LOMBARD ODIER
INVESTMENT MANAGERS

GLOBAL PERSPECTIVE

Noah's Rule

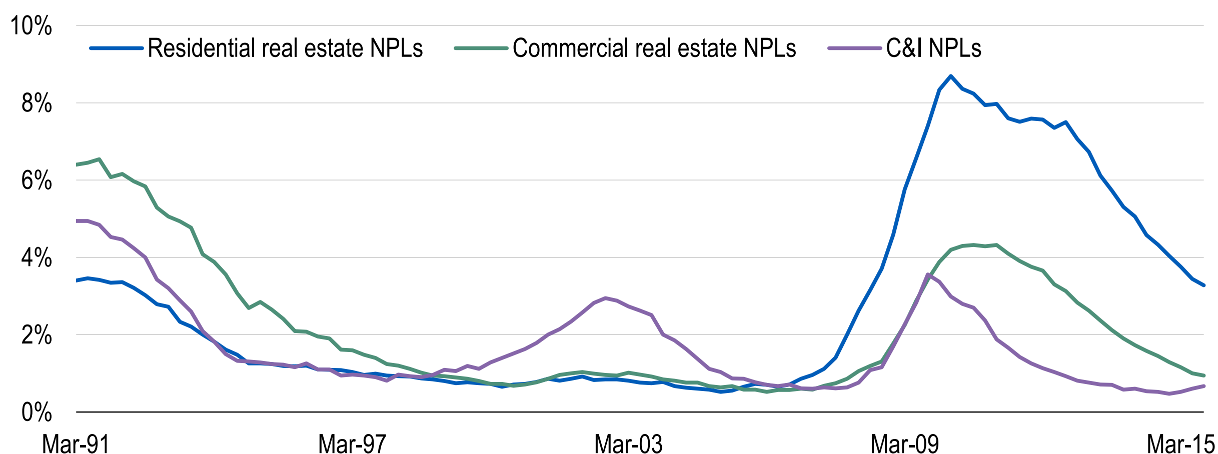
"Predicting rain doesn't count. Building arks does" as articulated by Warren Buffet (given his deep business interests in the insurance sector) clearly has wider investment design implications as well. When it comes to global investing, trying to predict the next rain shower may be futile but investors should still think about the kind of ark they need to build in case of structural "weather" shifts, especially those driven by policy, regulations and business cycle dynamics.

As an investment house, we firmly believe in the value of building arks but take it a step further and focus on constructing "fit for purpose" fundamentals driven solutions, which can hopefully withstand the storms that shifts in business cycles, policies and regulation can bring.

Weather check (I) - Global recession on the horizon?

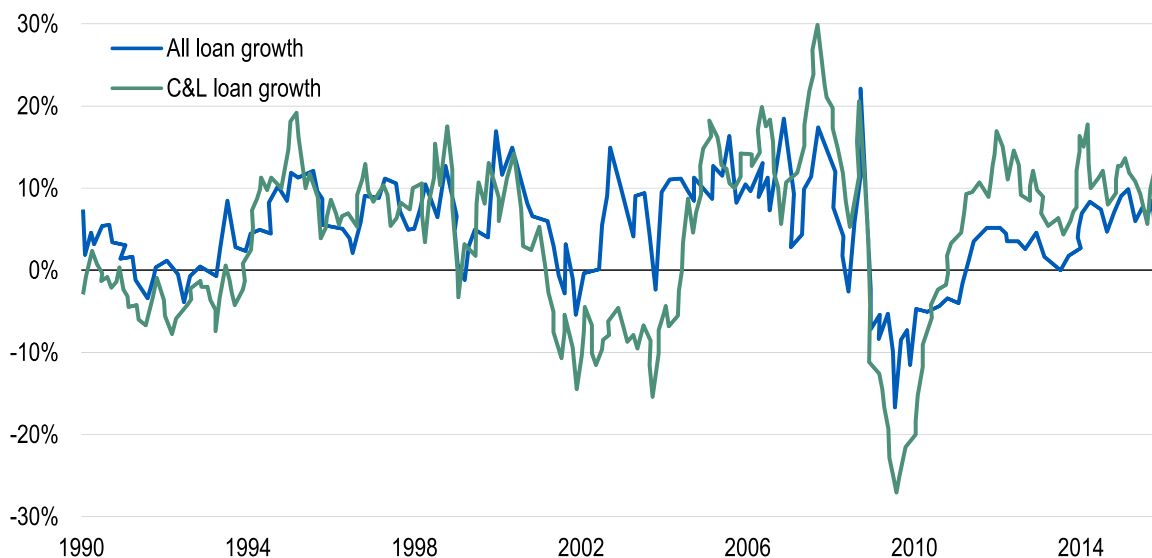
Given the sharp moves in risky asset markets since the start of the year, our first weather check is the probability of recession in the various major economic centres of the world. Starting with the US, labour market dynamics continue to look healthy despite the recent less than expected non-farm payrolls data. Unemployment has ticked down and wage growth showed signs of acceleration. The manufacturing sector coupled with the investment side of the economy (captured by durable goods order-type high frequency proxies) have been the major source of downward revision in recent growth momentum – which can be explained by the sharp fall in oil prices. However, the consumer side of the economy is still resilient with proxies such as auto sales showing robust underlying trends. Most importantly, there are no signs of a rise in non-performing loans (NPLs) or actual credit retrenchment, which would indicate any worrying patterns of credit tightening (Figures 1 & 2).

