DELMORE
ASSET MANAGEMENT

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Review

The markets have provided many challenges to investors over the last three months. The quarter started with a framework for resolving the Greek crisis, but markets were soon mesmerised by the slowdown in China and uncertainty about the Fed's intentions regarding US interest rates. The MSCI World Index tumbled 8.4% in U$ dollar terms in the three months to the end of September.

Greece now feels like a distant memory. Alexis Tsipras and his team (minus the renegade Varoufakis) managed to secure a deadline deal with creditors but, condemned by some hard-line Syriza MPs who fled the party, the Greeks were once again forced to head to the ballot box. Tsipras again emerged victorious and his intent to continue with the new bailout package has decreased the likelihood of "Grexit" and provided much needed stability in Greece and the Eurozone.

Since that debacle, aside from Eurozone inflation which remains well below target, Europe has had a stream of positive economic data. This was the ninth consecutive quarter of growth; driven by domestic demand. The European economy was less affected than others by the Greek crisis and the Chinese slowdown. However growth in the economy did little to offset the fall in the markets, with the MSCI Europe ex UK Index down 8.2% in euro terms. The fall in European markets was exemplified by the drop in the auto sector which suffered from reduced demand in China and later on the VW scandal which broke in America.

Perhaps the greatest challenge for markets this quarter arose when the Chinese authorities decided unexpectedly to devalue the yuan on 11th August. Evidence of a Chinese slowdown grew in light of poor economic data such as consecutive falls in the manufacturers PMI and a fall in demand for raw materials. With demand falling sharply many commodity-exporting economies were hit in the period. Investors became increasingly uncertain and concerned about the ability, or rather inability, of the Chinese authorities to control the stock market. Concerns came to the fore on "Black Monday" and over the course of the third quarter the domestically traded CSI 300 Index had fallen 27.8%.

The MSCI Emerging Market Index underperformed the MSCI World. Emerging Markets suffered due to concerns surrounding the state of the Chinese economy and the uncertainty of a US rate hike. The situation in Brazil was especially bad as its sovereign debt was downgraded to junk status.

The Fed once again decided to leave rates at historic low levels. In September, Janet Yellen cited the Chinese slowdown and the further disinflationary influence of further appreciation in the US dollar as a cause for keeping rates low. But there has been promising data in the States such as unemployment falling from 5.6% at the start of the year to 5.1% in August.

In the UK, markets fell as result of the issues outlined above, the FTSE All Share TR Index fell by 5.7% since the end of June. Glencore highlighted the pressures felt by resource companies, the share price of this FTSE 100 mining and trading company fell by almost two thirds in the weak commodity price environment. Government bonds performed well as investors sought “safe-haven” assets in lieu of the volatile equity markets. The FTSE Gilt TR rallied 3.1% over the quarter.

Outlook

We expect markets will remain fixated by the diverging global monetary conditions. The US and UK are moving closer to tightening whilst the Bank of Japan and European Central Bank appear to be on course to intensify their respective easing policies. Should economic growth continue to recover into 2016 then the US dollar could strengthen further.

Despite the hawks circling in the Fed, the “new normal” continues to prevail. This environment of historically low interest rates, strong corporate demand for credit and subdued global growth rates casts the shadow of deflation over developed economies even as labour market conditions have continued to improve.

In China the situation has calmed since the 8.5% drop in the Shanghai Composite on the 24th August. A correction seemed likely given the frothy Chinese stock market following a steep fall in property prices, a currency devaluation and disappointing economic data. The property market in China has since stabilised and retail sales remain strong but the impact of the fall shook the rest of the world. In particular the prospects for emerging-markets dependent on Chinese growth and the future price of commodities continues to look uncertain.

It seems these lingering fears are enough to ensure central bank policy rates remain “lower for longer”, however it is likely that for chairwoman Yellen the definition of “longer” is a rapidly diminishing period of time. Indeed during her latest speech, Yellen stated that she expects rates will rise by the end of the year - although with the caveat that the unemployment rate and inflation rate are no longer the triggers for Fed action. Focus will now shift to the prevailing price of oil, the stability of other economies (most notably China) and the strength of the dollar in deciding when it is ‘safe’ to raise rates.

Until then, and in all likelihood for an extended period afterwards due to the slow rate of any rise, yields on fixed income could remain supressed and equity valuations high. An environment of cheap credit with management incentivised to raise EPS will continue to drive share buybacks and provide a positive background for investors.

In summary the world economy has reached a crucial stage of transition whereby developed nations edge closer to normalising monetary policy whilst the Chinese super-tanker attempts to rebalance and bolster domestic demand. The markets will experience some strain and associated volatility, but interesting investment opportunities will emerge. We continue to prefer stocks with transparent earnings and a covered dividend to provide some ballast in these conditions. Additionally having held relatively large positions in cash during the August wobble we will now look to move gradually back into the markets.