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ASSET MANAGEMENT

MARKET COMMENT – MARCH 2016

Recent strategy perspectives

By Global Thematic Specialist Morten Springborg

By many measures, the start of 2016 has been the worst-ever start of the year for global equity markets. In the middle of February, the global equity market was down significantly compared to the market highs in April 2015. That said, since February 11, the equity market has reversed once again, regaining some lost territory. Have we just witnessed the start of a new bear market, or was the beginning of the year merely a correction in a mature bull market that will continue in the coming quarters? In our market comment from January 28, we looked at the reasons for the large price drops and with this comment, we will update our assessment of today's market. A number of explanations have been given for the weak equity market.

1. There is huge uncertainty regarding the economic outlook in China, and especially the currency outlook is murky.

2. The equity market has decided that an oil price of only 30$ is detrimental for the economy and therefore also for the equity markets. Historically, the equity markets have only had small correlation with the price of oil. However, the current correlation of 0.9 is extremely high. When oil prices fall, equity prices fall, and vice versa.

3. China's instability and collapse of the oil industry could push the US into recession.

4. The skeletons hidden in the finance markets' closets reappeared at the beginning of February; European bank equities fell dramatically, and many of these equities are now at a lower price level than in 2009. The equity markets seem to be adhering to the old saying, "no smoke without fire". Bank stocks are like canaries in a coalmine; falling bank stocks are rarely a good sign for the economy as a whole.

Sell first, ask questions later!

In our comment from January, we referenced the book "This Time is Different: Eight Centuries of Financial Folly" by Reinhart & Rogoff. Based on this, we concluded that China will most likely, at some point, experience financial unrest in the form of a combination of devaluation of the RMB, debt write-off and banking sector re-cap, as well as the possibility of high inflation.

However, we do not believe that a collapse of the Chinese economy is imminent. The primary risk is rooted in whether or not the central bank will be able to continue to control the currency. We believe that the bank will be able to do so, but it will be important to confirm whether the capital outflows from China worsen in the coming months or not. In 2015, outflows were $700b and currency reserves have been reduced to $3,200b.

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It is our belief that capital outflows will not continue at the same rate throughout 2016, and that 70% of the Chinese outflows in 2015 were "normal and healthy" repayments of foreign debt or foreign speculative capital leaving the country after it became clearer that the currency cannot solely strengthen, but also weaken. In February, the RMB strengthened marginally against the USD and if the USD ceases to rise in the coming months, it is very likely that this will lead to much less focus on China's international investment position.

China is in the middle of a transition from export oriented industrial production-based growth to domestic service and consumer spending driven growth. The outlook for the middle class is more important for long-term development in China. We have just finished reading China Reality Research's latest report "Keep Calm and Carry On". The report focuses on the state of the Chinese middle class, building on analysis of interviews with 1208 families in 58 different cities across China. These families serve as a representative example of a portion of the Chinese population that counts some 400 million people, i.e. the middle class. This middle class will likely serve as the most important group of people in regards to the prospects of the global economy in the coming years.

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To say the least, the analysis paints a very different picture of the Chinese citizen/consumer than that which is typically presented in Western media. 96% of the Chinese middle class own their own home. Housing makes up 56% of a family's savings. The value of property is increasing and is expected to continue to increase in the coming years. Incomes for middle class families rose 5% in 2015 and are expected to increase 7% p.a. in the coming years. The Chinese middle class is more optimistic about the future today than they were in 2013. 73% believe that they will be better off in 3 years. They dream about bigger homes, owning multiple homes (38% of families already own two or more homes), and a second child.

Hence, the middle class would like to use more money. Their biggest concerns are related to healthcare, education, and finally, retirement – something that the Chinese have always saved for themselves. Unemployment worries are minute.

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In our opinion, today's concerns about Chinese economic development are excessive. The Chinese central bank will not lose control of the RMB but rather, gradually liberalize its pricing, and thereby allow for greater fluctuations. This should not come as a surprise. In addition, the transition from export driven growth to consumption based growth is coming along as expected. The Chinese consumer is optimistic about the future, and consumption is now the largest part of the Chinese economy.

In the meantime, the oil price has currently taken the debt- and global equity markets hostage and dragged them along for the fall. Interestingly, equity markets began to decline at the start of December, concurrently with the drop in oil price that could be observed following the OPEC meeting on December 4. The meeting showed that the OPEC system does not work. As of this comment's writing, the oil price has since increased to 36$. Likewise, the equity and debt markets have increased again.