FIGURE 1: BANK NPLS BY SECTOR



Source: UBS, FDIC

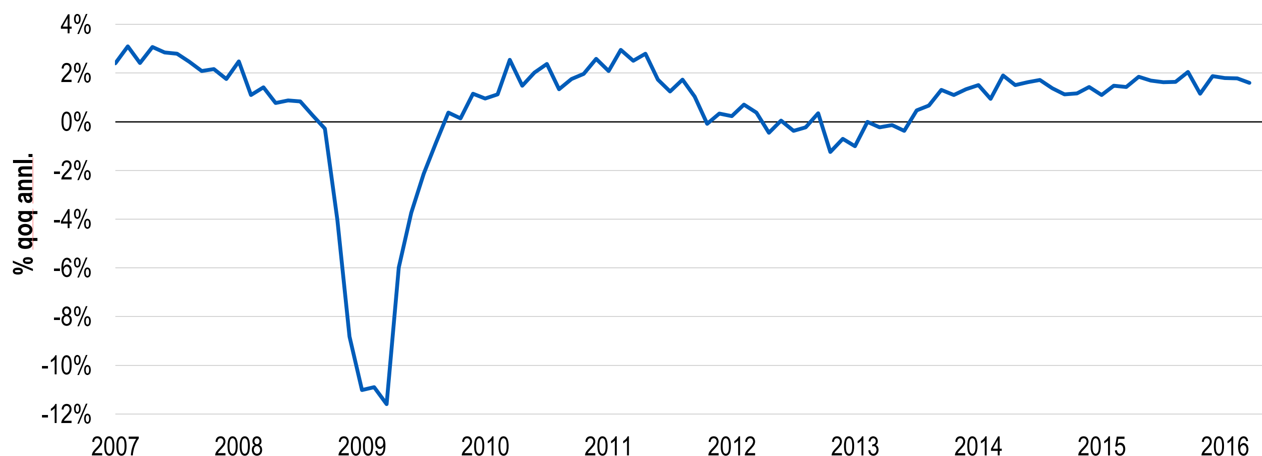
FIGURE 2 – US COMMERCIAL BANK LOAN GROWTH[1]



Source: Fed h.8 release, J.P Morgan.

Moving on to the Eurozone, a gradual trend of recovery in activity remains intact and credit deployment, especially to the household sector, continues to improve. High frequency business survey data has shown signs of a turn (which has been the main driver behind the steep fall in surprise indicators seen lately) in January but we think that is highly correlated with market developments rather than any underlying fundamental issue, given continued improving credit conditions. Based on the current level of various activity indicators (Figure 3), credit disbursement trends and ongoing improvement in corporate profitability, we think the probability of a recession in the Eurozone over the next 6 to 12 months remains quite low.

