



Weekly Insight

The commodity adjustment: A boost for developed economies?

The global equity rout continued for much of this last week, before a rebound on Thursday and into Friday, with many regional markets having entered so-called “bear market” territory. Asia has borne the brunt of the losses – Japan’s Nikkei Index was down 15.85% and Hong Kong’s Hang Seng had lost 15.39% so far this year at one point – but the FTSE 100, the Euro Stoxx and the S&P 500 were also 9% lower at their lows. Risk-averse investors sought refuge in government bond markets, the ten-year US treasury yield falling below 2% to levels last seen in the second quarter of 2015, as “safe-haven” currencies such as the US dollar and the Japanese yen, appreciated.

Overwhelmingly negative rhetoric, but the risks are not new

At times like these it is easy to be caught up in the rhetoric, particularly as there seems to be a race to go to press with the most unnerving and doom-laden headline. Market commentary has been overwhelmingly negative, focused on generally weak economic data, fears of a destabilising Chinese currency devaluation and speculation that the continuing disruption across commodity and energy markets will cause a 2008-like panic within financial markets.

Clearly there are risks, many of which are not new. Chinese activity is slowing, as the investment-led boom of recent years transitions slowly to a more consumption-orientated economy. The downward pressure that this slowdown places on demand for commodities should, however, not be confused as a proxy for overall activity across the Chinese economy.

While the lower oil price clearly creates significant problems for certain economies and companies, it is not unequivocally bad news. Indeed, it is worth highlighting that an oil price spike, which is inflationary and negative for consumption, has preceded all of the recessions of the past fifty years. Moreover, during times when the oil price has halved – 1982-1983, 1985-1986, 1992-1993, 1997-1998 and 2001-2002 – global growth actually expanded [Source: Gavekal].

Commodity-related contagion should be limited

In addition, we believe that the impact to the broader economy should be relatively contained for two reasons. First, we believe that systemic risk resulting from lower oil prices is limited and is not equivalent to the sub-prime-initiated banking crisis, for example, in 2008. Since then,

corporate borrowers have strengthened balance sheets and lowered debt levels as they have been able to take advantage of low interest rates to refinance and extend debt maturities. Moody’s global speculative grade default rate has been creeping higher at 2.5% (third quarter of 2015), but is still well below the historical average of 4.5%. Banks are also better capitalised and are actively taking steps to build their reserves for loan losses, as evidenced in JP Morgan fourth quarter results, in response to energy sector risks.

Secondly, lower energy prices are considered a boon for consumption, since input costs for manufacturers and oil importing countries are much lower and consumers benefit from the boost to real disposable income. This argument was widely held by investors in 2015 but has largely been ignored this year as consumers have been reluctant to spend the windfall. Instead, the focus has shifted to the cost to the real economy, as commodity-producing companies and countries adjust to lower oil prices, slashing expenditure and unwinding excess capacity. While these developments are painful in the near term, we believe they will be positive over the longer-term by helping to restore the balance sheets and corporate profitability of commodity-related sectors. Stronger jobs growth, low inflation and lower levels of household debt should all help to underpin consumer spending in developed markets, especially in the US and UK.

Overweight DM vs EM but with reasonable liquidity

The start of 2016 is turning out to be a more volatile period than most of us expected. There are valid reasons to be worried if steep equity market losses feed into broader economic confidence and stymie activity. At present, we believe that the fundamentals support our view of moderate growth with central bank support, but we are continually assessing the situation as events unfold. We are currently staying overweight in equities, but with a clear preference for developed over emerging markets. We are also maintaining reasonable levels of liquidity in this heightened period of volatility, which gives us the firepower to take advantage of attractive entry points.

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Risk Warnings:

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