Quarterly Newsletter / Spring 2016

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

As we indicated in the December issue of our Quarterly Newsletter, the markets were beginning to become obsessed with a wealth of negative news flow just as, in the previous quarter, they had been overly optimistic. Steering a path between such conflicting emotions can require resolve and, if possible, a dispassionate reading of the financial headlines.

Thus, when it was reported that China had experienced the slowest growth rate for 25 years, it is important to put this in context. Some commentators have even started to argue that the rate of growth of the economy (it reportedly grew at 6.9% during 2015) is less helpful as an indicator of financial wellbeing than figures for employment, income, inflation and consumer spending, all of which appear robust.

It is the quality of growth rather than mere quantity that matters, particularly given that the Chinese economy is so large. The capital intensive state financed infrastructure projects which drove the 'old China' are undoubtedly slowing but are being replaced by the 'new China' based on the consumer orientated service sector which has actually exceeded manufacturing in terms of percentage of GDP since way back in 2009. The much vaunted 'slowdown' is not necessarily a 'meltdown' and it is hardly a recent phenomenon although it does pose very real pressures on the traditional way of conducting trade - witness Anglo American's decision to pull out of coal and iron ore production in light of China's "evolution away from bulk commodity-intensive infrastructure development" or the CEO of BHP Billiton, announcing a $4bn loss in the second half of 2015 with the words: "It's a new world".

The markets, as we have frequently pointed out, do not necessarily mirror economic fundamentals and frequently are diametrically opposed in their reaction to data. Sentiment plays at least as big a part in short term market movements, although, of course, the market will eventually arrive at an assessment of value which broadly reflects the profitability of the underlying companies, which is exactly the point at which investors tend to get overly buoyant and the whole cycle starts again!

In periods of market pessimism, it is often factors such as comparative currency rates or inflation prospects that are key drivers. Many of the fund managers that we select for client portfolios take a 'bottom up' approach, concentrating on long term company basics rather than the broader macro-economic factors which often swing wildly in the short term. Just as markets do not necessarily reflect longer term trends, so fund performance does not necessarily reflect the moves in a particular index unless it adopts a ‘passive’ approach and seeks to replicate a benchmark. Following a benchmark downwards does not strike us as a particularly smart move and, whilst the so-called ‘trackers’ certainly have a place when markets are heading unremittingly upwards, it is precisely in times of volatility like the present that we feel an ‘active’ approach is preferable in our attempts to limit downside losses and make modest gains in any ensuing upside.

Much has been written about the collapse in oil prices (and in commodities generally). This, in large part, was a function of a strengthening US dollar which had risen steadily in value in anticipation of a return to a more 'normal' interest rate policy. As most commodities are priced in dollars, this had the effect of driving down prices, the situation in the oil market being exacerbated by conditions of oversupply. Thus, oil prices continued their downward trajectory until Fed Chairman Janet Yellen cast doubt on the likely pace of rate rises because of, you've guessed it, fears of a Chinese and, by extension, a global slowdown. By the end of March, the dollar had fallen some 3.7% against a basket of major currencies. As a result, oil prices started to rise, Emerging Market shares reversed their losing streak and the gold price moved steadily upwards.

When the BBC reported on 7th January that the Dow (the Dow Jones Industrial Average) had had its worst start opening week of the new year for a hundred years, people could be forgiven for assuming that Armageddon was at hand. Except, of course, the 'new year' is a purely artificial construct which sets an arbitrary line in the sand - indeed, Chinese investors could possibly regard it as the 'worst week with five weeks to go to the end of the year' since they work from an entirely different calendar. Assigning significance to such arbitrary dates can lead to all sorts of paradigms - the 'Santa Claus rally' et al - which distort longer term trends and exaggerate the prevailing sentiment, either for good or ill. It is unrealistic to view the end of a holiday period in the Western world as if market trends that were previously in place have simply been wiped clean, or that each year offers a fresh start.

“So why are you looking at the first quarter?” you might ask. It is a fair point, but we have to issue valuations at prescribed dates and can at least argue that three months' moves are of more relevance than a mere week. Markets did indeed fall quite steadily in the early part of the period, hitting lows around mid-February before staging a three-week recovery which seems to have petered out somewhat, leaving most major indices range trading at slightly below the level at which they started the year.

As at 5th April, the Dow Jones was up 1%, the FTSE down 3% whilst Japan's Nikkei was down 17%. More spectacular results were shown in the price of gold, up 16%, and the price of gold mining shares which were up over 50%.

Were the US dollar to continue weakening, this might indeed create a substantial headwind for ‘risk assets’ such as equities, particularly if it was taken as a sign of an impending US recession, but we feel that there are a number of factors which, for the present, make this unlikely.

Firstly, the central banks of the EU and Japan are still aggressively pursuing a policy of quantitative easing and negative interest rates whilst the pound has been under downward pressure since the EU Referendum was announced – all three currencies are major components of the ‘basket’ against which the strength of the dollar is assessed although, ironically, Yellen's cautious pronouncements have actually strengthened the Yen, thereby undermining the Bank of Japan's attempts to stave off deflation. Generally speaking though, the US is felt to be leading the move back to positive rates whereas many policy makers are still heading in the opposite direction (there were nine central bank rate cuts in March!) and this fact should help underpin the dollar.

Other research also suggest that there is little sign of a looming US recession – the ‘MRB Recession Indicator’ (complied by the Macro Research Board, a privately owned team of market analysts) plots data from 23 different measures in order to assess the state of the US economy. This indicator has shown, on average, a reading of 38% ahead of every US recession since the 1960s. The current reading is a benign 12% and the present climate is one of stable interest rates with little sign of economic stresses.