FIGURE 3 – GOLDMAN SACHS EURO AREA CURRENT ACTIVITY INDICATOR (CAI)



Source: Goldman Sachs.

Lastly, focussing on China, real activity indicators remain weak. However, what is clear, is that the deterioration in trend has started to stabilise (for example Caixin China Manufacturing PMI remains well above the lows seen in September 2015 and within recent range). Indeed, on the hard data side, there were some bright spots in Chinese commodity import numbers, with copper intake hitting a record as shown by the latest print. After panic in Chinese asset markets at the start of January, there are indications of further pumping of liquidity by the PBoC, which is likely to be confirmed by money supply and new Yuan loans data due out in the coming days.

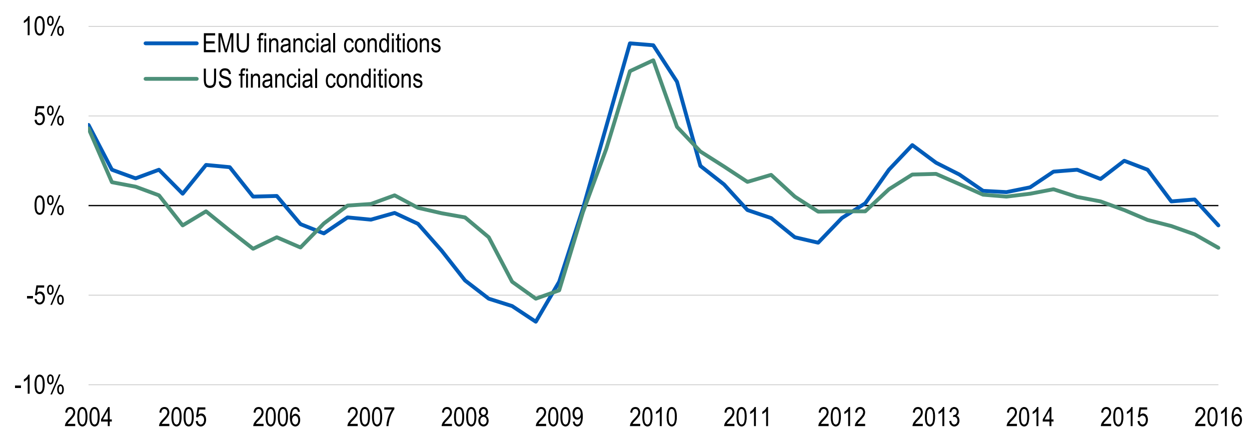
All in all, the results from hard fundamentals do not show any indication of an imminent activity recession in the global economy. The pockets of weakness connected to a China slowdown and weakness in the commodity sector are still visible in activity numbers but credit cycle dynamics, coupled with domestic services activity trends show low spot probability of an imminent recession in any of the main global economic centres.

[1] 3m annualised pace in %, monthly obs from H.8 Fed release, last obs is for end-January 2016.

Weather Check (II) – Rise of systemic risks

Despite low recession probabilities based on spot hard data trends, worryingly, recent price action in risky asset markets show a sharp tightening of financial conditions (Figure 4) which if sustained can start to weigh on real economic outcomes. This connection is even more important in the current cycle, given the strong role monetary policy and by extension financial conditions are playing as a key source of stimulus in a number of advanced economies. In addition, severe pressure seen on the European financial sector (especially in credit space) highlights a shift in the nature of the current sell-off, which now appears to be driven more by systemic concerns rather than pure economic recessionary fears (with the epicentre in China and commodities), which was the case in January. For instance, CDS of major European banks are now trading near the dark days of 2011/12 when euro break-up and potential currency redenomination were the key fear factors, which is difficult to explain on the basis of financial sector's energy exposure alone. Indeed, since 2012, central banks have flooded the financial system with more excess liquidity designed specifically to ring fence the financial sector from liquidity induced margin calls.

FIGURE 4 – FINANCIAL CONDITIONS IN THE EURO AREA VERSUS US



Source: J.P. Morgan.

