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Investment Commentary

Quarter One 2016

INTRODUCTION

Three words have dominated the first quarter of 2016: they've dictated economic policy across the world, and every ill has been laid at their door. As you can probably guess, the three words are 'slowdown in China.'

The slowdown – and we've dealt with the figures in the Far East section below – has given rise to a series of warnings on the state on the global economy. The World Bank kicked us off in January, warning of 'slow global growth.' In February it was the turn of the Organisation for Economic Co-operation and Development (OECD), as they cut their forecast for global growth in 2016 from 3.3% to 3% and called for "urgent action" to tackle slowing growth.

Finally, March saw the International Monetary Fund step up to the microphone. Second in command David Lipton warned that the world faced "economic derailment" and called for – you guessed it – steps to be taken. "We are clearly at a delicate juncture," he said, in a delicate IMF understatement.

While this was going on, the World Economic Forum came and went in Davos. The great and good paid £290 for bottles of Cheval Blanc and then listened to Leonardo di Caprio savage corporate greed. Sadly, they failed to take 'urgent action' or any steps at all towards solving the global slowdown.

January also saw North Korea claiming a successful hydrogen bomb test. But it was the continuing slump in commodity prices – especially the price of oil – which really set nerves jangling around the world's stock markets. There was only one way that markets could move in January, and all the major world indices were down in the month. China led the way, with the always-volatile Shanghai Composite index down by 23% in a month.

It took until March for markets to move in the opposite direction, finally calmed by remarks from Janet Yellen, Chairman of the US Federal Reserve Bank, that the US would now "proceed cautiously" with regard to any future interest rate rises.

While all this was going on, David Cameron returned to the UK from negotiations in Brussels. He may not have been waving Neville Chamberlain's 'piece of paper' but he was certainly claiming victory in his negotiations with the EU, and recommending that Britain vote 'Remain' on June 23rd. Two prominent Conservatives – Boris Johnson and Michael Gove – promptly abandoned ship in favour of 'Leave' as the two sides lined up for four months of reasoned, logical debate. Or name-calling and scaremongering…

UK

By the time we write the next of these reports at the end of June, the result of the EU referendum will be known. If Remain wins then David Cameron will be able to choose when he finally exits Downing Street: if Leave is victorious then Cameron cannot hope to survive and – at the moment – it looks very much as if Boris Johnson would be the one Googling 'Westminster removal companies.'

We won't re-hash the in/out arguments here: we strongly suspect that you will hear more than enough of them between now and June 23rd.

One man whose fate is very much bound up with the EU referendum is Chancellor, George Osborne. Six months ago he was the clear favourite to replace David Cameron: since then, however, shares in Osborne plc have been a 'sell.'

It all started to unravel before the Budget speech on March 16th, with Osborne being forced to abandon his widely-trailed and much-discussed reform of pensions taxation in the face of widespread backbench opposition.

Nevertheless, the Chancellor still managed to deliver his customary confident Budget performance, buoyed by figures released that morning showing unemployment had fallen a further 28,000 between November and January and more people were in work than ever before.

"Britain," the Chancellor declared, was "set to grow faster than any other major economy in the world." However his forecast for growth this year was lower than other predictions, at 2%. Growth would then rise to 2.2% in 2017 and then level out at 2.1% for the following three years.

These forecasts, the Chancellor was not slow to point out, were based on the UK remaining within the EU. Leaving, according to the Office for Budget Responsibility, "could usher in a prolonged period of uncertainty."

So despite the world presenting what the Chancellor described as a "dangerous cocktail of risks," everything appeared to be on course, with Osborne still committed to removing the Budget deficit in the lifetime of this parliament.

Sadly, everything then started to unravel remarkably quickly…

Iain Duncan Smith resigned and the Chancellor's plans for cuts to disability benefits were abandoned even before they'd reached the Commons. Welfare u-turn leaves Chancellor with £4.4bn black hole screamed the headlines.

