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Quarterly Investment Bulletin

April 2016

General Economic Overview – Quarter One 2016

The start to 2016 has taken many investors by surprise as the fall in markets was not expected – most of the economic news appeared to be well understood and no new crises occurred as we entered January. The cause of the apparent rejection of risk assets was much debated in the press without a specific reason being identified. The main culprits were the slowing down of the global economy and in particular China, and the declining oil price, which was deflationary for a lot of the globe but put pressure on oil producers to shore up their balance of payment deficits by dumping foreign assets such as shares. Other possible reasons included a poor earnings season alongside a much more sensitive investment environment. The higher level of volatility gave investors the incentive to move quickly to lower risk assets if it looked like weaker data was started to come through. It is perhaps not surprising given last quarters events that the lower for longer interest rate environment allied to a lower growth world would lead to higher levels of volatility. The rise in rates by the Fed in December was intended to be the first of a series in 2016 but the deterioration of the global economic environment since then has placed doubt over this policy. Indeed recent statements by Janet Yellen have been far more dovish and led to more uncertainty around when the next rise may be. At the end of the quarter many markets have recovered with the US S&P 500 slightly up for the year.

Globally, the markets worst hit by the declining oil and commodity prices were still unloved by most investors at the start of the quarter and emerging markets were weakened even further by the strength of the dollar and the slowing of growth led by China. This changed as we moved into March when a recovery of sorts was led by companies in areas such as mining and energy. After being hit so badly in the first few weeks of the year it is perhaps not surprising that on a valuation basis these sectors became more attractive to investors. This may be a classic short squeeze, where bearish bets are hastily unwound via the purchase of stocks and commodities and have little to do with longer term considerations. As is normal, from a global perspective, much of the fear is associated with data from the key economies of the US and China. In the US the buoyant and improving job market data has continued to support US economic growth so the fear gauge, the CBOE Vix index, is at its lowest since just before Chinese devaluation in August last year. The likelihood of a US recession has reduced considerably allowing investors to pile back into US stocks in recent weeks. It has not been just equity markets that have benefitted, bond markets, particular high yield and junk bonds, have rebounded as risk premia have eased. China is in a different situation - it has been the global engine of growth for a number of years but now faces a period of slower growth as it transitions to a more domestic service led economy. The growth numbers are still impressive but nowhere near the double digit numbers of the previous decade. The issues to be faced are how to manage this slowdown smoothly as investment growth declines and disequilibria occurs.

