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2Q 2015

Market Commentary

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The Waiting Game

Financial market returns were quiet in the second quarter, seemingly waiting for some kind of definitive signal that never arrived. The S&P 500 Index, MSCI EAFE Index, and MSCI Emerging Markets Index were each essentially flat for the quarter, with relatively limited volatility. The former two had each about a 3% gain going into the last 10 days of the quarter, but surrendered their gains as Greece threatened (for the fifth time in as many years) an uncontrolled debt default and exit from the Euro system. The Greek's gamesmanship was once again cauterized by international financial agencies only after the Greeks were very bluntly threatened back with the same medicine. This suggests that European authorities are no longer concerned that a Greek Eurozone exit would be a systemically destabilizing event.

The most curious financial action so far in 2015 is the Shanghai Stock Exchange's A Share (locals only) Index, which rose 38% from April to mid-June on a wave of speculation, before falling 22% in the last 2 weeks of June. For the year, the Shanghai A Index rose 63% by mid-June, and at its high point was up 155% in a 12-month span. It has all the markings of a dangerous, margin-fueled retail stock investment bubble that curiously commenced right around the same time as a formal crackdown on aggressive gambling and money laundering by China's citizenry in Macau. As the parabolic move went into reverse, the Chinese government instituted a barrage of selling restrictions, trading closures, and market stabilization commitments, notwithstanding the fact that stock prices have simply fallen back to where they were in April. It does not inspire confidence in their financial system.

Longer duration bond yields rose globally, with U.S. 10-year yields rising 50 bps to 2.4% from 1.9% in the quarter. The Eurozone's flirtation with negative interest rates continues on short term fixed income instruments, but longer duration 10-year yields rose dramatically, headlined by German *Bund* yields rising from essentially 0% in March to almost 1%, before settling in at 0.7%. These are hardly high enough figures as to act as a hurdle to equity valuations, but in raw percentage terms are big moves off of low bases.

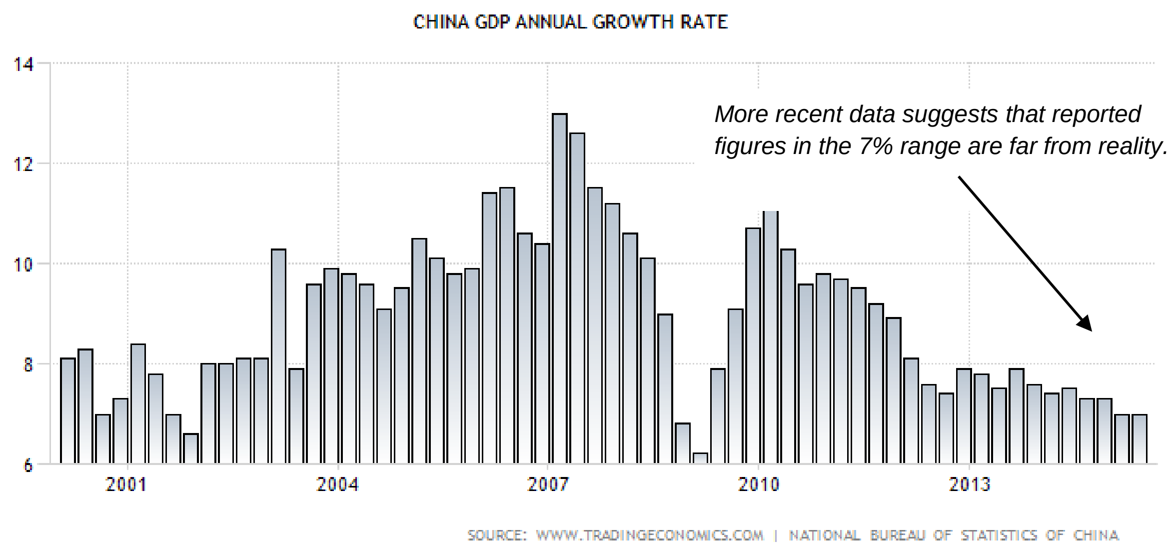
We continue to believe that a shift away from zero percent interest rate policy (“ZIRP”) by the U.S. Federal Reserve will prove to be the most significant financial event of 2015. Markets are becoming more comfortable with the notion that this will indeed occur later in the year, and perhaps as soon as the current quarter. For now, short term interest rates have been pegged at 0% in the U.S. for over 2,400 days, meaning that most children entering the second grade this fall have never seen a positive interest rate on liquid savings (Not that they would really care, it's just interesting to think this is starting to take on lifetime proportions). The economic data is supportive of a positive rate of interest, with new unemployment claims running at exceptionally low levels, providing evidence of an increasingly tight labor market. Corporate M&A and stock buyback programs are running at exceptionally high levels, providing wholly unsurprising evidence that Wall Street will take a free lunch and run with it, as a 0% interest rate does indeed incentivize financial engineering and roll-up business strategies. Rather like the Greek situation, absent a 0% short term interest rate, would the U.S. economy and financial system careen into crisis? It seems an outdated notion. It might very well be that the longer the Fed waits to move off of the zero-lower boundary, the more destabilizing the eventual move could be.

