CHESHIRE
WEALTH MANAGEMENT

Global Markets Bulletin

Quarter 3: 2015

General Economic Overview

It is not difficult to see that quarter three has been the worst quarter for equity markets for some considerable time. In fact most risk assets, with the probable exception of property, have fared badly in the last quarter which has been dominated by two key influencing factors - the Chinese slowdown and US Interest rates - resulting in higher volatility across most stock markets. There are a number of other issues, such as valuation, that interact with these but most of the increase in uncertainty has been as a result of these two factors.

Although the market catalyst was a scare about firstly Chinese and then global growth, one of the reasons markets fell so far and so fast was related to valuation. Valuation is never a good indicator of market timing and markets often stay overvalued until a catalyst occurs, as was the case in 1987. Concerns about both slowing growth and an inevitable rise in US interest rates were the catalyst for the recent market setback and high valuation levels in many markets meant that investors were reluctant to step in to support the market until stock market declines meant valuations were more attractive.

Taking the key factors in turn, China's rebalancing and transition from a fixed asset driven economy to a service driven one was always likely to cause some level of economic volatility. Many Asian based managers believe China is taking up the slack from its slowdown in manufacturing via its service sector, which is why unemployment has not increased to date. Whilst China is undoubtedly slowing, the impact of this is arguably more important for commodity exporting nations than for China itself. This may indicate that sentiment has a lot to do with recent moves in global markets rather than tested fundamentals and China has not helped this by fuelling the debate firstly with the recent devaluation of the Chinese Yuan (albeit by only around 3%) which appears to have unsettled investors' faith in the Chinese authorities to maintain growth and economic stability, and secondly by mismanaging the turmoil in the stock market by trying to manipulate the market which it proved was impractical and unachievable.

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Since the last rate hike in the USA on 29 June 2006 the world has been through a huge financial crisis during which we have seen 697 interest rate cuts globally and a combined $15 trillion of financial assets bought by central banks. Despite this, economic growth remains sluggish and many developed economies continue to grapple with close to zero inflation. Central banks seem to be sure of their roles in fighting these deflationary pressures and we are not likely to see a trend for interest rate rises for some time yet. The US has been more dovish on rate rises, not because of poor domestic data, but due to the concerns in the global economy and in particular emerging markets. This stance has been supported by global organisations like the IMF, but has been criticised internally and has created further uncertainty and market volatility as the rise was potentially priced into markets for September this year. The fact that inflation is so low and deflation remains a potential threat also points to lower rates which is unusual at this stage of the economic cycle. Overall markets will continue to watch the Fed and analyse each comment in detail for any signs of change but it seems that they are looking beyond the US for stabilisation before they act.

Asset allocators look to make decisions informed by experience and whilst most fund managers have grown up in a standard business cycle environment, the economic recovery post the financial crisis has not followed normal patterns. In particular, the credit channel of monetary transmission has not operated effectively and low interest rates have not resulted in a willingness to borrow and engage in capex by corporates. A muted capital investment cycle has now been further hit by the slowdown in the resources sector and as yet non-resource capex has not fully compensated for this.

Throughout the developed nations the pickup compared to previous cycles has been muted, and in this environment the slowdown caused by the hit to commodity exporting nations has resulted in some softness in the global economy in the third quarter. Investors should not necessarily panic at this as very often during extended economic recoveries there are periodic soft patches.

As we saw in January, the third quarter has again seen markets sell off on concerns about global growth. This came against the backdrop of the significant rally in markets which has occurred without a serious correction since the Draghi 'do whatever it takes' speech in July 2012. QE and lower than normal interest rates have previously resulted in markets front running the economic cycle.

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At the start of 2015 Europe was the only developed Western market trading below longer term valuation averages. European QE resulted in multiple expansion in Europe from below 14x to 16.5x earnings by April - by the end of Q1 all markets were trading either a little above fair value, or at expensive valuations. This was particularly true of the US when looking at the Shiller cyclically adjusted PE ratio which looks at an average of the last 10 years profits and certainly showed the United States to be trading at elevated levels. This left markets reliant on earnings growth to make further progress. Earnings expectations ex Europe have in the main been trimmed back since the start of 2015 and both the US and UK are expected to show negligible earnings growth in 2015, with Europe the only major region seeing upgrades, partly due to currency depreciation. Japan has been the strongest market year to date having only really fallen in recent months because of the knock-on effect from concerns over China.

