Quarterly Newsletter / Summer 2014

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

Thus far, it has been a strange year in the markets. For a short while, it seemed as if the positive returns of 2013 were simply going to continue and, by mid-February, the S&P 500 in America was at an all-time high. However, there were already signs that markets were becoming nervous about the rapid rise of prices in the technology and biotech sectors whilst a few commentators were also becoming concerned at the rapid expansion of margin debt as continued low interest rates drove people towards equities in a search for yield.

Margin debt basically represents the amount of money investors have borrowed from their stockbrokers in order to gear up their buying capacity. It serves as a good indicator as a high margin debt often coincides with the peak of a stock market index. To put this recent development into context, margin debt reached an all-time high in 2000 (just before the dot.com bubble burst) and again in 2007 (before the subprime mortgage crisis started). To see the margin debt levels this high again is deeply worrying, and it can point to a situation where greed triumphs over rational thinking.

The market did wobble a bit in the spring but did not produce the anticipated sell-off. It since has resumed a steady, if unspectacular, upward progression, chiefly in the developed markets, with Japan being the exception. Even corporate bonds and UK gilt indices showed a positive return in the first half of the year!

One of the concerns in all this is the level of investor complacency. Even potentially disruptive financial events like the recent problems at Portuguese bank ‘Banco Espirito Santo’, which raised the spectre of a renewed euro crisis, seem to have had only a short-lived impact on the general blasé mood. It is almost as if the markets are prepared to overlook potentially destabilising dangers and have become content with a ‘new normal’.

We have made mention in previous Newsletters of the “volatility index” (VIX) which measures implied volatility in US option markets and effectively indicates the level of perceived market risk among investors. The VIX, as well as comparable measures in the bond and currency option markets, are now at low levels not seen since 2007. In effect, the market is pricing in a very low probability of significant short term price swings across most asset classes. However, the VIX is also referred to as the ‘fear index’, suggesting that it drops to relative lows when stock markets peak. Right now, it is historically low!

There are, in fact, a number of reasons to justify reduced volatility. Volatility at the macroeconomic level has declined whilst there is a widespread belief that central banks will maintain low interest rates for some time. Indeed, the ‘new architecture’ designed by central bankers to mitigate financial risks has arguably dampened volatility in the credit markets. Investor behaviour is also changing as greater volumes are devoted to longer term retirement plans which tend to be inherently more stable in their asset allocation. In contrast, short term day traders have moved ‘off exchange’ (trading on electronic platforms that do not affect the official exchange) in order to secure the benefits of cheaper trading, thereby reducing the daily swings in the mainstream markets. It could be that there is actually more volatility than the indices might suggest.

Low volatility is not, of itself, a problem, particularly in a mid-cycle but there is a worrying historical phenomenon which points to the possibility of a volatility spike in response to some external shock. The most high profile spike in recent times is probably that shown in the wake of the Lehman Brothers' collapse when the VIX index reached 80 – it is 11 at the time of writing – a move accompanied by significant market corrections across the globe. Perhaps as a result of the structural reforms which followed the ensuing crisis, the market has convinced itself that it won't happen again. Unfortunately, such 'black swan' events are damaging precisely because they are unexpected.

It all depends on the speed of change. A steady rise in volatility should be expected as the economic cycle matures, particularly if growth is driven by economic activity rather than central bank stimuli. Recent downgrades of the outlook for the US economy are troublesome, therefore, particularly as inflation can spike very quickly in periods of slow growth. J.P. Morgan's research recently estimated America's potential sustainable growth rate at just 1.7% going forward, which is around half that experienced during the six decades from 1947-2007.

It has become commonplace for commentators to refer to a 'jobless recovery' and the employment figures from the US are certainly sending confused messages. Jobless totals are falling and unfilled vacancies are rising whilst the participation rate would seem to indicate that a growing number of people are simply not seeking work. If this is a result of technological change and a reduced demand for labour, it could well be that the economy is closer to full employment than has been assumed and that interest rates might rise sooner than expected. Janet Yelland, Chairman of the Federal Reserve, hinted as much recently.