UK

Away from the hurly-burly of Westminster there had been plenty of economic good news in the first three months of the year. Car sales – a useful barometer of the economy – were at a 12 year high in February, whilst car manufacturing was at a ten year high. While forecasts for UK growth were steadily reduced, the 2.2% growth for 2016 predicted by the British Chambers of Commerce and the 2% growth predicted by the Chancellor still put the UK well ahead of the majority of major economies.

But the end of March saw the news the Government must have been dreading, when Tata announced that they were putting the Port Talbot steelworks up for sale in the face of mounting losses. Please see the section below for a more detailed discussion of this.

There was one last twist of the knife in March. Figures released at the end of the month showed the UK's current account deficit had 'soared' in the last quarter of 2015: the deficit in the three months to December was £32.7bn – equal to 7% of GDP in that quarter, according to the Office for National Statistics.

How did the FTSE-100 index of leading shares react to the news in the first three months of 2016? The index had closed 2015 at 6,242: like all major markets it fell sharply in January, ending the month at 6,084. By the end of the quarter it had recovered to 6,175 – a fall of just 1% in the quarter.

The UK Steel Industry

As we write this on April 1st, David Cameron is leading a desperate effort to find a buyer for the Port Talbot steelworks, which has been put up for sale by its Indian owners, Tata. Estimates for the number of jobs that might be lost vary wildly, from 10,000 if you only include workers at the plant to 40,000, if you include the supply chain and the impact on the local economy.

Why have Tata put the plant up for sale? And whilst steel-making may be important to Britain, is British steel important to the rest of the world? Let's try and put it into some sort of perspective.

The reason Tata has put its UK steel-making arm up for sale is simple. There's a global oversupply of steel and, with the slowdown in China not likely to improve any time soon, the situation is likely to continue. Tata are currently losing "substantially more" than £1m a day, and they will not let that continue. If a buyer can be found, they are apparently willing to give the UK business away.

But will anyone want to make steel in the UK? After all, the over-supply in steel is so serious that China is on the point of laying off 500,000 steel workers (and a further 1.3m in coal production).

In 1990, total world production of steel was 770m metric tons. By 2000, this had risen to 850m: in 2010, the figure was 1,413m and in 2014 it was 1,670m.

Chinese production of steel in 1990 was a mere 66m tons – less than 10% of world production: in the same year, the UK produced 17.8m tons, roughly a quarter of the amount China produced. By 2014, China was producing 822m tons of steel a year – virtually half the world's production. In that year, UK production was almost 12m tonnes – less than 1% of the world's production.

Whatever David Cameron's efforts, in global steel production the UK doesn't even rank as a minnow. It is 18th in the league table, well behind Turkey, Mexico and Iran.

Given those figures, it is hard to see the Government's handling of the situation as a 'betrayal' or as 'chaotic' as the newspapers headlines would have it. Sadly, the current situation at Port Talbot is simply an accurate reflection of a traditional British industry's place in the global economy of 2016.

EUROPE

Last time we wrote this report, we were reflecting on the terror attacks in Paris: this time it's Brussels. Unsurprisingly these attacks are impacting the economies of the countries affected, with tourism figures dropping significantly. French President Francois Hollande declared that France was in a state of "economic emergency" and launched a €2bn job creation plan to try and combat France's high unemployment rate.

Sadly, Europe has more than just terror to worry about, with the wider Eurozone economy steadfastly refusing to accelerate despite the best efforts of the European Central Bank. February brought the news that consumer prices across the Eurozone had fallen by 0.2%, dashing hopes that the European Central Bank's efforts to boost prices was working and increasing the likelihood of further stimulus measures being announced in March.

But there was further evidence that the ECB's stimulus package – now running at €80bn per month – was starting to falter as consumer prices continued to decline in March, albeit by only 0.1%.

The only glimmer of light was that unemployment across the Eurozone came down to 10.3%, but it is difficult to see what other action the Bank can now take.

In company news, the first quarter of the year saw yet more misery for Volkswagen. The US Justice Department decided to sue the company over the emissions scandal; the shareholders' meeting was delayed as the company "needed more time to work out its accounts;" prosecutors in Europe widened the range of their investigations and the company's US boss resigned. Not surprisingly, sales fell by 4.8% in 2015 compared to an overall rise in European car sales of 9.2%.