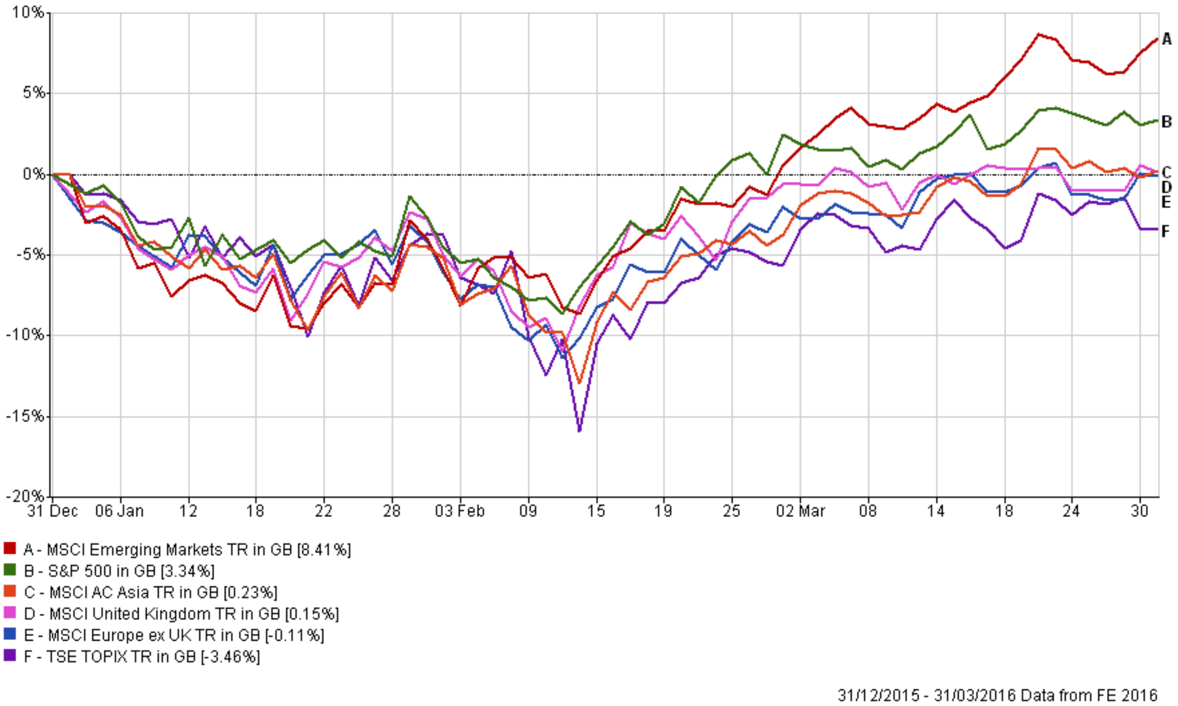
One of the more interesting features of the recovery since mid-February has been that of commodity prices – for example iron ore ended the quarter up almost 25% reflecting stronger Chinese steel prices and higher production levels. Gold was also a leading performer up 16% rallying due to concerns over central bank's negative interest rate policies, China, and global growth prospects. The rise in the oil price has also lifted investor confidence in the commodities sector leading to significant inflows into commodity ETF's and indices. The question is whether this current strength is opportunistic or a longer term diversified investment strategy after perceived lows.

Economic data has been fairly consistent in recent months allowing the market volatility in the early part of 2016 to subside somewhat by the end of the quarter but this may only be a temporary pause as the up and coming earnings season may well be disappointing, although analyst expectations are not high. We have not changed our view that regardless of how the earnings results are digested by markets, we will remain in a more volatile, lower growth environment. The underlying belief that central banks have the answer to all the issues is being tested and this can be seen by the reaction to negative interest rates around the world. Loose monetary policy continues in most western economies with bond buying or QE increasing in Europe and Japan. The arguments as to how effective this policy has been and how long it will go on for are many, but we are currently unlikely to see much change in the short term. There are now arguments for more direct intervention from governments using hybrid monetary and fiscal policies such as infrastructure projects and lowering of corporate taxation.

Equity Markets Overview

Chart showing 2015 returns for major market indices:

Chart showing Q1 2016 returns for major market indices:



Equity markets across the globe have witnessed a classic 'V' shaped recovery in the first quarter of the year with the falls in January and February being erased in most areas by the end of March. Concerns over the global economy at the beginning of 2016 have abated for the time being, buoyed by supportive central bank policy from Europe, Japan and the US Federal Reserve. The revival of commodity prices has been a strong driver of share price rises in the mining, energy sectors and resource sectors. The US S&P index has been the second strongest market after emerging markets in sterling terms despite dollar weakness. In US dollar terms the market is up close to 1% making the 10.5% fall to mid Feb a distant memory. Not all sectors are positive however with financials and healthcare lower by more than 5%. The banking sector across many western markets remains weak given the concerns over regulation and negative interest rates. The EuroStoxx index was down 7.7% in local currency terms but less so in sterling terms (-0.80%) – at one point it was down 18% so it has been a strong recovery. The Japanese Topix was also down in sterling terms but the strength of the yen helped to offset some of this for sterling investors. The strength of the yen also reflects the pressure put on shares by negative interest rates and the more dovish comments of the US Fed which caused further dollar weakness. Asian and emerging markets have had the strongest returns thanks in part, to the weakness in the dollar but also to the more stable view of the Chinese economy and the more general uplift in commodity prices.