In terms of risks of an actual liquidity event, as highlighted by a recent Goldman Sachs report, a number of standby tools (such as TLTRO) remain unused and more importantly funding markets (both USD and EUR) show no sign of an actual liquidity squeeze. Indeed, we think given the market moves, it is now considerably cheaper for a number of major European banks to long term fund themselves with the ECB rather than the markets – point highlighted by the latest news which suggests that Deutsche Bank is planning to buy back a big chunk of its senior paper.

Given this backdrop, we believe what we are witnessing currently is a severe bond\credit market liquidity accident where herding coupled with structural deterioration in micro liquidity provision is leading to sharp moves in credit markets (a theme we have been discussing consistently over the last 15 months). Although on the surface, it is now looking like a systemic risk issue but we think the nature of the beast we are dealing with is quite different to 2008/9 or 2011/12.

Weather check (III) – Central banks gearing to rain "liquidity again"

First and foremost, the longevity of the dislocations we are seeing currently will depend on how key central banks will react to current developments. Historical evidence shows that central bank easing measures (or credible promises) tend to be most effective when valuations are low and distress is high (for instance in early 2009 and 2012). One can question the long-term efficacy of QE and negative interest rates when it comes to real economic outcomes but, given the liquidity provision easing generates, its impact on liquidity conditions and by extension, financial assets is beyond dispute.

Given the rise in systemic risks and the sharp tightening in financial conditions witnessed over the last few weeks, we think key central banks will deploy a strong amount of easing to mitigate the negative impulse on economic growth and inflation. In the ECB's case, we expect a rate cut of 20bps at the next meeting and an extension of the QE program both in size and tenure together with a promise of more if required. We are also likely to see a reminder of the wide variety of backstops available to the central bank to buffer the financial system.

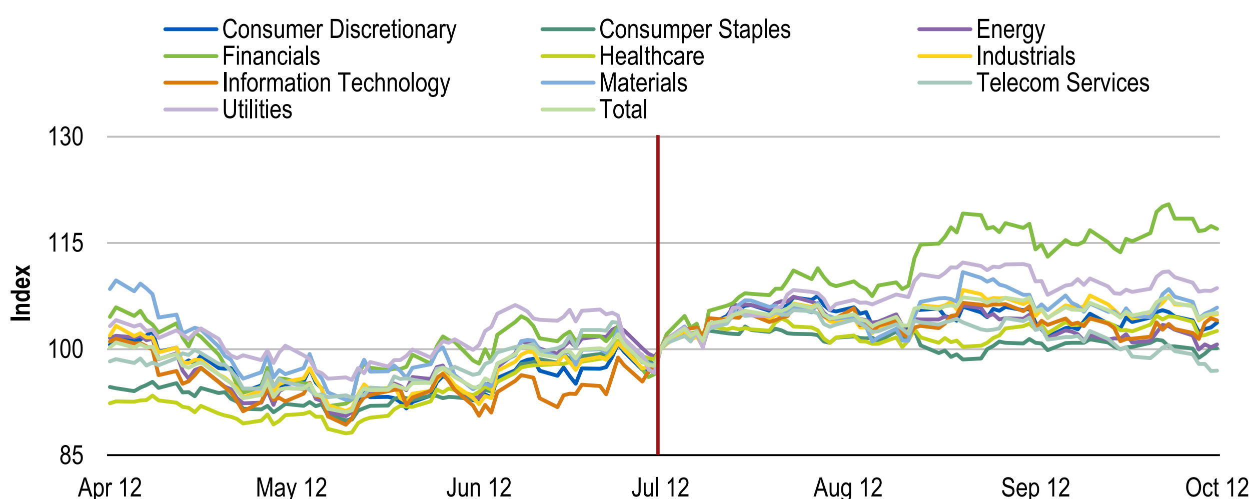
In the Fed's case, we expect a very cautious tone, with rate hikes being put on the back burner, given the sharp tightening of financial conditions. PBoC is already deploying liquidity to the domestic system and recent reserves data shows signs of stress but not panic unlike late last year. Last but not the least, we expect Japan to further ease policy in the coming months to ensure their relative stance remains in touch with the global shifts.

