Lacomp plc

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

When the World Bank – an international financial institution whose official goal is the reduction of poverty, mainly through the provision of capital to developing countries – met in January and warned of an impending slowdown in global growth, it listed four headwinds that would contribute to a slowdown. The problems they identified were weakening global trade, market volatility induced by interest rate rises (!), deflationary pressures in Japan and the Eurozone and the impact of the falling oil price on producer nations.

At Lacomp we were then also concerned about geopolitical developments in the Ukraine (and Korea, and the Middle East generally) and the impact of an economic slowdown in China.

Furthermore, we could also have added a dose of political uncertainty in the form of the Greek election and the generally expected hung parliament following the UK's general election in May. Well, the Greek anti-austerity Syriza party won a mandate to renegotiate terms with the Troika (ECB, European Commission and IMF). We all remember the ongoing saga of these "negotiations" which, in the end, came to absolutely nothing of substance for the Syriza-led government, and a snap general election was called in September which, quite surprisingly, again saw Syriza under its leader Alexis Tsipras as the victor. Whether you call it a great achievement for the Troika or political hokum, the Greeks in the end had to cave in to the Troika's demands, and those turned out to be tougher than the ones on offer in January.

If that was surprising, it did not match the truly astonishing outcome of the UK general election: few people thought Labour would win outright, the vast majority (and all the pollsters!) expected a hung parliament and virtually no one thought it possible for the Tories to gain an overall majority.

However, we had more surprises to come: a devastated Ed Miliband resigned as party leader, and a new leader was needed. The candidates were all reasonably well known except for one, namely Jeremy Corbyn. A left-winger by nature, his hat was thrown into the ring, ostensibly only done to "broaden" the debate. The trade unions were delighted and quickly backed him, and that soon brought out people who had either felt disenfranchised (among them a lot of young voters) or excluded (the old militant left). They paid their £3 and made themselves eligible to vote in the leadership contest. The other candidates – somewhat "plain vanilla" compared to Corbyn – tried their best but never stood a chance. Their personas were perceived to be tainted by the legacies of Blair, Brown or Miliband, whereas Corbyn was completely different.

So Jeremy Corbyn is the new Labour leader, but he has never led anything of note. Sure, he has been outspoken on many occasions, be that in the House, on demonstrations or other politically motivated rallies. A Member of Parliament since 1983, he has defied the Labour whip on more than 500 occasions. It will therefore be something of a challenge for him to command loyalty from his backbenchers or, even more worryingly, his Shadow Cabinet colleagues. We saw a good example of that only yesterday when senior Labour MPs were given "permission to abstain" from voting against the Tories' proposals to run a budget surplus. His Shadow Chancellor did not cover himself in glory either, having done a U-turn on the subject within a fortnight.

Returning to the view expressed by the World Bank in January, there was plenty to fret about and it is an old truism that financial markets hate uncertainty. Many of these problems arguably have been around for some time but, as this Newsletter has previously pointed out, markets appear to have become inured to bad tidings and tolerant of all but the direst of news.

The steady drip of adverse news finally seems to have overwhelmed the markets in June when the previously reported Chinese stock market bubble burst in spectacular fashion. We covered that event in our last Newsletter and had previously voiced our concerns.

The fall in the oil price which had begun last summer and continued into 2015 started to be felt not just by the producer nations, but it also had, in combination with the strengthening dollar, an impact on US corporate earnings. It could be argued that the US markets had previously managed to flourish under a strong currency – in the period from 1995 to 2002 for example, the S&P 500 averaged 12% returns while GDP grew at 3.6% – but the combination of external factors has begun to tell. The US is not an oasis of prosperity and cannot succeed in isolation.

The general global slowdown, coupled with the aggressive QE policies pursued in Japan and the Eurozone pushed the dollar higher. With around 40% of earnings in the S&P 500 constituents derived from overseas, US earnings downgrades began to rise and the average earnings per share fell by 14% in a matter of months. In January, US business sentiment was at a twenty year low.