In the UK the benchmark index was down 0.41% in sterling terms having had a strong recovery from February onwards led by the resources and mining sectors. The UK has a positive GDP growth rate thanks in the main to the growth of the service sector.

UK

Like most other markets the UK saw a large fall in January and a modest recovery to the end of March. The reasons for the market movements have been discussed in other sections but the effects in the UK were possibly more volatile because mining and energy stocks form such a large percentage of the main benchmark index and these stocks saw the sharpest falls and recovery in the first quarter as a reappraisal of the resources and energy sectors took place globally. The economy remains in good shape with the latest GDP figures suggesting growth of 0.6% in the last quarter of 2015 which was ahead of forecasts. This has been led by the service sector which has shown a 12th consecutive quarter of growth, up 2.8% year on year from the previous January. The main gains have been made in IT and professional services with financial services losing share since the financial crisis. There are still some causes for concern however as the current account deficit has reached a new post war high in the final quarter of 2015 of £33bn or 7% of GDP indicating we borrow heavily from the rest of the world. The main reason for the increase has been a loss of earnings from overseas assets, possibly reflecting global weakness. The threat is that with Brexit looming this debt will become more expensive as investors become concerned about a possible exit for the UK. The Brexit issue is likely to dominate political discussion until the vote in June and potentially increase market volatility as we near that date.

US

The strength of the US economy that saw the Fed raise rates in late 2015 has broadly continued in 2016 but with growth forecasts more muted despite employment data continuing to improve. The global economic backdrop has meant that there is more pressure on the Fed to keep rates on hold for the time being and this was reinforced in the first few months of the year when markets fell 6-8% on the back of a number of economic scare stories. The actual reasons for the fall has been much debated from the continuing Chinese slowdown to a weak oil price forcing sovereign wealth fund sales, suffice to say it was a poor start to 2016 for most investors. More recently markets have recovered with the S&P 500 up marginally for the year which looked unlikely several weeks ago. Risk appetite has returned in March with over $7bn of cash flowing into exchange traded funds that buy US equities in the last few weeks (source - XTF.com).

The US tightening policy stands alone even in the developed world with recent high profile reductions in interest rates in Japan and in Europe. Whilst these were aimed at the banking markets rather than consumers the underlying direction is what is perceived by the markets. The most recent earnings seasons in the US proved disappointing with the last two quarters showing negative earnings growth for US firms. This is often seen as an indicator of a recession or the need for some additional central stimulus and for many investment managers a slowing down of the US economy is seen as a greater risk to global growth than a slowing China. More positively there are many other indicators that read the other way such as the continued growth in auto sales and Q4 US GDP growth was revised upwards to 1% which does not indicate any immediate recession. The outlook from April is less certain if we have a third tough earnings season, and of course there is the forthcoming election which promises to offer greater uncertainty for US policy if Donald Trump becomes the republican candidate.

In terms of fund manager activity, despite the recent market recovery, there is a shift to capital preservation with cash, utilities and tech stocks as well as the US dollar forming a greater part of portfolios and larger cap equity funds have tended to outperform in the last year reflecting this shift. There is still some value to be found in financials and media stocks but most share prices are seen as coming back to fair value after recent falls.

Europe

The position of Europe as one of the strongest recovering economic areas took a blow as we entered 2016 with fears of a further slowdown and subsequent recession a distinct possibility. A lot of the fundamental data had not changed significantly but global growth prospects generally had come into question which then influenced sentiment and naturally affected share prices in Europe.

Weaker growth prospects and concerns over commodity exposures are taking their toll on financial companies, particularly the European banking stocks - the banks themselves have been significantly re-capitalised and have been stress tested and so the recent concerns seem overblown. Loose monetary policy is still being used by the ECB to bolster confidence and to maintain stock market prices which may be keeping some weaker companies afloat for the time being.

