

## Investment Letter dated 26<sup>th</sup> January 2016 (Part 2\*)

We were recently sent a piece of strategy research from a respectable macro consultancy. The article was entitled “No Recession = No Bear Market”. This statement of logic supposes that bear markets are the consequence of economic recessions, which they most often are. It ignores the possibility that measurable bear markets (-20% on a given index) could exist without a synchronous recession (generally acknowledged as two consecutive quarters of negative economic growth).

Stock markets run well ahead of economies, foretelling them with accuracy. Our intuition here is that their foresight is maybe extended beyond normal time frames. Divining quite why is not a scientific matter subject to deduction alone.

It is in the United States – the world’s largest economy, with the world’s largest stock markets – where expectations have furthest to travel in this regard. Only last month, the Federal Reserve adjudicated that economic conditions were robust enough to commence normalisation of interest rates. A cursory analysis of the Fed’s favoured indicators (measures of employment and wages) certainly seemed to supply sufficient reason from them to have done so.

However, other measures reveal more threatening trends. Industrial production in the US has recorded two consecutive months of decline; this indicator alone presages recessions with a high degree of accuracy. Credit spreads are rising, not just in high yield and not just in the troubled energy sector, but more widely. It would be sensible to expect this to extend into the critical auto sector where a super strong replacement cycle has been at the vanguard of post crisis growth. In the US, the motoring consumer did what was asked of them: they bought a new truck with a bigger engine and a bigger tank, filled it up and did more miles. Queasy (or canny) consumers in other parts of the world have not followed suit. The fabled “oil dividend” has not been spent.

We might query why? Again a question for the imagination. Perhaps consumers remember previous energy cycles and regard today’s low prices as temporary, perhaps the consumer generally speaking is as levered as comfort allows and we are experiencing a multi-year rise in savings rates.

One can also suggest that the prevalence of Quantitative Easing, in the US, in Japan, in the Eurozone and the UK has done two things: superficially raised spirits by boosting the prices of property and financial assets yet simultaneously undermined confidence. It *ain’t* normal for sure and for some it is *plain messin’*. Consumers and companies alike have had serious cognitive problems with QE.

The flavour of “good deflation”, a concept embraced by our own George Osborne and once spoken of in warm terms in this column, is going sour.

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It is hard to bank “good deflation” with the prospect of China weakening its currency further. At Davos last week, a spokesperson for the Politburo apologised for China’s imperfect communication with respect to its currency policy. That apology tacitly references the collateral damage caused whilst not apologising for the policy itself.

And why should they? They have seen other countries debase their currencies for economically selfish reasons, they must be irked that the world blames them when they action what others (Japan, Europe, US) have already done.

The logic of a sudden, large, one-step depreciation of the RMB is mounting. Those seemingly gargantuan US\$3tn reserves as not so if they are called upon to recapitalise the banks. Tim Bond of Odey estimates that system wide 10% NPLs would require all the reserves to mount a full recapitalisation. Across the hall on Upper Grosvenor Street, Crispin Odey has the issue on a skewer: years of wages rises unmatched by productivity gains, therefore requiring currency adjustment. The German option of deflating down wages is not a goer when the communist party requires better financial living standards to sustain its side of the bargain.

As others have found through history, it is folly to spend reserves on defending a currency that wants and needs to go lower. With respect to these thoughts, our expectations with regards to China have run full cycle: we were more pessimistic than our peers in 2014, then entertained more optimistic thoughts in the later part of last year and have become pessimistic again.

Should such a one-step devaluation take place, we would be snappy sellers of developed market equities and a buyer of Chinese equities. It would be beneficial to the outlook in China but, in the short term, toxic to the rest of the world. Good for China’s goose but definitively not a dish for the RoW gander.



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*\*part 2 of a piece that was entitled “January 2016 Outlook”.*

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