DELMORE
ASSET MANAGEMENT

December 2015

Review

2015 was dominated by two major themes, the faltering of the Chinese growth miracle and the steep collapse in commodity prices. These clear trends were enough to throw the Fed into disarray, and cause Mrs Yellen to delay consistently the timing of the first rate hike in the US for nearly a decade.

The year started unremarkably with most commentators anticipating healthy returns, particularly in stock markets, despite the impending hike in US rates and stretched equity valuations. During the summer Chinese growth continued to falter and their economic data, long mistrusted, were now well below consensus forecasts. As the penny dropped it became clear that the transition to a consumer led economy was not progressing as well as planned. This sent a chill around the globe as the implications sank in. The Chinese economy, that once had an unquenchable thirst for raw materials was not only faltering but seeing a big fall in domestic confidence and consumer spending. Orders fell sharply, stocks rose and the squeeze on working capital in the small and medium company sector intensified.

Meanwhile in the Middle-East Saudi Arabia was hatching a cunning plan to kill off the burgeoning US shale oil industry by turning on the taps thereby flooding the market with oil; smashing the oil price as a result. Surely this would see an end to US shale bonanza? The plan was a partial success as the oil price collapsed during 2015, but the American shale industry kept on producing at high levels. As a result both Brent & WTI were trading well below $40 a barrel in December. But necessity is the mother of invention and lower oil prices forced the US shale oil producers to become more efficient in this new environment by savagely cutting costs and dramatically increasing yields. Ironically the Saudis now find themselves in a financial predicament, since their five year plan requires an oil price near $100 a barrel to balance their financial budget, unfortunately their machinations have forced prices down to around $30 a barrel; truly a massive gap.

Whilst China misstepped and Saudi Arabia shot itself in the foot Janet Yellen patiently waited in the wings to announce the first rate rise in the US for nearly a decade. As the year progressed and the magnitude of the problems in emerging markets became apparent this historic day kept getting postponed. Would she have the stomach to pull the trigger; or had she left it too late? However in the final Fed meeting of the year she finally made her move and US rates duly rose by 25bp to 0.5%.

Outlook

2016 kicked off with further declines in both China's stock market and currency; severe enough to send shock waves through global stock markets. The Chinese PMI recently dropped to a 17 month low clearly showing the extent of the pain in the manufacturing sector and that the desired shift from manufacturing to a services led economy was proving to be very tough. This and a slump in demand for key capital goods and commodities has contributed to weak global trade which is indicative of lower global economic growth.

Furthermore the sharp rise in China's debt-to-GDP ratio over the last four years to 240%, does not give the impression that China can sustain its former high level of growth. George Soros maintained that the situation is similar to that of the US prior to the 2008 crash. Such a rapid increase in debt suggests loans are being made without sufficient attention being paid to credit quality and confirms that resources are being misallocated. However as the Chinese government seemingly has tight control over the economy and holds trillions of US dollars of reserves, one should expect limited contagion if the domestic situation deteriorates.

There are fears that China will devalue their currency more substantially in response to the economic weakness it is experiencing and the current soft demand for Chinese exports. If that devaluation is substantial then other emerging countries will face pressure to devalue their own currencies in order to retain a competitive margin. This would cause considerable difficulties for those countries that have borrowed in US dollars as servicing costs would rise significantly.

Meanwhile North Korea joined the party, claiming to have tested a hydrogen bomb; though many doubt the authenticity of this claim, the pariah state continues to cause tensions around the globe. At the same time the Middle Eastern cauldron continues to boil as the Sunni and Shia powerhouses face up to each other aggressively. This quarrel has the potential to turn into another long and difficult conflict.

In normal times America may have been able to restrain both parties, but under President Obama US power and status has become enfeebled. What is remarkable about this friction is that throughout the worsening situation the price of crude has dropped like a stone. Brent crude has now reached almost US$30 a barrel suggesting that the oil price is suffering due to weak demand as well as the supply glut.

Growth lies in developed markets…

The UK economy is at a juncture where interest rates could be raised this year, however the Monetary Policy Committee seems to be in no rush to tighten. Although there has been a moderate pick up in wage growth, core inflation remains very much below target. Another reason not to jump the gun is the upcoming EU referendum (Brexit) which is likely to take centre stage in British politics throughout 2016. Sterling has already been hit by these uncertainties and the large trade deficit suggests further weakness.

We do not expect developed markets to soar in the coming year however we think the divergent global recovery will continue. Domestic demand has continued to grow in developed markets. We have seen - especially in the UK and US – both higher real wages and household borrowing which together imply an increase in consumer confidence and spending. In addition they have both seen a revival in housing demand and prices.

The Eurozone has had a large uptick in consumer confidence aided by the fall in the price of oil which will continue to benefit Western consumers. The Eurozone grew roughly 1.5% in 2015 thanks to the relative strength in the periphery. If this trend can continue the Eurozone could grow slightly more which would be supportive for equities and world trade.

Whilst most comments in the last few months have focused on the deterioration in China, many people have forgotten the ongoing strength of the American economy which is now adding almost 300,000 new jobs per month. Although we do not know for certain, it would be easy to hazard a guess that the recent decision by the Fed to increase interest rates by a modest 25bps was influenced by this statistic above all others. We believe that the amount of liquidity injected into the American economy by QE will support a decent rate of growth for at least another three quarters. Primarily these effects will persist, in particular resulting in a further tangible increase in house building and consumption. Meanwhile the banking system continues to provide credit across the board with car sales reaching new heights and general activity in the service sector making good progress.

This illustrates that another basic fear of the markets, the decline in the levels of manufacturing over the second half of 2015, only relates to around 10% of the economy; meanwhile the US consumer seems to be in fine shape. Over the last nine months we have increased our exposure to American stocks in the sincere belief that the US recovery had considerable breadth and strength; we continue to believe this to be the case and have maintained our current weightings in the States whilst pruning some stocks which seem to be exposed due to the turmoil in the commodity markets.