Central bank intervention looks likely to continue after the most recent announcements. On the 10th March the ECB cut the deposit rate by a further 10 basis points to minus 0.4% but eased the impact on banks with cheaper short term loans and longer term liquidity at negative rates. They also raised the amount of bonds they buy each month to €80bn which was greater than expected and was almost certainly a reaction to falling inflation data which was estimated to be at 0.1% this year and illustrates that the ECB want to support growth and inflation in the Eurozone. They have also introduced an innovative new set of cash auctions which will in effect provide money to banks to lend under the targeted longer term refinancing operation (TLTRO) aiming to fuel the domestic recovery by nurturing banks to support credit growth - in effect the banks are being fed free money to lend to the business community to improve growth. These measures have taken only a short time to take effect with bond sales reaching €25bn in the week after the announcement. The new measures are positive but illustrate the fragility of the European economy at the moment.

Asia

Much of the uncertainty in world markets at the beginning of the year was thought to be the result of the weakness in Chinese growth which although still well above much of the western world was seen to be stalling. Whilst declining growth is a factor caused by China’s switch to a domestic led economy, at its current rate it would still have doubled the size of its real GDP per head by 2020, which is a substantive increase. The country does face some headwinds which will need careful negotiation and these factors are both economic and political. The 13th five year plan (2016-2020) is aimed at creating a ‘moderately prosperous society’ which is intended to improve the welfare of the people whilst managing a fall in the headline growth rate. This is a difficult task and will need some careful structural and social change to take place. This change is closely related to the challenge of managing a process that will throw the economy into disequilibria, particularly as the economy shifts from manufacturing to service led and private sector investment reduces. The growth then relies on a consumption led economy and could risk increasing the existing debt problems in the economy. Overall such issues, whilst daunting, have been dealt with in the past and are more than priced in to current market levels. As China rebalances away from fixed asset investment driven growth, commodity exporters (many of whom are emerging market countries) will continue to find economic conditions difficult. Those Asian countries running current account deficits at a time of tightening US monetary conditions have, as one would rationally expect, been worst hit. In general lower commodity and oil prices are a plus for the developed world and most of Asia.

Markets in Asia suffered as earnings expectations were pulled back partly but not solely due to the slowdown in certain parts of the Chinese economy. Arguably the impact of the current change in

China is far more negative for commodity exporting regions, with Asia a net importer of most commodities including oil.

Asia is of course more than just China and the more recent rise in oil prices has helped a number of countries recover a little from the difficulties of the declining oil price last year. India is another example of an economy which has the ability to overtake China in its contribution to world GDP growth. The Indian Manufacturing Purchasing Managers' Index rose to 52.4 in March from 51.1 in February, (survey figures released by Markit and Nikkei). The reading stayed above the 50 mark that separates expansion and contraction for the third month in a row. This comes with higher levels of inflation and may stop the government from reducing interest rates in the short term. India remains the most exciting long-term story in the region. Prime Minister Modi is continuing to drive the reform process forward and whilst there has been some disappointment with the pace of reform, India is a democracy and therefore decisions take time to enact.

For some, Indonesia and Thailand offer good investment opportunities as the governments continue to invest in infrastructure projects and consumer spending is increasing in a steady and stable fashion. Australia remains stagnant in the wake of the post resources boom with valuations appearing stretched at the moment.

Japan

The debate about the strength and purpose of the reform process in Japan continues with year to date numbers challenging many investors, as the market and the currency both unnerve investors. A stronger yen has been a reflection of weakening global confidence as expected growth rates have been reduced alongside fears over Chinese growth. Generating increasing inflation continues to be a problem, as evidenced by the latest 0% figure, and the Bank of Japan have already pushed out the expected date for reaching its 2% target. Many investors and commentators are expecting the announcement of further monetary stimulus in the coming months following the move to cut the benchmark interest rate to negative in January and the poor Q4 GDP growth figure. Should this occur, and in sufficient size, it could be positive for markets and negative for the currency but expectations may have already been priced in and, as in Europe, QE expansion seems to be having less of an effect each time it is used.

