capital at work
Wealth Management Foyer Group

"What the companies in which we invest tell us about the state of the world economy."

Global equity markets started the year with a new plunge. The crash on the Chinese equity market pulled Western markets in its wake. European indices have lost nearly 10% since the start of the year and are about 20% down from their peak levels of April last year. Same story in the US, where indices year-to-date are down 8% and 12% below the record levels reached last summer. Other regions in the world were unable to escape from the massive selling pressures. It seems that equity investors all over the globe are anxious and looking *en masse* for a way out.

What explains the general market *malaise*?

The start of the year was characterized by some nervousness surrounding a potential political escalation in the Middle East. Nonetheless, the current malaise primarily pertains to the state of the Chinese economy. Are we heading for a hard or a soft landing in one of the greatest economies worldwide? This appears to be the main question. A highly relevant one, given that China was the locomotive to pull the global economic growth in the recent past. Many see evidence in the recent devaluation of the Renminbi that the Chinese economy is in a bad shape. Furthermore, the continued sharp declines in commodity prices, and in particular in oil prices, creates additional unrest. One could easily link sliding oil prices with decelerating global economic growth, which further nourishes confusion. In the meantime, gurus are queuing to announce the next crash.

We would like to put these views into perspective.

Some major challenges are out there. Notwithstanding, we notice a growing discrepancy between what we learn and read about the global economy and the panic reaction in the markets. With regards to China, we are rather proponents of a soft landing. That China encounters some difficulties in its transition from an investment driven to a consumer and services driven economy is inevitable. We believe it is more than acceptable that an economy, that used to grow spectacularly over a long period of time, eventually decelerates. Trees just do not grow to the skies. In absolute terms, the latest reported economic growth of 6.8% is more valuable than, say, the 10% economic growth 10 years ago.

Today, the undoubtedly very low, or even negative, industry growth while consumer and services driven industries are still booming, constitutes the main discrepancy in China. A lousy financial asset allocation combined with inefficiently managed state owned enterprises have led to substantial overcapacities in many industries. Just have a look at the steel industry, where Chinese corporations are dumping excess steel production in Europe and the US. Unsurprisingly, this is disliked by the western steel companies.

Many western companies with important operations in China are sending out comments lately picturing the opposite. Apple, for instance, doubled its revenues in China last year. Nike and Adidas are both witnessing impressive growth. Even players in the luxury market, which were initially impacted by the anti-corruption measures imposed by Chinese authorities, are noticing significant growth again. As such, luxury company Richemont sent out encouraging messages with respect to China in its earnings reports.

The Chinese stock market crash also requires some nuance. Compared with early 2014, today's Chinese equity indices still trade 50% higher.

Besides leading indicators being back up rising, further encouraging news was reported in the course of last week. Indeed, Chinese export data proved to be above expectations, while the trade balance surplus further improved. The latter should in turn support the Chinese currency. Hence, the somewhat limited depreciation of the Renminbi up to now seems rather logical to us. Due to the strong dollar, the peg of the Chinese yuan with the USD resulted in a strong appreciation against all other major currencies in the past few years. A limited correction then seems appropriate.

Also the considerable plunge in commodities and oil prices should not derail us. These price slides are clearly the result of a strongly increased supply, which is a consequence of the high prices noticed in the past few years. It is not the outcome of a lowered demand as we have witnessed in the recession of 2008. In fact, the demand for oil in 2015 exceeded the 2014 level. China, for instance, never imported more oil than it did last year, building inventories at depressed price levels. Moreover, iron ore imports in China last month reached an all-time high.

The European economy is improving. The massive injection of liquidities in the markets seems to be bearing fruit, though some modesty seems appropriate. The trends are positive while economic growth is slowly but surely on the rise. European companies keep benefitting from low rates, a weak euro, depressed commodities and energy prices, and a moderate economic revival. We are convinced the upcoming earnings season will be promising. In the meantime, the European stock markets are currently priced lower than at the start of last year, while corporate earnings have risen. This year, we expect earnings will keep on rising, except for the oil and commodities industries. This means that valuations have become more attractive.

All in all, we remain positive on the global economic fundamentals and corporate earnings, especially in Europe. This explains our overweight in that geographic area. Nonetheless, stock markets are not only driven by fundamental considerations but also by emotions. These days, the latter clearly get the upper hand. It seems evident to us that markets will remain volatile this upcoming year.

In case of further questions, please do not hesitate to contact us.

Yours Faithfully,

The Direction of Capital*at*Work Foyer Group