There was better news for Airbus, with the company signing a $25bn deal with Iran – one of the biggest since Western sanctions against the country were lifted.

Europe's two major stock markets followed the general pattern by declining sharply in January and recovering somewhat in March. By the end of the quarter, the German DAX index was at 9,966 – still down 7% for the year as a whole – whilst the French index had fallen by an overall 6% to 4,385.

UNITED STATES

Three months ago, Hillary Clinton was the overwhelming favourite for the Democratic nomination in the US Presidential race: the contest to be her opponent on November 6th was wide open. Now it looks very much like it will be Donald Trump, as Messrs Bush and Rubio have dropped away, leaving only Ted Cruz to challenge 'the Donald.' By the time of the next report, we'll be only three weeks away from the Republican National Convention – and the probable confirmation of Trump as candidate.

While a few people were vying for the very top job, far more Americans were securing normal jobs: the US consistently created more than 200,000 jobs per month from December to March, with only January seeing a dip below that level.

This may have been a reflection of economic growth in the final quarter of 2015, with an initial estimate of 0.7% being revised sharply upwards to 1.4%. The US economy grew by 2.4% over the whole of last year, with forecasts for this year suggesting a rate of around 2.2%.

In company news, Walmart announced that it was to close 269 stores, stating that it was struggling to compete with online retailers such as Amazon. Amazon's sales rose 21.8% in the final quarter of 2015, allowing the company to post record profits. Despite this, the figures were below analysts' expectations and shares fell sharply when the figures were announced.

There were no such worries for Facebook as Q4 profits more than doubled to $1.56bn – but Apple warned that sales of the iPhone were likely to fall this year for the first time since the product was launched in 2007. Apple also found itself pitted in a battle with the FBI over the unlocking of a terrorist's iPhone – but could at least console itself with the news that its legendary 'cash pile' has now reached $216bn.

On Wall Street, the Dow Jones index started the year at 17,425. It declined sharply in January to 16,466 but by the end of the quarter it was up 1%, finishing March at 17,685.

FAR EAST

And so to China, the source of nearly all the world's worries. In January, Chinese manufacturing fell for the sixth month in a row. The economy continues to expand – and at a rate the West can only dream of – but that rate is much slower than in previous years, which has meant a consequent drop in demand for steel and natural resources.

Manufacturing – and the economy – may be slowing down but China continues to produce a huge trade surplus every month. In December, this was just over $60bn – ahead of market expectations and well up on the $49bn of a year earlier. The surplus did fall to $32.5bn by February but it's important to note that the surplus is increasingly being invested overseas, with January seeing major purchases in Germany (a machinery supplier) and in the US (a Hollywood studio and a major stake in Grindr, the online dating app).

Beijing has also just overtaken New York as the billionaire capital of the world. According to a new report, it leads by 100 billionaires to 95, with Shanghai also on the list at number five.

Despite these positive signs, March saw credit ratings agency Moody's cut the outlook for China from 'stable' to 'negative.' Unsurprisingly, China's chief economic planner took an entirely different view. Predictions of an abrupt economic slowdown "were destined to come to nothing," said Xu Shaoshi, the head of China's state planning agency.

China's economic growth target for 2016 has nevertheless been cut to a range of 6.5% to 7% – compared to the 6.9% at which the Chinese economy actually grew in 2015.

Over in Japan the news was less good, with confirmation that the economy had contracted by 0.4% in the fourth quarter of 2015, and the stock market tumbling into bear territory.

Commentators were asking if this signalled the end of 'Abenomics' – the economic policy of Prime Minister Shinzo Abe which has been an attempt to reverse 20 years of stagnation in the world's third largest economy.

The Government has expanded Japan's monetary supply, increased spending and reformed the economy to make it more productive. In January, the Bank of Japan went one stage further, surprising the markets with the introduction of a negative interest rate – which we comment on in more detail below.

However, if these measures don't work it becomes very difficult to see where the growth in the Japanese economy will come from.