In Japan, market volatility has continued, perhaps resulting from the lack of depth of domestic institutional buyers of Japanese equities. Despite the volatility the overall market environment continues to see some improvement in macro and micro fundamentals. There has been a recent boost for the government as the $1.2tn state pension fund reported its biggest quarterly gain in a year, a 3.56% return on investment in the three months to December 2015, the primary source of which was the rise in domestic equities. A new pension fund index (Nikkei 400 index) includes measures looking at a company's ROE for inclusion, so company management must consider the needs of outside investors, and corporate governance is also on an upward trend leading to greater capital efficiency and total dividends paid by listed companies will rise by over 10% for the sixth straight year. All these factors are seen as positive but caution is still required as there are still many uncompetitive companies failing to adapt to this new environment.

Valuations remain attractive relative to their history, particularly on a Price to Book basis, and Japan has been one of the few markets where companies have continued to demonstrate earnings growth, partly due to the significant weakening of the currency (until recently) but also due to greater concentration on shareholder value and corporate governance. Further positive market movements may depend on foreign investor sentiment and whether there are more signs that the government and the Bank of Japan's policies can lead Japan into a period of sustained economic growth.

The structural reform programme continues, but it needs to achieve greater acceptance across a wider base of companies and domestic investors to keep the momentum. Inflation has been achieved but not yet at the levels set by the government and this remains a goal that they need to maintain. 2016 has seen market momentum reverse, which is the same for most markets around the world, as investor fear has taken markets to new levels of volatility. Abenomics has certainly come under greater scrutiny in the last six months over the effectiveness of policies to stimulate growth and inflation and this will only increase if policymakers continue to take more extreme measures to achieve this.

Emerging Markets

Emerging markets were the strongest area of performance in equity markets in sterling terms in the first quarter after what was a poor opening to the year. The combination of a perceived change in the interest rate policy of the Fed and the strengthening of commodity prices were the main factors in the improvement in sentiment and increase in market valuations. The commodities story has been explained in the sections above but clearly a number of EM economies depend on these exports to stabilise their economies. There is also a marked contrast between companies benefitting from the strength of the service sector such as outbound tourism and increased levels of consumer spending, compared to those countries / companies reliant on strength in commodity prices. China has a significant effect on this region, most obviously on commodity exporting nations such as Australia or Brazil and many of these countries slackened off on the reform process during the commodity super cycle and are now having to re-trench more aggressively.

In Latin America falls in commodity prices in the last two years have provided a negative backdrop. Mexico's close trading links with the United States have been overshadowed by investor perception of the country as an oil exporter. The Latin American region has been difficult to invest in over the last few years, even outside of the normally high levels of volatility that regularly drive markets in the region, however there are signs of improvement. Argentina has now, under the new government of Mauricio Macri, moved to address the decade long dispute with creditors and bring in a range of market orientated reforms including the removal of currency and trade controls.

Brazil has suffered from weakness in both soft and hard commodities and has also had domestic corruption problems. There are now fears that an already ballooning budget deficit in Latin America's largest economy will deteriorate further and Brazil sums up what is at fault with many economies in the emerging world – a combination of over-reliance on strong commodity prices, not recognising that in this market commodity producers are price-takers not price-givers, combined with the debilitating effects of high levels of corruption on economic activity and foreign investor confidence. The headline impeachment proceedings for leading political figures has however masked the strong performance of markets so far this year and can be attributed to lowly valued markets rallying the hardest during periods of so called 'risk on'. Brazil is up 55% from its lows (in GBP terms), and the Brazilian equity market has recently been trading at valuation multiples in line with those last witnessed during the financial crisis.

Emerging markets are a significant part of world GDP and an ever increasing influence on global trade and therefore need equal attention when assessing the prospects for global growth. The fears of US rate rises and a slowing China definitely mean many areas will struggle but equally there are some strong areas of growth such as India or Indonesia.

