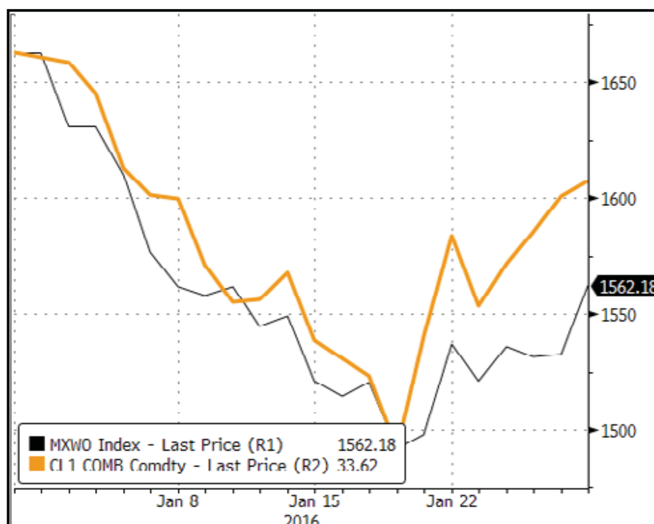
Elgin asset management

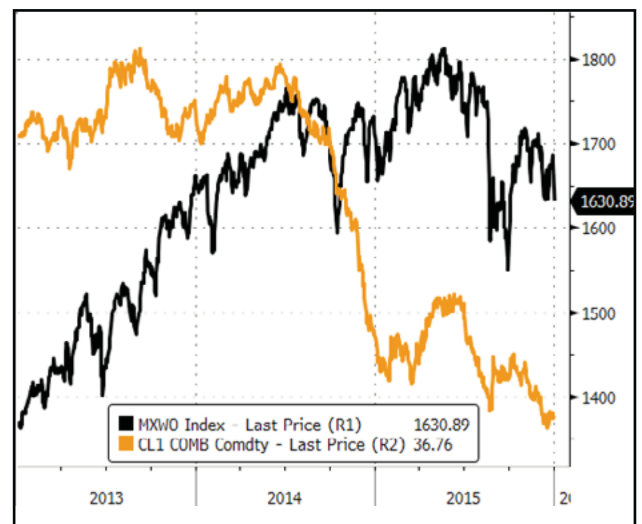
investment commentary monthly

Monthly Commentary 1st February 2016

January was not a good month for financial markets as, at different times, it broke records for the "worst ever start to the year" for many of the world's major indices.

With confidence shaken, emotional investing seems to have taken over. The graphs below tell the story, as correlation levels between oil prices and equity markets have reached a staggering 95% in the last month (first graph). This is at odds with historical levels (second graph).





Crude Oil vs World Equities in the last month and over the three years prior to that

Emotional investing is rarely successful, and we are certainly avoiding it. There's certainly much to worry about. Strategists at Schwab captured the main reasons quite well:

"Global growth worries, centred in China, seem to be part of the reason, expressed most readily by the continuing drop in a broad selection of commodity prices, with oil being at the top of radar screens. As the drop in oil has decimated the energy market, worries have escalated that the drop is foretelling a serious economic problem…"

Mix in the beginning of the Fed's rate-rising cycle (that some believe will cause the US to go into recession) and the formidable geopolitical issues, and one can see why markets have convulsed. Yet as Merrill Lynch elegantly put it in a research note recently, "This too shall pass". Without being cheerleaders, we tend to agree with their conclusion.

Frankly, we do not know if the markets will drop another 5%, 10% or 15% from today's levels, and we venture to say that no one does. What we do know is that if we had sold 10 days ago, we would not have participated in the subsequent near-7% rally in global markets. In the next page, we list the reasons why there are grounds for optimism.

China

China is making a painful transition from an investment-led to a consumer-led economy. It certainly has the financial firepower to manage the current credit stress, with massive international reserves and large trade and current account balances. In the following years, it is still expected to grow at 3-5% annually, thus remaining a major contributor to world growth. Retail sales growth is still in the double digits, and over 400 million millennials are tech savvy, health-conscious and love to travel.

US

Driven by a strong services sector, strong employment data and a stable housing market, it is unlikely that the US will fall into recession. Markets have never fallen sustainably and meaningfully unless a recession loomed around the corner. Additionally, leverage in the financial system is a fraction of what it was in 2008; and while consumers—the major drivers of the US economy—were heavily exposed to the financial crisis via housing, today they are on the "right side" of one of the causes of volatility by being oil consumers. Finally, equity market valuations are not demanding, the funding markets are not showing signs of undue stress and the yield curve - a good predictor of recessions - is not much flatter today than it was a year ago.

Europe, Japan and others

Valuations of European and Japanese companies have fallen back to levels not seen since 2012/13. Earnings growth, the major driver of markets, is expected to be strong. Ongoing QE and low energy prices are a huge tailwind. On the rest, we are still concerned about Emerging Markets, and thus, as we have done for over two years, are still avoiding them.

Oil

One of the major concerns is that many energy companies will go bust, thus defaulting on their obligations and creating stress for banks that are exposed. Yet, many of the defaults will be in high-yield corporate debt and banks such as Bank of America have only got a 3% exposure to energy loans from their total loan portfolio. This is certainly manageable. We view the fall in energy prices as a net positive as 90% of the world's GDP are energy importers. This is a big boost to consumption, which is likely to outweigh the negative effects for the energy sector.

Conclusion

We are undergoing a stressful period in the markets. It is never fun to live through turbulent market times, but it can flush out some of the excesses in the market and set up the next move higher. As always, patience, diversification, discipline, and a long-term perspective and plan are required. Implementing this plan with solid funds and securities, and without emotion, is the best course of action.

The Elgin Analyst Team

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