With America technically at full employment and non-farm payroll returns showing a steady improvement, commentators assumed that the second of the World Bank headwinds, a rise in US rates, would seem to be upon us. In fact, the negative news flow from around the globe seems to have caused the Federal Reserve to hold back on a rate rise, conscious that a further strengthening of the dollar potentially could undermine the US recovery which periodically appeared to be far from robust. In the event, a series of downward revisions to previously reported job figures and particularly weak data in September appear to have justified their inaction. It would seem that rate increases will not be seen until December at the earliest; some even predict that it will not be until the spring of 2016, and at Lacomp we share that view.

The aggressive monetary easing in Japan and the Eurozone has further weakened their respective currencies against the dollar. The oil price, having rallied somewhat in May, has fallen back to below $50 per barrel again. At the heart of this is a factor seemingly overlooked by the World Bank back in January, namely the economic slowdown in China.

Whilst economic data emanating from Beijing often is rather suspect and best taken with a pinch of salt, Western commentators reckon that China has provided over a third of the growth in global GDP since 2010. As the world's second largest economy, China clearly is an important factor. The avowed policy aim of the Chinese government to switch from capital-intensive, investment-led growth (such as long-term infrastructure projects like building high-speed train lines currently leading to nowhere – the cities will follow!) to a consumer-orientated economy must inevitably entail a slowing demand for steel, concrete and industrial commodities, which inevitably will have repercussions for the producers of those goods. This transition is likely to be neither smooth nor painless.

Given the oversupply problems in the oil sector and the general slowdown in global trade, China has clearly stepped back from its role as an insatiable consumer of commodities. It is easy to view Chinese policy as the main cause of the recent sell-off, exacerbated by Beijing's mismanagement of the fallout when the stock market bubble burst (culminating in increasingly desperate measures to prop up share prices alongside the unexpected devaluation of the renminbi), all of which combined to provide further instability. It probably serves as a salutary lesson to a controlling Chinese government that you cannot control everything!

Having said that, China is not alone in struggling with change. The attempts at reform in both India and Japan have also not yet produced the anticipated results with a faltering of the reform process in India and a stubbornly persistent lack of inflation in Japan, the latter despite the huge wave of monetary stimuli.

Meanwhile, at a corporate level, we have seen accounting scandals at Toyota and Tesco, investment cuts and job losses at BP and store closures at Morrisons, Homebase and B&Q, not to mention the disgraceful emission cheating by VW.

This all makes pretty grim reading, but there are positives out there as well. In a world where the prospects for a return on capital seem uncertain, there has been a steady rise in merger and acquisition activity. Heinz and Kraft joined to create the fifth-largest global food producer whilst the tie up between AB InBev (Budweiser, Beck's, Corona and Stella Artois) and SAB Miller (Peroni, Pilsner Urquell and Miller Lite) which was agreed only last night will create the world's largest brewer.

Even here, the global factors have played a role as persistently low oil prices have potentially undermined the viability of Shell's £47bn takeover of BG Group, the UK's third-largest energy company, apart from a new problem with Australian antitrust regulators. In an increasingly connected world, the impact of far-off events can often create unexpected consequences.

We have long argued that stock markets would benefit from a sell-off and the events of recent weeks have arguably produced an attractive entry point into many equity markets for those who take a sufficiently long view on their investments. The recent correction saw global indices give up virtually all of the gains that had been made in the first half of the year. By the end of September, the Dow Jones average was down 8.6% and the FTSE 7.7%

At the time of writing, there has been something of a comeback although year to date returns are still negative in the US and UK, with only the Nikkei Dow in Japan and, ironically, the Shanghai Composite showing positive returns for the year.

We are keeping a careful eye on developments and are pleased to have taken action prior to recent events by de-risking portfolios.

Bagshot 15th October 2015