Meanwhile, the South Korean government was also announcing a fresh stimulus package following a raft of disappointing data for the export-dependent nation. The stimulus package will include an extra 6tn Korean won (£3.42bn) in public spending.

FAR EAST

The Chinese stock market declined sharply in the first quarter of 2016. Having started the year at 3,539, the Shanghai Composite was as low as 2,738 at the end of January, and despite a recovery in March was still down 15% at 3,004. Japan was down almost as much, falling 12% in the quarter to close March at 16,759. The Hong Kong market did better, recording only a 5% fall to 20,777. The one bright spot was South Korea, up 2% in the quarter to finish March at 1,996.

Negative Interest Rates

In January of this year, the Bank of Japan sprang a surprise move – they introduced a negative interest rate, setting a benchmark rate of -0.1%. In simple terms, this means the commercial banks will be charged to keep some deposits with the country's central bank.

Japan is far from the only country to take such action: it's currently estimated that perhaps 25% of the world's economies have some form of negative interest rates.

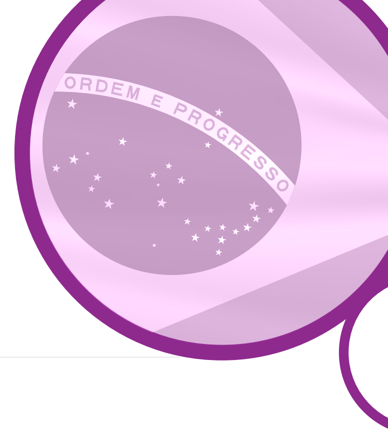
Why would a country do this? Surely if you deposit money with a bank – whether you're a private customer or another bank – you should receive a return on that money?

The reason is simple. Like virtually every other country in the world, Japan is desperate to stimulate its economy. It doesn't want the commercial banks putting money on deposit: it wants them to lend the money to businesses in an attempt to kick-start the economy. Hence the negative interest rate: the theory is that it will make the commercial banks more likely to lend.

Negative interest rates are not confined to the Far East, or to smaller economies. The European Central Bank experimented with them before turning to a massive programme of quantitative easing. ECB Chief, Mario Draghi, has said there are "no limits" to what the Bank will do as it seeks to stimulate the Eurozone economy – so don't be surprised if they make a comeback. After all, Sweden, Denmark and Switzerland all currently have negative interest rates in some form, and it's estimated that around the world more than $7tn of government bonds offer yields below zero.

So could they happen here? Could the High Street banks suddenly start charging depositors? It seems highly unlikely: most banks have been reluctant to pass on negative rates for the obvious fear of losing customers. However, some banks have charged very large depositors.

Never say 'never' as the saying goes: fifteen or twenty years ago we would all have laughed at the idea of interest rates at or near zero.



EMERGING MARKETS

If there was one bright spot in world markets during the first quarter of the year it was in the emerging markets sector, where two of the markets on which we report – Russia and Brazil – both rose significantly. Having started the year at 1,761 the Russian index closed March at 1,871 for a rise of 6%. Brazil – for so long the source of nothing but bad news – did even better, with a rise of 15% to 50,055. This came despite Petrobras, the state oil producer, recording a loss of $10bn in the final quarter of 2015 and planning to lay off 12,000 staff.

India did less well, falling by 3% in the quarter from 26,049 to 25,342.

Perhaps the major news in the emerging markets sector was February's signing of the Trans Pacific Partnership trade deal, which covers 12 nations and accounts for 40% of the world's economies.
The deal has been five years in the making, and the signatories now have two years in which to ratify the pact.

CONCLUSIONS

To say the first quarter of 2016 has been volatile is a serious understatement. All the world's major stock markets fell in January: they all rose in March. Led by China, the majority continue to show a loss on a year to date basis and clearly news from China will be critical as the year develops.

By the time we report again at the end of June, the odds are that the uncertainty of the UK's EU referendum will have been removed and the position regarding the US Presidential election will be clearer. But to risk another understatement, 2016 is shaping up into an interesting year: if you have any questions at any time on the various developments, please don't hesitate to contact us. We are never more than a phone call or an email away.

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Chair of the Investment Committee

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