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ECONOMIC PROSPECTS AND INVESTMENT STRATEGY

"… and the weird world rolls on" ***Paul Auster***

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Growth in the world economy remains weak at under 3%, the expansion of Emerging countries has been slowing down since 2011 and pessimism prevails among economic actors, although we are seeing a welcome reduction in the "savings glut" in many countries, and therefore a considerable transfer of wealth from the commodity-producing countries and China to the consumer countries. If we accept the idea that high oil prices held back world growth from 2012 through to June 2014, and that the excessively high Chinese investment rate in recent years, at close to 50% of GDP, has been spreading deflationary pressures around the globe and hitting margins in many sectors, then stock markets should only suffer for a time from the drop in oil prices and the shift of the Chinese model from investment-driven to consumption-driven.

1 – ECONOMIC PROSPECTS:

2015 taught us five useful lessons to help foresee the economic trends in 2016:

1.1 – THE SHARP FALL IN OIL PRICES, and also in metals and other commodities, is worrying the markets despite the fact that it should be good for the world economy. The recessions triggered by the two oil crises were driven by rising prices, not falling prices. Given that the oil-producing countries represent just 20% of world GDP while the countries that consume that oil make up the other 80%, the slide in prices means less in the way of world savings and more consumption potential. The amount of this transfer from the often low-population, high-reserve oil-producing countries towards the oil-consuming countries is estimated at $2,500 billion since mid-2014, equivalent to 3% of world GDP. It is equivalent to a cut in taxes and should drive increased levels of confidence. In real terms, today's petrol prices in the US are on a par with those of the 1960s, while iron ore and coal prices are at half their 1980 levels!

So why have we been seeing markets sliding over the past month or so when oil prices are falling? The answer to that particular question comes in four parts. First, intuition would suggest that the oil-producing countries are having to sell off assets on the financial markets in order to finance alarmingly-high budget deficits. Next, there is apprehension surrounding the possibilities of political instability in certain countries. There is also the (exaggerated) perception of a risk of seeing cancellations of contracts for exports to these countries. Finally, there are the fears of bankruptcies among American shale gas producers who are all making losses now, which would weaken the US banking sector which is carrying their debt to the tune of $300 billion, with 15% of that debt being high risk.

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1.2 — DEVALUATION OF THE YUAN.

The question here is whether this is just a quick-fix solution to the problems of the Chinese economy, or the only solution in the absence of any possible alternative.

The devaluation of the Yuan worries financial markets because it exports deflationary pressures, does nothing to encourage Chinese companies to strive for productivity gains, hinders the country's ambition of moving more up-market, can only increase an already very high trade surplus. It runs contrary to the strategy of promoting consumption over production, and points to the likelihood of other monetary crises in Emerging countries. We should not forget, however, that since he became President in 2012, Xi Jinping has not given in to the temptation of a major stimulus via credit, like that in 2008/2009. He has accepted the lower growth rate, thereby avoiding making the banks' bad debt problem even worse and protecting Western countries from additional overcapacity. Nor should we forget that there is a positive side to the depreciation of the Yuan, in the form of a transfer of purchasing power to countries and businesses that import Chinese products.

- Do the Chinese have a choice? Since 2010, the trade-weighted rise in the Yuan stands at over 30%, according to the BIS. Companies are becoming less profitable and competitive, building up debt and exporting their overcapacity, therefore driving deflation around the world. Since the start of 2015, exchange reserves have fallen by more than$500 billion.

- The opening up of capital markets and the economy has been announced, but is set to be difficult. The necessary closures of public companies cannot but be costly in terms of jobs, given that the public sector still represents 25% of GDP, capital outflows are likely to accelerate and depreciation is therefore a must. Savings, however, which currently stand at half of GDP ($5,000 billion), will decrease and that is a very good thing for the world economy.

1.3 — LIQUIDITY INJECTION POLICIES HAVE SHOWN THEIR LIMITS: 3 LESSONS.

- ***Injections as a factor in deflation.*** If some readers of Milton Friedmann long thought that injections would trigger inflation, they were wrong, because by allowing the survival of uncompetitive companies and facilitating debt, low rates have contributed to growing overcapacity in a number of sectors and have driven deflationary pressures.

- ***Liquidity injections and the markets.*** While injections have allowed stock market indices to rise sharply, as the policy of the FED has clearly shown, stopping them has had the opposite effect. Since injections were halted at the end of 2014, the market has gone nowhere and that is a lesson to be remembered as regards future market performances in Europe and Japan.

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- ***Negative interest rates set to become the economic weapon of choice.*** The situation is very obviously becoming widespread, with Switzerland, then Sweden, the Eurozone and others likely to follow in the future, and this can be interpreted in two ways. On the one hand, it can be seen as an abdication on the part of governments, incapable as they are of enforcing increases in taxes to scale back their debt. On the other, it can be perceived as the central banks asserting themselves, as they see it as the sole solution to seek to cut debt in a low-growth, no-inflation world.

