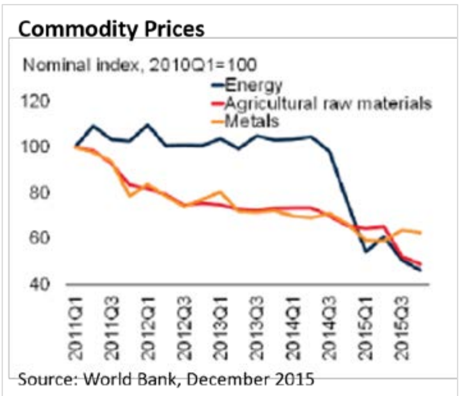
DECEMBER 2015 COMMENTARY

CHINA SNEEZES

The 6 year old global recovery is fraying at the edges and the big change is of course China's economic performance, where growth has downshifted considerably. This is well worth a closer look. Investors knew China's shift from investment to consumption spending would be tough. Indeed, global growth, while revised lower, remains positive at just over 3%, according to the World Bank (Chart 1). But plenty has changed at the margin.

Commodity prices have collapsed along with OPEC's price discipline in the face of much weaker Chinese demand and surging US supply (Chart 2). The oil market may eventually re-balance by 2017. In the meantime, US investment spending, once driven by shale oil, will retrench though both US and European consumers will have more purchasing power too. The net effect is clearly positive in developed high-income economies and, as an oil supply shock, is the exact opposite of the OPEC price hikes and embargos in the 1970s.

A decade of Chinese over-investment weighs heavily on the global economy, even as we have recovered from the housing boom that turned to bust on 2008. China has made good progress shifting from metal-bashing industry to a service based economy with more domestic consumption. But there is a considerable debt overhang, with total private and public debts approaching 250% of GDP. The IMF believes this is manageable though China is no longer driving global growth.[1]



Emerging markets, many of them commodity producers, are under pressure as investors demand higher spreads to own their bonds and capital flows out. On top of this, China is depreciating the yuan while the US Fed raises rates for the first time in more than 10 years. For EM borrowers with US dollar debt, the cheaper yuan makes China more competitive while the dearer dollar makes the debt burden grow.

The hope is that investment spending will rise in the developed world now that China's investment binge is over and Europe is on the mend. Indeed, the World Bank and IMF estimate the US and Eurozone will grow in 2016 at slightly higher rates than 2015. Even emerging markets are expected to recover in 2016 though this may need to be revised if capital flight leads to crisis in some countries or regions.

THE KNIFE HAS FALLEN

Experienced investors know better than to try to "catch a falling knife" by stepping in too soon when prices fall. But as the market cycle turns, opportunities will present themselves. The commodity price rout is plunging the so-called super cycle to depths of depression which equal the euphoria that preceded it. Oil has been over $100 for most of the past 5 years and is now expected to touch $10 before the market recovers. In early 2016, global markets are now reacting to the same "new normal" of lower growth. We can safely say that the knife has fallen!

We know that that the biggest economy in the world (USA) has slowed while the second biggest economy in the world (China) is slowing faster. Thanks to extended QE, Europe's economy is picking up while Japan's economy is still stuck in neutral. The second order effects of the above are that economies dependent on global growth (Canada, Australia and most emerging market economies) are effectively in recessions. All of the above presents an equity investor with a simple matrix where you would be long the U.S. and Europe and short everything else. In 2015, this would have worked well.

Generally speaking, the US is the best off in terms of navigating the challenges of a slowing global economy. In addition to the above points, you can add specific structural issues for every region; in Europe it is labour market rigidity, migration, refugees and the lack of fiscal union; in Japan it is demographics and protectionism; in many EM markets, it is corruption (e.g. Brazil) and high levels of USD denominated corporate debt. If you add in a good number of cyclical and monetary divergences around the world, one has a decent opportunity set from which to generate future returns. Table 1 below shows various key interest rates, where credit spreads on low grade debt have blown out sharply.

GETTING INTERESTING

We currently cover 41 funds on behalf of our clients, allocated globally across asset classes and strategies in order to maximise the benefits of diversification as well as the potential returns.

Our credit book includes a fund invested in European bank loans as well as global multi-strategy credit hedge funds. In a terrible year for credit, where the BAML Global High Yield index lost 2.1% and the BAML Global High Yield CCC or Lower Index fell 10%, our funds fared quite well.

Table 1: Interest Rates	Yield
US Treasury 10 Year	2.3%
US Investment Grade	2.8%
US High Yield	8.8%
US High Yield CCC or Below	18.2%
European High Yield	5.4%
Global Emerging Markets	9.0%
Source: US Federal Reserve FRED, 31.12.2015	

European loans made a small profit, as did multi-strategy credit, though distressed debt declined marginally. US distressed looks very interesting now.

In Europe, market turmoil created opportunity, particularly in peripheral sovereign and bank sector bonds. We expect the US shale boom now turned bust will eventually do the same.

Indeed, the number of distressed bonds trading with yields more than 10% over US Treasuries is the highest since 2009. Low grade US bonds now yield nearly 20%.

ACTIVE MANAGEMENT

2015 proved to be a very challenging year for investors, particularly in the commodity complex. Even a limited exposure could have resulted in portfolio losses for the year. Going forward, market turbulence has created substantial yields in risky assets, where returns are biased heavily towards current cash flow, but this requires careful analysis.

China's rebalancing and transition to more consumption and services will take years and lead to more bouts of market volatility. Even so, the authorities there have considerable foreign exchange reserves to manage the transition to more open capital markets. As such, we continue to view China as risk more than an opportunity. We believe the best opportunity is to trade the resource collapse which stems from China's transition as the sector eventually recovers.

Interestingly, both of the energy managers we cover see markedly higher oil process in 2017, when supply will succumb to large capital expenditure cuts already implemented and demand gradually rises. This is a highly cyclical business, and once excess capacity is closed down, turnaround can come quicker than many expect. In other words, markets do work.

We suggest investors focus on active investment strategies in developed and select emerging markets, principally in equity and credit assets. Declining liquidity in credit markets has already demonstrated that active security selection can produce vastly better results than a passive approach. In our view, in a low growth global economy, equity markets will also eventually reward active money management much more than is the case today. The tail-wind from falling interest rates and rising market valuations, which drive markets up indiscriminately, cannot go on forever.

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[1] http://www.imf.org/External/Pubs/FT/GFSR/2015/02/index.htm