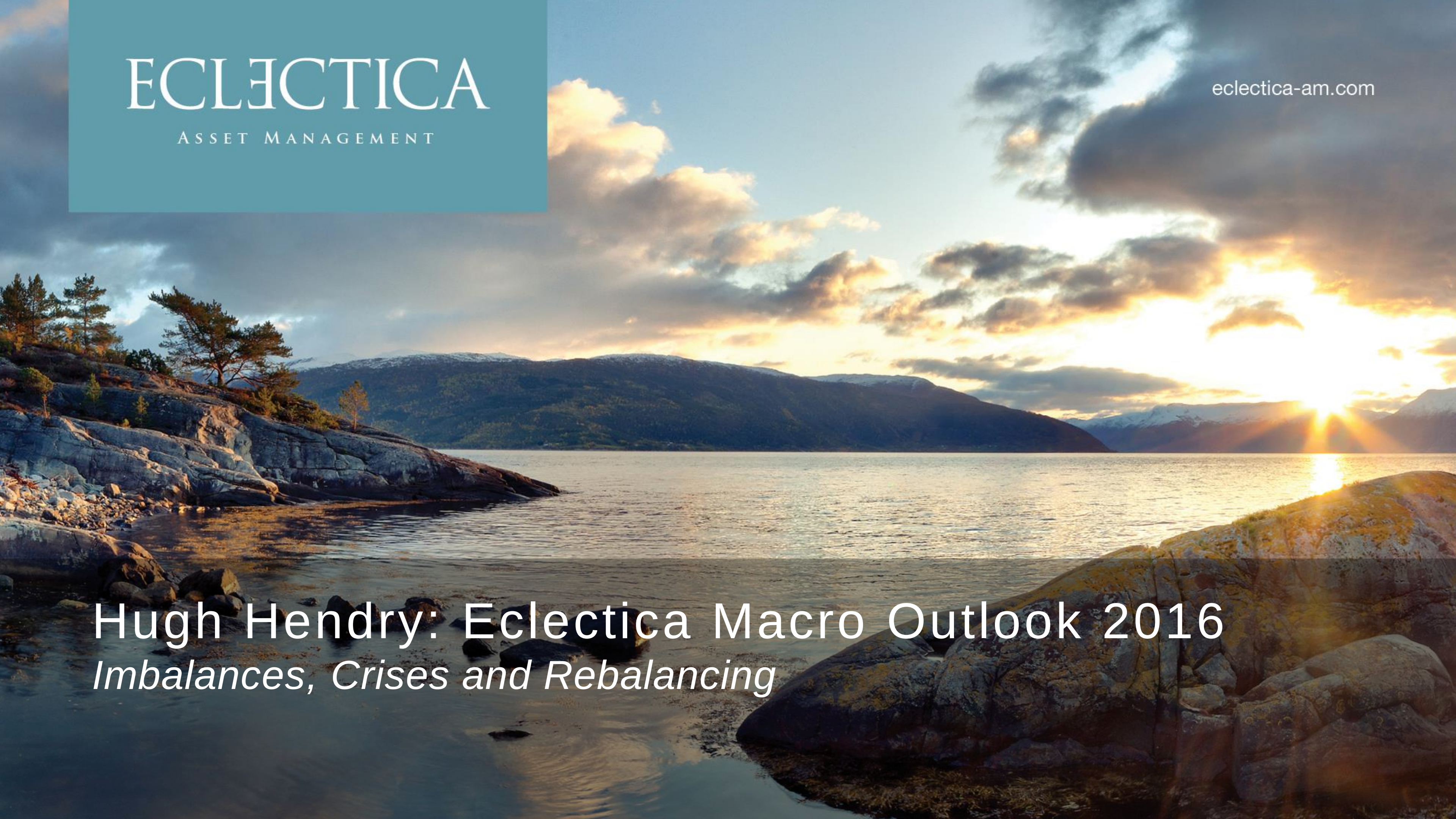


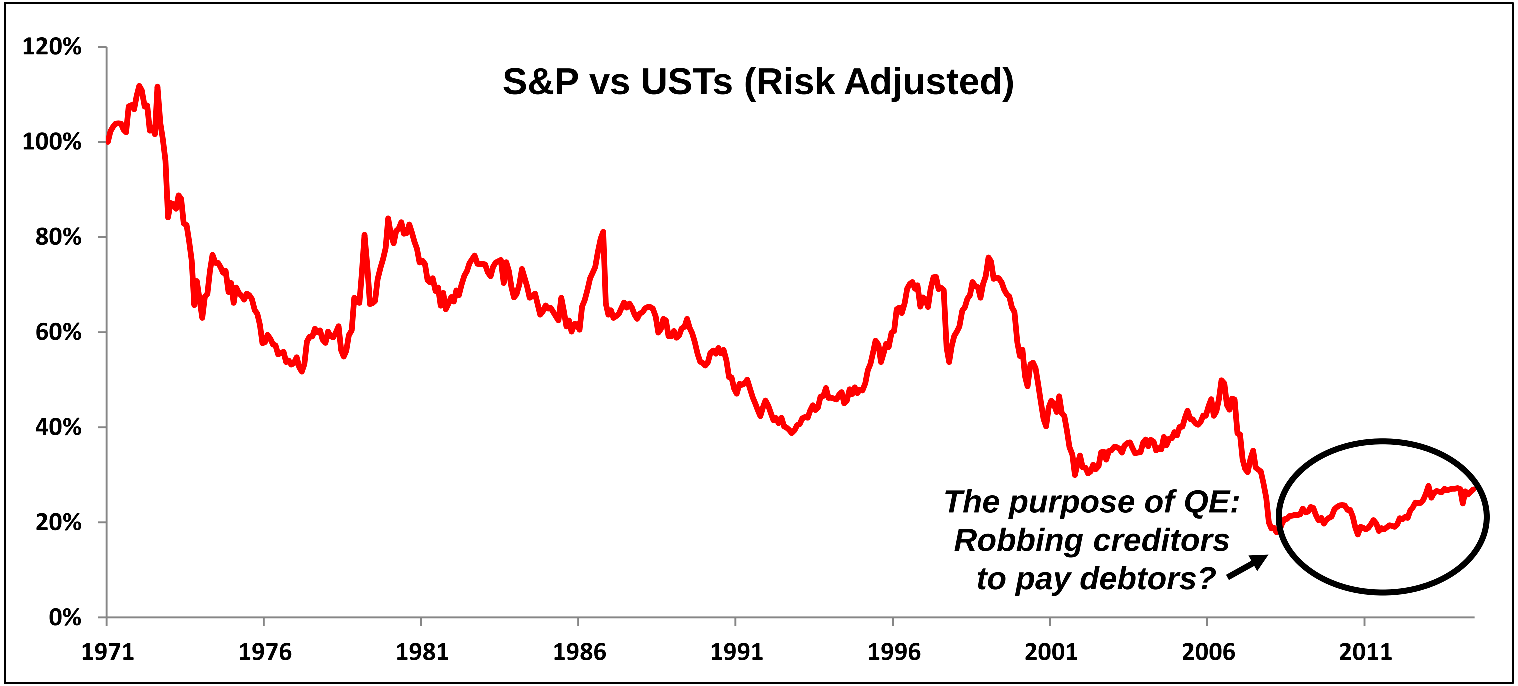
eclectica-am.com

Hugh Hendry: Eclectica Macro Outlook 2016

Imbalances, Crises and Rebalancing

Imbalances

Imbalances: US equities have lost c. 75% of their value vs bonds since 1971

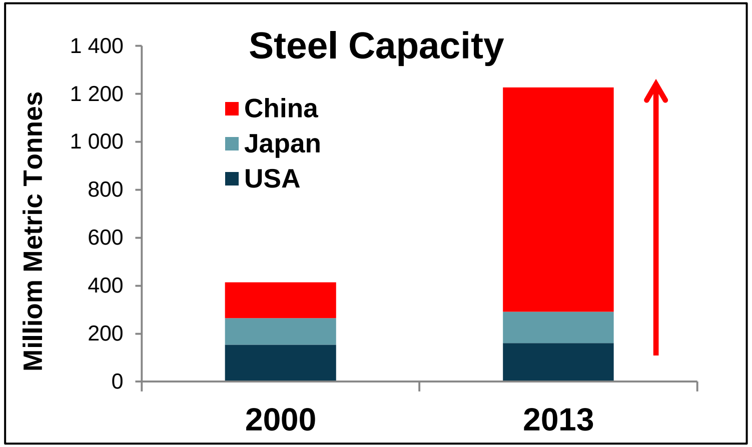


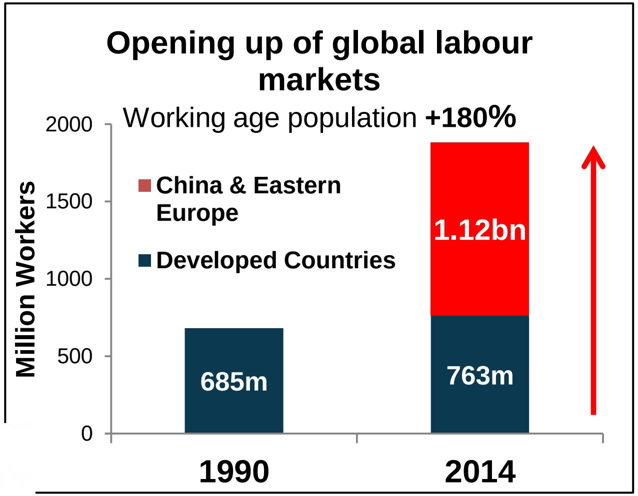
Source: Bloomberg/EAM

Imbalances: Why did interest rates stay so high?

1970s

INFLATION





