DELMORE
ASSET MANAGEMENT

March 2016

Review

The volatility from the second half of 2015 leaked through into the first quarter of 2016 as equity markets suffered a turbulent first six weeks. However, after a classic "V-shaped recovery", equity markets ended the quarter at levels very similar to the end of December. Actions of central bankers and rebounding commodity prices proved pivotal for markets as investors' fears about the global economy in January were gradually calmed.

Initial jobless claims in the U.S. began to creep up, leading some to believe that the unemployment rate was also beginning to rise. At the same time the ISM manufacturing index fell in both January and February signalling continued contraction in the US and global manufacturing sector from 2015.

Since February both of these indicators have improved. The increase in initial jobless claims at the start of the year did not flow through into rising unemployment and initial jobless claims have picked up since February whilst unemployment is expected to continue falling. The March report by the ISM noted that economic activity in the manufacturing sector expanded in March for the first time in the last six months.

The economic uncertainty in the early part of the year allowed Mrs Yellen to save some face when the Federal Reserve decided to march to the beat of the market's drum. Instead of four more 0.25% rate rises this year, the projection of the median Fed Funds Rate now suggests two. This positive move by the Fed was appreciated and the S&P 500 finished up 1.35% for the first quarter.

In Europe the unemployment rate has been falling with steady growth in the PMI but Eurozone equities endured sharper declines than most early on in the year and were unable to recover all their losses. The Euro Stoxx Index finished the quarter down 6.50%.

The European Central Bank (ECB), like the Fed, delivered some positive policy news which buoyed the market. In early March, Mario Draghi announced a significant easing package which increased the ECB's quantitative easing programme by €20 billion a month. Mr Draghi added that the central bank will include buying non-financial investment grade corporate bonds within the programme.

European banks were sold off as some of the convertible bonds on offer, notably those of Deutsche Bank, fell dramatically in February. The market calmed when Deutsche Bank intervened to buy back some of its debt and the bonds have subsequently recovered most of their losses.

The FTSE All Share Index was relatively flat, dropping only 0.35% in the quarter. The UK market was helped by commodities, consumer goods and the completed merger between Royal Dutch Shell and BG Group. The UK has however suffered from lower consumer confidence so far; this was indicated by the slowdown in the UK services sector. The Chancellor's budget did little to soothe this negative sentiment which impacted the financials sector and sterling, which began to depreciate ahead of the Brexit referendum.

China continued its transition from a manufacturing to a service-led economy. Chinese firms so far this year have been on an international shopping spree fuelled by the nation's ever growing debt pile.

For some this could be a sign of economic weakness at home, but for others the large one off cash flows are a chance to generate a regular stream of inflows to make the debt burden more tolerable. However should China wish to protect their share of global exports they may have to reconsider devaluing the renminbi further.

Outlook

Here in the UK Brexit looks set to dominate perceptions and dampen confidence until a definite outcome has been reached in a vote which remains wide open. There are still no hard facts about the benefits of EU membership or an analysis of the consequences which would flow from leaving the EU. The 'out camp' cannot provide any details of the likely severance conditions but there are considerable uncertainties regarding the status of sterling should the UK vote to leave. Obviously this will have an impact on bond prices while many stocks will be affected.

The whole shape of the UK economy depends on trade with the EU, both inputs and outputs. Naturally these calculations will also be important for many European corporations since the UK remains a very large market for them. We continue to monitor how the stocks we hold could be affected by a Brexit vote and are looking with interest at the percentage of revenues and profits sourced from the domestic market.

Across the pond the US will continue to drive world growth. Crucially domestic demand remains elevated, driven by the fall in fuel prices and prolonged low interest rates. This has been corroborated by the addition of roughly 225,000 jobs per month on average for over a year and an unemployment rate of around 5%.

Regardless of the quality of these jobs, the magnitude of the rise has provided a clear increase in activity across the board. Indeed this was the line Chair Yellen took at a recent panel in New York when questioned on accusations made during the current political campaign. In an uncommon, if not tentative, venture into the maelstrom of US politics she praised the strength of the labour market concluding "this is an economy on a solid course, not a bubble economy." It seems the Donald Trump publicity machine will need to be a little more creative with its catchphrases moving forwards!

Meanwhile minutes of the March Federal Open Market Committee (FOMC) meeting confirm what most analysts suspected; rate hikes will come slowly as the economy continues to gather momentum. In particular the FOMC want to avoid signalling any degree of 'urgency' by their actions.

Whilst the US Fed unwind the unprecedentedly loose monetary policy, the ECB drives ahead with negative interest rates and an expanded quantitative easing (QE) asset-buying program. In addition four new targeted longer-term refinancing operations have been created to foster new lending and round off the broad assault to encourage the demand for credit. Despite the dovish verve, this mixed policy approach and recent press releases do appear to suggest the ECB shares our concern about relying too heavily on negative interest rates for any prolonged period of time.

However we do remain concerned that the current political decision making structure in Brussels remains severely blunted, as shown by the recent Dutch rejection of a trade and political agreement with the Ukraine and the failure of EU institutions to perform in the fight against ISIL. Such strains within the Union will only contrive to hamper much needed economic reform.

In Japan, finance minister Taro Aso has expressed his concern regarding the recent surge in the value of the Yen. This unsolicited advance has been borne amidst the introduction of negative interest rates by the Bank of Japan, with the Yen rising roughly 10% on the dollar since the turn of the year. In response Aso has cautioned that the government would take action to avert these “undesirable” currency movements in order to sustain the prevailing economic medicine of ‘Abenomics’; a policy programme that promised to finally kick-start the stalling Japanese economy, but many question when we will see further action.

Finally China has been better than expected with foreign exchange reserves increasing by $10.3bn in March; the first rise in five months as the tide of net outflows abates. The premier, Li Keqiang, revealed on March 5th that the government is targeting real GDP growth within a range of 6.5-7% in 2016. We believe the lower end of this range could be possible but remain mindful of the government's increasingly authoritarian behaviour and poor track record of economic reform, with particular regard to State Owned Enterprises.

In summary we continue to believe that longer term equities look more attractive than government and corporate bonds. However we currently hold a higher level of cash tactically as market volatility remains elevated with a number of uncertainties looming, not least Boris and his merry Brexit brigade. We prefer US equities for earnings visibility and economic strength, but remain alive to UK equity opportunities as the pound devaluation continues.