Hence, there still seems to be a correlation between oil and equities. One of the reasons for this might be the (unrealized) financial losses that the oil collapse resulted in. The world's oil reserves are about 1700 billion barrels of oil. The 70$ per barrel decrease in oil has thus resulted in losses of over $119 trillion (119,000 billion or 119,000,000,000,000!). By comparison, the nominal GDP of the world is said to be around $80 trillion. As a result of this, many of the oil producing countries' sovereign wealth funds have begun selling off their accumulated savings.

As these funds own about 3% of all global equities, there is now huge selling pressure from investors that for past 10 years – when the oil prices were higher – have been large net buyers of global equities.

Our view is that in the medium run the demand for oil will decrease due to increased use of renewable energy and the electrification of cars. Please read our White Paper "Solar Power and Disruption in Energy Markets". However, in the short run this will not affect the oil market. Short term, demand for oil will continue to increase while the low oil prices will reduce the supply of oil. It is therefore likely that in six months the oil price will be higher than today. This will support the equity and debt markets in the short term.

It is important to note – both for the global economy and thereby also for the global equity markets – that energy prices will be lower in the coming years than in the years between 2005-2015. This will be conducive for economic growth. The drastic fall in energy prices implies a massive transfer of purchasing power from the indebted global energy producers to the common consumer in the Western world and select emerging market countries.

We believe that a potential U.S recession is the most important factor to keep an eye on in regards to the prospects for the equity market. For the past few years, U.S growth has been less than expected. However, we believe that the market is underestimating the innate strength of the U.S economy. Over the course of the past two years, the dollar has strengthened by 30%. This has been a headwind for American competitiveness. Nevertheless, growth is currently above 2% and core inflation is at a surprisingly high 2.2% despite the strong USD that, ceteris paribus, should lower inflation. Nominal growth in the US is around 4%, so what is the problem? The U.S economy is 10% larger today than it was in 2007, the year before the great financial crisis. Both the Japanese and the European economy are still smaller than in 2007.

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We believe the possibility of a U.S recession in the coming years is low. We will change our stance if the housing market starts to decline for one reason or another, or if the banks start becoming hesitant to lend money.

In our opinion, the biggest risk for the equity markets is still concentrated in European banks, and the declines in the equity markets in the beginning of the year can, with some fairness, be attributed hereto. Large parts of the European economy are in a situation where most are focused on reducing excessive debt and few are focused on maximizing profit a so-called balancesheet recession . Normally, ultra-low interest rates would lead to lending growth. Under normal circumstances, if you were able to borrow at 0% you should be able to find sensible investments opportunities. However, this does not appear to be the case today as lending growth is disappointingly low. At the same time, banks are being forced to reduce their balance sheets by regulators. However, as liquidity in the credit markets has dwindled to almost nothing due to stricter regulation, the banks are having difficulties selling their assets and thus reducing total assets. Meanwhile, the ultra-low interest rates are putting pressure on the profitability of the banks, making it difficult to make money and build capital.

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The result is that the European banking sector continues to lack capital despite the last eight years' focus on reducing risk. When volatility in the credit markets increases significantly, as we have seen during the last few months, the banks are hit badly. In our opinion, many banks still need very large equity expansions, but this will not happen due to the very low prices these banks trade at. The banks leverage – the ratio between equity and assets – needs to be reduced soon. However, the banks are not able to do this themselves, as the market for equity capital is non-existent and the credit markets, where the banks would be able to sell their assets, are not liquid enough. The European Central Bank will be forced to buy the assets from the banks. This will be positive for the equity markets when it happens, but before we must expect to live through very volatile markets.

> **We remain constructive regarding global equities and expect positive absolute returns on a 1-year basis.**

Conclusions

In conclusion, one can say that we are in the late stage of a global equity bull-market. Historically there has been a tendency to increased volatility in equity markets as the bull market matures. This is what we are experiencing today. We remain constructive regarding global equities and expect positive absolute returns on a 1-year basis. However, the consequences of major uncertainty rearding

European banks as well as political uncertainty in Europe due to the refugee crisis, Brexit, French presidential election in 2017, etc. mean that we generally believe that the risk/return ratio particularly in Europe is not attractive in comparison to the investment opportunities we see in the rest of the world.

As previously discussed in our perspective "Outlook for 2016", we are living in a changing world and in the coming years there will continue to be great divergences in return between the best and the worst investments. The terms are therefore ideal for the active investor and we remain optimistic about the global opportunity set and the possibility of identifying unique stock-picking investments at reasonable valuations.