Charts source: Bloomberg/EAM

Imbalances: Supply creates its own demand…

Carnegie

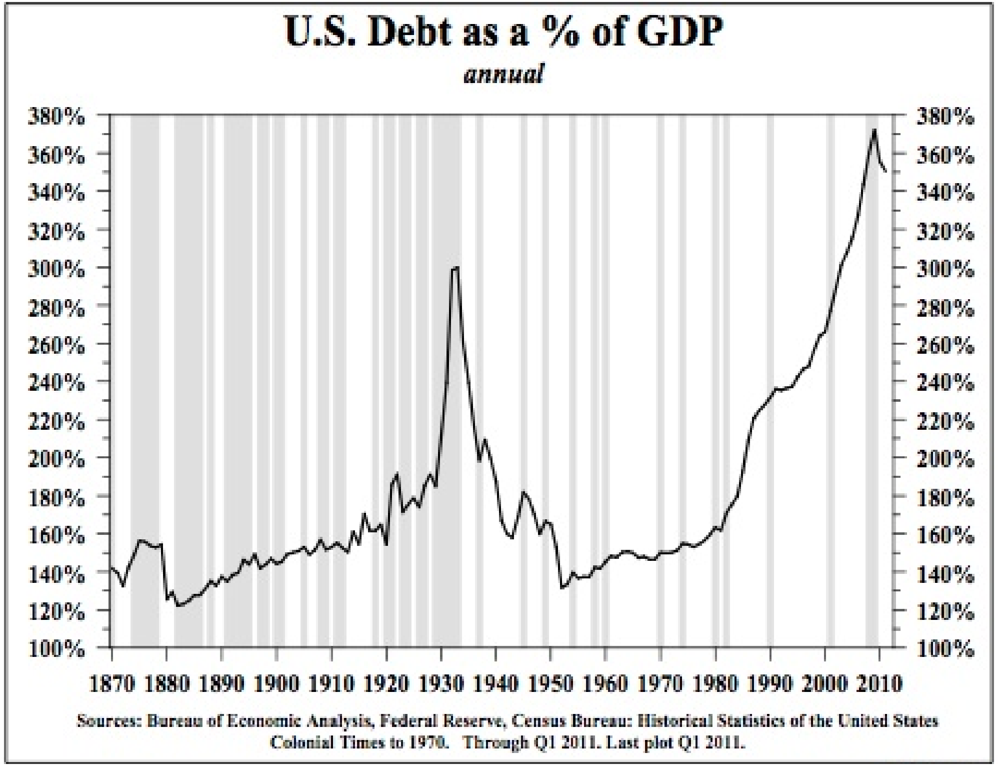
Countrywide

Roskilde Bank

northern rock

No **I**ncome
No **J**ob
No **A**ssets

and with inadequate returns on investment, debt spirals…



Crises

Crises

"It has long seemed to us to be the case that this economic crisis would start in the US and make its way to Europe. That has happened. However, we also think it will end in Asia"

Hugh Hendry, April 2012

LEHMAN BROTHERS

Old Confucius Saying:
"Wise Man Not Invest in Over-Capacity"

Rebalancing

Rebalancing: China - “Paying” Offshore Chinese Interest Rates

- We were initially seeking to benefit from the **convergence** between offshore rates and higher onshore rates as part of a more general play on Chinese **liberalisation** (i.e. allowing a greater proportion of onshore domestic borrowers to tap the offshore market and thus bid rates higher)

