Quarterly Newsletter
Winter 2015/2016

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

TV, radio and the press all tell us that stock markets are having the worst start to a year for 16 years, referring to the year 2000 when the dot-com bubble burst. This time, however, and ignoring the bubble in the property market, there is no evidence of a bubble as such in the equity markets. True, valuations have been somewhat stretched for some time, something we have repeatedly said in our previous Quarterly Newsletters.

So what has caused this mayhem in the markets? This time round, there are several reasons: worries about interest rates going up again after a seven-year hiatus, concerns about the global economy, the dramatic fall in the oil price and, of course, the much talked about slowdown in Chinese GDP growth. Add to that geopolitical events, particularly in the Middle East and the migration from there and Northern Africa towards Northern Europe, and you can see that all this adds up to a fairly toxic mix of background circumstances. Although all these ingredients have an impact on financial markets, the major driver in this particular downturn is investor sentiment which has turned very negative.

Let us take a closer look at the various points we have just made, starting with China.

China certainly has captured the attention of the media in recent months. There are plenty of eye-watering statistics to justify this attention. A US$10 trillion economy, the second biggest after the US, and a burgeoning middle class that is predicted to grow to 600 million thereby outnumbering the current population of both the US *and* Japan by the year 2025, for example.

Long the supplier of cheap goods to the Western consumer, the Chinese middle class's wealth has been steadily reversing this trend, providing a substantial component in the demand for cars and other luxury items from the developed nations and establishing itself as a major driver of the world economy. Hitherto, the rest of the world has been content to supply the seemingly insatiable demand for commodities whilst receiving cheap Chinese goods in return. In so doing, it had become dependent on a trading relationship which now has clearly changed.

China has established itself firmly as a global key player, as is evidenced by the inclusion of its currency, the renminbi (or yuan), as part of the IMF's foreign exchange reserve assets at the end of November. This is the first change to the IMF's XRD (also known as the "Special Drawing Rights") composition since the inclusion of the euro in 1999.

Why the two names for the Chinese currency? Renminbi means "the people's currency" but prices are expressed in yuan. As an analogy, it is not dissimilar to sterling and pounds. For example, we may say that a settlement is in sterling, but a specific good would cost x pounds, not x sterling. China, in that respect, is very much the same. When reading financial reports, RMB stands for renminbi, whereas CNY is short for Chinese yuan.

A major consideration in any discussion on the prospects for global growth, China has found itself castigated as the cause of all manner of market headwinds. Falling commodity prices, weaker manufacturing data, "dumping" of cheap steel, currency manipulation, stock market volatility and general economic malaise have all been blamed on the country's slowdown. It should be remembered that this is a *deliberately induced slowdown*, initiated by the avowed policy of restructuring away from capital-intensive infrastructure projects fuelled by cheap money.

Of itself, this policy strategy has some logic as a move in favour of consumer-led development makes sense for such a large economy, offering a more sustainable albeit flatter growth trajectory. This transition cannot be achieved overnight, however, and will inevitably bring periods of volatility and disruption.

Unfortunately, China's stock markets have not yet caught up with the economic progress and, as a result, they often send conflicting signals to an outside observer. For example, weaker purchasing manager data might spark worries over the pace of the slowdown and trigger a sell-off. This is particularly true when we look at the Shanghai stock exchange. It is estimated that about 80% of the trades are down to relatively inexperienced retail investors, and sizeable institutional investors are few and far between. If you accept that the Chinese like gambling, you can understand that this leads to short-termism which brings about a casino type atmosphere at the Shanghai stock exchange, often causing disproportionate upset that might not necessarily relate to the real economic story. We wrote about the Shanghai “casino” in our Summer Newsletter.

Whilst there are undoubted economic implications in slower Chinese growth, we would regard it as a major error to conflate stock market volatility with the broader economic picture as the two are distinct phenomena which influence each other at the psychological rather than causal level.

The plethora of indices used to describe the Chinese market does not help to resolve the issue, particularly as not all Chinese shares are available to all investors. Focussing on the “wrong” index could provoke an overreaction, whether of pessimism or euphoria.