The China Syndrome

In a 1979 movie by the same name, a TV reporter accidentally stumbles upon a near nuclear meltdown at a power plant, as key parts of the plant's infrastructure fail owing to deficient construction and inept plant management. Called the *China Syndrome*, the nuclear core threatens to melt into the ground and keep descending into the earth *all the way to China*. Well, before reaching China, the nuclear material would reach ground water under the plant and explode into the atmosphere, rendering most of Southern

California radioactive and an uninhabitable wasteland. The reporter's efforts to report the story are obstructed by the plant's staff and her employer, who for various reasons do not want to allow an unflattering story to be told. At the end, she is able to report some of the story, but one is left wondering how much will ever really be disclosed, or whether the nuclear plant's problems will honestly be remediated.

The commodity landscape appears to be enduring its own *China Syndrome*, complete with a meltdown in prices, uninhabitable business wasteland, and squelched official statistics belying the true causes and magnitude of the problem. For the bulk of the 2000s, China's breakneck economic growth and urbanization drew in massive quantities of physical commodities. Explosive demand pushed prices up dramatically for industrial metals, energy, and other physical resources. Commodity-driven economies in South America and Australia boomed from the sudden surge of prices and volumes. While commodity prices crashed in the 2008 financial crisis, they quickly recovered as the financial system re-stabilized in 2009, with some even reaching new highs in early 2011. One could quickly look at the recovery in Chinese demand as a basis for support. However, starting in late 2011, China's economic momentum clearly slowed, and most commodity prices began to roll over. While this process was at first gradual, it has now reached the meltdown phase – with many commodities now trading below their 2008-09 lows. Although physical demand for commodities remains well above 1990s levels, a great deal of physical supply has been added by suppliers in anticipation of sustained demand growth from China that is not coming to pass. Prices have reverted to early 2000s levels, and yet markets remain oversupplied. Absent significant closures of mines and wells, only an unlikely surge in global/Chinese economic growth would rebalance many commodities' supply-demand relationship.



Like the movie, China's government appears willing to promulgate an increasingly fictitious narrative. China's GDP growth is rapidly slowing, but the government won't give the financial world usable information to work with. We have always found China's reported economic statistics challenging to believe at face value. No nation growing at 8%+ can predict to the decimal point its growth rate from quarter to quarter, except evidently China. More recently, China's government has begun to scale down its articulated target growth rate to the mid-7% range, and curiously enough, the official statistics have come in within decimal points of this target as well. However, the numbers on the ground appear very far from supporting any growth, let alone 7%. Auto sales, which were growing at 30-40% per year in the 2008-2011 time frame, have suddenly turned negative. Luxury goods makers have seen similarly swift collapses in demand growth in China. Apartment sales and new apartment construction have crashed. The growth of Macau as a gambling hub, the Las Vegas of China, has suddenly gone into sharp decline, with visitations down 30-40% year over year. Much of the reduction in Macau traffic has to do with a crackdown on corruption and prolific money laundering in Macau, but those are very big numbers. China's once massive trade surplus has become a small deficit, a national income accounting shift that very negatively impacts GDP calculations. There are still enough farmers living hand to mouth off the land that will migrate into cities over the next few years, such that it will be hard for China's growth to go below 0%. But for a lot of the key sources of commodity demand, China might as well be in an official recession, as evidence of the physical infrastructure overbuild is overwhelming.

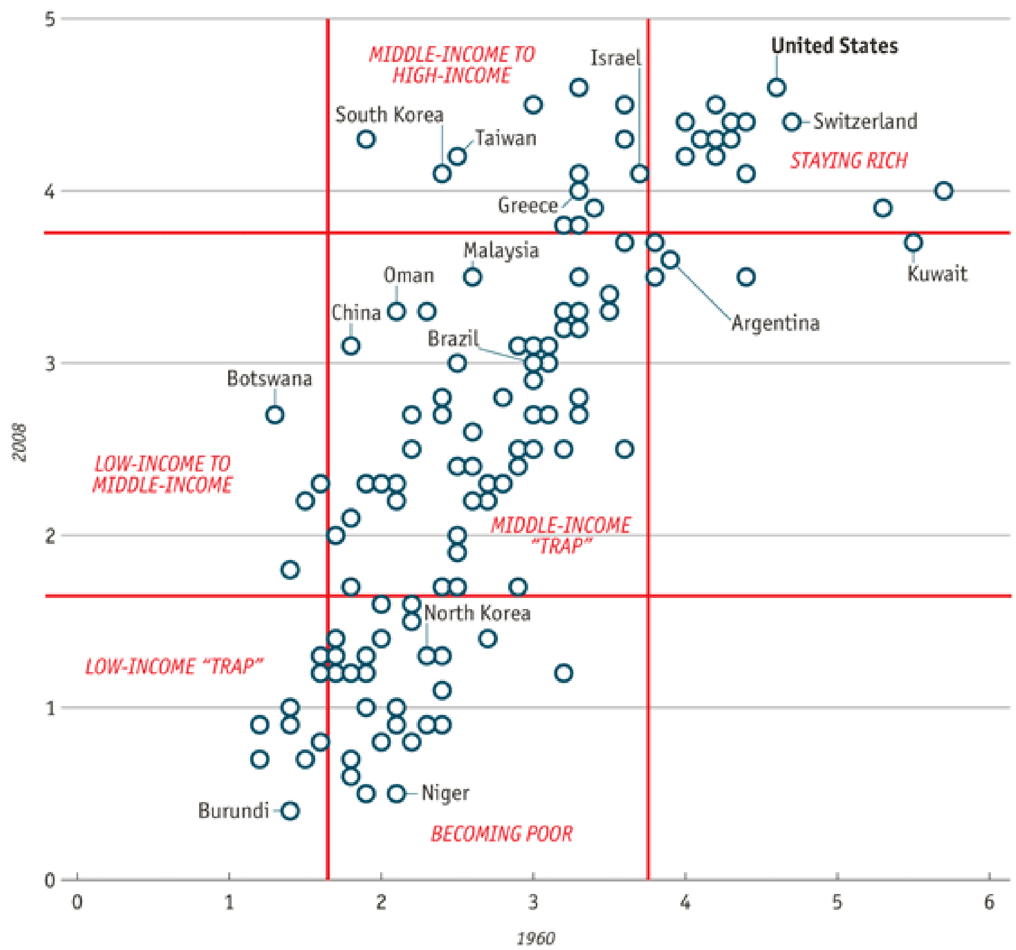
Growing resource production for nearly any commodity that is extracted from the earth requires large budgets and considerable forward planning. New mines being completed this year generally commenced construction well before China's local economy began to stumble. And if China was growing at 7% as they are still maintaining, the eventual need for more (copper, iron, zinc, aluminum, oil...) would be clear enough.

