



ELECTICA

ASSET MANAGEMENT

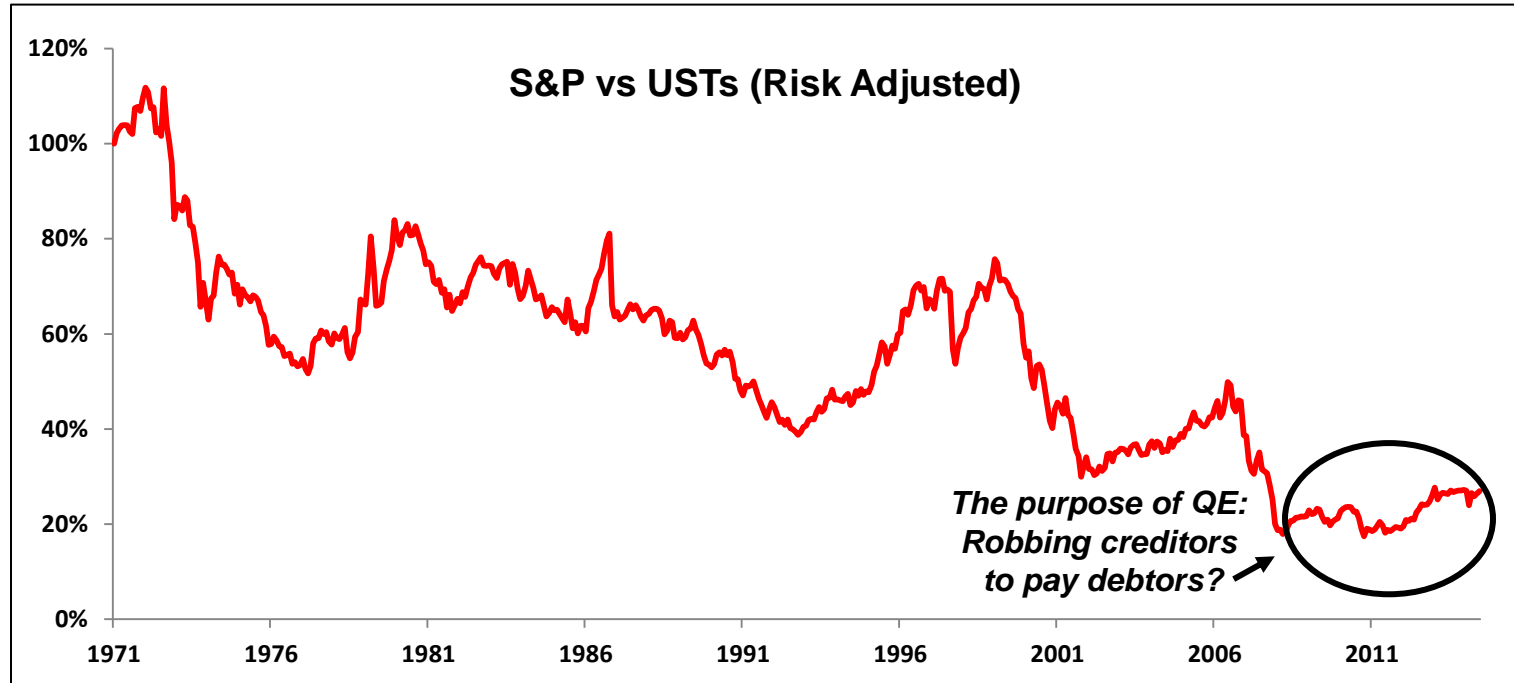
eclectica-am.com

Hugh Hendry: Eclectica Macro Outlook 2016

Imbalances, Crises and Rebalancing

Imbalances

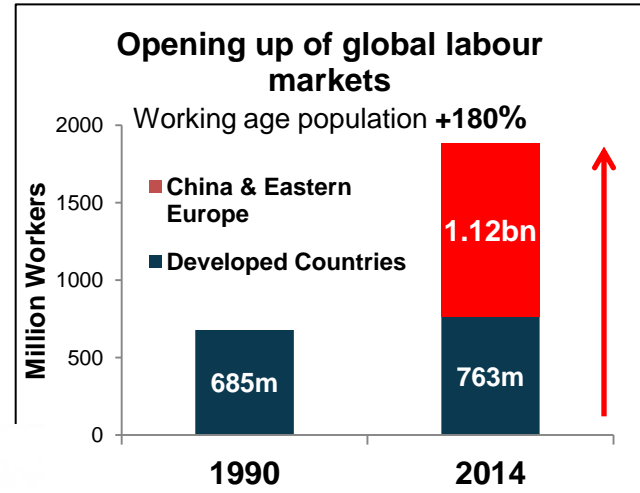
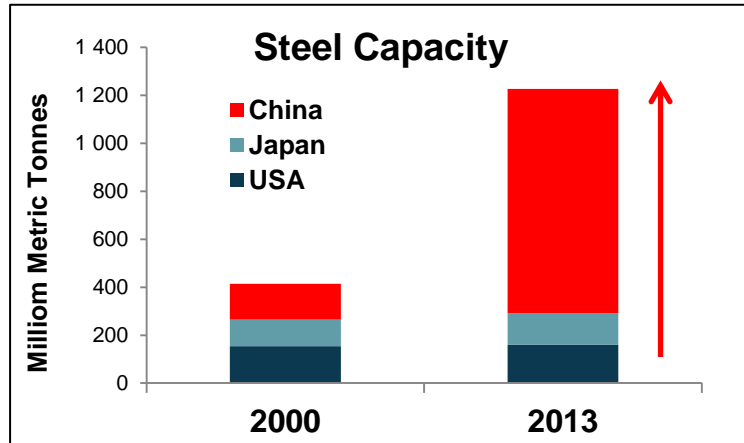
Imbalances: US equities have lost c. 75% of their value vs bonds since 1971