Building an ark (I) - European equities are very sensitive to ECB policy dynamics but harnessing differentiation is key

If we are right in our thinking that the current stage of stress we are witnessing in global risky assets is driven by a credit market liquidity accident, then we believe coordinated central bank easing can indeed short-circuit the negative feedback loop. Structurally, as we have argued many times before, the incidence of liquidity induced storms is likely to remain high given the changes in regulatory backdrop. But these accidents are just that, "accidents", as the global back drop of disinflation and deflation implies that central banks can continue to use extra liquidity provision to force investors to take risk as valuations become compelling on liquidity-adjusted basis.

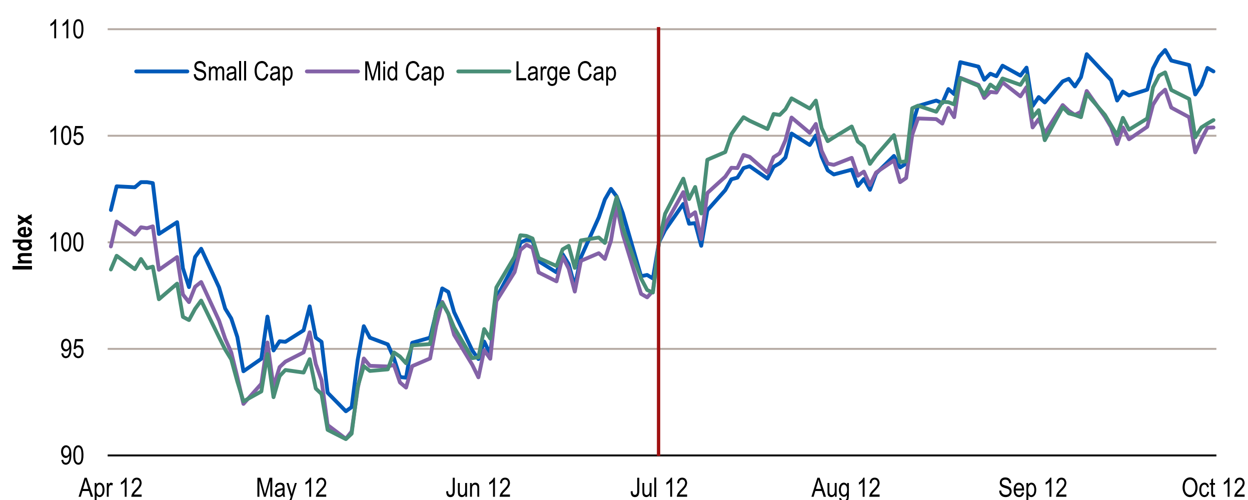
As a reminder of the power of central bank policy on risky assets, we have shown below the dynamics of European stock markets before and after major policy developments (Figures 5,6,7 & 8). With MSCI Europe price to book reaching 2011/12 lows (Figure 9), we think valuations have enough stress now priced in for central bank easing to have an instant and sustained impact.

FIGURE 5 – MSCI EUROPE INDEX RETURNS ACROSS ALL SECTORS BEFORE AND AFTER DRAGHI'S "WHATEVER IT TAKES" COMMENT[2]



Source: MSCI, Bloomberg.