There are three main elements that affect equity market pricing – valuation, fundamentals and sentiment. The most important of these continues to be valuation. This does not provide a reliable timing indicator but is an excellent indicator of risk – a negative catalyst when valuations are high can result in a sharp pull back in equity prices. Very often the perceived catalyst such as China today is not the real reason for a market setback as when valuation levels are high, there is less market support in the initial stages of a pull back. This appeared to be the case in August of this year.

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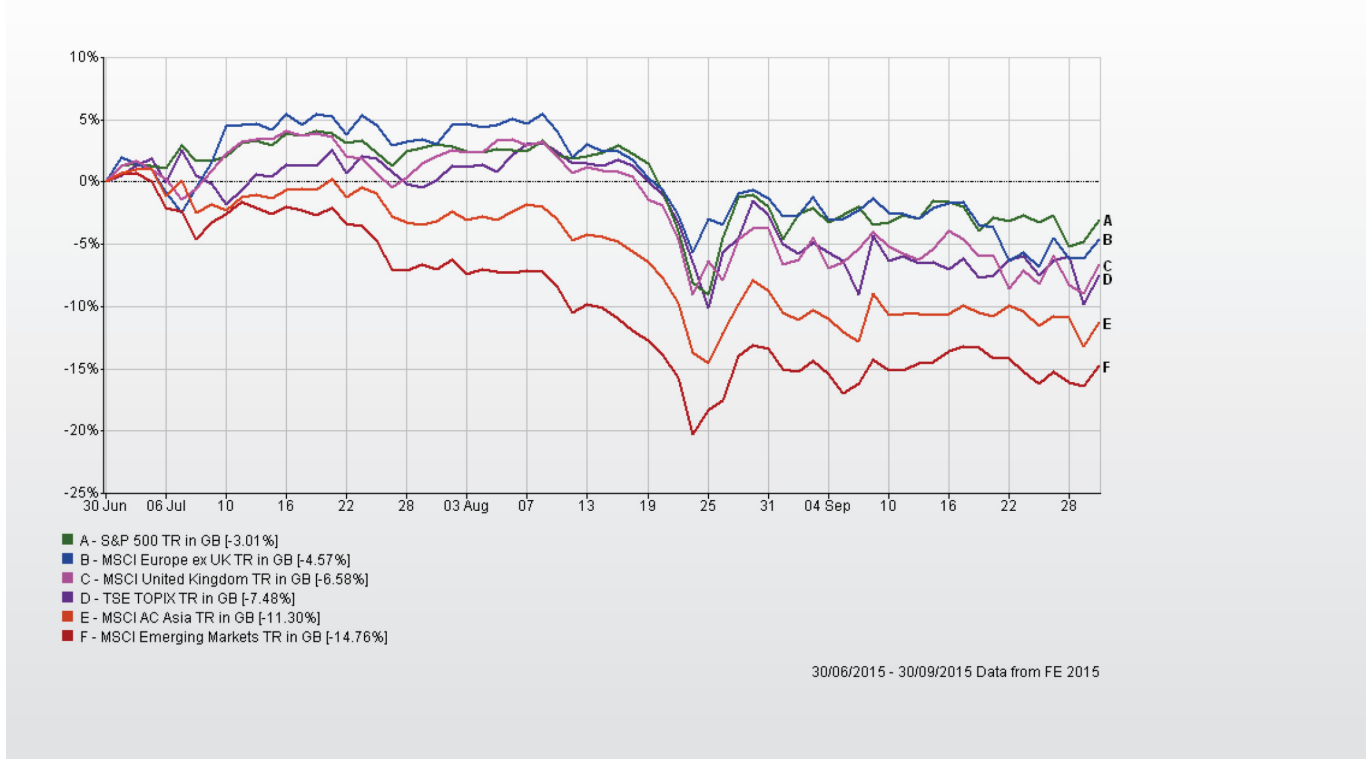
Equity Markets Overview

Chart showing 2015 year to date returns for major market indices:

Chart showing Q3 2015 returns for major market indices:



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Looking at fundamentals, despite the slowdown in China and parts of the emerging world, the global economic recovery is now more broadly based with both Europe and Japan on an improving trend and central banks in both the US and UK contemplating an interest rate rise. Even though the recovery in the developed world is now more synchronised, it will be restrained by the excessive levels of debt in the global economy and the slowdown amongst commodity exporting nations so overall accommodative monetary policy is likely to remain in place for an extended period.

