

Fine Wine Demand: Relevant Pointers in an Uncertain Environment

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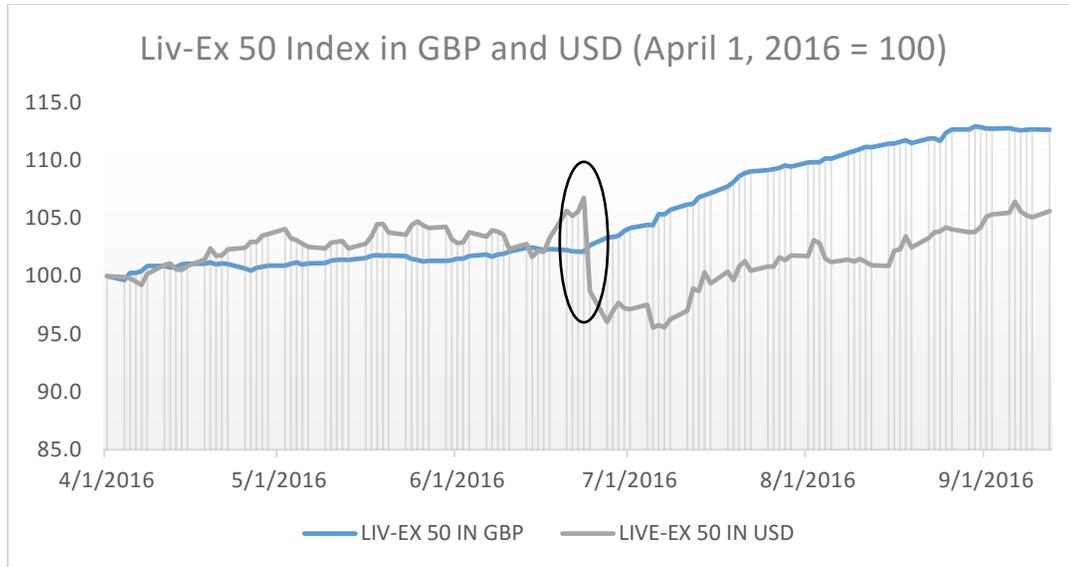
Introduction

In the aftermath of Brexit - the decision by U.K. voters to leave the European Union - a number of articles were written highlighting the ensuing increase in demand for collectible wines. Demand for ultra-premium wines and the associated price dynamic are complex. In this article we examine what actually happened post-Brexit and review the factors that are most likely to drive fine wine prices in the months and years ahead.

Brexit: Only A Footnote

Following the U.K.'s unexpected decision to leave the E.U., many commentators noted a sharp increase in the demand for ultra-premium wines in the London market. Some suggested that fine wine had assumed safe haven status against an uncertain background, and further price rises could be expected. A little digging reveals a different story. Whilst it is true that fine wine demand in London surged in the immediate aftermath of the June 23rd Brexit vote, this is because London merchants failed to update their prices in GBP terms, despite a plunging currency, even though the fine wine market is essentially a U.S. Dollar-based market. Hong Kong buyers took advantage of this currency arbitrage opportunity to place a number of large orders, pushing the sterling-based Liv-Ex Fine Wine Index higher. In U.S. Dollar terms, the index actually fell sharply in the aftermath of Brexit and has only gently appreciated since. The bigger picture is that there is no fine wine production in the United Kingdom and demand from within the U.K. tends to come from international high net worth individuals who are unlikely to see their wealth impacted significantly by Brexit. In sum, the medium term supply/demand dynamics stemming from Brexit are a

footnote in the overall international picture. Other factors will play a more important role and the picture is far from clear cut.



HNWI: A Key Driver

The health of the High Net Worth Individual (HNWI) population is one of the most important drivers of fine wine demand and pricing. The *2016 Cap Gemini World Wealth Report* reconfirmed that investments of passion are “a core pillar of some HNWI’s portfolio, in part due to their low correlation with traditional assets.” Investments of passion include art, luxury cars and fine wine, amongst others. As the HNWI population grows, so does demand for passion investments, because the newly wealthy have a higher propensity to spend on luxury goods as a sign of their newly-acquired social status. The table below shows the very strong correlation between the growth in the HNWI population by region and Liv-Ex 100 price changes.

