Investment Letter dated 29th October 2015

With a few exceptions, 2015 will be remembered as an unremarkable year for financial returns in mainstream portfolios. As a multi-asset investor with a bias to longer term investment the lack of opportunity has been comment-worthy, a phenomenon in itself.

Like London tube trains that are too packed to enter, we have remained on the platform many more times than we have boarded this year.

A measure of caution has been warranted and that, in our context, has meant the use of cash. Cash, which was built up to 30% in June, helped take the edge off the steep falls of August. More importantly, cash has provided the necessary flexibility to consider both critical and supportive positions on different theses.

For we have sought to avoid what mountaineers call being “rim rocked”; the point at which you can go neither up nor down. Caution and patience have been warranted as we bivouacked whilst waiting for better opportunities. Some of these have begun to arrive, but only recently.

Since late August, the central topic has been China: its currency and its economic growth profile. Between August 11 and 14, the Peoples Bank of China (PBoC, China’s central bank) weakened the RMB rate by just over 3% versus the US dollar - for many an unexpected move. We have no doubt that PBoC officials were aghast at the global reaction. Tim Bond of Odey has suggested that there was some design behind the scale of the adjustment, as 3-4% works out to be the average annual profit on carrying the RMB long against USD in recent years: a free-lunch to speculators also taken advantage of by Chinese corporations borrowing in foreign currency. One theory goes that if those same corporations have now hedged (as they have been prompted to do), further depreciation can take place without creating big financial losses for state champions. However, this is just one side of a many sided argument and not a view we favour.

Our own belief is that China’s State Council has mandated stability and that extends to the exchange rate and therefore all talk of change is back in the box for the time being. The circumstances in which exchange rate weakening becomes an active consideration is, we think, dependant very much on US dollar strength. A burst of dollar strength is certainly possible in the near term, particularly if Japan and the Eurozone follow through on hints of further monetary expansion and the Fed makes an upward nudge on rates in December. Even so, we doubt whether this confluence of events will be sufficient to spur a change to the value of the Chinese currency, a variable that is, after all, under the control of the Chinese authorities.

Whilst the Chinese currency and weakness of the Chinese economy remains the central topic of discussion internationally, the ball has moved away to another part of the pitch. For what is happening now in China is a very coordinated set of policy easing measures, measures that are designed to check this and address economic risks. In modern China a weak economy means loss of political legitimacy. Accordingly, the list of measures is impressively long and avowedly stimulative, including the conversion of bank loans to bonds (freeing up balance sheets to lend), a cut in interest rates, relaxation of loan-to-deposit ratio caps and easing of the anti-corruption drive. Taken together, we believe that these, in tandem, will be sufficient to get the key measures of economic activity moving upward once more, perhaps as soon as the 4Q.

Even before they came into play, some indicators had already based out: notably both prices and activity in Tier 1 and 2 residential property markets (the main cities, including Shanghai and Beijing).

Geoff Barker, the talented manager of the Counterpoint Asian Macro fund, has contributed to this new understanding; we have long drawn on his close understanding of Chinese macro. His observations run against the grain of consensus thinking on China which is very bearish and entrenched. Given this bearishness, the price reaction in many asset classes will be very significant should data begin to support a counter-trend recovery. We agree with Geoff that it is entirely consistent to harbour doubts about China’s long term growth model and ability to transition to a service led economy whilst opening its capital account and admit that the authorities will be able to resuscitate this model, at least in the short term.

As investors, we should be more drawn to the opportunities and pay-offs than the purity of the arguments here. These pay-offs could be quite considerable over the next months and extend in several areas: Chinese equities, industrial metals, emerging currencies, the Australian dollar and Brazilian bonds. Whilst it may prove difficult to construct the perfect basket of investments sympathetic to the theme, a fairly blunt approach should suffice, provided the safety net of adequate liquidity is in place.

Even before we had appreciated the full extent of the reflationary easing now taking place in China, we had incepted a position in Brazilian interest rates with duration of one year that will yield 10% if the Brazilian real remains unchanged from its current post-devaluation, post-downgrade level. Whilst, in the short term, currency risk remains paramount, this is compensated by the scale of the interest rates on offer.

We view Brazil’s current condition as very much typical of emerging market challenges. A political regime that long in the tooth, caked in the type of populism that works well enough in good times but spells trouble in bad. Government dysfunction plays out in poor construction and presentation of the budget, lax economic management and dissent between President and key technocrats. The sovereign bond has already suffered a downgrade, somewhat accelerating the processes at work. Brazil, in market terms, is now sensitive to any good news.

Within portfolios, we are re-provisioning US dollars to act as a bulwark against what could be a skittish period as the Fed prepares to increase short term interest rates whilst the Eurozone and Japan move to further accommodation. Holding dollars (and broadly speaking GBP) also helps offset part of the implicit currency risks that go along with some of the better opportunities which are now emerging. Currency gyrations apart, we are constructive on markets through the New Year and into 2016 and cash is being deployed.

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