wealth & asset management

International Perspective & Independent Advice since 2004

Global Market Strategy – November 2015

Back to the Future - we know what will happen in 2016

The film in 1985 of *Back to the Future* starring Michael J Fox, took Marty, the central character, forward thirty years to 2015. When he returned to 1985, he was able to tell his friends and family how to profit from his knowledge of the future.

The main event of 2015 which affected detrimentally the stockmarket this year, was either unforeseen or ignored, depending on your point of view. The threat of a hard landing in China, causing sustained falls in commodity prices and global concern over knock-on consequences in Asia, emerging markets and in developed markets from too-strong a US dollar, caused equities across the board to slide downwards from late April, until further concern over a Fed rate hike resulted in a severe correction in August and September.

However, preceding the stockmarket fall were five key positive events which equally were either unforeseen or ignored, namely the dramatic fall in the oil price (oil has fallen 50% in the last 12 months); a fifth expansionary year for the US economy (meaning it is no longer dependent on monetary stimulus and jobs are at last growing, companies are investing, wages are increasing); Europe's improved economic climate (thanks to the overwhelming bond-buying program of the ECB which is committing four times as much capital to purchasing debt instruments as did the Federal Reserve); Japan's reversal in October 2014 of its policy mistake of raising taxes in April 2014, and its subsequent postponement of any tax rises until at least 2017 (which was then followed by Shinzo Abe's reelection and the Bank of Japan's 50% increase of its own bond-buying program); and finally, David Cameron's Conservative party won the UK general election much more comfortably than anyone predicted, removing uncertainty of what would happen to a Labour Britain.

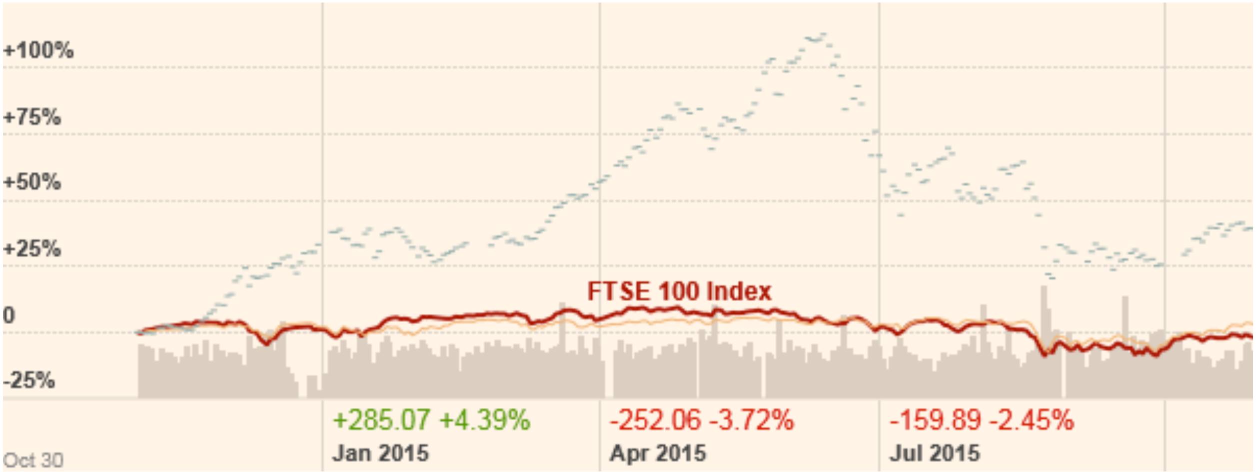
The combination of concerns over China, which appear to be abating, and worries over the knock-on consequence of a US rate hike, undid in six months all the good work of the five aforementioned upside events, such that asset prices now are at the approximate same levels in relative and absolute terms as they were in October 2014. The FTSE, the S&P500 index, bond yields, and non-US shares relative to US shares are all at levels now which they held one year ago but we now know what is taking place with oil, with Japan, with Europe, with the US, and now investors have an opportunity to benefit from a greater sense of certainty that if China is not going to fall off a cliff, they should perhaps be committing cash and bond capital to what is likely to be a sustained recovery in real asset prices.

Europe in particular presents opportunity. It is probable that the ECB will escalate, not just maintain, its bond-buying. Despite QE's effectiveness on southern European bonds (confidence in European debt has noticeably improved such that ten year paper in Spain and Italy pays less than the 10 year gilt), European equity prices have been subdued, irrationally so. With additional monetary stimulus needed in order to lift the Eurozone out of the threat of deflation (inflation is still below zero across Europe), company valuations could be buoyed significantly if concern over weak global growth turns to optimism that consumers' disposable income is increasing and job prospects are more certain. This is different to what happened in America and Britain. In the US and in the UK, investors were led to invest in the equity market by Federal Reserve bond buying which drove down bond yields and cash interest rates, and as a consequence of rising asset prices the wealth effect began to stimulate the economy. In Europe, what will happen is that asset prices will rise as or following a lift in economic conditions. Already signs are positive. Consumer confidence in Italy is back at 10 year highs and bank lending is rising at 5-6% whereas one year ago it was falling by 3-4% in Italy, Spain and France.