Aside from the oft-quoted Shanghai Composite Index, there is an index that seeks to reflect the 'A' share market in both Shanghai and Shenzhen (the “CSI 300”), Hong Kong's “Hang Seng” which reflects the 'H' shares, the “Zhong Hua” which combines MSCI indices for the mainland and Hong Kong, and also the “Golden Dragon” which includes Taiwan alongside Shanghai and Hong Kong.

The domestic market (for 'A' shares) centres on the two major markets of Shanghai and Shenzhen. Those shares that were available to international investors were generally bought through the 'H' share market in Hong Kong. There are a growing number of Chinese companies with a listing in the US which are purchased as ADRs. ADR stands for an American Depository Receipt, a negotiable instrument issued by a US bank that is backed by physical stock in the underlying Chinese company. Each ADR represents a specified amount of stock and can be freely traded on the US exchange.

This wide offering of indices (and there are many more!) reflects the generally underdeveloped market, hampered by limited buying opportunities and the existence of the large state owned enterprise sector which generally is not tradeable. It is not surprising, therefore, that in a situation where not all shares can be bought and sold, and where the psychological motivations of a large number of individual investors predominate, volatile conditions can and often do result.

The expansion of licences on the Shanghai exchange and the 'Connect' link-up with Hong Kong has gradually opened up the market and will lead to improved liquidity over time. This should induce a reduction in volatility but, for the present, the Shanghai market remains dominated by retail investors who have a characteristically short investment timeframe.

The Chinese stock market bubble which inflated on speculation that China would achieve a listing in the MSCI index, rocketing 152% in the year to 12 June 2015, burst spectacularly last summer and resulted in a number of measures by which the Chinese government sought to re-impose some sort of order. The banning of share sales by those who held 5% or more of a company stock helped to settle things in the short term but merely put off the final unwinding of the bubble. The market resumed an upward path, rising 20% from the August lows but, as soon as it became clear that the ban was to be eased, there was another sell-off as small investors tried to get out before their larger counterparts sought to take profits.

Another measure, the "circuit breaker", was introduced early in 2016 with the aim of putting a stop-loss in place that would be triggered if markets fell sharply. The idea was that there would be a fifteen minute cessation if markets fell by 5% and a closure for the day if losses rose to 7%. This unfortunately became a self-fulfilling prophecy and the scheme was abandoned after the markets were closed twice in a week.

Just as the giddy rise in the Shanghai market in 2014-15 did not presage a renewed economic boom, it is no more logical to assume that the unwinding of the bubble necessarily spells disaster – and the Shanghai Composite is *still* up 42% since 12 June 2014. We would view these developments as the inevitable growing pains of a country striving to modernise its stock market and bring it into line with the achievements of the broader economy. The one undoubtedly influences the other but they are *not* the same and it would be a mistake in our view to rush to conclusions as a result of what must be every newspaper headline writer's dream.

At the time of writing, the Western media reported China's "slowest growth rate for 25 years" (it is officially 6.9% against a target of 7%) and sought to draw all manner of dire predictions of contagion from a number that had, in fact, been widely expected to be somewhat lower. Interestingly, the Shanghai Composite and CSI 300 indices both rose by 3% on the day the "news" broke.

A Chinese "hard landing" would undoubtedly have negative consequences for the global economy but it would be rash to predicate such a calamity solely on the vagaries of an immature and volatile stock market.

Leaving China for the moment – we undoubtedly will return to it in future newsletters – the falling oil price also has rattled the markets. In 18 months, the price has dropped from US$108 to around US$28, and it is likely to fall further. Whilst this is good news for motorists and countries that have to rely on oil purchases, it spells calamity for oil producers like Russia, Saudi Arabia, Nigeria and others. Put simply, they pump more oil than the rest of the world want to consume. The world's largest oil producer, Russia, is already suffering from the effects of economic sanctions, and its economy currently is in recession. It therefore badly needs oil revenue. Saudi Arabia, the biggest oil producer of the OPEC (Organisation of the Petroleum Exporting Countries) members, used to adjust its production to help other OPEC states, but it is no longer willing to do so. Add Iran who, having just signed an agreement to restrict its nuclear aspirations, is now also free to sell its oil on the international market after an absence of four decades. In fact, we can see something of an oil price war developing between the Saudis and Iran. It looks like the old Sunni-Shia problem raises its ugly head even in the commercial world. Venezuela, already an economic basket case, is calling for an OPEC emergency meeting, but one is reminded of the old saying that an OPEC agreement is a contradiction in terms.

