DELMORE
ASSET MANAGEMENT

June 2015

Review

So far 2015 has provided plenty of spills and thrills. During the first quarter all markets raced ahead together so that investors found themselves looking at falling bond yields along with rising stock prices. Indeed the search for yield was so intense that property prices continued to rise as investors became desperate to lock in the yields available. We felt that this scenario was a little too good to be true and accordingly raised liquidity as the first quarter progressed. We also trimmed some of our exposure to overseas stock markets since developments abroad, particularly the clear slowdown in the US, suggested that some of the valuations were too rich.

During the second quarter pessimism reigned for much of the time and we continued to modestly increase liquidity as the international situation remained cloudy. Here in the UK the markets celebrated the Conservative victory with both gilts and stocks moving ahead. In the US, markets began to recover as economic growth seemed to pick up after the severe winter conditions in the north of the country. Meanwhile the Greek tragedy got steadily worse, placing a strain on the Eurozone but not so much on its sovereign bonds or currency.

Outlook

Markets have been tested in the past fortnight as the slowdown in China gathered momentum and their Politburo tried to halt the slide in stock prices. Concurrently the Greeks voted against a proposal from the Eurogroup which was no longer on the table, having been fooled by their finance minister who assured them that the rest of Europe would cave in to their demands if they voted no. By Tuesday morning the full extent of this miscalculation became clear as the Europeans insisted that a clear action plan, not fulsome words, would be required from the Greeks. By the end of the week Mr Tsipras had capitulated, but there is now considerable opposition in Athens hence the deal remains uncertain.

The angle of descent in the Chinese stock market has improved because the government has used a large variety of policy tools to try desperately to calm the situation. Many commentators have argued correctly that the percentage of the Chinese population which invests in the stock market is very small compared with the millions of people in the country and so has limited importance. Whilst it is true that it is mainly this small sub-group that are currently suffering severe loss, we feel quite strongly that the loss of confidence by the general population in both the party and the Chinese version of capitalism has been considerable.

One cannot deny that the Chinese expansion has achieved a massive amount to date, but the scale of the fall since the market toppled over, has shown quite clearly that there are definite limits to the system of quasi capitalism which the party has put in place. This hits a raw nerve because many Chinese embraced the cult of equity after they suffered paper losses on their property investments. Both of these incidents highlight the urgent need for the Chinese authorities to put in place a better national health service and to start encouraging a culture of saving for retirement backed up by proper tax incentives.

For the time being we would expect confidence in China to remain fragile and already capital investment plans seem to have been scaled back. But the biggest question remains; how will the loss of confidence affect consumer spending? This is a vital question for China's trade partners since any notable downturn in consumer spending, especially luxury items, will hit exports from the West.

The Iranian nuclear agreement has finally been signed, but there is a long way to go before conditions are normalised. The price of oil, both in the US and Brent, has been falling steadily in preparation for this event, however there appear to be a number of conditions which need to be met before the broad list of sanctions are relaxed substantially. Whilst oil supplies are a key determinant of the price, the pattern of demand also plays an important role. At the present time growth in Europe remains anaemic and the US economy has recovered from the severe weather, but not sufficiently enough to positively affect oil prices.

Meanwhile supplies have been plentiful since Saudi production has returned to the highs last seen in the 1970s and US production has also moved to new highs; this has occurred despite the substantial fall in market prices. Finally excess supply and the slowdown in China has also impacted the price of base metals so that both copper and iron ore have reached or exceeded the levels last seen during the depths of the Great Recession. Nevertheless the mining majors have continued to increase production hoping, like the Saudis, to pulverise the small and medium producers. So far only the consumer has benefitted from the low prices as the pain of the price war continues to harm most producers of metals and minerals.

We continue to believe that the American recovery will gather pace and so expect that market interest rates will gradually rise in the second half of the year. Such a development, provided it is a gradual rise, should help to consolidate the recent improvement in the economy and encourage both the US dollar and American stocks to move higher. Here in the UK we might follow American rates higher if wages continue to and economic growth improves. This would help to support the stock market. We also expect stocks to improve in Europe and Japan, because of monetary easing, but do not have as much confidence in their currencies.

In the final analysis we are all dependent on Mrs Yellen. If we see a rise in American interest rates, encouraged by the Fed, the rate of increase in rates will be the most critical factor. Some economists and central bankers believe that the most important action is to get started and have floated the idea of very small increases of only 10 basis points during the final months of 2015. This would signify a clear change of trend, but hopefully not worry the markets, which though rational, are not always patient. So the risk remains that any officially endorsed rise, however small, might not smooth the markets in the way that some commentators would hope.