Fixed Interest

Chart showing 2015 returns for major fixed income indices:

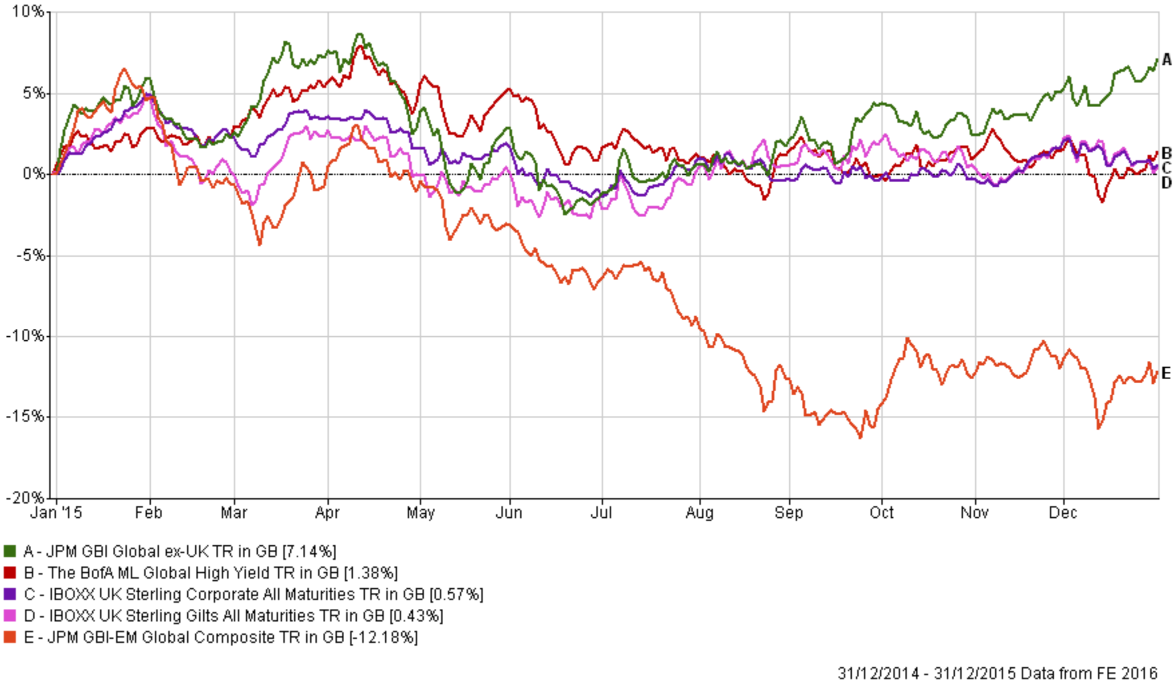
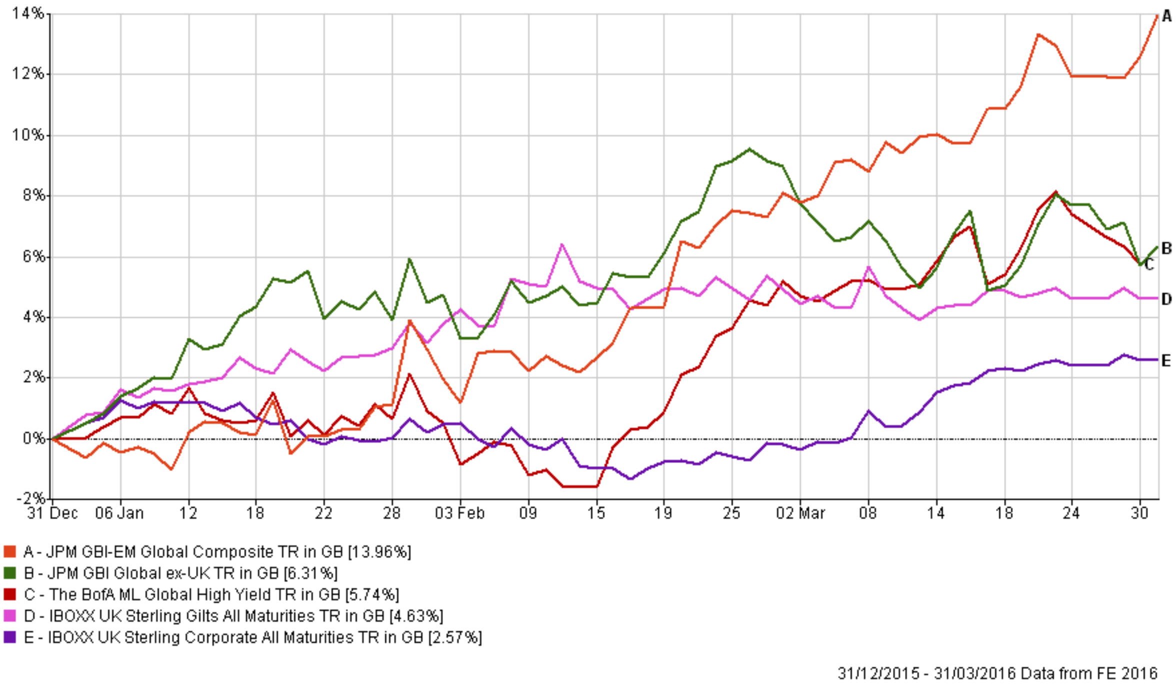