1.4 — INTERNATIONAL GROWTH REMAINS HOPELESSLY WEAK

at a time when it should be benefitting from a combination of very positive factors: interest rates stand at zero, liquidity injections are greater than in 2014 and as high as in 2015, fiscal policies are restrictive only in name, commodity prices are at their lowest in years, and there is effective full employment, if the statistics are to be believed, in the majority of the major countries (US, Germany, Japan, the UK and China).

- Should we be questioning those employment statistics and pointing to the growing numbers of poorly-paid part-time jobs? If consumption is weak, perhaps it is because ***"it is not so much being poor that makes people unhappy, it is becoming poor,"*** as ***Stendhal*** observed in ***Une Vie de Rossini.***

- Should we place our belief in the ideas of Larry Summers or of Gordon on the slowdown in the economy?

- Should we see the recent US statistics, with weaker growth in lending, declining confidence levels and a slowdown in production indicators, as a sign that the economic cycle is running out of steam after seven years of growth?

- Or on the contrary, should we consider that it is just that GDP figures somehow misjudge the gains in productivity generated by new technologies?

1.5 — DEBT IN THE EMERGING COUNTRIES COULD BE A CONCERN.

The sharp slide in currencies makes service of debt in $ all the more expensive, while the slowdown in growth can make debt repayments more difficult. Debt in Russia, for example, very often exceeds the figures that are published as many public companies have borrowed heavily.

The countries that are most severely exposed to the slowdown in China are Taiwan and South Korea, with the latter posting a sharp fall in exports, down 14% in December, which is likely to trigger a new slide in its currency.

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2 — INVESTMENT STRATEGY:

We will continue in 2016 as in 2015, which means staying out of commodities, keeping clear of the emerging countries which must introduce policies to boost their competitiveness again, opting for just a little in the way of bonds, overweighting the Eurozone and Japan, and remaining neutral on the US.

2.1 — OIL.

Failing political upheaval in one of the major oil-producing countries, supply and demand are still not balanced. Output increased by 2.5Mbd in 2015 and, contrary to expectations, the major producers (Saudi Arabia and Russia) increased their production, with world stocks reaching record levels. Although down by 20% in 2015 and 2016, exploration and production budgets will still come to $500 billion this year, way above the $200 billion annual figures at the start of the 2000s. It should be remembered that the 1986 price collapse was followed by 12 years of low prices, and it is not the advances or retreats of Daesh in Syria or Iraq that are going to change anything. As ***Jankelevitch*** so rightly put it, ***"violence is a weak strength."***.

2.2 — REMAIN OVERWEIGHT ON THE EUROZONE AND JAPANESE MARKETS as they

continue their generous liquidity injection policies throughout the course of the year.

- ***Eurozone***. We should think back, just a moment, to the pessimism that surrounded prospects for the Eurozone just one year ago. Since then, liquidity injections have allowed interest rates to be cut to levels that were once inconceivable, even in the countries of the periphery. The decline in the Euro has enabled countries such as Spain to make gains in competitiveness and to post current balance of payments surpluses. Lending volumes are beginning to grow, manufacturing output indicators are on the up, and growth in profits in the Eurozone stood at 13% in 2015 (Stoxx 600) and could reach 9% this year, while the core inflation rate is just 0.9%, providing good reason for the ECB to keep its policy unchanged, all of which goes to make a lot of positive news.

- ***Japan***. The Bank of Japan increased its balance sheet by the equivalent of 15% of GDP and will do the same again this year.

- ***On the US Market,*** where the cycle is admittedly at a more advanced stage, a slight rise has been observed in default rates, along with a fall in orders of durable goods, a perceptible slip in corporate margins (from 13.2% to 12.5%) and stagnating profits among S&P companies, although the budget deficit has been slashed and the market is holding up better than others in

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these times of political and financial tensions. In addition to all this, the fall in commodity prices and depreciation of the Yuan induce a rise in purchasing power and therefore, sooner or later, a rise in consumer spending and growth in GDP above its long-term trend. So far, US households have increased their savings ratio, but this could change, especially as the debt ratio has fallen considerably since 2009 and is now back to its 2003 level, while the recent rise observed in wages could continue.

- ***Currency***. Keep long positions on the $ and Swiss Franc, with the other currencies as hedges.

- ***Interest rates***. Three rate hikes are still expected in the US this year. We can hope for a gain of around 5% for portfolios.

- ***And what about the alternatives?*** There are none. Real estate is not rising after five or six years of zero interest rates, and is even falling on some key markets, while there is also every reason to expect tighter monetary policies, as is already beginning in the US and will no doubt follow elsewhere one day or another. The liquidity in the Eurozone since implementation of the banking law could be wiped out by a bank failure, while ETFs and credit markets may well reserve some nasty illiquidity surprises.

CONCLUSION

The sharp slide in the markets as we start the year is being driven by a unique combination of the two risks perceived by markets as being the biggest worries, the depreciation of the Yuan and a new fall in oil prices. That is not to say that we are condemned to ***"vertigo, collapse, routs in battle and lasting pity" as Rimbaud put it.*** It is possible that the Fed may postpone a further interest rate hike and, most importantly, we should not forget the gain in purchasing power being driven by the fall in commodity prices, a factor that is infinitely more decisive for growth in OECD countries than any fall there might be in their exports to the oil-producing countries.

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