Source: Bloomberg/EAM

Imbalances: Why did interest rates stay so high?

1970s INFLATION



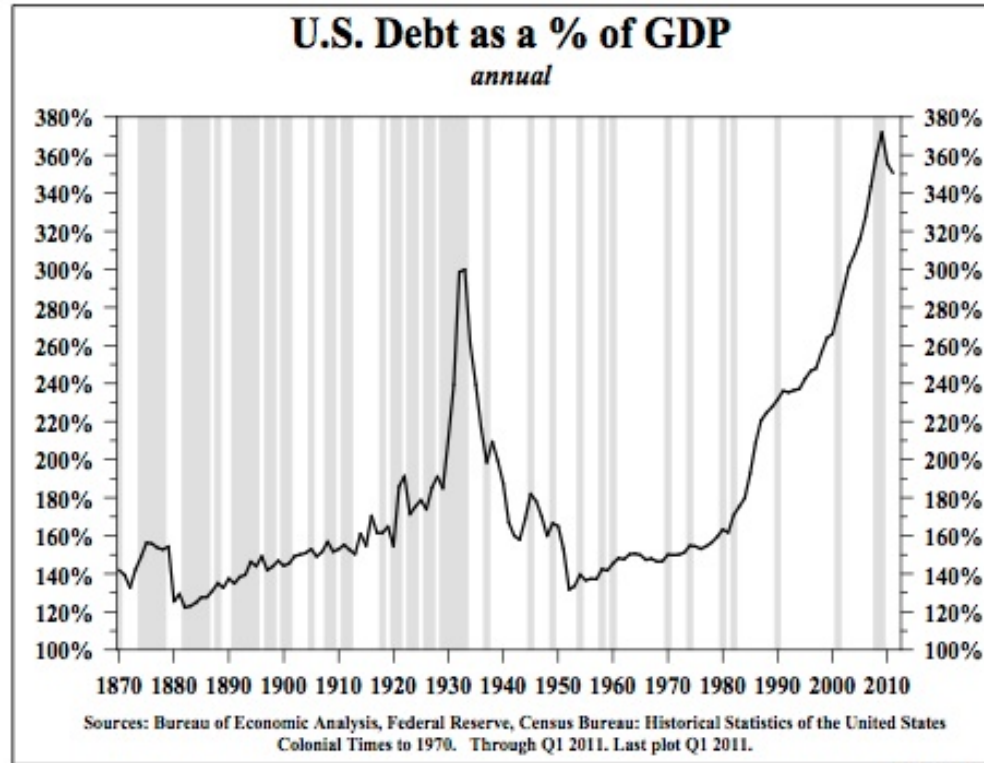
Charts source: Bloomberg/EAM

Imbalances: Supply creates its own demand...