Finally sentiment – this is very often the contrarian one. Sentiment towards equity markets by private investors is now more cautious, especially towards Asia and this is generally a positive sign. The sharp selloff may have succeeded in putting off cautious investors from moving into higher risk assets.

UK

The UK, like the US, has been on a steady growth path for some time and has the benefit of being in a stronger position than other European economies with the exception of Germany. The stock market has not been able to avoid the recent falls with the FTSE down some 7% over the quarter, which is a reflection of both uncertainty in sentiment and the general global downturn based on China. The UK has a global stock market, particularly in mega caps, and has been gradually dominated by mining and oil majors over the last ten years as financials have struggled. The commodity related slowdown has therefore hit this part of the stock market more significantly than perhaps other western markets. The domestic economy has been in good shape and this is why we have seen greater strength in mid and small cap stocks since mid-2014. The market had also started to anticipate a rising rate environment which was affecting the valuations of the traditional high dividend or so called bond proxy stocks. The strength of the UK consumer has however been robust in the last 12 months, helped by a low interest rate environment and weaker commodity and energy prices. Earnings have generally been stabilising if not increasing and M&A activity is still growing making the valuation of UK equities more attractive after the recent falls. The UK has a stronger growth rate than many economies in Europe and will also benefit from the fact that Europe is also strengthening following the fears created by the Greek crisis. This will help to support the UK economy as exports begin to improve. House prices have continued to rise, but now on a nationwide basis rather than just being focused on an improvement in the south east. The labour market continues to tighten and wage growth has at last shown signs of acceleration. Wages at the lower end of the economy will improve further with the introduction of the new minimum wage which takes effect next year.

The UK is now part of the global market which is interconnected and interdependent to a far larger degree than ever before. This means scares in the emerging markets and China will continue to deliver volatility to the UK market.

US

The US economy continues to deliver good GDP growth and has positive employment and wage trends leading many investors to have priced in a rate rise in 2015. Whilst this looks sensible in isolation the Fed has chosen to resist increasing rates so far, taking a more global view of the effect this may have. At the end of Q1 all markets were trading a little above fair value or expensive in the case of the US and were reliant on earnings growth to make further progress, expectations of which have been trimmed back since the start of 2015 – particularly in the energy and related sectors in the US. Multi nationals (Including the tech sector) have suffered from the strong US dollar negatively impacting on earnings estimates and so the US is now only expected to show negligible earnings growth in 2015, when, after the market re-rating, earnings rather than multiple expansion was the factor expected to take the market higher. One sector that will see benefits from a rising rate cycle is financials which, given their stronger asset bases, may allow them to start lending more than in recent years. Low oil prices are also a direct benefit for the consumer and consumer confidence surveys are certainly at levels not seen since the financial crisis.

One part of the US economy which is showing less strength is manufacturing, which has suffered to some degree from US dollar strength. US employment numbers do not suggest emergency interest rates are at the right level for the US economy and this is frustrating for US domestic investors who are having to look for wider global signs of recovery before Fed action. The debate is creating uncertainty in all markets, particularly in emerging and Asian markets where a rate rise would be seen as damaging. Another issue for the Fed is that there is no inflation pressure and the strength of the dollar is hurting US exporters and any rate rise is likely to exacerbate this in the short term.

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Europe

European markets have enjoyed a significant rally since the Draghi 'do whatever it takes speech' in July 2012 ended fears of a collapse in the European project. At the start of 2015 Europe was the only developed western market trading below longer term valuation averages. By the end of quarter one all developed markets were trading either a little above fair value to expensive and were reliant on earnings growth to make further progress. Earnings expectations ex Europe have in the main been trimmed back since the start of 2015. Europe has been the only major region seeing upgrades, partly due to currency depreciation. As fundamentals would suggest, Europe has outperformed this year.