Chart showing quarter one 2016 returns for major fixed income indices:



Most investors have been wrong footed by fixed interest markets for a number of years with the general consensus being that bond yields would rise rather than decline further. This was again the case in the first quarter of the year when bond yields declined initially on the growth scare that hit the global economy. A background where interest rate rises have been pushed further out and European QE expanded have been favourable for fixed interest markets but there still appears to be little long term value in fixed interest markets which is a problem for those trying to achieve portfolio diversification. Government bonds have traditionally been a way to achieve diversification and low correlation in investor portfolios but with bond yields at present levels, both equities and bonds are vulnerable to higher interest rates or higher inflation.

2016 has been a much stronger year for bonds of all types as the threat of further rate rises following the December US rise have receded. All areas of the bond market have seen positive contributions as yields have edged downwards and government and corporate bonds performed well as monetary policy dominated markets. In Europe the quarter was marked by the first non-government bond to be sold at a negative interest rate. The ECB asset purchases in March were expanded to include corporate bonds for the first time and while this boosted prices in the short term it also raised concerns over distortions that might arise. European banking concerns were one of the main factors that caused pain in February with riskier bank capital bonds (Cocos) falling dramatically, indeed Deutsche Bank eventually had to buy back its own senior debt to stabilise markets. The pricing of bank debt remains volatile and continues to be a cause for concern in Europe with the Novo Banco crisis in Portugal an example to investors that governments can introduce rules which can wipe out investors assets without redress. There was also a similar improvement in the high yield junk bond market as the 'V' shaped recovery looked similar to that of equities. The Barclays US High Yield index has a total return of 4.2% leaving the sector up 3.1% for 2016. Clearly the more dovish comments from the Fed have boosted sentiment for this area as well.

Property

The UK commercial property market continues to produce good, consistent, positive returns, although the monthly returns are slightly moderated from those seen in 2014 and earlier in 2015 but are expected to remain relatively strong through 2016, although the absolute number is likely to be lower than the last couple of years. Investors may still be looking for an income alternative to their fixed income allocation but the strong returns may also be due to the relative stability of the UK economy and the low volatility of the asset class. Direct property should continue to be a good diversifying asset class during these uncertain market and economic conditions with returns driven mainly by the yield. Capital growth returns may remain strong over the short-term but this is expected to weaken with rental growth becoming a larger driver of total returns. There are ongoing concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven due to strong demand for this type of asset, as evidenced by overseas investor figures from 2015. There is increasing investor interest in secondary markets with the yield gap versus prime property looking attractive but individual property selection will remain important.