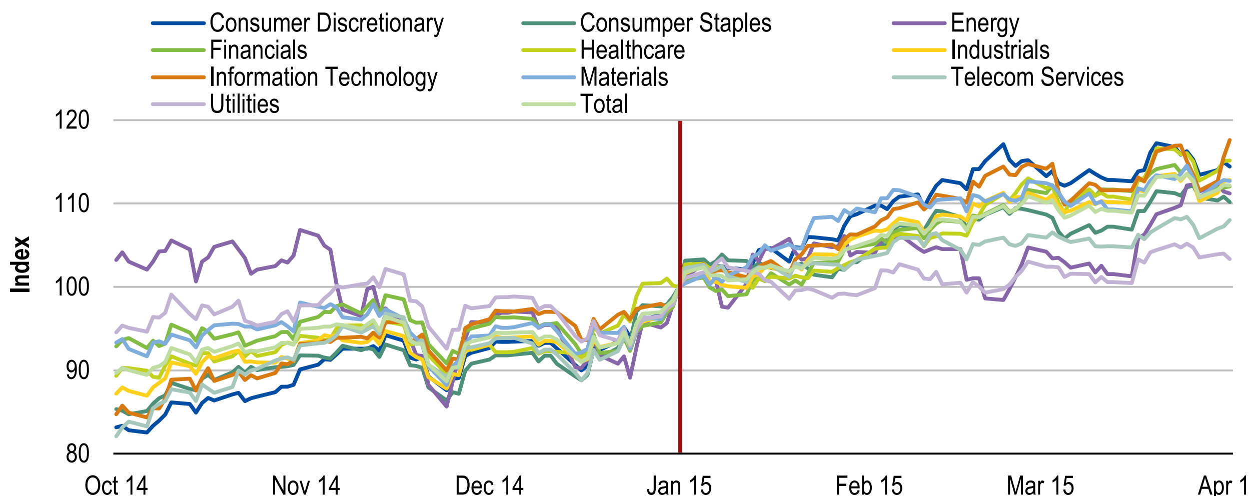
FIGURE 6 – MSCI EUROPE SMALL, MID AND LARGE CAP INDEX RETURNS BEFORE AND AFTER THE DRAGHI'S "WHATEVER IT TAKES" COMMENT[2]



Source: MSCI, Bloomberg.

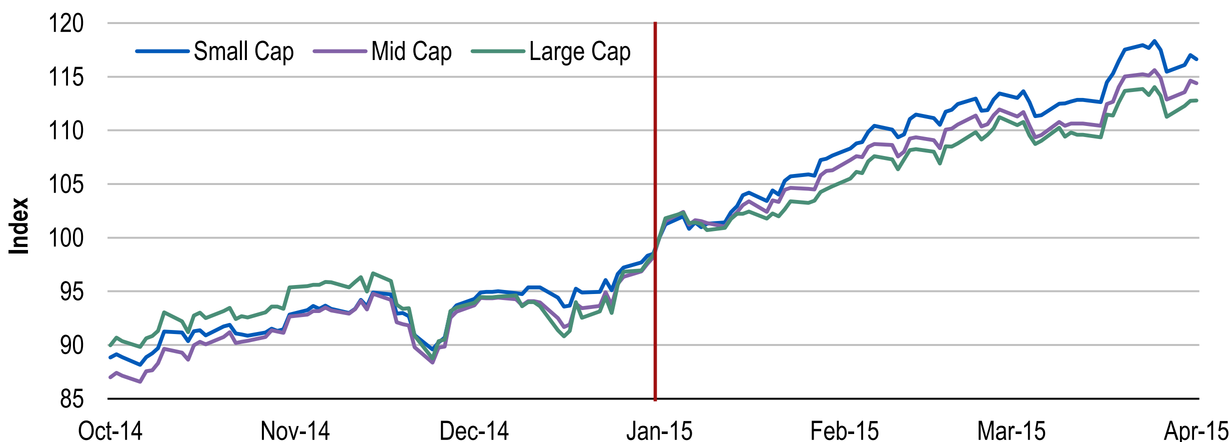
[2] Re-Indexed with base period being the date of the comment: 26 July 2012.

FIGURE 7 – MSCI EUROPE INDEX RETURNS ACROSS ALL SECTORS BEFORE AND AFTER THE ECB'S QE COMMENCEMENT[3]



