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Global Market Strategy – June 2015

Slower growth, lower returns, so seek smaller companies

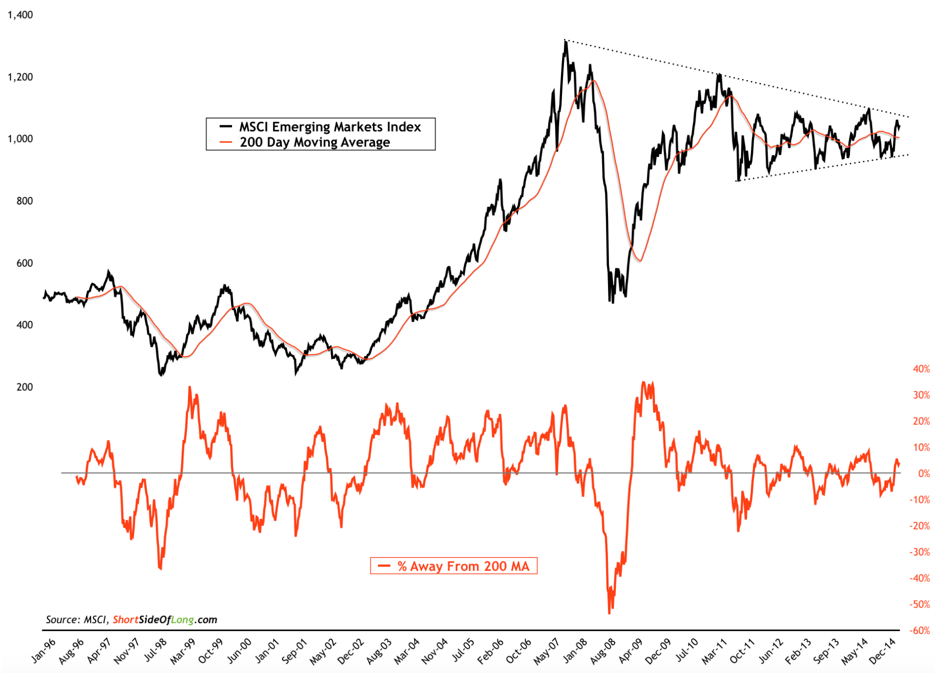
It is indisputable that growth is slow across the world. It's one of the reasons central banks are injecting liquidity into their economy, driving down interest rates, weakening their currency and trying to make their exports more competitive.

The UK is fortunate in having the largest and most liquid small companies market in the world, namely the Alternative Investment Market (AIM). With sluggish global growth, investors should turn their attention to smaller companies because they truly represent growth potential and have consistently given investors better returns than larger companies which are less nimble, slower to adapt and, for the most part, followed by analysts so closely that they offer few surprises.

As a snapshot example of how small caps outperform large caps, the FTSE100 has showed gains of 0.54% over 3 months and 1.65% over the last 12 months. This compares to FTSE250 (the next 250 largest companies listed on the FTSE) returns of respectively 5.10% and 13.79%. European stocks show the same outperformance from small caps. The EuroStoxx50 index is up 3.18% over 3 months, and 14.50% over one year, as against 12% and 21% for the FTSE Developed Europe small cap index. It is the same story in emerging markets: 3 month performance of Global Emerging markets shows arise of 2.4%, and over 1 year an increase of 7.5%. This contrasts markedly with Emerging Market smaller companies performance of 7.5% and 25.1% respectively.

Yes, it necessitates a higher risk tolerance because many smaller companies fail, however, at a time of globally low interest rates and a tight labour market, smaller companies have never had better conditions in which to continue their outperformance.

Continuing with emerging markets, we could at last be about to see a break-out of EM equities after 6 years fighting unsuccessfully against a strengthening US dollar. As can be seen from the chart below, EM equities are in a classic technical wedge formation which usually foretells either a strong move higher or lower, and their move back above the 200 day moving average is bullish. EM is an underowned sector, as money has favoured US equities and the US dollar. This has meant EM currencies have fallen in value and have made EM exports an attractive proposition.



EM equities - trendless since 2008 (Source, The Short Side of Long)

With the US earnings season behind us, it is interesting to note that early in the reporting season 65% of companies were beating analysts' forecasts but as the reporting progressed, fewer companies beat forecasts, such that final beats were around the 61% mark. This compares to beats of around 75% in the previous quarter, and the downward trend is one reason for equities marking time since mid-April.

