Quarterly Newsletter / Autumn 2014

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

The message of impending doom that may have pervaded the last issue of our Newsletter might have seemed somewhat misplaced against the backdrop of generally benign markets and broadly coordinated policy approaches across the globe. We warned at the time of undue complacency and the apparent acceptance of risk. Indeed, we argued that the 'new normal' was distinctly abnormal.

Since writing that Newsletter on 25th July, the markets seem to have suddenly woken up to the potential headwinds which could so easily presage the end of the era of relative calm that has marked the last few years.

Indeed, the markets initially continued on their gentle upward path, but things changed markedly around the middle of September. Since we wrote in July, the major equity market indices have fallen back – the S&P 500 is down 5.9%, the FTSE 8.6% and the Eurostoxx 8.9%. Japan has got off relatively lightly in the last three months, but only because there had been heavy falls earlier in the summer in response to a rise in the Japanese consumption tax.

This is not a major fall by any means – a 10% fall technically would still only be a 'correction' – and whilst things could get worse, there are a number of positives, among them the strengthening US economy and similarly positive – albeit slightly more tentative - improvements in the UK.

Both countries show falling unemployment figures, which clearly is to be welcomed. In fact, the US jobs market is already showing signs of tightening, not least because some 9,000 American 'baby boomers' – people born between 1946 and 1964 – retire every day. When well over three million retire in a year, that clearly has an impact on unemployment figures, but it also creates a headache of a different kind for the US government. Retirees don't contribute as much to the economy as workers do, and by no means are all of them self-sufficient. They can easily become a burden for their children or, alternatively, the government.

To the casual observer, this may not register as a serious problem, but the situation is likely to worsen in future. Often referred to as 'deteriorating demographics', the projected world population growth in the developed world paints a worrying picture. According to the United Nations, the developed world population currently is made up of about 64% in the 15 to 64 age bracket (i.e. the 'workers'), whereas approximately 16% are over 65. The UN reckons that by 2050, the demographics will have altered considerably: the 'workers' will have reduced to some 58%, and the over-65s will account for 26%. In other words, fewer people producing wealth, and more people expecting to receive their pensions. Given the general indebtedness compared to GDP globally and the parlous state of most nations' pension pot reserves – non-existent in some countries! – this trend is quite alarming. Some of us clearly will not be around by 2050, but think of the next generation or two. How on earth will they balance the books?

On the economic front, the global consensus on monetary policy brought about by the financial crisis seems to be finally unravelling as both the United States and Britain move to tighten – or at least talk as if they were soon to increase interest rates – whilst the Eurozone has just embarked on a series of moves in the opposite direction. Japan, despite a massive injection of liquidity, has still not attained its avowed aim of 2% inflation and could easily move to provide a further boost in the coming months.

Europe or, more to the point, the eurozone and its central bank, continues to confound common sense. ECB President Mario Draghi's famous pledge in 2012 that he would do "whatever it takes" is now being considered by the European Court of Justice. It has to decide whether, in making that promise, he overstepped the ECB's powers. A court in Germany thought so when it considered the case in February of this year, and it now has been referred to the bloc's highest court for a definite ruling. Bearing in mind that it typically takes the Court's 15-judge panel 16 months (!) to rule on cases, this looks like another elegant manoeuvre to at least temporarily kick the issue into the long grass.

The ECB has tried many things: lengthening its main refinancing operation to 6 months, 12 months and then 3 years (LTRO – long-term refinancing operation), offering low-interest loans to banks against collateral, such as government securities, mortgage backed securities and other forms of 'secure' commercial paper and providing eurozone member states with financial assistance by buying their government issued short-term bonds, with the proviso that the countries concerned agree to certain 'domestic economic measures' (OMT).

Nothing appeared to work properly, and finally last month, after repeatedly stating that quantitative easing was not on the cards, he introduced what is now generally referred to as 'QE-lite', which effectively is quantitative easing of sorts. The ECB will buy 'private debt' in the form of asset-backed securities but avoid buying government bonds, so the real QE tool remains unutilised. Moreover, Signor Draghi carefully avoided stating how much money would be involved.

In changing his oft-declared stance on QE, he clearly has decided to go against what the Bundesbank and the German politicians have always insisted upon, namely that QE would go against agreed fiscal rules, something the German electorate will feel very strongly about. Many in Germany see QE – light or otherwise – as a stealth bailout for the poorer eurozone countries.

Ever since the financial crisis started, the ECB's actions largely have been misguided and destructive, condemning the periphery states into long-term depression. Furthermore, the real problems now are Italy – stuck in a triple-dip recession with its GDP back where it was in the year 2000 – and France whose economy has been stagnant for months. Worse still, even Germany looks like sliding back into recession, due to its very weak industrial production and poor export figures. The eurozone increasingly looks like falling into a Japan-style deflation trap. If that were to happen to the world's second-largest trading bloc, the repercussions would be felt across the globe, including the UK.

In the last issue of our Newsletter, we talked about the VIX index – often referred to as the 'fear index' – which provides an indication of nervousness in equity markets. It was then at a historically low level (11), leading us to talk about 'investor complacency', but the index has recently shot up and now stands at over 26, having recorded an intraday high of 31 (!) yesterday when the markets threw a major wobbly.

There is another, equally useful forward indicator of global trade conditions in the 'Baltic Dry Index' which provides a measure of the cost of moving raw materials by sea. "So what?" you might think. The 'Baltic Dry Index' is useful because the supply of large ships is virtually static in the short term so any movement in the index is effectively an indication of the anticipated direction of global trade volumes. Since the start of the year the index has fallen by 59%.

On top of these indices turning more negative, we are also aware of other events that could exacerbate the situation, namely geopolitical worries and other issues.

Politics, as ever, continues to exert an influence. The conflict in Ukraine continues despite a 'ceasefire' in September and the ensuing sanctions against Russia have already started to impact on the Russian currency and could easily induce a domestic recession. But in a global marketplace, few things happen in isolation and Russian gas supplies to the West could easily be threatened if the impasse continues. One could envisage a situation whereby the sanctioner ends up facing a bigger problem than the sanctioned! An ongoing conflict is in nobody's interest and yet neither side appears ready to back down any time soon.

Meanwhile, whilst the latest chapter in the Gaza conflict seems to have calmed for the present, the ISIL situation in Syria and Northern Iraq could easily draw in increasing numbers of willing or unwilling participants. Added to this geopolitical uncertainty, there is the issue of the Ebola outbreak in West Africa. A knee-jerk reaction to either of these issues could trigger a rapid decline in air travel at a time when the global economy already looks like stumbling.

So do the recent falls in equity markets signal the beginning of a collapse into recession? Investor sentiment is notoriously fickle, and nobody can predict exactly how the markets will react.

Let us not forget that the S&P500 in America has hit a succession of all-time highs this year, passing the psychologically significant 2000 mark in August before retreating to its current level. In many ways, such a pause for reflection is no bad thing. The greatest danger for markets in our view would have been for indices to continue ever upwards in total disregard for the considerable headwinds that exist and without caution or recognition of the potential dangers. That was precisely the message of our somewhat downbeat view in July.

At Lacomp, we have not been idle. As you will see from your quarterly valuation, we have further de-risked portfolios, moving from growth orientated equities into more defensive fixed interest instruments. In addition, we have made some further and similar adjustments only at the beginning of this week, an action which turned out to be very timely in view of this week's downward trend in equity indices.

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