BROMPTON ASSET MANAGEMENT

Equity market commentary

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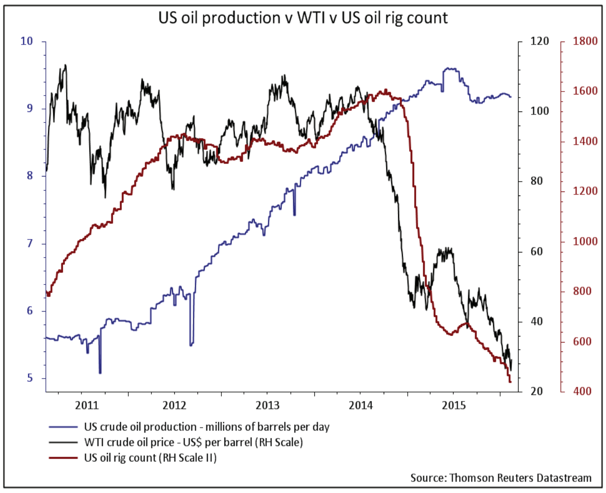
Global consumer stocks offer shield amid turmoil

Equities fell sharply in the first six weeks of 2016, declining almost 9% in sterling during an extended period of volatile trading. Safe-haven assets such as government bonds and gold were in demand and the yen rose against other major currencies as it often does at times of financial market stress. The volatility was accompanied by alarming headlines and calls to "sell everything!"

The turmoil resulted principally from two factors: the oil price fall and uncertainty regarding Chinese economic growth and monetary policy. Both could lead to deflation should they prove persistent. In a deflationary environment, longer-maturity bonds are likely to perform better than equities.

The oil price tumbled 42.17% in sterling in 2015 and fell a further 20.76% over the first six weeks of 2016. It is important to realise weaker oil prices result from a supply-side shock, not falling global demand. Last year, Saudi Arabia surprised investors when it maintained output in the face of increased production from US shale producers, effectively launching a price war to protect or increase market share. As the chart below shows, the US oil rig count fell in tandem with the oil price as producers shut non-producing wells yet, crucially, oil production remained stubbornly high. It only started to fall in mid 2015, almost a year after prices began to decline sharply.



The recent rise in US energy sector high-yield bonds reflects the financial distress shale producers now face. The risk these companies will default on their bonds has increased markedly. It is not in Saudi Arabia's interest for oil prices to recover until a significant amount of US capacity has been closed otherwise its price war will not have achieved its goal.

Low oil prices are painful for many oil-producing nations, which must now fund current account deficits from reserves or borrowing or risk political problems by cutting public sector spending. Wealthier oil producers can finance deficits from reserves for many years to come. There is, however, anecdotal evidence that some sovereign wealth funds have been selling equities. It is possible lower oil prices are causing more domestic disruption than might initially be inferred from the scale of their reserves. These powerful vested interests would benefit from an oil price recovery, which makes an increase likely as soon as circumstances permit.

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The impact of decisions by the Saudi and other oil-producing nations makes it hard to make short-term predictions about oil prices but a change in strategy when it does come might cause them to recover swiftly from recent depressed levels. Janet Yellen, the Federal Reserve chair, has described low oil prices as a “transitory factor” and expressed surprise at the extent of the fall. An oil price recovery would lift inflation expectations and may reverse the market movements seen in January and early February.

The other significant factor affecting markets is uncertainty over China. Chinese economic growth may have slowed to well below the official 7% annual target. The lack of confidence in published data makes it difficult for investors to determine the underlying state of China’s economy. In addition, the bouts of renminbi weakness in August 2015 and in January 2016 have created uncertainty regarding Chinese monetary policy and the extent to which China will allow the renminbi to fall.

The significant decline in central bank reserves is, however, evidence that the People’s Bank of China has intervened in currency markets to stabilise the currency. A rapid fall now the International Monetary Fund has awarded the renminbi reserve currency status seems unlikely but there is little official rhetoric to support this view.

Renminbi weakness is the latest development in a programme aimed at stimulating growth. During the last year, China has cut interest rates, increased bank lending and sanctioned major infrastructure projects in an attempt to foster growth. Equity markets globally would respond positively to evidence that this barrage of policy initiatives was proving successful.

During 2015, Brompton’s asset allocation shifted to reflect my more cautious view on global stockmarket prospects. The overall investment in equity funds reduced and within the equity allocation, the bias towards developed economies increased in preference to Asia excluding Japan and emerging markets. I focussed on funds with significant allocations to global consumer companies that should benefit from increased discretionary spending following the oil price fall. I maintained a significant allocation to dollar-denominated assets as the Fed moved to raise interest rates while other major central banks retained ultra-loose monetary policies. At the start of 2016, I added longer-dated sovereign bonds where appropriate given the increased deflation risk.

Over the coming months, the dollar may stop rising or weaken as the prospect of further significant US interest rate rises recedes. This should lead to a sharp recovery in developing economy equities from recent depressed levels. The near-universal gloom means any policy shift by major oil producers or evidence that Chinese growth is recovering would result in a sharp recovery in equity markets.

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