The expectation of low rates for the foreseeable future might suddenly appear less than realistic and it will be the ability of the financial markets to anticipate this and react in a measured way that will determine the impact of a change in monetary policy.

Talking of monetary policy, the IMF only last week launched a blistering attack on the European Union authorities, complaining that inflation had been too low for too long (currently at 0.5% against its central bank's benchmark of "just below 2%"), resulting in the eurozone being stuck in a low-growth environment. They said that any negative external shock could throw the eurozone into deflation. That really would be scary and could result in a long-term depression!

The IMF clearly was not impressed by European Central Bank (ECB) boss Mario Draghi's raft of measures which he announced last month. They included the novel step of cutting its own deposit rate to a negative 0.1% in order to make banks lend money into the real economy rather than parking it at the ECB. In addition, the ECB cut its benchmark interest rate from 0.25% to 0.15%, continuing the slide in the rate from 4.25% in 2008. Signor Draghi also hinted that he may take other steps to help the ailing economy, but he stopped short of considering quantitative easing as we have seen in Britain, America and Japan.

European banks face another problem: the ECB has decided that eurozone banks ought to undertake a probe into the strength of their balance sheets. It is called Asset Quality Review, and the results are likely to be published in October. We have long argued that eurozone banks have not yet fully lifted their skirts to reveal which of their loans are not performing. It effectively is another stress test, and we hope that this one will not be fudged like stress tests in the past. Let us assume for a moment that collateral backing loans has been wrongly valued. In that case, a bank's balance sheet would show holes that need to be filled, possibly by raising more capital. It could add to the problems the banks are already facing, and it certainly is not conducive to get banks lending money to small businesses and private individuals.

The eurozone economy is close to stalling and some member states register 70% youth unemployment (overall unemployment in the eurozone stands at 12% but is much higher in countries like Greece, Spain and Portugal), and the region's industrial production is still 12% lower than it was six years ago.

Apart from the periphery nations that already are in deep trouble, France now has joined them: unemployment is 4% higher than a year ago, output is stagnating, exports are falling and inward investment is in serious decline. The political far-right is gaining momentum; they are promoting the old idea of trade barriers and are hell-bent on blocking the proposed transatlantic trade agreement between the EU and the US. This is a worrying development, as it potentially could scupper any trade deals that would benefit the UK. In addition, France is Britain's third-biggest trading partner after the US and Germany, and that merely highlights the need for Britain to find new trading partners.

Britain being hindered by EU rules from entering separate trade agreements with other countries will add grist to the mill of eurosceptics. They may well point to the first Free Trade Agreement which came into effect on 1st July between China and a European state, that country being Switzerland, with most tariffs being dismantled on both sides.

It also adds an interesting perspective to the Scottish referendum on independence in just over nine weeks, particularly as it is now far from clear whether Scotland, should they decide to secede from the Union, could remain in the EU. Last week, the newly appointed (not elected, you understand) European Commission president Jean-Claude Juncker suggested that there should be a five-year hiatus before any new member states could become part of the EU. The referendum's outcome is far from certain, with the gap between Yes and No sides narrowing.

The UK economy continues to move in the right direction – it has grown back to the levels seen before the recession. The IMF, very critical last year of Chancellor Osborne's spending cuts now has performed a u-turn and has upgraded its forecast for UK economic growth to 3.2% for this year and 2.7% for 2015. Of course, the question of whether the recovery is sustainable remains, particularly if we see interest rates going higher. Nevertheless, you would expect that the UK stock market should have been booming as well. Not so! Since 1st January, the FTSE index has only added 1.1%. It basically proves that the UK stock market is not immune to the global economic climate, and if markets elsewhere were to go into a downward correction, a similar performance could be expected in our own indices.

Overall, it is difficult to make a case for continued upward growth in the indices. Stock market valuations currently are rather stretched, and there are simply too many indicators that suggest the party may soon be over, leaving us nursing a hangover.

To us at Lacomp, the above mentioned 'new normal' is somewhat abnormal, and although we have long adopted a fairly defensive stance in the portfolios we manage, we will go further in that direction. At the risk of using and mixing too many metaphors, we see our job as not just making hay whilst the sun shines, but protecting our clients when storm clouds gather.

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