However, there has been no real market correction, at least in developed market equities. A pullback of 5-8% has to come at some point but probably not as sharply as that experienced at the end of May in China. Chinese stocks fell 6.5% on the penultimate day of trading, having at one point been close to a 10% fall. The fall was not totally unexpected following a 40% rise in the Shanghai Composite this year alone, but the trigger was two major trading houses tightening their margin requirements. Margin trading is the facility to borrow from a broker using the share(s) as security. It is a cheap form of finance which has lured the retail investor into the Chinese market possibly without full understanding of the dangers of trading on margin. (If the trade goes against the investor, the broker then 'calls' the investor to place further capital to cover the margin.) The action of brokerage houses to themselves tighten margin requirements could actually preempt the Chinese authorities from taking more draconian action which would inevitably lead to an even greater sell-off in Chinese equities. China is a volatile market but the big picture in China is of a population which has huge savings and minuscule exposure to asset-backed investment, including property, despite hullaballoo to the contrary. On a further positive note, China is already permitting purchase of Hong Kong listed shares; if it allows in due course the purchase of overseas assets, that should be good for all markets.

Asian equities generally have been ticking along well over the last 12 months. Ex Japan, Asia is up 19% year on year but country allocation is crucial. Those funds doing best have had a predominance of Hong Kong, China and India exposure, and the fund managers with the skill or luck to get asset allocation correct, are those to follow, but they tend to move around frequently in the Far East and need to be kept an eye on.

Similar to under-ownership of Chinese equities, European stocks have scope for investor participation. Any time there is a spike in European bond yields the ECB doesn't like it, so there is no doubt the central bank will continue bond-buying to restrain yields. It's a good environment for European equities, so unsurprisingly US investors have been switching their positions to Europe.

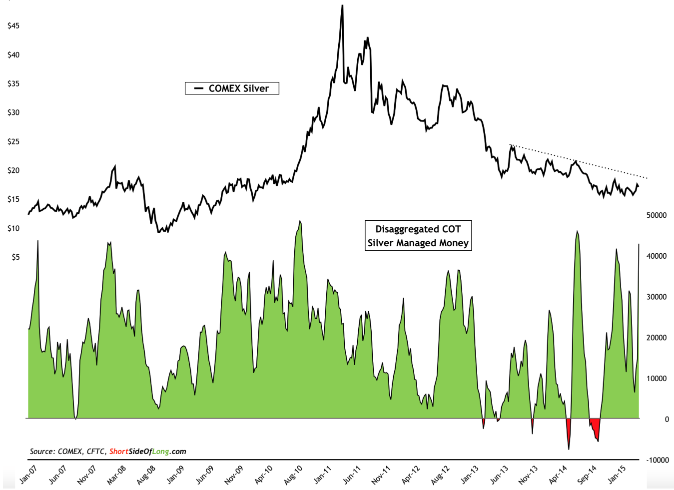
Greece is acting as a ball and chain but many countries and companies are exiting recession and seeing increasing profitability. Spain is now the fastest growing European country in the Eurozone, up 0.9% quarter on quarter to the end of March, the quickest quarterly appreciation for seven years.

Yet Europe cannot muddle through forever with Greece's debt repayment postponements, and it now seems more likely than ever that Greece could leave the Eurozone without causing a ripple effect. Greece is now back in recession and in all probability capital controls will be introduced. At that point, either they will run a twin currency operation to allow euros and drachma to be spent inside the country, or they will leave the EU completely.

If things are looking up in Europe, what is underpinning an inflated US stockmarket where earnings numbers are disappointing? Corporates are awash with cash, and equities are held or rising due to an appetite for Mergers and Acquisitions, corporate buybacks (the purchase by a company of its own shares) and the distribution of higher dividends. If the US sneezes and equities fall, in all likelihood so will all world equity markets, but the current scenario where the US market inches higher from investors' search for yield and belief in a continuing 'easy' Fed, probably for months to come, is good for equities elsewhere, particularly in countries where stocks are underowned and undervalued (including Japan).

What is worrying for the US is the fact that 20% of Americans own 90% of the stockmarket. That statistic, which portrays the rich getter richer at the expense of those who cannot afford to participate in the market, or rather perhaps who participate only at the top of the market and then get caught holding the baby, spells resentment and social instability.

Over the last week traders are wondering why has the price of Silver started to fall so quickly. The truth is so-called 'dumb money'from hedge funds has piled into the precious metals sector, especially into Silver. The chart below shows hedge fund contracts sitting close to 45,000 net longs which could presage a massive shake-out and further falls. Gold also is still displaying bearish signals, as the price keeps posting lower highs. The Gold price is currently trading at a similar level to where it was exactly two years ago.



Favoured investment plays:

Nil risk: USD & GBP cash (in preference to Euro cash)
Cautious risk: AAA Corporate / Government bonds (short duration)
Balanced risk: Managed funds
Market risk: UK**, European equity**
Adventurous risk: Global Real Estate, **Japan, Asia,** US equity
Speculative risk: **Timber, China,** India, Africa & Middle East, **European Telecoms,** Emerging Markets

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 17%, US equity 4%, US smaller cos 1%, UK equity 11%, UK smaller cos 6%, Iberia 2%, European equity 7%, European Telecoms 4%, Japan 8%, Asia 11%, China 5%, Emerging Markets 3%, Timber 2%, Precious Metals 1%, Energy 6%, Pharmaceuticals 12%

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