The recent sell off has been driven by a number of factors, the main one being that the market valuation in the States, the world's dominant market, was expensive. The current catalyst has been a scare about firstly Chinese and then global growth and markets have also had to recognise that the timing of the first US rate hike draws ever closer. One would expect this event, or firm forward guidance to this effect by the Fed, to result in increased levels of market volatility and this has been a further factor behind the selloff. Recent economic data from Europe has been encouraging with PMI's indicating continues expansion. Lower commodity and oil prices are a plus for the developed world and most of Europe. This is a boost to the consumer.

Markets have been able to sustain high valuation levels because of Central Bank policy - generally speaking, the quicker monetary policy normalises the more valuation pressure the market would face – and also fears over the first US rate rise was likely to result in some form of market setback, albeit historically a transitory one. Markets have also attracted certain investors who have chased yield due to zero interest rates and these may well have panicked, compounding the market setback, which occurred in August/September, traditionally a time of lower market liquidity. The base case scenario is for markets to recover their poise as investors realise growth concerns have been overdone. European companies continue to have scope to raise profits as the cycle catches up with the States and UK. European companies have the potential to increase margins towards the previous peak and earnings can take European markets higher as long as growth concerns dissipate.

Asia

The recent market sell off has been driven by a number of factors. In the case of Asia the current catalyst has been a scare about firstly Chinese and then global growth. China's rebalancing and transition from a fixed asset driven economy to a service driven one was always likely to cause some level of economic volatility. Many Asian based managers believe China is taking up the slack from its slowdown in manufacturing via its service sector - which is why unemployment has not increased to date. Retail sales in China are still up over 10% year on year even though the pace of growth has slowed - small ticket items such as cinema tickets or mobile phone data usage continue to grow strongly, but big ticket discretionary items such as high end cars are seeing a slowdown. Whilst imports are down significantly by value this partly reflects the significant falls in commodity prices. Looking at H1 2015 vs H1 2014 volumes of iron ore shipped to China are perhaps surprisingly higher.

The recent modest devaluation of the Chinese currency (the RMB) needs to be put into the context of a currency which has been one of the world's strongest in the last 5 years, appreciating against even the US$. Against its Asian trading neighbours, including Japan, the Chinese currency has shown significant strength. Over time and as China moves towards inclusion in the SDR, the RMB might look to peg against a basket of currencies, rather than just the US dollar. This is the approach taken by Singapore.

As China rebalances away from fixed asset investment driven growth commodity exporters, many of whom are emerging market countries, we are always likely to find economic conditions worsening. Those Asian countries running current account deficits at a time of tightening US monetary conditions have, as one would rationally expect, been worse hit but in general, lower commodity and oil prices are a plus for the developed world and most of Asia. The ASEAN countries which have current account issues have seen currencies come under pressure and have therefore underperformed.

India remains the most exciting long-term story in the region as Prime Minister Modi continues to drive the reform process forward. Whilst there has been some disappointment with the pace of reform, India is a democracy and therefore decisions take time to enact. The most important reform bill is the nationwide GST (goods and sales tax) which will hopefully be passed in the first quarter of 2016. India continues to have the potential to be a global centre for low cost manufacturing and as the country continues to catch up with more developed countries in Asia the consumer remains an excellent long term story.

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Markets in Asia have suffered as earnings expectations have been pulled back partly but not solely due to the slowdown in certain parts of the Chinese economy. Arguably the impact of the current change in China is far more negative for commodity exporting regions, with Asia a net importer of most commodities including oil. Returns for some markets have been depressed by adverse moves in currencies namely Australia and the ASEAN region. After the market setback valuations in Asia are trading at depressed levels offering value to medium term investors.

Japan

Japan remains the only core western market with a positive return over the year to date following two negative quarters.

Until recently, the market movement in Japan has been positive but with the recent worries over China and its growth prospects alongside some more general global growth fears, the Japanese market has fallen back. Up until June the MSCI Japan index was up 15% but following the August setback the market has been more volatile. The Chinese weakness has not helped Japan's stuttering reform agenda - between April and June Japanese economic growth contracted by 0.4% compared to the first quarter, pushed down by sluggish consumer spending and a fall in exports. This put some pressure on the reforms of the new government and saw foreign buyers of the market become net sellers in August. China accounts for 20% of Japanese exports so any reduction in demand affects the flow of goods and export potential and also affects the broader region into which Japan exports, thereby having a bigger overall effect on the GDP figures. The yen, whose weakness has also had a positive effect in the last year, has strengthened more recently resulting in a negative effect on exports as well.

