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Lacomp plc

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

With the UK general election less than two weeks away and having to endure vast daily media output on the subject, we thought we would spare you the pain of yet more commentary, other than to say that the polls have the two main parties running neck and neck, suggesting a hung parliament which, from an investor's point of view, is the worst possible outcome. Financial markets simply hate uncertainty, and the result is highly likely to give us plenty of that!

Stepping away from our shores, Europe, or to be specific the eurozone, faces similar uncertainty as Greece and the troika (ECB, European Commission and the IMF) grapple with the problems of Greece's insolvency.

Athens is keen to receive the final tranche (€7.2bn) of the second bailout package, but the money has not been forthcoming as the lenders feel aggrieved by the new anti-austerity Greek government reneging on previously given commitments to privatise state-owned assets and cut welfare expenditure.

As this is being written, the so-called Eurogroup (consisting of the finance ministers of the eurozone) is meeting in the Latvian capital, Riga, in the hope that a breakthrough might be achieved.

When the radical left-wing coalition, led by Syriza, surprisingly won the January election, it threatened in its rhetoric to default on the debt and leave the single currency. This has not happened, and it is not what the majority of Greeks want, if polls are to be believed. So far, there has been a lot of sabre rattling by both sides, yet everybody is keen to find a solution. Only recently, Greece managed to pay a €348m instalment to the IMF. However, much bigger repayments are due in the next few weeks and months (just under €1bn to the IMF in the first two weeks of May). As an emergency measure, Greek Prime Minister Tsipras on Monday even ordered state-owned enterprises to move any surplus funds to the Greek central bank. This move is mostly designed to help the government pay its wage and pension bill, which runs at around €1.7bn per month. In other words, this is done to avoid a default on its own citizens!

Similarly, the Greek banks are in deep financial trouble, reflected in the price of bank shares which have lost more than 50% of their value in three months. Since January, the ECB has kept the banks afloat by providing emergency liquidity assistance (ELA) on the proviso that the banks remain solvent. The banks face real pressure as customers withdraw deposits and move them abroad – some €15bn since January's election! According to rating agency Standard & Poor's, if ELA is withdrawn, the Greek banks will go bust in a matter of months.

Much has been written and speculated about what would happen if Greece were to leave the eurozone – the dreaded "Grexit". Of course, it is not a merely economic problem; politics also play an important part in such a scenario. Greece is a member of NATO and therefore of strategic importance, yet it enjoys close cultural and religious links with Russia.

From an economics point of view, Greece has already suffered considerably in recent times. Its current GDP stands at €47bn (down from a peak of €63bn in 2007). What would happen if Greece were to go it alone?

Well, there is an interesting study which compares the two possibilities. According to Oxford Economics/Haver Analytics, going it alone would further reduce the GDP down to €36bn by 2017. However, it would then start closing the gap to the GDP projection if it stayed in the eurozone, and the two curves would converge within 8 to 10 years.

If that prognosis is anywhere near accurate, some Greek citizens may well feel a Grexit would not be all that bad. Simply put, if you have nothing at present and no real chance of improving things by continuing with the euro, reverting to the Drachma and sharing the pain with everyone else may well be a viable alternative. As a line in a Kris Kristofferson song says: "Freedom's just another word for nothing left to lose"...

Ignoring Greece and looking at the rest of the eurozone, ECB boss Signor Draghi has at long last taken the step that we long ago said was absolutely necessary. The introduction of a €60bn per month programme of quantitative easing (QE) seems, thus far, to be following the experience of the US and UK in that, whilst there is no anticipation of a rapid feed-through to the 'real' economy, stock market prices have generally rallied, buoyed by the impact of a weakening currency which had fallen to an eleven-year low against the dollar in anticipation of the policy.

At the time of writing, Germany's DAX index is standing at 11,815, a rise of 20% since the beginning of the year.

We mentioned the aftershocks that resulted from Switzerland surprisingly abandoning its currency peg to the euro in our last Newsletter. Such events can come from anywhere and are, by definition, unexpected. They have been termed 'black swan events' – just because they have never been seen before does not mean that they can never occur!

For the moment, global markets seem to continue to regard the current overall situation in a positive light – the American S&P 500 has breached an all-time high, Europe and Japan are at seven year highs and the FTSE is above 7000.

However, it is worth noting that, more often than not, it is the seemingly innocuous events that ultimately have the greatest market impact whereas the high profile events frequently cause little more than short term volatility.

Talking of volatility, the sharp drop in crude oil prices since the middle of last year has caught many by surprise. The decline continued apace with the turning of the year, falling to a six-year low, and global equity markets reportedly lost US$1trillion(!) in the first three trading days of 2015.

This nervous reaction centred on the debate over falling oil and other commodity prices. Optimists argued it was merely a case of oversupply whilst pessimists saw it as symptomatic of a more general global slowdown. European stocks reversed a five week rising trend on these worries which were exacerbated as copper prices fell to a five-year low – with China as the world's largest consumer of copper, it appeared that the pessimists might have a point.

On the face of it, the oil oversupply theory does look somewhat exaggerated – global demand is for 90 million barrels per day (90MBPD) whereas daily production is at 91.5MBPD. Not a massive difference you would think. There would surely be a self-correction as producers cut back and prices would stabilise. And yet, in the face of a 60% fall in price over the last twelve months, both the US and Saudi Arabia have not significantly cut production. There is an undeniable political factor in this – cheap oil hits the producers hardest (Iran and Russia, for example) whilst benefiting consuming nations in Europe, China and Japan. With US inventories at levels last seen in the 1930s it looks as if low oil prices will remain until some of this capacity is used up. In this context, it is interesting to note that America has significantly increased its oil storage capacity in recent times.

