HENDERSON ROWE

MARKETS NOTE SPRING 2016

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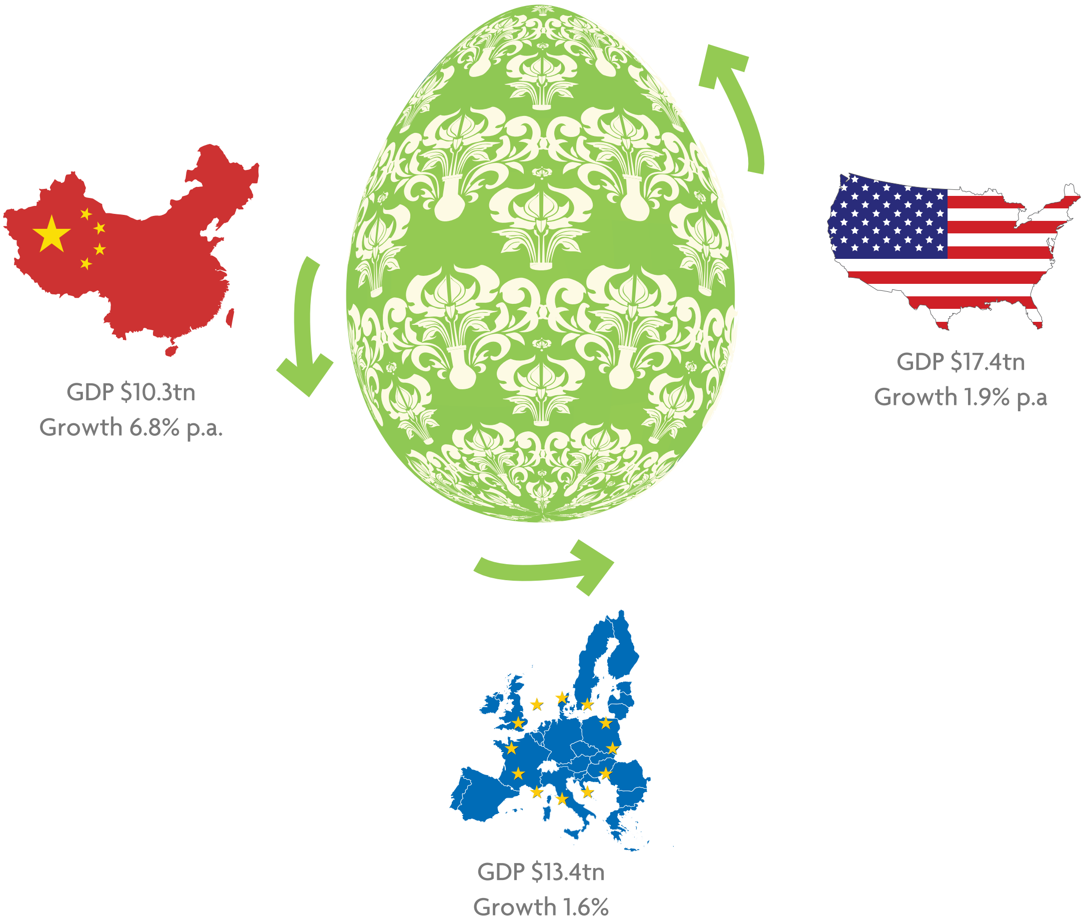
HAPPY EASTER

Our ‘Easter Egg’ this year gives a visualisation of the relative stages of the three main economic blocs in the economic cycle.



Data and Chart Source: GDP growth rates - www.tradingeconomics.com

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SPRING IS SPRUNG

The anxiety fuelling the December to February sell-off has gone a little quiet as markets have headed back up to December's levels. The trigger event for the fall was Janet Yellen's 0.25% Fed Funds Rate rise, the icing on the cake with cratered commodity prices, an anticipated wave of US shale oil bankruptcies later in the year and an imminent China collapse. Brexit did not help. Investors fled to the US Dollar, and its resulting rise exacerbated pressure on Emerging Market Dollar borrowers, a vicious circle feeding fears of extreme stress in credit markets.

The rebound came at the end of February as the Dollar began to soften, improving the Dollar value of Commodities and rescuing Emerging Markets and Junk Bonds. The stress machine has largely unwound, assisted by Chinese interest rate cuts and by Mario Draghi's further plunge into negative interest rate territory. The ECB is now charging banks -0.4% on unnecessary deposits and buying E80bn bonds a month. Rates could go lower still.