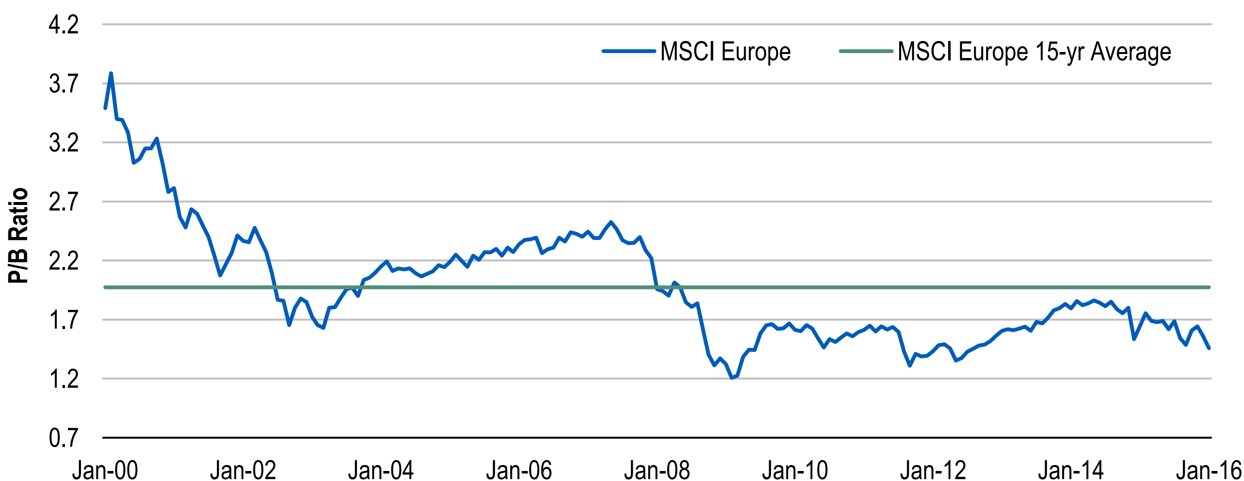
Source: MSCI, Bloomberg

FIGURE 8 – MSCI EUROPE SMALL, MID AND LARGE CAP INDEX RETURNS BEFORE AND AFTER THE ECB'S QE COMMENCEMENT[3]



Source: MSCI, Bloomberg

FIGURE 9 – MSCI EUROPE INDEX PRICE-TO-BOOK RATIO



Source: MSCI, Bloomberg

[3] Re-Indexed with base period being the date of the commencement: 22 January 2015.

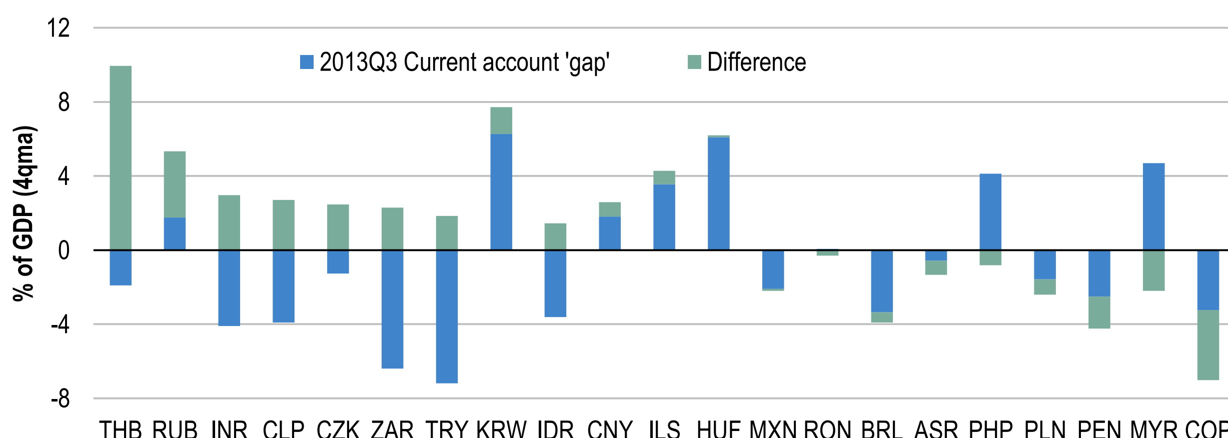
In terms of implementation of this currently contrarian view, we think the quality of the "ark" one can build will matter. Here, we think differentiation amongst sectors\styles will remain a sustained theme, together with dominance of idiosyncratic factors, which will determine both the volatility and long-term return profile of any exposure, especially given the strengthening reality that the current liquidity induced dislocations have structural roots. As such, we think plain beta is unequipped to deal with the current challenges and proven manager skill can go a long way in facing the complex global economic and financial interconnections.