Of course, what happens in the US is of little comfort to people employed at the Port Talbot steel plant, where its owner Tata has decided to rid itself of what has become a highly unprofitable business. It employs 15,000 people, but if it were to go under, another 25,000 jobs in the support line would almost certainly be lost as well. Quite apart from the dire social and economic consequences for those workers, the public purse would probably suffer to the tune of £4.5bn – lost income tax and VAT receipts, as well as having to fund benefits for those affected.

Britain can ill afford losing more of its manufacturing base, so how was this allowed to happen? Two reasons seem predominant: the first is the dumping of cheap steel by China, the other is our obsession to lead the world in achieving an 80% reduction in the country’s CO_2 emissions.

China exports steel to the EU (and therefore the UK), suffering a mere 9% import tariff. Compare that with America, who has just increased its tariff on Chinese steel from 236% to 266%! In case you are a Brexiter and want to point the finger at the nasty EU, it actually was the UK who vetoed an increase in import tariffs, although those included imports other than steel as well. Adding insult to injury, China has just levied an import tariff of 46% on some high tech steel products the UK manufactures!

In the old days, the UK had a Secretary of State for Energy whose job it was to keep business energy costs low. The title then was changed to Secretary of State for Energy and Climate Change, and the Climate Change Act introduced by Ed Miliband in 2008 and rigorously pursued by Chris Huhne and Ed Davey afterwards has resulted in exorbitant electricity prices for industrial users. Our energy prices are now twice as expensive as those in the EU and four times as high as our American competitors pay. Blast furnaces are hugely energy-intensive, and the old way of burning coke and iron ore was no longer in keeping with the cross-party agenda on renewable energy. Still, we can claim the moral high ground, but we doubt the Welsh steel workers see it in the same light.

So, leaving Port Talbot to one side, the Lacomp view is that there is no obvious sign of imminent danger to the global economy although we expect the usual cocktail of geopolitical events and aggressive posturing by politicians to provide plenty of short term volatility in markets.

Talking of posturing by politicians, we are seeing plenty of that in the UK at present. Campaigning for the EU Referendum has just started in earnest on Monday, although the government spent some £9m prior to the official 'off' to tell us that it is in our interest to stay in the EU, much to the dismay of the Brexiters who thought the brochure was tantamount to taxpayer-funded propaganda.

Also on Monday, George Osborne brought out his 'bazooka' argument, telling us that if the UK leaves the EU, by 2030 the economy will have shrunk by 6%, equating to a £4,300 hit per household, although the Chancellor seems to have mixed up national GDP with household income – not a good start! He also reckons that income tax will have to rise by some 8%, leaving us 'permanently poorer'. The Chancellor is basing his predictions on a Treasury report which runs to over 200 pages and, basically, consists of 'economic modelling' which is a hugely complex construct, frequently using mathematical techniques. Put simply, you hope to reach conclusions that are logical, but you nevertheless have to accept that everything is based on assumptions and expectations of future economic activity.

Well, we are most impressed. The Chancellor and the Treasury are telling us what will happen over the next 14 years, which is a bit odd given the fact that he/they rarely get their forecasts right when addressing the next six or twelve months.

The "Vote Leave" campaigners call the report absurd and far-fetched. Trouble is, neither can *they* say with any certainty what will happen if the UK heads for the exit door!

At the end of the day or, to be more specific, on 23 June this year, the currently 'undecided' part of the electorate are likely to go with whom they trust most. According to a sample of the latest polls, the 'undecided' amount to some 11 - 17%, with the 'Ins' and 'Outs' pretty balanced. Of course, we saw in the last general election that polls can get it terribly wrong, so the final outcome at present is anyone's guess. We have a sneaking suspicion that both the 'Ins' and 'Outs' are already quite committed and unlikely to change their views.

Needless to say, issues other than the economy play on people's minds. The question of sovereignty and the European Court of Justice are two of them, and immigration will feature large as well. The lack of affordable housing (particularly in the South East), an NHS which is barely coping and insufficient primary school places make many people wonder whether the EU's freedom of movement is becoming a problem that potentially could get completely out of control.

It is a pity that the arguments on both sides have been, shall we say, less balanced and truthful than ideally would be the case. Opinions often are delivered as if they were facts, and statistics are frequently misquoted. Accurate analysis of the situation and likely outcomes sadly get corroded by political posturing and spin.

When David Cameron and his followers talk about staying in the EU, they invariably refer to it as the *reformed* EU. 'EU reform' strikes us as a bit of an oxymoron, but there is always hope, and 'Stronger in

Europe' may well prove successful, probably based on the old idiom 'better the devil you know'.

The EU, for many reasons, is desperate to keep the UK as a member of its club. The same goes for many of the big UK companies who would prefer the status quo. A cynic might point out that there are around 30,000 lobbyists in Brussels, roughly matching the 31,000 staff the EU employs. Put simply, lobbyists seek to affect legislation as it is conceived and formulated, and you will not find any SMEs (small and medium enterprises) or self-employed funding their payroll.

If the UK does decide to leave the EU, it will undoubtedly send shock waves throughout Europe, and the core EU countries are worried about a possible contagion effect leading to other member states questioning and considering their own position.

As the EU Referendum outcome is unpredictable, and since we know from experience that markets hate uncertainty of any kind, we at Lacomp have been busy devising a strategy which is designed to mitigate the associated risks as much as reasonably possible.

By the time we will write our next Quarterly Newsletter, the result will be known, and half the electorate will be licking their wounds. If the UK remains in the EU, our politicians and civil servants will be busy talking about reform, and if the UK leaves, the same people will be talking about new trade agreements. Either way, a lot of talking will ensue. Plus ça change...

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