In our Easter Egg, a stylised map of where the three main economic blocs sit on the recovery curve, the US is climbing out of recession, Europe is sitting at the bottom, mired in political contradictions and conflicts but improving, while China is sliding down from very high growth rates. Recent market gyrations stem from a clash between finely balanced growth rates and the impact of slowdown or recovery on credit markets. Investor perspectives are very polarised, but the ECB has just helped push Europe along a bit.

Since December we have taken a little money off the table, partly to see which way the wind is blowing given the risks, but also to take advantage of any bargains. It would be nice to pick up some bonds actually yielding something. For now we have also bought a couple of stocks with attractive yields. If the rise continues we will have missed out a little, but with Brexit looming and complacency returning we are not averse to keeping some powder dry for a while longer.

Happy Easter,

Giles Rowe
Chief Investment Officer

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CASH

NIRP

The inexorable decline in interest rates has the feel of an unstoppable force. The chart below shows the US 10 year generic yield’s relentless fall since 1982. The slope is repeated in many major developed economys’ yields, and the crushing slide has not only blocked Yellen doing more than a token 0.25% rise but pushed yields down into negative territory for many economies. Hungary is the latest. The World Bank paper on Negative Interest Rate Policy (NIRP) in Europe starts “A number of major central banks in Europe have set key policy rates at negative levels in order to further encourage lending by making it costly for banks to hold excess reserves....nominal yields on some bonds of highly rated European governments have also dropped below zero.”

This is obviously a massive problem as high quality bonds now yield nothing, and investors are forced into risky assets. Cash is not a long term solution, because NIRP is a currency devaluation strategy that also heightens credit risk. The USSR failed in large part because it removed the price mechanism from the Soviet economy, and our own central planners are now doing the same with money itself. It is curious to see negative rates since Silvio Gesell, who invented them in the 19th Century, did so because economic activity reduced (people hung onto their money) if rates were less than 2.5%. Negative rates were his solution to boom and bust. Stop people holding money without cost by reducing notes’ value over time, and they should spend. The Greens have latched onto the idea as it stops wealth accumulation and is a step towards the confiscation of land. Governments like negative rates as the abolition of cash would assist tax collection. For now, they continue to distort asset and currency values in a way that is intended to advantage investors and doubly disadvantage cash.

Data: World Bank “Global Economic Prospects June 2015”; Margrit Kennedy “Interest and Inflation Free Money” SEVA 1995. Chart Source: Bloomberg.

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BONDS

HOW LOW CAN YOU GO?

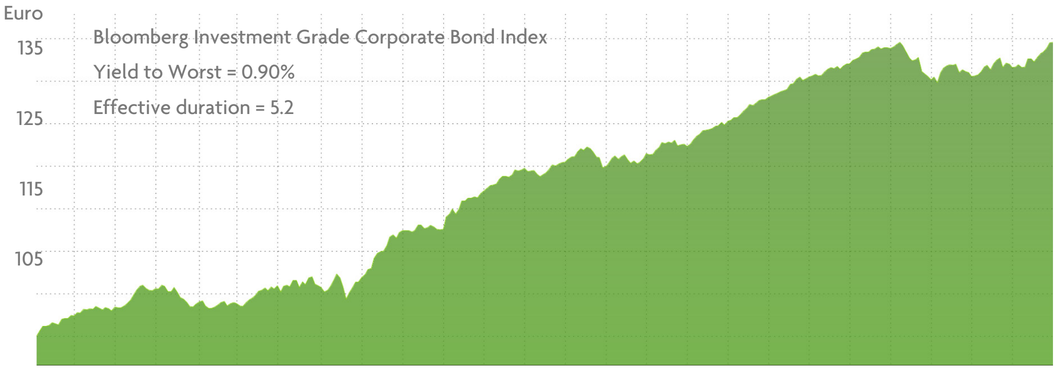
After the crash of 2008 low rates have helped to improve households' balance sheets, reduced bad debts and lifted the value of assets, much needed in many Western economies to stimulate credit demand. In 2015 mass bankruptcies were averted as struggling US energy companies rolled over debt. Persistent low rates also inhibit new loans, and Draghi has taken this into account by giving the banks access to their own cheap loan schemes.