Not all of the recent volatility has undermined the changes delivered by Abenomics however; monetary and fiscal stimulus has been implemented with some success although the third arrow of reform – structural – is a much slower process. Unemployment has continued to tighten in Japan as a consequence and the economic improvement has meant that companies are hiring more people. The introduction of the Stewardship and Corporate codes has seen a renewed focus by management on dividends and buybacks and performance related pay is being introduced rather than tenure based pay. PMI indices have also moved into expansionary territory alongside improving credit conditions. Earnings growth overall has been improving and, although we have seen stronger valuations, they remain reasonable at 14 x earnings on average.

The economy does need to see greater momentum in the short term to help to continue to push through to the third arrow of reform which can help to drive the economy to a more competitive environment.

Emerging Markets

A decade ago a malaise afflicting emerging markets would have had a much lower impact on the world. Today these economies account for 38% of global gross domestic product in nominal terms, and over 50% when calculated by purchasing power parity. The slowdown in China impacts the whole world because of its knock on effect, firstly on commodity exporting nations and then these countries demand for goods and services produced in the developed world. GDP growth in emerging markets is likely to fall to around 3.5%, the lowest level since 2001 excluding the crisis year of 2009 - even this number assumes that the reported Chinese growth rate of 7% is accurate. Emerging markets have become a net detractor to global trade growth in 2015 for the first time since the GFC and many that have seen a sharp depreciation in their currency do not have a strong enough export base to benefit from currency weakness. As a result they have capped imports as these have become more expensive. Brazil, where import volumes for the past three months have been falling at a pace of 13% year on year, has problems which are symptomatic of the malaise affecting commodity exporting nations, most of which are concentrated in the developing world - export driven growth has collapsed. Many had enjoyed a credit fuelled consumer boom during the commodity super cycle, with corporate and sovereign debt levels also increasing significantly. These countries, which had been reliant on foreign capital flooding in, are now seeing it exit and the fall in commodity prices has resulted in a significant deterioration in the terms of trade for many, a comment also true of Australia, despite its place in the developed world. In many cases emerging market currencies have taken the strain. In Indonesia, exports have fallen by 15% and it is only the fact that imports have declined by 25% there is not a current account crisis. The fall in both exports and imports of commodity driven economies is likely to be behind the weakness in global trade this year.

Whilst some economists and commentators see a fundamental reversal of fortune for emerging market countries, in reality this is too simplistic a view. Countries such as India, which is a commodity importer

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Fixed Interest

Chart showing 2015 returns for major fixed income indices:

