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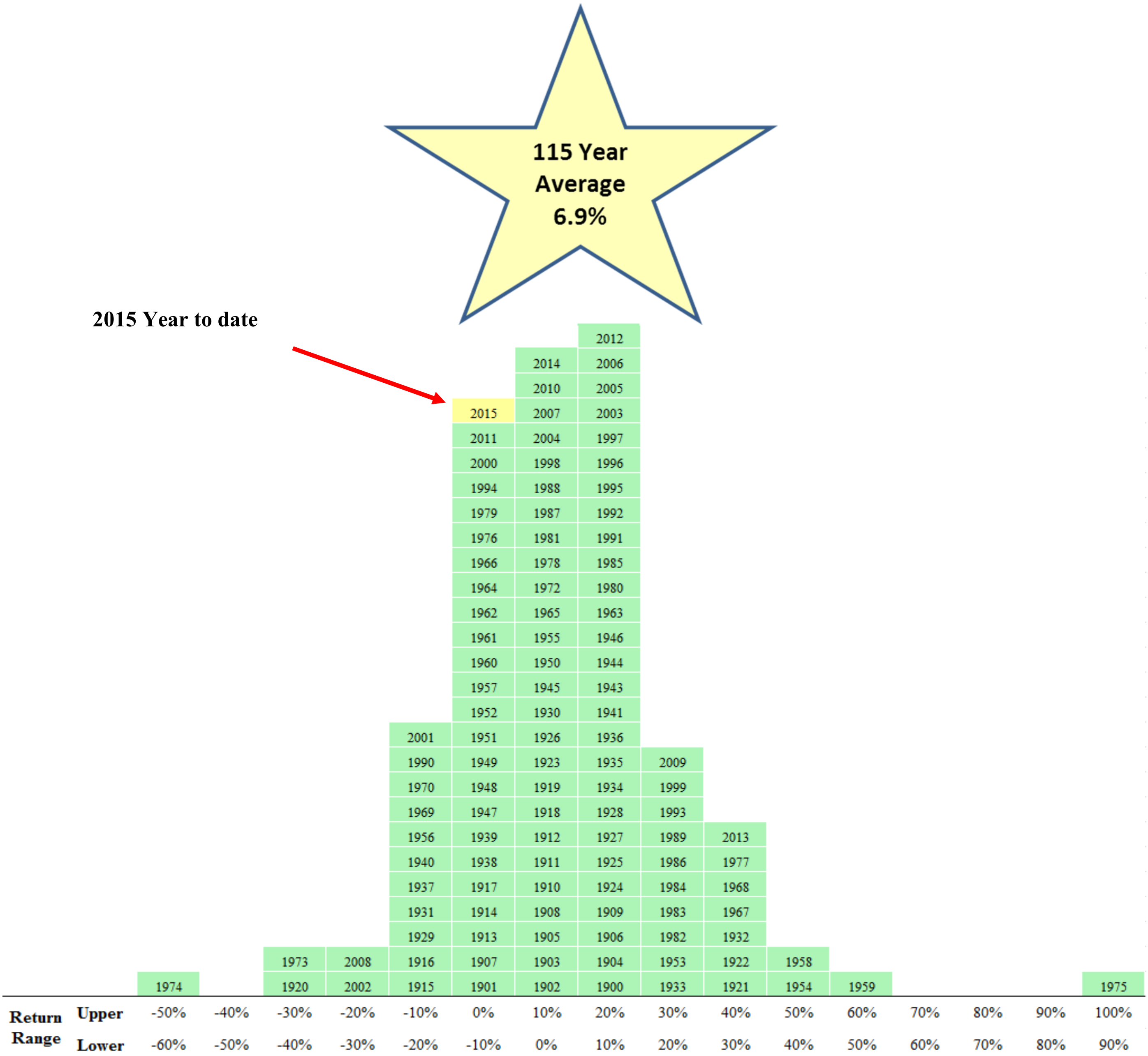
18th December 2015

Happy Christmas

Analysts: Giles Rowe
Artur Baluszynski



Data and Chart Source: BarCap Equity Gilt Study 2013 and Bloomberg

Our 'Christmas Tree' chart shows the performance of the UK Equity Market each year since 1900. The worst and best years were 1974 and 1975, and the average total return over the period has been 6.9%.