At a national level, the fall in oil prices has seen BP announce job cuts and reduced previously planned capital expenditure for 2015 (from $26bn to $20bn) following the announcement of a loss in the last quarter of 2014. Press speculation about further North Sea job losses inevitably followed, and at least one fund manager has reported higher than normal payout ratios (the ratio of dividends to earnings per share) on UK oil stocks which might indicate a fall in future dividends.

The US clearly has been the first economy to recover from the prolonged aftermath of the 2008 financial crisis and posted the best performing sterling adjusted equity market return last year (up 19.7%). With recovery in Europe delayed by the continuing euro crisis and Japan still struggling to break free of its deflationary spiral by means of aggressive QE (resulting in a weakening Yen), the US dollar has steadily gained in value. Measured against a basket of currencies representing its major trading partners, the dollar has appreciated by more than 10% since January. This is not simply an indication of economic strength – indeed, with nearly half of S&P 500 companies' earnings derived from overseas, it actually represents an economic headwind which some claimed has "wreaked havoc" with company earnings.

A significant factor bolstering the currency is the anticipated rise in US interest rates. Admittedly, it seems to be forever delayed but few believe it will not come before too long. The US dollar is expected to appreciate as rates rise, particularly as many other central banks have continued easing. Apart from the massive QE programmes in Japan and, since early March, in the eurozone, there have been over twenty instances of central banks cutting rates or otherwise easing monetary policy – even Bank of England governor Mark Carney warned in February that UK rates could fall still further. Meanwhile in Asia, India has seen two rate cuts and Asia's fourth largest economy, South Korea, cut rates to an historic low in response to falling inflation. In China, the People's Bank of China has cut rates and the easing has also taken the form of reduced reserve requirements for banks, but there is still concern that yet more will be needed – China's Consumer Price Index continues to fall and factory gate price deflation has accelerated on the back of falling commodity prices.

All of this feeds the argument of the pessimists who point to falling earnings growth and the dangers of premature rate rises in the US potentially leading to a stalled recovery. Even now, the spectre of 1937 (when rates were tightened too early) haunts US policy makers. They are conscious of the fact that the US cannot succeed alone and that it is not an oasis of prosperity that can survive without global growth. Even the suggestion of a reduction in QE sparked the so-called 'taper tantrum' in 2013, and there has been a significant fall in asset values since the new Fed Chairman Janet Yellen indicated that a 'normalisation' of rates would happen during her tenure. The Fed clearly is finding it difficult to balance the conflicting dual mandate of growth and low inflation. Indeed, the World Bank's downgrade of global growth forecasts in January pointing to four risks - weak trade, premature rate increases, weak oil prices and deflationary pressures in Japan and the eurozone - can hardly have bolstered the resolve for an early monetary tightening.

Returning home, the UK has presented something of a puzzle for economists with unemployment remaining lower than in previous recessions. Indeed the UK has the highest proportion of those aged 16-64 in work since records began in 1971. However, GDP growth has not matched this positive trend and remained largely flat from 2010 to 2013 before starting to recover in 2014. As a result, real wages have fallen yearly from 2009 to 2013 and have only begun to pick up latterly because of falling inflation rather than stronger nominal wage increases.

The net result of higher employment and low growth has been a fall in productivity. At first this was attributed to firms 'hoarding' skilled labour in anticipation of an economic upturn but as growth has picked up this has not led to a discernible rise in productivity. Structural change is possibly to blame – there has been an increase in part-time and temporary contracts at the expense of full-time jobs. The predominance of the UK service sector with its tendency to use lower skilled and part-time labour is an inevitable drag on productivity levels which arguably cannot recover whilst manufacturing, construction and agriculture remain subdued. It was a criticism often levelled at the so-called 'Clinton recovery' in the US that thousands of new work places were being created every month when, in reality, it required a person to hold two or three jobs in order to make a decent living.

One possibility suggests itself: are firms substituting labour for capital, employing low-paid labour rather than committing to expensive capital expenditure until there is greater certainty of a sustainable recovery? Companies' balance sheets are generally sound with most holding decent cash reserves. Therefore, affordability generally is not an issue. Perhaps negative or uncertain sentiment is at the root of this apparent reluctance to invest.

As far as the outlook is concerned, we stick to our view that interest rates are likely to remain low for some time and that the US, albeit cautiously, will raise rates first. Given the increasing amount of data which points to falling inflation and in some instances even deflation, it is hard to take a different view at present. However, events can change rapidly and we continue to monitor these in an attempt to offset the impact of any sudden change of tack. We remain relaxed about holding quality bonds (not sovereign issues) within our portfolios as they produce a respectable level of income with, at present, little default risk. Bonds will continue to provide a stabilising influence in our portfolios for the foreseeable future.

As for equities, opinion is, as ever, divided between those who fear that the US growth engine is faltering with no obvious replacement candidate in sight and the more optimistic who see weak oil prices as an opportunity, a tailwind for growth rather than a symptom of a slowdown. Only hindsight will show who was right but, for the present, markets generally seem to be taking a positive view of events. However, beware of general euphoria – a sure sign that things have gone too far!

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