The property securities sector will continue to be influenced by the outlook for interest rates (as expectations for rate rises are generally negative for the sector), economic growth levels and the outlook for property and equity markets in general plus investor sentiment and valuation levels over the short term. The first interest rate rise in the US had no effect on the US REIT sector, as the rate rise was well flagged. Rate rises are not expected by bond market investors but it will be interesting to see how the REIT/property securities sector reacts to future news, both positive and negative. This will also have an influence on non-US REIT markets, however local market factors typically have a larger influence on this sector than for the main equity indices and these should also be taken into consideration.

Summary

The first quarter of 2016 has been somewhat of a surprise for a most market analysts with the falls in January a reflection of a more volatile, increasingly sentiment driven, start to the year. By the end of the quarter this had abated and we had a more stable perception of global economic growth and those areas most hit in January were making strong recoveries. The equity markets of the emerging world recovered to lead returns over the quarter which was far from likely at the end of January. The uncertainty that led to the large falls in January was replaced with greater confidence over the US economy in particular as well as a reappraisal of the resource and energy sectors which had taken a lot of the losses last year and in January. The stabilisation and then rally in the oil price proved to be a circuit breaker. The ECB increased QE but did so in a way that banks were not negatively impacted by lower rates and in some cases could be paid by the central bank to lend.

Currency has played a more significant part in returns over the last six months as alongside competitive devaluations, like that of the yen and the yuan, the dollar has finally weakened after a more dovish approach has been signalled by the US Federal Reserve. Perversely the US have reduced the likelihood of regular rises in interest rates in 2016 because of global weakness which has in turn given emerging market investors more confidence (thanks to a weaker dollar). By the end of the quarter a number of currencies had appreciated against the dollar including the yen which is not what the market or the Japanese government wanted or expected.

Markets over the rest of 2016 now face a similar dilemma as occurred in 2015 - if central bank policy has become more accommodative because the global economy is weak, increases in corporate profitability will be difficult to achieve. This year has already seen significant downgrades to expectations on corporate profits growth and with markets at higher than average valuations in the developed world, company profitability needs to pick up in order to make new market highs. High valuations are only justified by very accommodative monetary policy and any sign that this could change, led by the United States, could see these valuations coming under pressure and a stronger US currency leading to concerns about the emerging world. To make sustained progress markets need to see more definitive evidence that there is currently only a mid-cycle pause in corporate profits and that the economic cycle can re-accelerate.

The next few years are likely to see a continuation of slow economic growth, but this is occurring at a time when corporate margins in many countries and sectors are at peak levels. We now live in a world where many corporates lack pricing power and have harvested the low picking fruit of cost cutting and corporate restructuring and therefore overall profits growth for global markets is likely to remain muted.

Overall, for most stock markets and especially those trading at a premium to historical valuation levels, stock market gains at best will only match earnings growth and the US in particular remains vulnerable to some market de-rating if interest rates rise. We are currently in a period where profit growth is subdued, partly due to the setbacks that have occurred in mining and oil companies (although optimists believe there is a prospect of an earnings bounce back in these names post 2017) however we remain in an environment where most commodities including oil remain in oversupply. An environment of low nominal GDP growth and uncertainty over Central Bank policy means volatility is likely to continue. As investors have seen, moves both down and up can occur rapidly giving little opportunity to react once a new trend has started. Whilst the prospects for equity returns are likely to be modest over the next few years, it is hard to find other attractively valued asset classes. Government bonds continue to be supported by Central Bank behaviour, particularly outside of the States and whilst this may well persist for a while it will not necessarily be the case over the next decade. Investment grade credit looked particularly cheap after the set-back which occurred in February this year, but spreads have already snapped back to a greater extent.

Looking forward, the next big issue for investors in the remainder of the year may well be the pace of US monetary tightening. Bond yields in the States have already rebounded from their Q1 lows and the rally following Yellen's late March speech has petered out after fairly robust March employment data was released on the first Friday in April. The likelihood is that investors will at some stage have to factor higher US interest rates into valuations of both government bonds and equities – past market data shows this is not a positive factor for returns.

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April 2016

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