tamifications
OCTOBER 2014

TAM INTERNATIONAL INVESTMENT NOTE

Weighing it up

When you are in deep conflict about something, sometimes the most trivial thing can tip the scales.
Ethel Merman

Stock markets appear to have regained some poise after a few frantic weeks that saw the FTSE100 fall around 10%, and 10-year Gilt yields, which move inversely to Gilt prices, fall from 2.5% to below 2% as investors were attracted by the perceived safe haven of Government bonds in response to a growth scare that could stave off interest rate hikes until after the election. **The last few trading sessions have reversed around half those moves but a nervous mood has settled on global markets.**

At the peak of all the volatility, it was clear from our discussions with some of the UK's leading fund managers that it was unclear exactly what was causing so much angst. Disappointing US retail sales numbers appeared to be the initial trigger for a sell-off, but was an unremarkable piece of data, at a relatively unimportant time of year the real reason? Why were falling unemployment numbers and stronger industrial production numbers ignored?

The media, as is their way, chose to hang the story on fears over the end of QE, a slowing global economy and Ebola. This seemed to open the flood gates to a list of negatives which overwhelmed anyone quietly pondering the economic positives that had driven stock markets to record highs. As the market spiralled lower, more negatives seem to be revisited as if they were new news, reinforcing the stock market falls further. The FTSE didn't find a base until just north of 6,000.

So in the wake of the bursting of the bullish sentiment, let's conduct a quick audit of the list of dreads that have been piling up over the last year but somehow didn't concern stock markets until now. In no particular order:

- Fear of rising interest rates in US and UK.
- **Fear over eurozone disinflation/deflation.**
- Ukraine. Sanctions between US, EU and Russia.

- Fear that falling oil price affirms global economic slowdown.
- Ebola.
- Brazil. Or rather economic slowdown in 3 of the 4 BRICs.
- **End of US Quantitative Easing.**
- Strong US dollar. Bad for emerging markets.
- Middle East: Syria, Iraq, ISIS and now Turkey, or Jordan…
- ECB inaction/inability to intervene.
- Israel and Gaza.
- German Industrial production slowing.
- UK inflation weaker than expected.
- Low wage growth despite falling unemployment.
- Italian politics.
- French politics.
- **Fear of Chinese property bubble.**
- Expensive equity valuations.
- Expensive bond valuations.

Depending on where you draw the line in the UK (Fracturing of right wing politics, ending of double Irish tax regime and Cameron's dubious claim that the EU will tear up founding principals etc.) this is pretty much the list of things that the financial media thought we should be worried about. But if you look at the events that have shaped the markets all year until now, the three stand-out culprits from this list, as far as TAM is concerned, are:

- ECB inaction/inability to intervene.
- Fear over eurozone disinflation/deflation.
- Fear of Chinese property bubble.

Everything else was either a given, or a situation where the real impact on financial markets was, and remains, well understood. Before we come onto these, here are some examples of what we consider to be red herrings if one is thinking about either panic selling out of stock markets or buying Gilts:

Fear of rising interest rates in UK and US. This can hardly be surprising since the UK is leading the world in economic growth and will be second only to the USA in 2015 which could quite feasibly grow at between 3%, according to many economists, or even 3.5% if you believe Federal Reserve Bank President, John Williams. A move up in Bank of England interest rates before the UK election could be justified even though wage rises are lagging growth and inflation. Although we are in the midst of one of the greatest financial experiments history shows us the early-stage rate rises are not to be feared.

Ukraine/Russia/Germany and sanctions. Sanctions are affecting Germany already. There were profit warnings from German machine tool and building machinery manufacturers weeks ago. But the sanctions are hurting Russia too. Foreign direct investment in Russia has halved and growth is projected to fall to 0.5% (IMF) or 0.3% (World Bank). The sanctions work because they target individuals and this geopolitical chapter could have a predictable end whereby a compromise can be reached, sanctions eased, and where everyone saves face. Fears that Russia will switch off the gas to Ukraine are likely overblown. Remember that Russia is not at war with Ukraine. Direct action would only confirm that the rebels are Russian backed, which Putin denies. But Crimea has gone. The endgame may look something like Transnistria. Stalemate, with some occupation by Russian troops that trumps any talk of Ukraine joining Nato and leaves Russia with a say in Ukraine's geopolitical destiny.