- Following the renminbi “devaluation” of August 2015, Chinese **authorities were forced to intervene** heavily in the FX market having underestimated the extent of the subsequent currency sell-off – this opened up an opportunity to reinitiate the position : As the PBoC buys renminbi from the market, there is less liquidity for the offshore money market, pushing short-term interest rates higher

- **In the event of a more aggressive slowdown/liquidity squeeze** in China, we would expect to see rates rise sharply and the strategy is therefore also attractive as a positive carry “risk off” trade”

- We believe that profitable high carry **opportunities such as this will continue to arise** due to the PBoC’s persistent need to intervene in markets and we therefore continue to focus on China as an area of strong macro opportunity

Rebalancing: China - Long Consumers vs Short Producers FX

- As **growth in emerging markets has shifted to a less commodity intensive consumption model** - the decline in the price of commodities has been catastrophic for some parts of the global economy, but has produced a significant windfall for others

- **On the long side** we have focused on **consumer nations** which:
    - Have a **low dependency on external trade**, with a large non-tradeable goods and services component of GDP
    - Are significant **importers of energy/commodities** (and so are enjoying a large positive terms of trade shock)

- This leads us to the **Asian 'consumer' nations** of the Philippines and India, populous countries with large domestic markets and low penetration rates of consumer credit - both also feature a heavy weighting towards services sold to customers in DMs

- **On the short side** , we believe that deflationary pressures are likely to continue to inch higher up the supply chain to developed Asia where exports-to-GDP are the highest in the world

- Nations such as Taiwan, Singapore, Thailand and Malaysia, without large domestic consumer markets of their own, are likely to be the most at risk

Rebalancing: Europe - German Property

- Idiosyncratic opportunity, less dependent on binary higher/lower stock index values

- **Macro level**: European monetary policy set at a level which is arguably **too loose** for more productive countries like Germany - German asset prices should appreciate relative to other European assets

- **Berlin house prices cheaper than Madrid**

- Domestic German assets are **less exposed to uncertainty over Chinese growth** (better play at this point than the huge car and chemicals exporters that dominate the DAX)

- **Fundamental story** : German property market is changing as the **population moves** away from rural and eastern areas in favour of large cities - vacancy rates are low and falling and so pressure on housing stock means that prices are finally rising from a low base

- **The sector typically prices off a 7% rental yield** – with 10 year German bunds currently yielding less than 1%, we believe that there is clear potential for upside to current stock prices

Rebalancing: Europe - UK Housebuilders

- **UK is building far fewer houses than the growth in new household formations**
- The previously significant **“mom and pop” segment (c. 40%)** of the market, has almost been eliminated owing to the severity of the credit contraction from the banking sector
- **Land prices have remained remarkably low**
- **Mortgage approvals are still running at around half the peak level**
- Deflationary global macro winds seem set to confer the most **muted form of interest rate hikes (if any)**
- **The UK government, it would seem, is determined to underwrite a longer more profitable housing cycle**
- A typical basket of UK house builders trades profitably on 12x earnings, yields 4% and has the capacity to enhance this return with special dividends

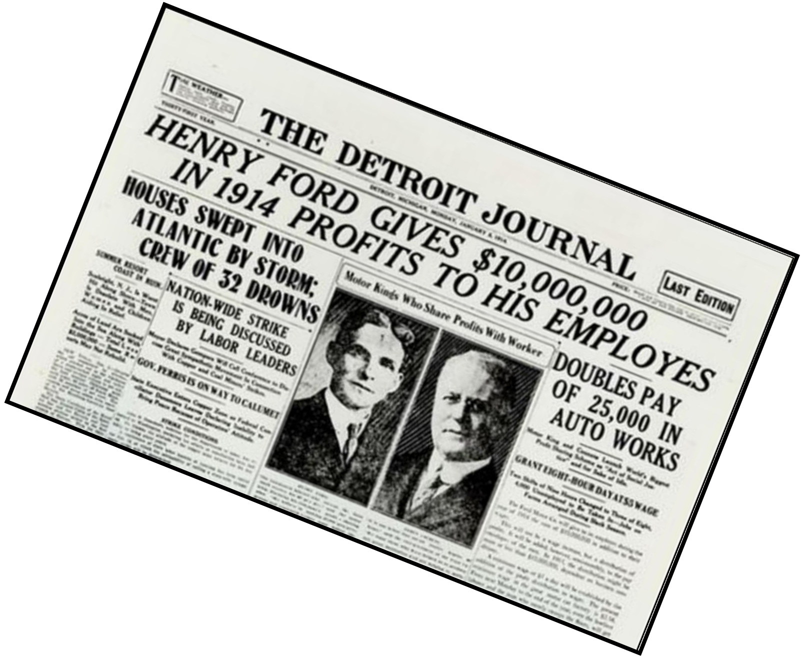
Rebalancing: Europe - UK Recruiters

- We see a potential **shift to a global policy promoting higher wages, correcting the imbalance between capital vs labour**