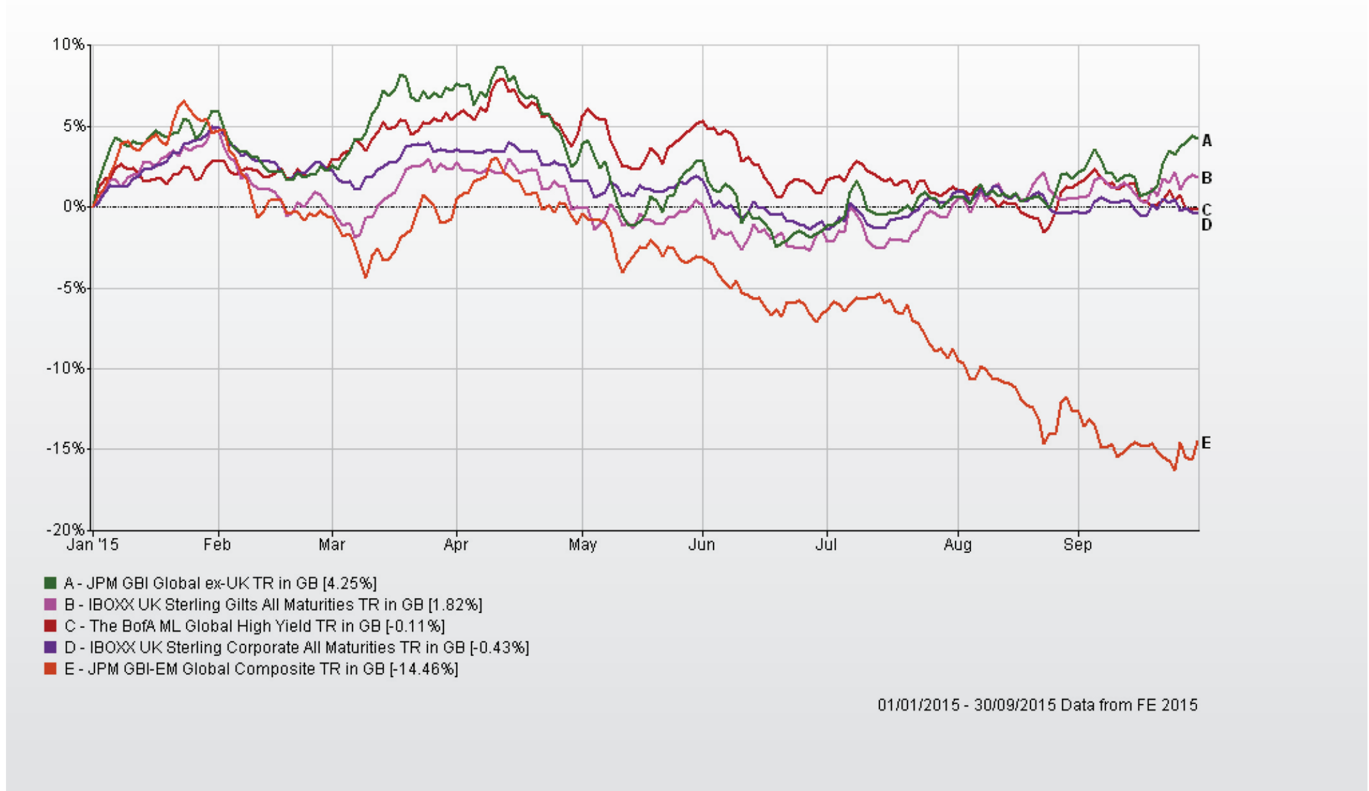
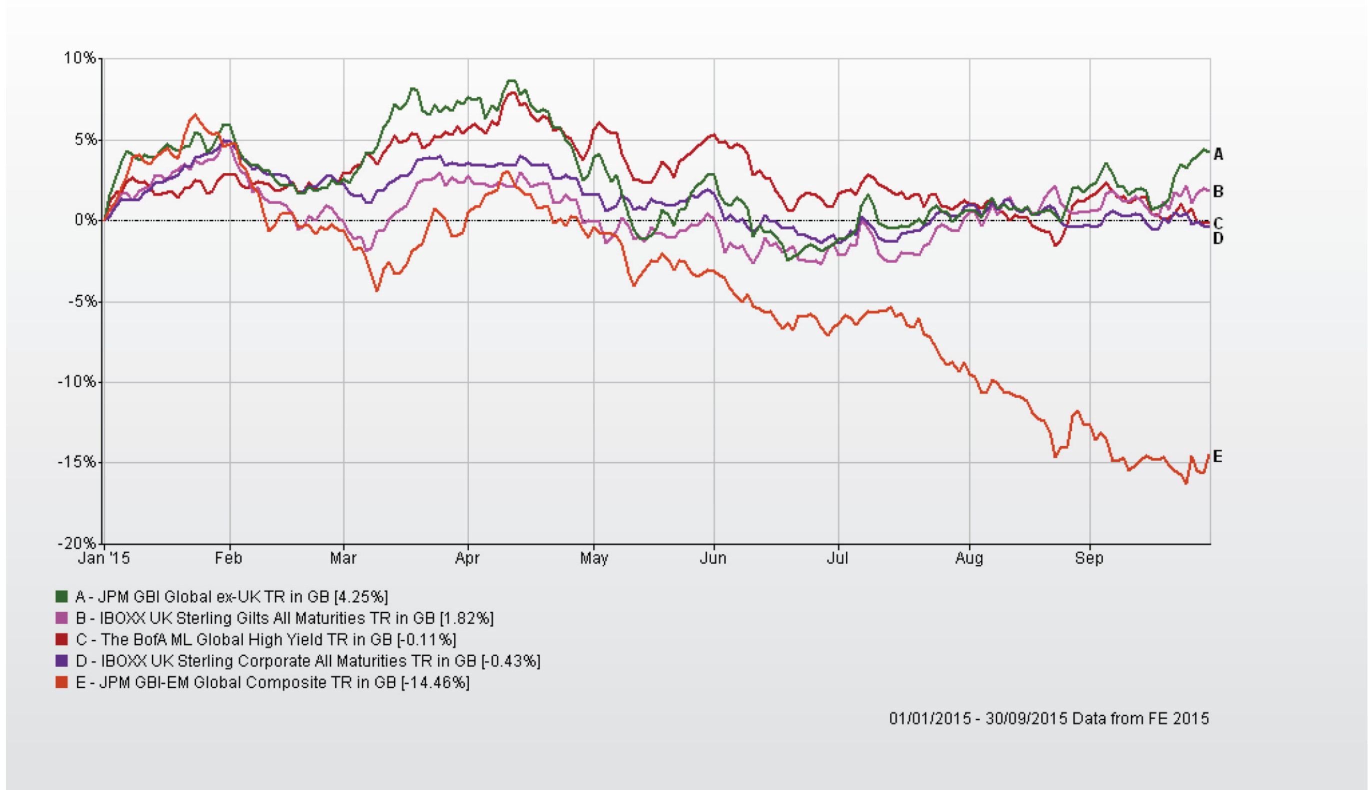