Now is the time to be investing in Europe because in the coming months the positive effect of oil's impact on the economy will fall out of account in calculating inflation. The ECB knows that due to oil and falling commodity prices, inflation remains stubbornly below the 2% target, and it wants to make sure that it uses the (superficial) pick-up in inflation figures once oil's contribution is taken out of account, as a genuine springboard for sustained real inflation; thus QE will be accelerated.

As far as China is concerned, worries over a slowdown in the economy should be allayed. We have been warned for some time that China has wanted to slow its economic growth speed from a pace of 8-10% to one which is more measured and less inflationary and more internally consumer-driven, therefore a level of 5-6% growth should not be surprising. The greater concern, that the Chinese authorities are not capable of properly managing their economy (reference the mess that was made by the Chinese central bank and finance ministry in creating the boom and bust in the Chinese stockmarket and subsequent move to devalue the currency in mid-August which caused panic to spread around the world that China was embarking on a sustained effort to devalue its currency) should also be allayed. Yes, China communicated its intentions poorly but there is evidence to believe that they will instead use their $3.5 trillion currency reserves to manage their exchange rate. The Chinese currency has stabilised in recent weeks and as a consequence risk assets have picked up markedly since the beginning of September.

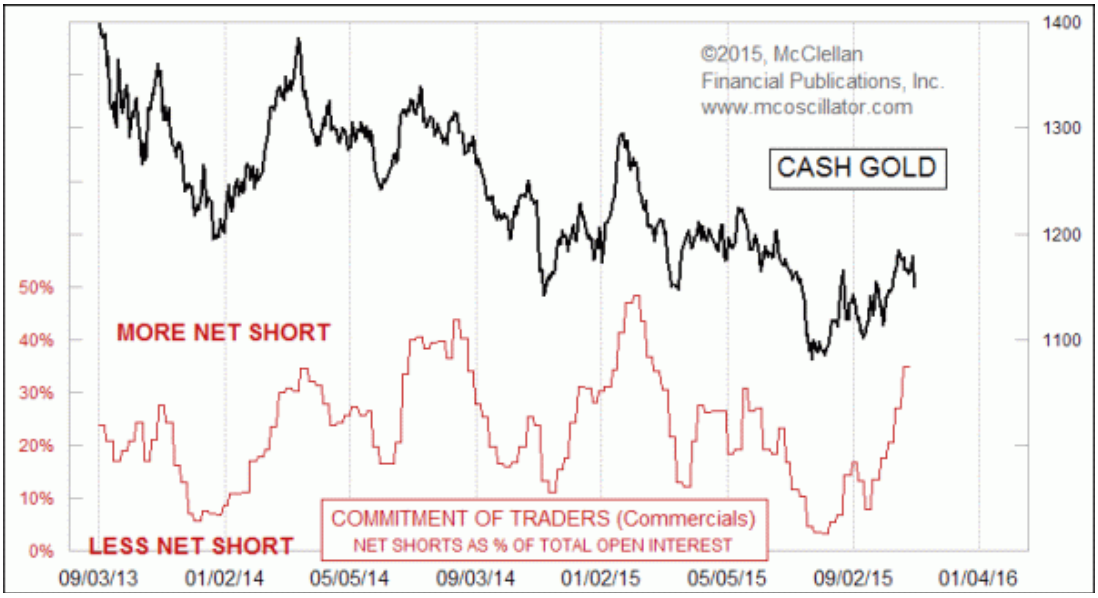
Japan is another area of great interest. The Japanese stockmarket is one of the most attractively valued of all markets. The yen has fallen so far that Japanese equities are at their lowest for 40 years, and because of the extent of the fall in the yen, and the likely slower rate of further depreciation, the need to hedge currency when buying the market is arguably reduced.



FTSE100, S&P500 and Shanghai Composite (dotted) comparison performance over one year (Source, Financial Times)

Gold has been in a bear market since its record high of $1920 in August 2011. Recently it has rallied somewhat, however from a technical perspective the rally is countertrend. July's low was at the 50% retracement level of the rally that started in 2001. Fifty percent retracements are important insofar that they typically presage a decent rebound, such as we have seen since then, but with no real reason for gold to sustain its momentum the likelihood is that gold will drift lower, down towards the $1000 bare minimum production cost for most miners.

That is certainly the verdict of the trading community. There has been a rapid movement over the past few weeks by commercial traders of gold futures to increase their net short position as a group (see Tom McClellan's chart below).



There is one possibility of a sustained rise however. China's ongoing acquisition of gold as a hedge against its US treasury exposure, could propel gold to all-time highs, but for the moment, and in the face of increasing US interest rates (eventually), capital is better invested elsewhere, notably in equities.

Favoured investment plays:

Nil risk: USD & GBP cash (in preference to Euro cash)
Cautious risk: AAA Corporate / Government bonds (short duration)
Balanced risk: Managed / Multi-asset funds
Market risk: UK**, European equity**
Adventurous risk: **Japan,** Asia**,** US equity
Speculative risk: **Timber, Water, China,** India,

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 17%, US smaller cos 1%, (Other) US equity 10%, UK smaller cos 7%, (Other) UK equity 15%, Iberia 2%, European Telecoms 1%, (Other) European equity 8%, Middle East & Africa 1%, India 2%, Japan 10%, China 4%, (Other) Asia 8%, Energy 3%, Pharmaceuticals 11%