Fear that falling oil price affirms global economic slowdown. This is not a re-run of the fear over supply in the wake of 9/11 and the fall of oil to $11 per barrel based on a severe slowing of the US economy. If nothing had changed in the last 13 years, it appears logical that a falling price of oil would be a predictor of a slower economy ahead. But this time it's about supply, and the US has become virtually energy self-sufficient thanks to gas fracking and shale gas. Energy is significantly cheaper in the USA than continental Europe (see Germany). If you really want a cynical point of view, consider that even though the price of oil has fallen from $110 to just under $85, OPEC is not easing up on production. Not trying to put the high cost US 'frackers' out of business surely? Or perhaps word got around that the entire Russian budget is built on assumptions of $100 per barrel rather than $85? That's got to hurt unless you're the US consumer. Estimates put the immediate benefit to the US consumer at $40 billon or $80 per household per month in fuel savings. That's a positive coming into Q4 and holiday season (Thanksgiving and Christmas in US). Interestingly one of the best performing sectors in the US equity market has been the transport sector where lower fuel costs equal higher margins. And this despite the Ebola threat outlined next.

Ebola. This is a big subject covered non-stop on TV news but we hear today that suspected cases are turning out to be false alarms (Carnival cruise ship, a health worker in Ohio and Spanish nurse) and Nigeria declares itself Ebola free with no new cases since July. The virus has the power to create genuine fear for the devastating effects on its victims but we consider the crisis, as it stands and understood, to be containable with little impact on financial markets. Many African economies will be undoubtedly affected by the recent outbreaks but many are already working on post-epidemic recovery plans and the IMF has already cut deficit rules for the hardest hit countries.

End of US Quantitative Easing. This has to be the most predictable event of 2014. The Federal Reserve said they would reduce the quantitative easing bond buying program by $10 billion a month until it finally ended in October 2014. This is what has happened with the final 10-year US Treasury buy-back on 21st October as planned. The Federal Reserve is not an institution given to U-turns, which, oddly, illustrates why markets got in a flap with the "taper tantrum" last year. Once the Fed started the taper, they were not going to stop under the new Chair, Janet Yellen (as unemployment continued to fall). The only surprise is that the Fed are dropping hints that a fourth round of QE is being discussed already. The bond markets are fully aware that unexpectedly bad news on the economy will be countered by continued support from the Federal Reserve.

Things to be very concerned about.

ECB inaction/inability to intervene and fear over eurozone disinflation/deflation. Despite some significant progress among the peripheral laggards, the problems of the eurozone cannot be underestimated. The latest chapter in the never ending eurozone saga involves stock and bond markets waiting to see how bad things will get before Germany allows the ECB to engage in US-style QE to stave off deflation and create some stimulus for the eurozone economy. On 20th October, the ECB started a covered bond buying program announced a month earlier. The plan involves the buying of billions of Euros of covered bonds and other asset-backed securities (loans, really) onto the ECBs balance sheet over the next 2 years. However, this ambitious plan, whilst notionally welcome, will struggle to carry out its objectives in a market with relatively low liquidity. There are simply not enough bonds for the ECB to buy. As this knotty problem has not been explained and apparently not thought through, it does actually leave the bond markets seeing this latest development as a stepping stone to full blown QE which would allow the ECB to buy far more liquid sovereign bonds.

Furthermore, a cynic might imagine Mario Draghi rubbing his hands with glee as German industrial production data came in far weaker than expected, thus driving down bond yields further without the need for bond buying at all whilst simultaneously weakening the German stance against QE.

Finally, the latest market volatility has left the Euro weaker at the expense of the relative safe haven of the US dollar – a role always taken during periods of risk-off stress. Even here there is a silver lining because a weak Euro is good for German exports and the eurozone as a whole. The fact that German growth comes at the expense of countries like Italy is another matter to be fixed in the very long term but not something that has changed in the last month. However, even this issue can have a silver lining as we witnessed only this weeks when stock markets posted one of the best one-day gains following rumours that ECB