Prices can go down as well as up. Past performance is not a guide to the future and estimates are subject to uncertainty. Please see the important notice at the end of this document.

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Winter Note

All change

18th December 2015

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There is no such thing as financial security, which is why the financial services industry likes to refer to its products as 'securities'. The uncertainty surrounding their valuation is no different than usual today, though it still feels like it even as we come through the first Fed tightening for nine years unscathed.

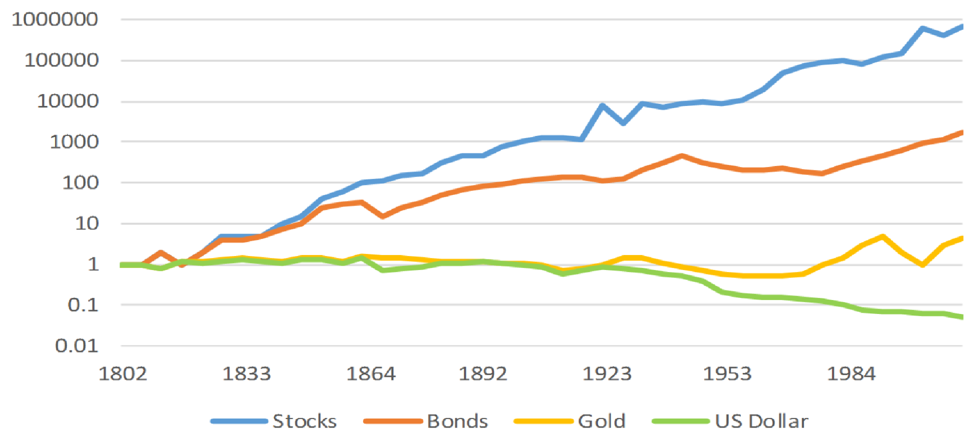
The S&P 500 Index has tended to rise in the first year following the beginning of US interest rate rise cycles. This has been the case since 1970. The reason is probably threefold. First, markets tend to fret before the event and be relieved afterwards. Second, the US Dollar has tended to fall as the Fed tightening cycle starts, helping US exports. Again, this may be because it rose too much beforehand. Third, the rises come because the economy is emerging from recession. While our base case is for history to repeat, the US recovery has been in place for a while and there are likely to be adjustments in, for example, currencies as the price of money has a regime change. Stresses in the high yield or 'junk' bond markets expose risks to the benign view.

Some significant US junk bond funds halted redemptions last week as investors rushed to the exit and rival bond traders shorted the bonds the funds were trying to sell. The UK's Prudential has asked the regulator to relax bond fund liquidity requirements too. While this smacks of the pre-2007 closure of Bear Sterns' credit fund, it is not the same. Bear Sterns was highly leveraged. Most of the pain today is in the Commodity and Energy sectors, but there is a risk of contagion to other issuers, and since there are around $2 trillion junk bonds outstanding, a crisis here would have repercussions for equities. For the moment bank bonds are not weakening, which is good news.

So although our base case for equities remains upbeat, with a gently rising Fed rate in the US, equivalent rates in Japan and Europe low, Europe emerging from the trough and China pumping furiously, we have taken a little out of our existing equity positions and plan to recycle into deeper value. Our thoughts on the main asset classes are summarised inside, and again we have shown their real returns over the last 210 years, below.

Happy Christmas.

Total Real Returns 1802 to 2012
on Stocks, Bonds, Gold and US Dollar. Log scale.