Chart showing quarter three 2015 returns for major fixed income indices:



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and used weakness in the oil price to reduce fuel subsidies, has not seen significant currency weakness. Whilst the Indian rupee is down marginally year to date versus the dollar, it is up versus other currencies such as the euro. It is in commodity exporting countries that the growth models are challenged – they were slow to reform and therefore did not take advantage of the benign conditions from the commodity super cycle.

It is not all doom and gloom however. Countries do have the option to push through urgent structural reforms. In Indonesia, where hopes were high 12 months ago, efforts to improve its economy have struggled, but in recent weeks President Jokowi has finally delivered the first part of his economic reform package in a push to bolster the flagging economy where growth has slowed to below 5%. India has less dependence on a commodity led economy and has made significant strides in moving to a stronger consumer led economy.

The threat of interest rate rises hangs over emerging markets and has caused many investors to move assets away from the region, and they are likely to suffer capital outflows for the first time since the 1980's. The rate rise may not be a significant event if it is priced in at current levels but the situation has to be looked at on a more country specific basis and will depend a lot on an investor's perspective on data from China. We feel that concerns on China are exaggerated at a fundamental level but the current sentiment will create increased volatility in the coming months.

The different bond markets have remained flat over the quarter with Emerging Market debt the biggest loser, both over the quarter and year to date. The threat of US interest rate rises and the slowdown in China (commodity related) has had a significant effect on this area of government debt with any rise in interest rates seen as a negative for those countries which have a large debt pile. Although the threats have changed, the underlying focus of the market is the same as it was at our last point of review. Investors need income at the lowest risk possible and traditional sources are not providing this. The current rates of interest/yield in both the government and corporate sectors do not provide the long term security many investors require. We saw in the most recent market downturn that the yields in most debt assets did not fall very far despite the uncertainty and volatility seen in equity markets. This is seen as more evidence that the twenty year bull phase of the bond market has reached its end. The ability for investors to make capital gains when holding

"It is not all doom and gloom however. Countries do have the option to push through urgent structural reforms."

fixed interest assets is now limited and many investors are looking to alternatives to avoid the potential risk to capital if we enter a rising rate cycle. The other area of concern for corporate debt investors has been the lack of liquidity seen in bond markets since changes in the regulatory regime with the introduction of laws such as the Volcker rule limiting proprietary trading. This is more likely to manifest itself in the lower investment grade areas but there are concerns over larger funds should we see significant exits from the sector.