Correlation Between Fine Wine Price Changes and HNWI Population Growth (2009-2015)

	Japan	China	U.S.
Correlation	75.86%	70.65%	52.99%

Author’s own calculations

Given this very strong correlation, it is worth considering current trends in the HNWI population. The 2016 Cap Gemini report contains a wealth of information, as follows:

- Globally, the growth in both the number of HNWI’s and HNWI’s wealth slowed significantly in 2015 after robust growth from 2010 to 2014.
- Weak performance was concentrated in the United States, driven by a poor stock market performance. Growth in Asia matched that of 2010-2014.
- The number of HNWI’s in North America still exceeds that of Asia, but HNWI’s aggregate wealth is now higher in Asia than in North America.

- The population and wealth of HNWI in Latin America has contracted significantly, most notably in Brazil.

There are good reasons to believe the health of the HNWI population has improved in 2016.

- After a difficult start to the year and against expectations, the U.S. stock market is moving from one record high to the next.
- Against expectations, the Chinese markets have not collapsed.
- The Latin American markets have performed well since the start of the year, albeit with weak economic fundamentals and high volatility.

If these trends persist, the ranks of the HNWI population will grow strongly, providing healthy support for fine wine demand.

China Demand: A Learning Curve

Chinese demand for fine wine is now almost legendary. There is no doubt that the surge in wealth in China over the past two decades has impacted luxury goods markets across the board, including fine wines. Predicting its evolution from here is complex, but here are a few points to bear in mind.

- As explained in the presentation *Red Obsession: The Ascent of Fine Wine in China*¹, Chinese buyers have consistently been willing to pay a significant premium for fine wine. That premium is strongly correlated with name recognition i.e. Parker scores and overall name fame, but is beginning to erode as the educational gap closes.
- Chinese demand for luxury goods, including fine wines, has been negatively impacted by China's anti-corruption crackdown. The SPP - China's main criminal prosecution agency - recently held its official work meeting and re-emphasized its focus on high-profile corruption cases.
- China is now producing its own fine wines, with the help of some of the world's best wine minds. For example, LVMH is now producing a Ningxia fizz, along with a fine red wine in Yunnan. China's ability to catch up on, and surpass, foreign technology is humbling. Undoubtedly, some Chinese demand will eventually shift towards homegrown wines.

Emerging Markets: Yesterday's Story

In 2011, Serhan Cevik and Tahsin Saadi Sedik published a fascinating study² showing a strong correlation between fine wine and oil prices. The paper identified strong demand from emerging markets for both commodities as the main driver. In 2011, fine wine prices peaked. This August, Linda Jao presented a working paper entitled *The Macroeconomic Determinants of Wine Prices* confirming that the significant decline in wine prices since the 2011 peak is highly correlated with the decline in emerging market growth and the deterioration of their local currencies versus the U.S. Dollar.

The outlook for emerging markets is poor. Brazil's economy and political environment are weak. The rest of Latin America has its own political and economic challenges. Low oil prices have a direct impact on the

¹ Philippe Masset, Jean-Philippe Weisskopf, Benoit Faye, Eric Le Fur.

² "A Barrel of Oil or a Bottle of Wine: How Do Global Growth Dynamics Affect Commodity Prices?" IMF Working Paper.

finances of many oil and gas producing emerging economies. Demand from weak European economies cannot provide any relief. Outside of Japan and China, the rest of Asia remains small and equally challenged. In 2015, even Singapore's HNWI population shrank by 3%.

Art Market: An Interesting Indicator

Last but not least, the art market is an interesting contiguous market to fine wine, and worth keeping an eye on. In March, the European Fine Art Foundation ("TEFAF") released its 2016 Annual Report on the state of the art market. A number of points are worth keeping in mind.

- For the first time since 2011, the art market contracted in 2015.
- The Chinese art market contracted by 23% in 2015. This decline is probably in part attributable to China's crackdown on bribery, where artworks are used in exchange for favors from officials.
- The U.S. market - by far the largest - grew by 4%. However, this was the result of a few very large sales.
- Interestingly, the old master segment of the market experienced the steepest decline in value at 33%, due to a generational shift away from that sector.

No Clear Path

In sum, there is no clear story on the outlook for fine wine prices. Most indicators suggest a sluggish period ahead, but whilst financial markets continue to surprise on the upside, the wine market may very well do the same.