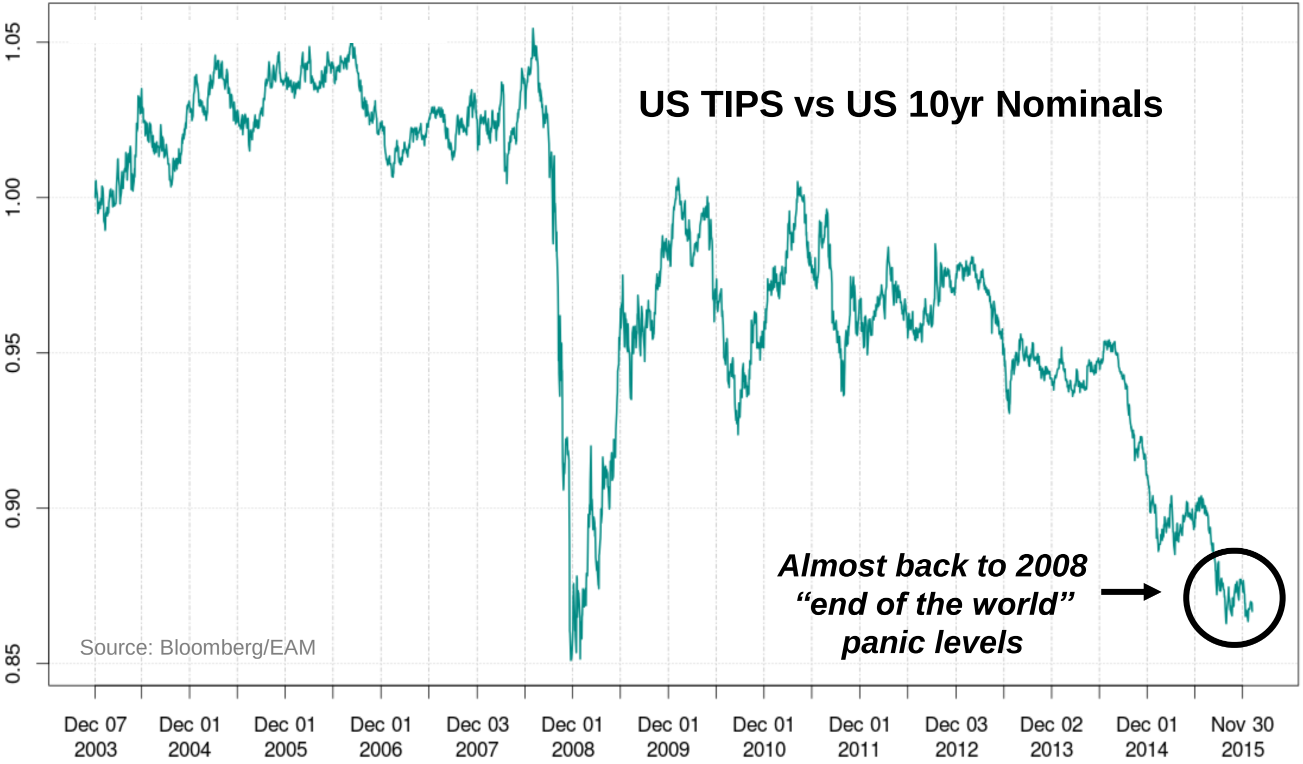
- **Henry Ford** notion that if workers have more money, businesses have more customers

- For those fortunate to find themselves in the economies of the early adopters of QE the jobs' market has strengthened significantly such that we are **bullish on the return of risk seeking activity on the part of those in work in the West**

- We are willing to bet that as the tide turns the extreme profit gearing to economic cyclicality will **make a mockery of analysts' modest expectations**