Source: 'Stocks for the Long Run' 2015 edition
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Giles Rowe
Chief Investment Officer

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EQUITIES

18th December 2015

At long last

Analysts: Giles Rowe
Artur Baluszynski

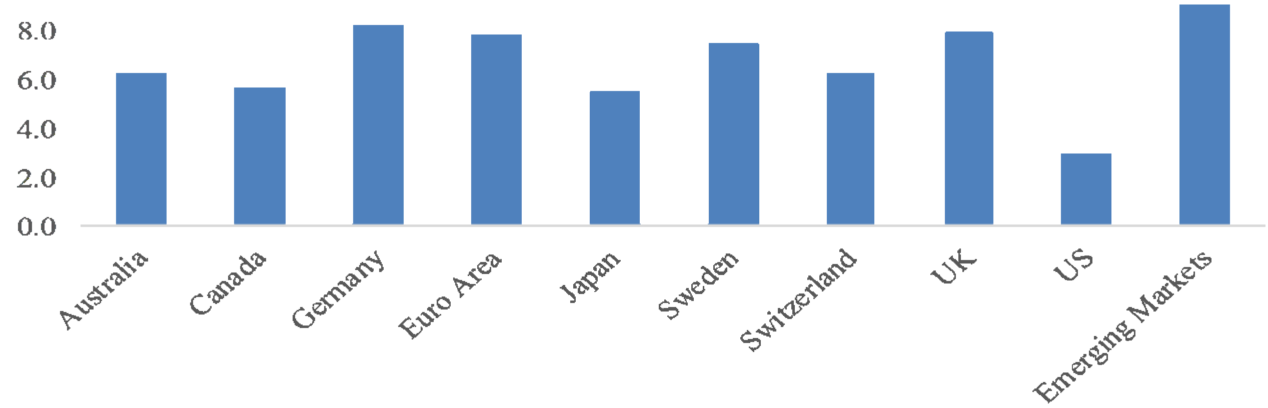
Now that Janet Yellen has taken the first steps in raising interest rates without collapsing the world economy, the US equity market's primary trend remains in Bull mode and the investment grade bond market is stable. The Fed has also undertaken to keep rolling over maturing bonds on its balance sheet, so will not be reversing QE any time soon. Though base rates have doubled from 0.0% - 0.25% to 0.25% - 0.5%, the shift in absolute terms is small and it is doubtful whether this cycle will see rates rise to the 'normal' 5% despite the Fed promising to react strongly to signs of inflation. Yellen has to say inflation is on the way, whether it is or not, to help justify moving rates up.

Geographically, the Fed tightening implies risks for Dollar dependent resource based economies like Brazil and South Africa if prices fall as the Dollar rises. China's publication of a broader currency reference basket is only a sticking plaster for now. But non-resource cyclical sectors in Asia remain attractive, China's investment program is expected to hold firm for 6 to 12 months, and the recoveries in Europe and the US are continuing.

We can, therefore, sensibly revisit equity valuation. One general measure is the 'Equity Risk Premium' or ERP. This can take many forms but generally takes the earnings yield on equities and compares it to the yield on bonds. If equity yields are much greater than those on bonds there is a 'premium' for the extra risk in the cheaper equities. Since (as shown on page 2) equities tend to perform better than bonds long term anyway, a premium implies equities are pretty good value compared to bonds.

Economists MRB have recently reviewed various measures of ERP. They are high (e.g. around 4% for 12 month trailing ERP versus 10 year G-7 government bonds) at the moment, signalling elevated levels of investor fear and, therefore, possible future equity gains. Obviously one half of the equation is low bond yields, and it is these that are mainly responsible for the premium rather than deeply undervalued stocks, so the bullish conclusion is not inevitable. If bond yields rise substantially then both equities and bonds could fall. But bond performance has nearly matched equities in recent years and if bond yields remain relatively low, the message for equities is positive. Equity valuations are discounting a very disappointing economic outlook and could 'solidly' outperform bonds over the next decade according to MRB.

MRB's 10-year Total Return Projections: Stocks minus bonds
% annual difference in the decade ahead



Source: MRB economics. Chart from 'Asset Allocation Research Highlight December 8th 2015.'
N.B. this is an estimate and the performance shown may not be achieved.