The Middle Income Trap

In the realm of developing nation economics, a term called "The Middle Income Trap" likely encapsulates China's fundamental challenge. First coined in 2007, it suggests that the forces of economic convergence are not all powerful. Poor countries can grow faster than rich ones, largely because imitation is easier than invention. But that does not mean that every poor country can or will catch up, and most don't. Poor nations can generate GDP growth and raise incomes simply by tossing their population and resources into a modern economic system, as China did when it re-engaged with the rest of the world in the 1980s. Low wages attract investment and create many labor-intensive jobs, many of them requiring limited skills. As costs rise and these basic industries become less competitive, countries need to start developing higher value added industries. Middle-income countries literally get stuck at this point. Costs are too high to compete with lower-income economies, but they don't possess the know-how and technology to compete with the truly advanced nations either. Semi-industrialized economies such as South Africa and Brazil have not, for decades, left what the World Bank defines as the 'middle-income range'. The chart below appeared in the World Bank's China 2030 report (2012), and appears to have presaged the current slowdown. If every country had caught up, they would all be found in the top row. In fact, most countries that were middle income in 1960 were still middle income in 2008 (see the middle cell of the chart). Only 13 countries escaped to become high-income economies in 2008 (top-middle) over the 48-year measurement period. One of these success stories was Greece, which has since headed back down. South Korea was and remains the only larger population success - the rest are very small countries, where the impact of moving up the value-added chain in a few industries can be spread across the whole country.

The middle-income trap

Income per person relative to the United States, log of %



Source: World Bank

If China was emblematic of the breakneck emerging market growth since the end of the Cold War, and if it has entered the middle-income "trap", the prospects are bleak for a sudden reversal of fortunes in the commodity stack. Their central government's heavy-handed interference with basic market forces are more likely to elongate the stagnation, in my opinion. As for the world's financial markets, a stagnant China, potentially for a decade or longer, does not bode well for a host of industries, or for central bankers to manufacture a higher inflation rate either.

It All Means…

Actually, it is not entirely clear what this means to returns on capital and investment in the U.S. and other developed nations. So far, it has meant a growing list of industries and sectors are "avoids". In the Cambiar International strategies, we have successfully steered clear of mining and metals for some time, as well as limited investments in Emerging Markets. The list of China beneficiaries is long, leading to a commensurate list of potential victims as the tides flow back out. Investors in commodity businesses have already been demolished. Secondary commodity plays, such as metallurgical coal miners, have practically gone to zero, while orders for mining equipment and related infrastructure are down 80-90%, or probably well below replacement demand. There may be some deep-value plays in these areas, and there will of necessity need to be survivors, but a lot of capacity still has to be shut in. Industrial capital equipment businesses and transportation stocks have come off their highs, but have still been outperforming businesses for much of this century; these industries seem vulnerable to us, given the overcapacity that may be poised to erupt in these businesses. The energy story is a good deal more complicated than a lack of demand growth from China; that said, if China's energy consumption growth falls to half or less of the prior demand profile, it certainly does not help the case for a major price recovery soon.

There is probably another leg to this story geo-politically speaking, as China's population has grown accustomed to the idea that their nation was barreling inevitably toward a date with prosperity. In developed nation democracies, we change governments when economic progress turns south. In China, we don't know what would transpire should stagnation become more pronounced.

We appreciate your continued confidence in Cambiar Investors.

Brian M. Barish
President
Cambiar Investors LLC

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