THE DETROIT JOURNAL
LAST EDITION
HENRY FORD GIVES $10,000,000 IN 1914 PROFITS TO HIS EMPLOYES
HOUSES SWEPT INTO ATLANTIC BY STORM; CREW OF 32 DROWNS
NATION-WIDE STRIKE IS BEING DISCUSSED BY LABOR LEADERS
Motor Kings Who Share Profits With Worker
DOUBLES PAY OF 25,000 IN AUTO WORKS

Rebalancing: Inflation Reset



Rebalancing: Inflation Reset

- We would argue that China's GDP expansion post WTO entrance in early 2000s imposed a **"growth tax" on Western consumers:**
    - Investment-driven model **boosted global commodity prices**
    - **Headline inflation** rates consistently printed **higher than core inflation**

- China's **lighter commodity growth model** removes "growth tax" on the West, with headline inflation rates now below core

- Real rates have fallen but, in our view, still remain too high to support growth - the problem: **long term inflation expectations have crashed**

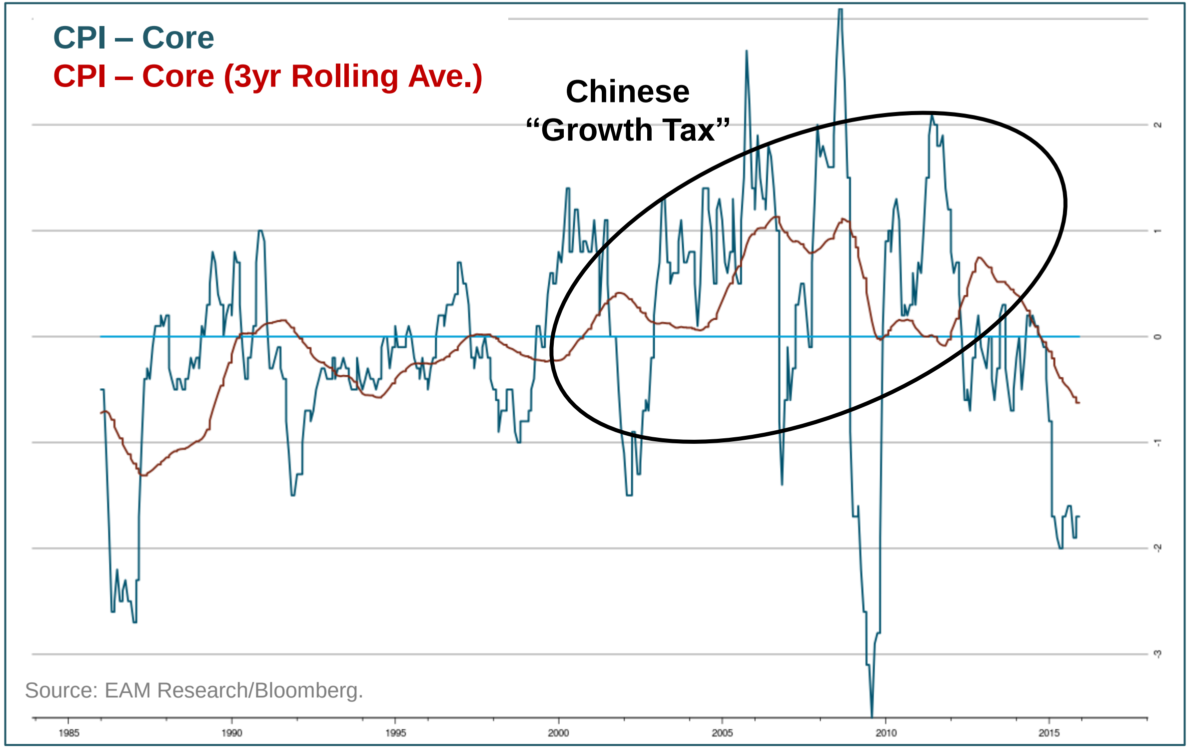
- We sense an opportunity:
    - US **wage inflation** highest in 5 years at 2.5%
    - **Core inflation** has been stable and near 2%
    - **Services inflation** increasing to 5 year highs

- In our view, longer term inflation expectations have exhibited **too much correlation with the decline in oil prices** (it makes sense for shorter term inflation expectations to decline)

- As oil prices wane, consumers eventually **shift their spending** elsewhere (chasing the same amount of goods)

- Capacity in corporate America has been cut dramatically - if consumer spending returns in force, we believe that it is likely that **minor shortages of desired goods will increase prices**

Rebalancing: Inflation Reset



Source: EAM Research/Bloomberg.