No Income
No Job
No Assets

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



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

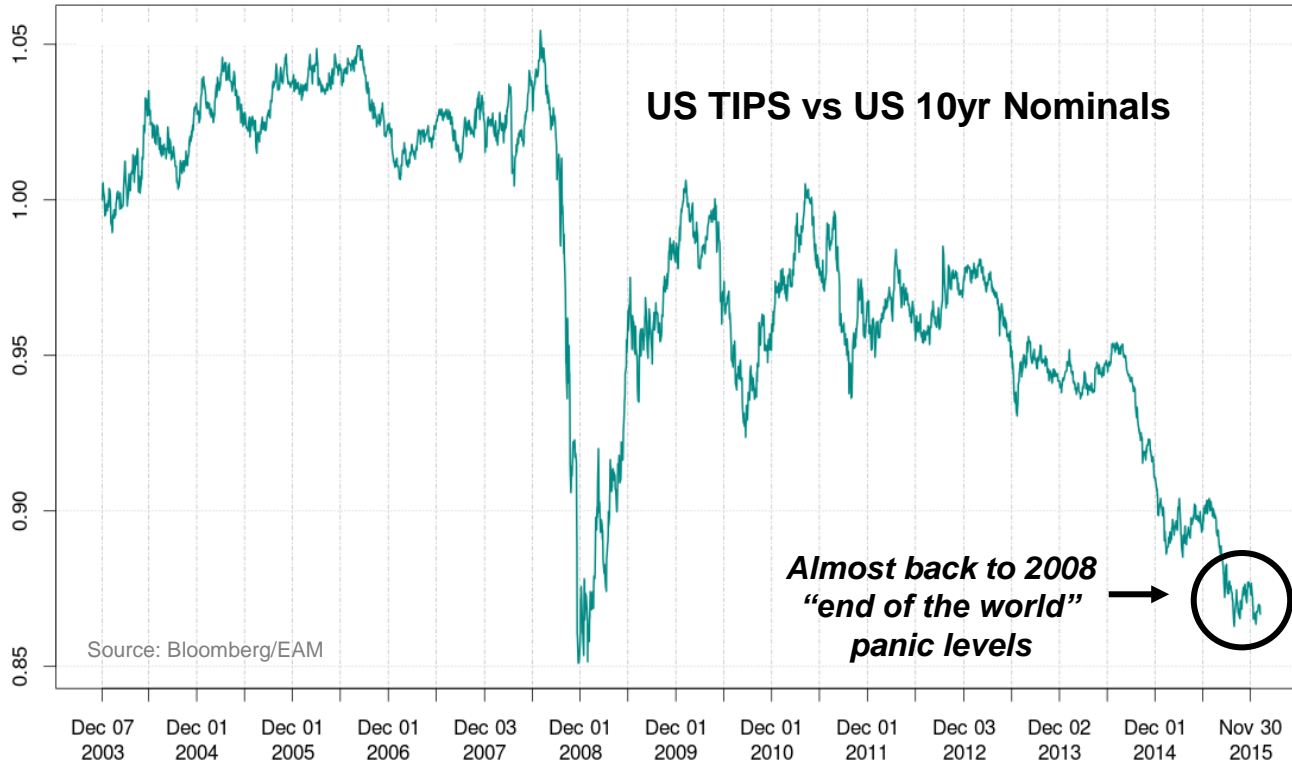
- **UK is building far fewer houses than the growth in new household formations**
- The previously significant **“mom and pop” segment (c. 40%)** of the market, has almost been eliminated owing to the severity of the credit contraction from the banking sector
- **Land prices have remained remarkably 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 cyclicalilty will **make a mockery of analysts' modest expectations**



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



This document is being issued by Eclectica Asset Management LLP ("EAM"), which is authorised and regulated by the Financial Conduct Authority has filed with the SEC as an exempt reporting adviser. EAM is registered with the CFTC as a commodity pool operator and is a member of NFA. The information contained in this document relates to the promotion of shares in one or more unrecognised collective investment schemes managed by EAM (the "Funds"). The promotion of the Funds and the distribution of this document in the United Kingdom is restricted by law. This document is being issued by EAM to and/or is directed at persons who are both (a) professional clients or eligible counterparties for the purposes of the Financial Conduct Authority's Conduct of Business Sourcebook ("COBS") and (b) of a kind to whom the Funds may lawfully be promoted by a person authorised under the Act (an "authorised person") by virtue of Section 238(5) of the Financial Services and Markets Act 2000 (the "Act") Chapter 4.12 of COBS. No recipient of this document may distribute it to any other person. No representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of, and no liability is accepted for, the information or opinions contained in this document by any of EAM, any of the funds managed by EAM or their respective directors. This does not exclude or restrict any duty or liability that EAM has to its customers under the UK or US regulatory systems. This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase, any securities mentioned herein nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract therefor. Recipients of this document who intend to apply for securities are reminded that any such application may be made solely on the basis of the information and opinions contained in the relevant prospectus which may be different from the information and opinions contained in this document. The value of all investments and the income derived therefrom can decrease as well as increase. This may be partly due to exchange rate fluctuations in investments that have an exposure to currencies other than the base currency of the relevant fund. Historic performance is not a guide to future performance. The results portrayed for the Eclectica Fund are estimated, unaudited and subject to adjustment. Also, the net results reflect the reinvestment of dividends and other earnings and the deduction of costs and the management fees and profit allocation to the investment manager and the general partner, as applicable. Particular investors' returns will vary from the historical performance due to participation in New Issues and due to the timing of subscriptions, withdrawals, and redemptions. Past performance is no indication of future results. Inherent in any investment is the potential for loss. Eclectica has had positive trading results over certain periods in the past in the Eclectica Fund. However, prospective investors must consider the uncertain significance of past performance in determining whether or not to invest in the Eclectica Fund. Investors should not substantially rely on Eclectica's past record as a prediction of future performance. Investors should not assume that trading decisions made by Eclectica in the future will be profitable. An investor must realize that he or she could lose all or a substantial amount of their investment in the Eclectica Fund. All charts are sourced from Eclectica Asset Management LLP unless otherwise stated. Side letters: Some hedge fund investors with significant interests in the fund receive periodic updates on the portfolio holdings. © 2005-16 Eclectica Asset Management LLP; Registration No. OC312442; registered office at 4th Floor, Reading Bridge House, Reading RG1 8LS.