DELMORE
ASSET MANAGEMENT

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The Fear of Contagion

As you know global stock markets have fallen significantly over the last ten days, triggered principally by concerns surrounding the state of the Chinese economy. Yesterday's market reaction in the UK - when the FTSE 100 index fell as much as 6% at one point - counts as one of the largest one day corrections in a generation (see table below).

China's announcement on 7th July of 7% GDP growth disappointed the markets, whilst questions about its validity also abound. This news was quickly followed by a limited (3%) Chinese devaluation raising the suspicion that the Chinese needed a competitive advantage to address loss of market share in the ASEAN region. This naturally sparked fears of an emerging markets currency war, although so far only Kazakhstan has followed suit and formally devalued to any significant degree (20%).

Commodity prices - which have been under pressure all year - have slumped further this month, increasing the pain in many of the emerging markets which are so dependent on these primary industries. This is part of the reason why the Shanghai Composite Index (CSI 300) has fallen 20% over the last two weeks and 38% from its peak in 2015.

Turbulence in China also explains the dash for classic safe haven assets such as high quality government bonds and even gold which has bounced 6.6% from its August lows.

In the background Greece finally came to an agreement with its creditors on a new bail-out package, thus avoiding a default and a messy Grexit; we are sure the Greeks were thankful that the China Crisis kept them off the front pages of the financial press.

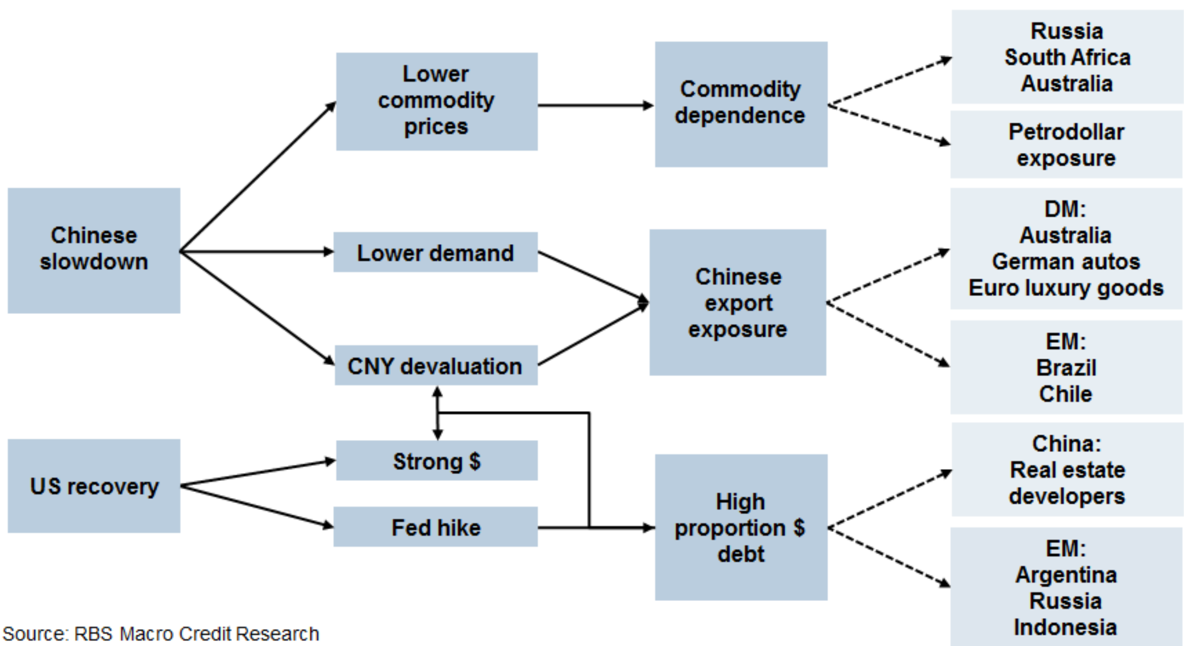
All of this bad news coincided with the summer lull in volumes in the major stock markets which has probably magnified the impact of this sequence of events.

FTSE 100 Biggest Falls (in one day)

Date	Close	% fall
20/10/1987	1801.60	-12.22%
19/10/1987	2052.30	-10.84%
10/10/2008	3932.06	-8.85%
06/10/2008	4589.19	-7.85%
15/10/2008	4079.59	-7.16%
26/10/1987	1684.10	-6.19%
11/09/2001	4745.98	-5.72%
06/11/2008	4272.41	-5.70%
22/10/1987	1833.20	-5.69%
18/01/2008	5578.23	-5.48%

Contagion has to be the fear – China has the capability to send a tsunami of financial woe crashing round the globe if it melts down. The table below illustrates this, there are few economic regions that will escape lightly.

Mapping China contagion



Source: RBS Macro Credit Research

China and View on Interest Rates going forward

China has always tried to radiate an air of confidence in everything it does; this recent upset will thus annoy President Xi enormously. The impact on global market confidence is clear; Monday afternoon's Vix (volatility) spike to 53 was the second highest reading in the last 20 years.

One benefit of this market shock is that one doesn't have to worry about the Fed raising rates in September. This is not a flippant comment, because all over the world Central Banks will be ready to calm the troubled seas. Whether President Xi is willing to accept the advice from some of the more experienced heads of international finance remains to be seen.

How we are positioned in this dynamic environment

We have been cautious about market valuations for the most of the current year; consequently we have been underweight equities and overweight cash. The recent turn of events has seen us selectively cut our equity positions further with particular focus on those areas that are most at risk of an emerging market slowdown.

The setback in the markets over the last few days will undoubtedly throw up opportunities from the panic and we are attuned to this prospect. We are actively monitoring a number of high quality high cash flow generating stocks, looking to buy on weakness for the long term on these lower valuations.

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