instances. Eurozone growth has recovered from a very low point, although is still only at a moderate level, and one must differentiate carefully between countries. The eurozone has benefitted from euro weakness, now helped by some quantitative easing by the ECB. Over the long-term, of course, equities outperform bonds, because they have dividends that grow when economic growth facilitates this, although they do have higher volatility.

`Down-markets likely for a while, with a better Q4'

After a year when overall most asset classes were essentially flat, we don't expect a similar out-turn for 2016, although with the proviso that residual bearishness should have been flushed out by the end of the third quarter, and the year should end on a firmer note. It is likely to be rather a wild ride at times, and the kind of environment not seen by many younger investors. Value investors will be presented with a selection of opportunities to behave in a truly 'contrary' fashion – although even the most experienced amongst them will feel rather 'brave' when they do so. We are expecting opportunities to buy commodities and related markets (and oil in particular), selected emerging market currencies and carefully-chosen frontier equity markets like Vietnam and the Philippines to add spice to properly diversified global investment portfolios.

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