The most important influence over the next few months will be the sentiment around US interest rates which has clearly been a large part of the current uncertainty in both equity and fixed interest markets. One would expect higher rates to result in increased levels of market volatility and this was a further factor behind the August selloff. In recent weeks investors have been worried that the lack of action by the US Federal Reserve indicated a softening of economic growth. In all likelihood these growth concerns are overdone as they were in January of this year.

In summary there seems little value in government debt with the exception of some selected emerging market countries and we may see diverging interest rate policies as we move further into 2015. Liquidity remains an issue but there are tools for managers to use including SWAPs, shorter duration assets and higher quality debt to mitigate some of the issues. Investors and markets will continue to watch the Fed, and whether it remains dovish or kicks off the rate tightening cycle in the next few months will dictate sentiment. The current level of uncertainty around rate rises is likely to cause continued volatility until it is resolved.

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Property

The UK commercial property market continues to produce good, consistent, positive returns. Returns from the direct property market are expected to remain strong for the remainder of 2015, although the absolute number for the year as a whole is likely to be lower than 2014, as investors are still looking for an income alternative to their fixed income allocation, but this may also be due to the relative strength of the UK economy. It should continue to be a good diversifying asset class during these uncertain market and economic conditions with returns driven mainly by the yield, although capital growth returns may remain strong over the short-term. There are continuing concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven due to continued strong demand for this type of asset. There is increasing investor interest in secondary markets but individual property selection will remain important here.

The property securities sector will continue to be influenced by the outlook for interest rates, as (expectations for) rate rises are generally negative for the sector, the outlook for property and equity markets in general plus investor sentiment is likely to be another factor over the short-term, although local market factors typically have a larger influence on this sector than for the main equity indices and these should also be taken into consideration.

"There are continuing concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven due to continued strong demand for this type of asset."

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Summary

Markets have been fixated on two main factors (China and US Interest rates) in quarter three, which has influenced most global market activity. We have covered these in detail in the sections above suffice to say neither has been resolved and they will continue to create volatility in quarter four. Recent market turmoil and concerns over Chinese growth in particular, has allowed the Fed to hold rates in September, although with the underlying strength of the US economy we would hope that the Fed does not delay until 2016 as other evidence such as US employment numbers, do not suggest emergency interest rates are the right level for the US economy. The base case scenario is for equity markets to recovery their poise as investors realise growth concerns have been overdone. Although markets will have to face up to the prospect of tighter US and eventually UK monetary policy, this at least now will occur at a lower level of market valuation. The pre-results season for US Q3 earnings in October could see some companies disappoint. More definite signs of stabilisation in the Chinese economy would likely ease the current fears over growth, but markets need to see more concrete signs of profit growth in 2016 to make new highs. The events of the summer are a reminder that bull markets do not go on forever, and there are some indications globally that corporate margins have peaked. Europe remains an area where the profit cycle still has scope to catch up. This year Asia has been hit by downgrades as growth has slowed and at current valuation levels these markets appear attractive.

Concerns over economic growth have seen credit spreads widen and renewed confidence in the global economy should allow spreads to come back in. High yield debt has had a difficult period, but part of this reflects the sector makeup in the States, where energy is a large part of the high yield market. Inflationary pressures remain muted at a time of weak commodity prices and all in all the nature of the post GFC recovery means interest rate rises will be shallow compared to previous cycles. There is scope for credit spreads to tighten from current levels, even if rates rise modestly. Low growth is a benign environment for credit as long as recession is avoided and this environment should favour well managed strategic bond funds to deliver returns ahead of cash.

"More definite signs of stabilisation in the Chinese economy would likely ease the current fears over growth, but markets need to see more concrete signs of profit growth in 2016 to make new highs."

Looking further ahead markets are likely to remain range bound until there is meaningful evidence of another upward leg to the profit cycle. Notwithstanding that, seasonal factors are usually supportive of markets in the November to January period and this, combined with continued accommodative monetary policy, suggests a year-end rally is likely. The extent of this will determine whether investors should look to sell into future market strength. Markets are now transitioning from ones which have been liquidity driven, to where returns will be driven by fundamentals and particularly earnings growth. Multiple expansion for this bull market has already occurred and even modestly higher interest rates in the US and UK mean investors can no longer rely on valuation gains for positive returns. Whilst it will be many years before investors can gain decent returns from cash, equity returns will continue the pattern

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