Building an ark (II) – EM fixed income offers yield and shows valuation support but recent challenges back a fundamentals-based approach

With negative interest rate profiles firmly intact in major economic centres, further easing by key central banks is likely to be an important theme for 2016. At the top level it points to an environment where the need for diversification (given tangible tail risks) coupled with a "prudent" yield search would be supported. From an investment design angle this would require looking at non-traditional sources of returns (such as uncorrelated cash plus strategies) and /or improved implementation, where "beta" still offers some long term return potential.

On the latter, with a China slowdown coupled with the sharp down shifts in EM asset prices seen over the last 2.5yrs, EM assets have no doubt seen some intense pressure. However, IIF capital flows data show that international investors are now systematically underweight EM at a time when the external profile of a number developing markets is starting to improve (Figure 10), while valuation based metrics are starting to highlight signs of a deep wedge between fair and current values (especially, when it comes to FX). On China, we continue to think that fears of a financial meltdown are overblown given the wide range of backstops available to the authorities which they can use to stop locals from losing trust in the domestic currency (for instance, see Emerging Markets: Challenges versus Opportunities).

FIGURE 10 – CURRENT ACCOUNT PROFILE DYNAMICS ACROSS EM[4]

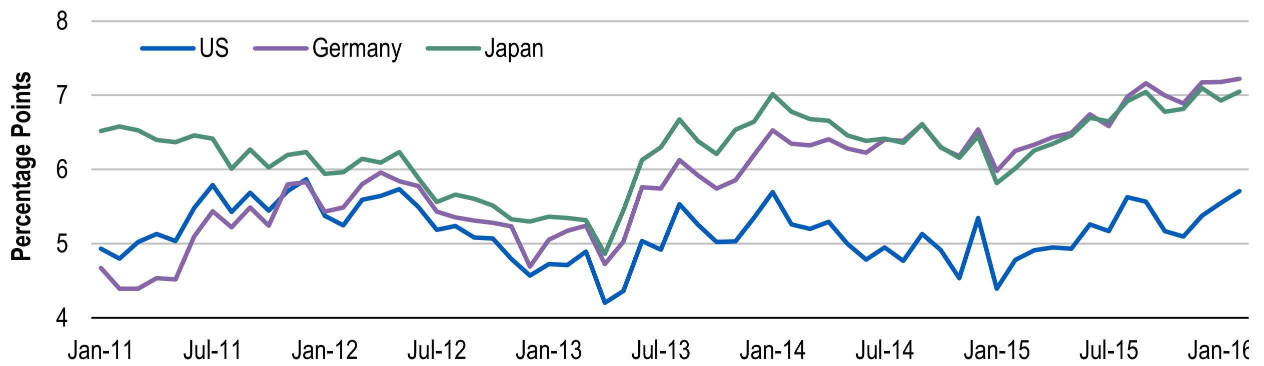


Source: Bloomberg, LOIM, GS.

Against this backdrop, we think the additional advanced economy liquidity becoming available will likely find its way into EM in the coming months, given the lower foreign ownership and attractive yield profiles offered by the asset class in a world of deep and widespread negative interest rates (Figure 11). Indeed, such a buffer is also available in the EM equities space as well, which are now showing attractive valuations, especially when compared to developed markets.

[4] Difference captures shift between Q3 2015 levels and Q3 2013 level.

FIGURE 11 – EMERGING MARKET YIELD DIFFERENTIAL VERSUS ADVANCED ECONOMIES AT MULTI YEAR HIGHS



Source: Bloomberg, J.P Morgan. Yield differential is J.P Morgan's GBI-EM Index Yield minus advanced economy's 5-year government bond yield'

Once again, building the right "ark" to navigate the current complex challenges is key. When it comes to implementation, we firmly believe that the current status quo of using market cap benchmarks (based on price and size of debt) is unequipped to deal with the current situation. In terms of investment philosophy, we think assessing each country on its own merit is important and therefore, we recommend using a fundamentals based approach to building such an exposure which directly aims to mitigate underlying default risk and deliver quality based diversification.

Jan Straatman
Global CIO
Lombard Odier Investment Managers

Salman Ahmed
Global Strategist
Lombard Odier Investment Managers

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