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An alternative to panic: Investing in real assets in 2016

Summary

The start of 2016 brought in sharp relief the bane of all “advisors” including this one. We all look at the same data and come to totally different conclusions! I do not believe that China will land hard (whatever that means...most of those who use this expression never bother to quantify it) or will have a banking and credit crisis, or that the Fed will need to reverse policy, or worse, will hike three more times in 2016. But investors do, and act accordingly. Hence the need to suggest an investment strategy, which, while not based on my own expectations as, clearly, investors disagree, still offers some sensible suggestions without being contrarian. Econotes does not believe in being contrarian on purpose!

Investment Conclusions

Equities are in for more volatility triggered primarily by volatile Chinese equities, while the Chinese economy has not clearly bottomed. Fixed income assets will have the overhang of higher USD rates, or the likelihood of a US recession, either case pointing to different investment conclusions. No wonder investors have been advised to “sell everything”. We suggest avoiding pure paper investments and try exposure instead to investments which are explicitly and directly based on, or backed by real assets, such as niche property widely defined, some natural resources and, a step further removed, on structured credits, where possible, backed by real assets.

Unresolved conflicts

As there is a substantial amount of consensus as to the causes of the market collapse at the start of 2016, we will summarize them here briefly and also our take on them. **First**, the Chinese economy will decelerate further and will also likely have a credit crisis thereby driving even further down the global economy. We have written extensively and presented ample evidence to show why the global economy is NOT driven by China and especially the G3 economies. The evidence is based on the unimportance of exports as growth drivers for G2 and partially for Japan and, hence, the unimportance of China as an export market. China as a market is important for Australia, Brazil, Russia etc., but these economies represent a small percent of the global economy. The Chinese economy cannot have a domestic credit crisis because its fiscal deficit is small, about 3% of GDP, and totally domestically financed. The exposure of the banking sector to property is limited and the government owns the major 4 banks thus making any banking crisis a fiscal issue. Last but not least, there are still the USD 3.3 trillion of forex reserves, which can be used for domestic purposes albeit constrained by the forex policy of the PBOC. **Second**, the Fed hike was ill-timed as the US economy could easily enter a recession, or the hike is the first of three more in 2016. Either of these scenarios is bad for equities. We judge that the US economy may not perform strongly in 2016 and

that the Fed will stay on hold in 2016. **Third**, the collapse of oil and of commodity prices have added to the gloom despite the fact that they involve large transfers of income from commodity producers to the G3 and to most Asians which are not commodity producers. There are significant impacts on oil firms and miners but these are micro and not macro impacts on the global economy. A return of oil to USD 100 would be considered a disaster right now.

Fig.1: Commodities (soft green, metals black, total red) Baltic Dry Cargo (blue) 2014=100



Source: Bloomberg

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Why real assets in 2016 ?

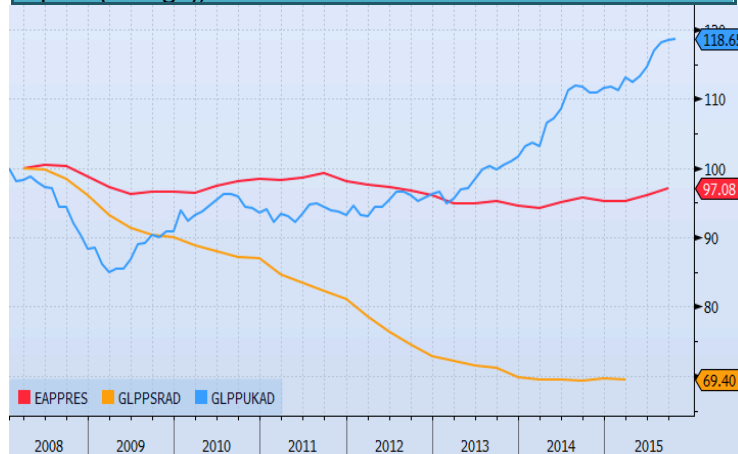
At the time that equity markets are on a seeming free fall, calling cyclical bottoms or focusing on rate sensitive or incentive companies might appear irrelevant as there are doubts as to the likely direction of the USD rates. Hence our suggestion to focus on real assets and on real assets backed paper. Consider the case of commodities in Fig.1 with the general index falling but with soft outperforming hard commodities and with the whole situation reflected in the collapse of the Baltic Dry Index. The latter development led some shipping companies to a wholesale sale of dry cargo vessels and/or the cancellation or resale of ship orders. Some shipping companies are building up fleets cheaply even if there is no guarantee that the shipping cycle has bottomed. Same considerations may apply to the disposal of, and investment in mines despite the general price collapse. Residential property prices in Europe as a whole have

FACT BOX: Defining investment in “real assets”

Investing in real assets may involve investment on claims on these assets, in other words on paper backed by real assets. The difference between buying a mine and then collateralizing it, from buying shares in mining companies is that the first type of investment looks to the physical value of the asset as collateral, including of course for resale purposes, as well as being focused on one project only as opposed to mining companies which may be exposed to various projects and/or metals. Similarly, investment in real estate projects follows the same paths of reasoning. Buying real assets at the perceived bottom of the cycle is neither simple nor risk-free and, hence, a case-specific rather than a purely sectoral approach is crucial here.

been stable with some signs of an uptick. There are differing individual performances as shown in Fig.2, which, on purpose, shows the two extremes of UK and of Spain. The investment policy here would not be the obvious one based on cyclical but on the niche and differentiated property sectors in the EU helped along by the guaranteed low interest rates by the ECB for the foreseeable future. A parallel investment aim would be to invest in structured credit products in companies where real assets are the main collateral.

Fig 2: Residential Property prices: EU (Red), UK (blue), Spain (orange), 2008=100



Source : Bloomberg

Drawing all strings together

At this stage we need to reiterate and draw attention to our disclaimer in our masthead, that Econotes does not offer investment suggestions on named or specific shares, bonds or structured products, nor does it make specific and named buy or sell calls. Hence our “theme” on real assets investment for 2016 is, by necessity, broad. While it calls for real asset investment, it does not offer specific suggestions as to the actual instruments to execute it. Although this limits the immediate practicality of our advice, it equally avoids the more dire suggestions of “sell everything” or “go short on equities”. Even more specifically, our call is not necessarily based on expectations that the local and global real and financial cycles have bottomed and, hence, now is the time to buy cheap. We have always had serious doubts on the familiar call “buy on weakness” because, like other similar calls, is hardly ever quantified !

Andrew Freris (writing completed 24/1/2016)