It costs most oil producers more to pump a barrel of oil than they can sell it at, and in some areas considerably more, particularly when you consider the more expensive ways of extraction. The IMF has warned that even countries like Saudi Arabia, Oman and Bahrain will run out of cash within five years unless the oil price settles in at above 50 dollars a barrel.

Even America's oil producers, having ramped up the shale oil production during the period of high oil prices, will feel financial pressures if a prolonged period of low oil prices becomes a reality. Many other large companies like ExxonMobil, BP and Royal Dutch Shell will face tough challenges.

Moving on from the oil price, what about the threat of higher interest rates? As we pointed out above, rates have not moved higher for some seven years, and during those seven years we have been repeatedly told, indeed warned, that a hike in rates was about to happen. Long-term readers of our newsletters will know that we have almost always believed that such prognostications were rather premature. Still, after months of predicting a shift upwards, the American Federal Reserve finally did up its rate by 0.25% in December. Having finished its QE program by October and obviously feeling that the economic recovery was sustainable, Fed Chair Janet Yellen hinted that more hikes might be on the cards for 2016. We think that the Fed's move could also be seen as building up a buffer, just in case things don't work out as planned economically. In other words, there would be room for another interest rate *cut* if the recovery were to falter. Let's face it, after all the QE and the current low interest rates, central banks have run out of ammunition.

It is interesting to see that monetary policy in the US is going in a different direction to that of the European Central Bank where QE is in full swing and interest rates are likely to remain low or go even lower. The ECB has introduced a negative interest rate, currently charging banks 0.3% to park their money with them overnight. Others are doing the same thing. Switzerland, Denmark and Sweden have central banks that charge negative interest in a move to either stop capital inflows that put the currency under upward pressure or to force commercial banks to engage in lending rather than hanging on to the cash in the hope that it will help their respective economies.

In the UK, Bank of England Governor Mark Carney had only recently suggested interest rates could go higher very soon, only to do a volte-face by now declaring rates could stay at the current level until 2017. Good for borrowers, but not so good for savers with money on deposit! Low interest rates have some other negative effects. They encourage consumer borrowing that could lead to unsustainable levels of indebtedness once rates increase, and they could further inflate the property bubble.

Returning to financial markets, after a pretty poor 2015 with the FTSE 100 down 4.5% and other indices also in negative territory – the exception being Japan which was up 9.1% – the FTSE 100 is now officially in a bear market phase, having lost 20% from its April 2015 high. We have seen bigger falls than this when the dot-com bubble burst in 2000 and again when the financial crisis hit in 2008. The current situation is nowhere near as bad as the problems we faced during the financial crisis, and the economic reality is far better than equity prices suggest. As indices go, the FTSE 100 is a peculiar animal, as it is heavily biased towards miners and oil producers, and those two sectors are suffering much more than others.

This may not be much consolation for investors – and our clients! – when they look at depressed valuations, and it certainly is not helped by headlines that keep reminding us just how many billions have been wiped off the stock market. Just remember, though, that losses are only crystallised when you actually sell up. The aforementioned crashes corrected themselves in no time, and even the Black Monday crash of 87 now appears as a mere blip on a long-term chart.

Bagshot 21st January 2016

Lacomp plc
77 High Street, Bagshot, Surrey, GU19 5AH, England.
Tel: (Intl. +44) (0)1276 475123 Fax: (0)1276 475273 e-mail: info@lacomp.co.uk website: www.lacomp.co.uk & www.lacompeisfunds.co.uk
Registered in England No. 1851201
Authorised and Regulated by The Financial Conduct Authority (FCA)