Where does this leave a fixed income investor? Money market funds yield nothing. The case for some exposure to duration still holds in Europe and Japan, since both economies are bank financed and it is difficult to see how inflation can rise while banks' balance sheets continue to shrink. But the bond markets in both are trading at very expensive levels and any reversal in yields could mean double digit loss.

High Yield markets have experienced a nice rebound since the January sell-off, according to Bank of America Merrill Lynch a case of smart money selling to retail investors. While we see some opportunities in the energy and technology sectors we are not buyers of any bond index products.

Consensus has been obsessed with interest rate risk but we have been mindful of credit risk. Do not be a hero at the bottom of the default cycle, as there will be no warning when it turns. We stick with medium duration and higher quality credits for now. While we might be accused of missing out on a good party, we think this one might not be worth the hangover.

More caution on long term bonds is warranted in the US where recent positive inflation, wage and growth data pushed market-implied probabilities of a July hike above 50%.



Data and Chart Source: Bloomberg

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REAL ASSETS

YIELD AND VALUE

In our portfolios we have a corner for ‘real assets’: Property and Commodities.

As interest rates set to rise back in December the Property asset class began to look vulnerable globally. With the exception of high end London property which has cash backing thanks to ‘tax efficient’ inward investment of £100 billion over the last six years, the sector overall is generally leveraged and illiquid. It is therefore sensitive to shifts in the direction of background growth and to interest rates. UK REITs and housebuilders began to sell off in the third quarter of 2015 but have since won back some ground. Yields are tempting, 3% to 4%, and Price to Book is below 1x for REITs. The UK is late cycle, though housebuilders still see strong demand. Europe is interesting and less saturated with investment.

Commodities and Energy stocks are hated. Foundations, charities and other politically sensitive institutions have disinvested from fossil fuel on principle. In the case of Coal this has been lucky. Even the once mighty Peabody Energy warns of impending receivership. Low oil and gas prices have slashed rig counts and US crude production is set to fall 1.7m barrels per day from 2015’s 9.7m to 8.0m by 2017, possibly enough to persuade OPEC to cut back too. Meanwhile the International Energy Agency and US Energy Information Administration announced the world’s oversupply of oil has worsened. Near term, producer hedging suggests they are not expecting a price rally till 2017. As oil has risen above $40, the contango, spread between forward prices and spot, has disappeared as producers cash in immediately. If this continues storage will be uneconomic and oil in tanks could flood back on the market. There is so little good news that we are beginning to reinvest in oil stocks with decent cash flow cover.

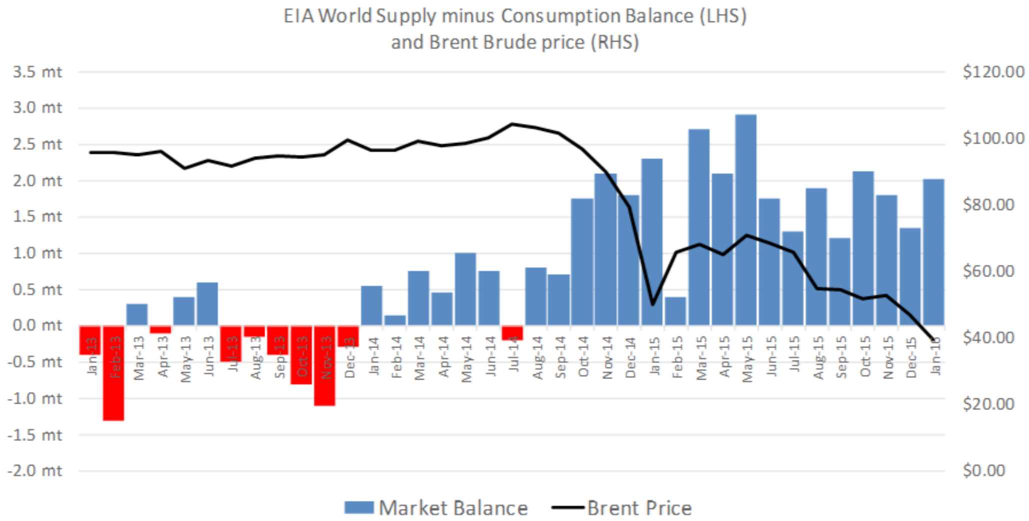

Chart showing world oil supply balance and Brent Crude price from January 2013 to January 2016. Data and Chart Source: EIA, Zerohedge

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