DELMORE
ASSET MANAGEMENT

March 2015

Review

2014 was a year full of surprises with the main features of the period being the rise in the US dollar and a dramatic fall in oil and other commodity prices. Most expectations of a further decent rise in world stock markets were disappointed; apart from good progress in the S&P and the stunning surge in the last quarter when Chinese stocks finally took off. Meanwhile the Japanese still seem to lack sufficient resolve to push through tangible structural reforms necessary to kick-start meaningful growth.

The other side of this equation was the continued appreciation in government bonds and investment grade corporate paper. As a result of the substantial increase in the prices of these high quality bonds, the yields available at the low risk end of the market continued to contract as the year progressed.

Later in the year there was a common perception of an increasing risk of deflation taking hold in Europe due to the precipitate fall in commodity prices and inflexibility of monetary policy. The European economy had become a poor advert for the German advocacy of austerity, but the launch of substantial QE by the ECB has helped to alleviate the situation. The other source of considerable concern was the clear failure, across the world, to see a break out of the minimal annual rise in average real wages which has been a distinct feature of this recovery over the last 3-4 years.

This absence of a recovery in real wages, together with the lack of inflation, means that the recovery in economic activity which has been seen so far has been of substantial benefit to the corporate sector and those people who were fortunate enough to own real assets such as property and stocks. The buoyancy of the corporate bond market has allowed many large companies to raise enormous cash resources. Finally the continuing crisis in Greece has restrained European growth and reduced confidence.

Outlook

Many investors still fear that the global recovery, unlike the American one, lacks sufficient vigour. They believe that these historically low bond yields reflect a bond market perception that the fall in the oil price could mark the start of a secular trend of low prices and little growth in real wages over the next few years.

The current rise in the price of safe bonds suggests that the recovery might fail to gain sufficient traction as investors continue to worry that consumers remain stuck in a rut throughout 2015. Consequently we may find that activity is impacted heavily by falling confidence and a perception that many countries will spend this year in the grip of deflation. If this conclusion proves to be correct we could see a further year of good relative outperformance by government and investment grade bonds.

Some stocks will perform quite well since they are large enough to provide reassurance that their dividends will be paid and they have sufficient resources to protect their market position. These globally diversified companies will continue to flourish provided that we do not see a fierce deflationary cycle setting in; however many smaller companies may not be capitalised sufficiently well to weather such a storm of low prices and tepid demand. Such conditions might reveal a number of casualties in the consumer space if these smaller companies are denied adequate banking resources and they experience a noticeable fall in sales - which will hit cash flow - as consumer confidence falls.

So at the present time “safety first” remains the most sensible course of action. The big question remains:- Is the current fall in commodity prices caused by cyclical factors or does it presage a totally new structural scenario ushering in a period of lower global activity characterised by low prices and wages? If the latter scenario proves to be the case we will need to take additional action to move the portfolios further into safe harbour assets.

We are not yet that bearish, particularly in the medium term, since we think that a decent fall in oil prices will be similar to a large tax cut for global corporates and consumers. Nevertheless these benefits might take much longer to gain popular acceptance than some commentators currently expect. The time lag between the rapid fall in oil and commodity prices against the blossoming of a possible feel good factor among consumers is one of the principal problems currently worrying the capital markets. Only time will tell; but 2015 certainly started with a bang.

Finally the impending UK election could provide further reasons for increased domestic volatility. The two major parties remain neck & neck in the polls, with the Scottish Nationalists hoping to hold the balance of power after the result. This election marks a new situation in UK politics and we remain concerned that capital markets might baulk at economic policy uncertainty if the lack of a clear majority for Labour or the Tories is confirmed. If Labour was to “team up” with the SNP over the course of the next five years, this would undoubtedly mark a major shift to the left. UK markets may then be subjected to considerable volatility going forward.