Fear of Chinese property bubble. Again, this is not new news but does hang over markets due to the size of the potential problem and the unknowable ability of the Chinese authorities to keep the financial system propped up; other than the fact that the west has repeatedly underestimated the ability of the Chinese to do so. Actually, regional Asian governments and emerging markets see China in a much more positive light than in the west. There appears to be a greater recognition that the true winners from globalisation are the Chinese middle class and that as trade corridors continue to open up, China will be at the centre of all of them. Today's GDP release showed that the economy grew at 7.3% in the third quarter from a year earlier, which is the weakest since Q1 in 2009, although slightly better than economist forecasts. The drop is attributed to the property sector with both property sales and new construction on the slide. The Government has some leeway to cut mortgage rates and lift construction controls but it remains a cause for concern. Again, this is not new news and nothing in the last few weeks has brought a day of reckoning any closer. TAM has not directly invested client portfolios in China and with 3 out of 4 of the BRICs emerging markets experiencing economic slowdown; we are not in any rush to do so.

Conclusion

The last few weeks have been perplexing for many investors but it must be remembered that stock market corrections of 5%-10% are not unusual in the broader scheme of things and, whilst we believe that equities are the only liquid asset class that can deliver inflation beating returns, we had retained only a mild overweight as valuations had reached new post-Lehman highs.

The low volatility we have witnessed over the last few years is a direct result of central bank stimulus in the form of a supply of cheap money. That is not to say that the global economy has not improved. Far from it. From 2000 to 2013, the world economy grew from $32 trillion to $74 trillion. There was some inflation, to be expected during loose monetary policy, but it was mostly genuine growth.

Today, we witness the end of the Federal Reserve's QE3 program of bond buying stimulus. This program has run exactly to script and the chance exists for the economy to stand on its own two feet with markets unencumbered by intervention.

The outlook for the US and UK economies in particular look good and if stocks are to be valued on their fundamentals, rather than second guessing the manoeuvrings of central banks, then that is no bad thing. The FTSE 100 index is not expensive relative to the rest of the world. We retain a strong bias towards UK equities and, within that, exposure to income seeking stocks. The overall yield on the FTSE is 5% and this gives us the confidence to seek risk in opportunities elsewhere, such as Japan and selective oversold European investments.

We are part way into the third quarter earnings season in the USA, an important time of year to not only asses the overall health and progress of companies, but to get an insight into the fourth quarter and the financial strength of the US consumer. So far, we can see that big companies are in pretty good shape although we expect some degree of caution to be built into forecasts into 2015.

As we write, the S&P500 Index of leading US stocks has rebounded from the low of 1,820 following the fall from 1,975. However, Goldman Sachs has reiterated its target forecast for the S&P500 of 2,050 by year end and JP Morgan has called a market bottom on 3 out of 4 indicators. There is some technical analysis going on here, which is unsurprising given recent volatility but their targets are also a factor of valuation and the earnings growth we are seeing coming out on a daily basis.

To believe that equities, both in the US and UK, are realistically priced, would be to assume an overly bearish outlook not supported by the evidence nor the earnings guidance of already cautious CEOs. Markets are extremely good at shaking out the weak bulls with short investment horizons and unrealistic expectations. We have not designed client portfolios to trade around the narrow trading ranges of interest rate expectations and have retained some cash to make opportunistic investments where appropriate. **Ultimately, we expect to be rewarded for getting the longer term call on Gilts right as well as having the conviction to stay invested in the stocks of well-run companies that continue to grow profits and dividends.**

.

JOIN THE CONVERSATION ON

This document is not intended in isolation as an offer or solicitation or recommendation to use or invest in any of the services or products mentioned herein. Investors should be aware that the value of the portfolio and the income from it can go down as well as up so you may get back less than you invested. Past performance is not necessarily a guide to future returns. The value of investments denominated in foreign currency may fall as a result of exchange rate movements. The investments and services referred to in this document may not be suitable for all investors and, if in doubt, you should seek qualified independent financial advice. Any opinions, expectations and projections within this note are those of TAM International Limited, represent only one possible outcome and do not constitute investment advice. TAM International Limited is a subsidiary of TAM Asset Management Ltd and is regulated by the Financial Services Commission of Mauritius. TAM Asset Management Ltd is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

TAM INTERNATIONAL LIMITED
7th Floor, Wing B, Cyber Tower, Ebene, Mauritius

+230 454 6400

+230 454 5413

www.tamint.com