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BONDS

18th December 2015

Stars in their eyes

Analysts: Giles Rowe
Artur Baluszynski

Last week's suspension of redemptions in the Third Avenue and the Stone Capital credit funds sent shockwaves through high yield markets. Contagion from commodity markets quickly spread to other low quality credits triggering a wave of redemptions with fund managers selling what they could and not necessarily what they should! European and US High Yield bond markets are now down around 20% or 14%, respectively, from 2014 highs as shown in the chart below.

While weakness in the high yield market can be seen as a prelude to an equity market sell off, this is not the case here. The two funds were at the high end of the credit risk spectrum and when sentiment changed investors changed their 'risk appetite' too. A classic case of a fund being marketed to the wrong customers, enchanted by the lure of high yields.

The economy and banking system are in good shape and regulators have a better understanding of underlying risks. However, negative sentiment can snowball very quickly and infect other asset classes especially lower quality debt.

We identified these problems and their potential impact on our clients' portfolios in mid-2013, sold our high yield bond ETFs and drastically cut our emerging market bond exposure. While many macro driven investors focused on the relative valuations of junk bonds versus other fixed income assets and chased attractive yields, our bottom up approach made us question what was on offer. When you overemphasise asset allocation driven by expected returns, you forget to look under the bonnet and like a driver relying on a faulty GPS, can end up in a river or a lake.

The Fed's comments following the December rate announcement indicate gradual hikes over the next 12 months and our fixed income portfolios are well positioned for that. Bloomberg forecasts the Federal Funds target rate at between 1.25% to 1.50% by Q1 2017. We are closely watching commodity and energy markets which we believe could offer the best bargains in 2016. Our duration is close to 5 years and our average yield is around 4%.

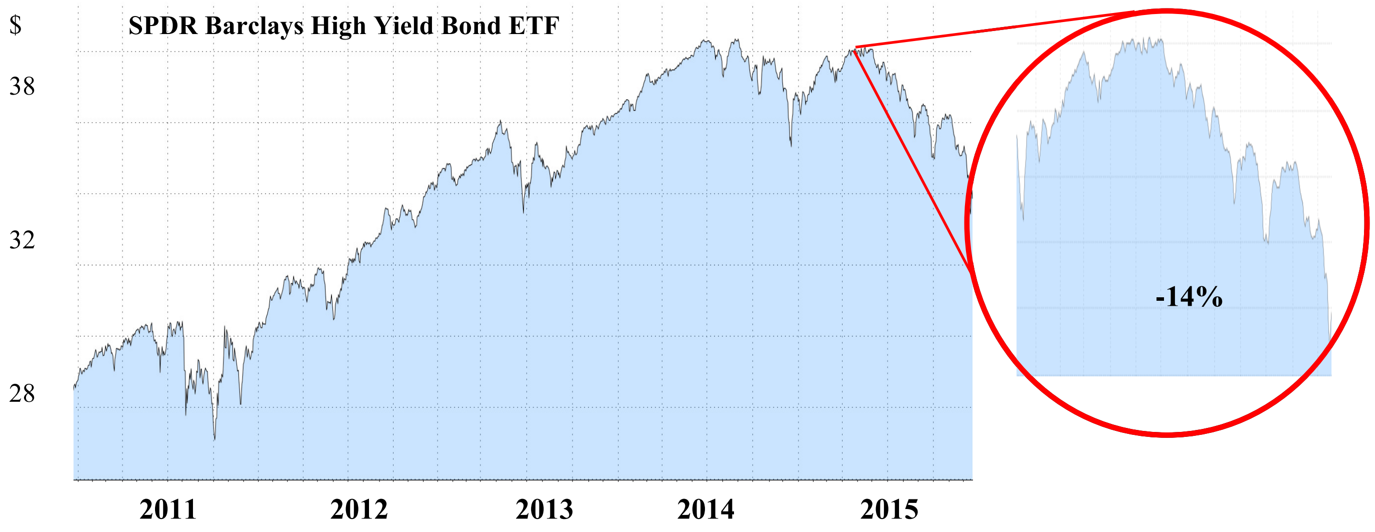

Chart Source: Bloomberg

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REAL ASSETS

18th December 2015

A tale of two bubbles?

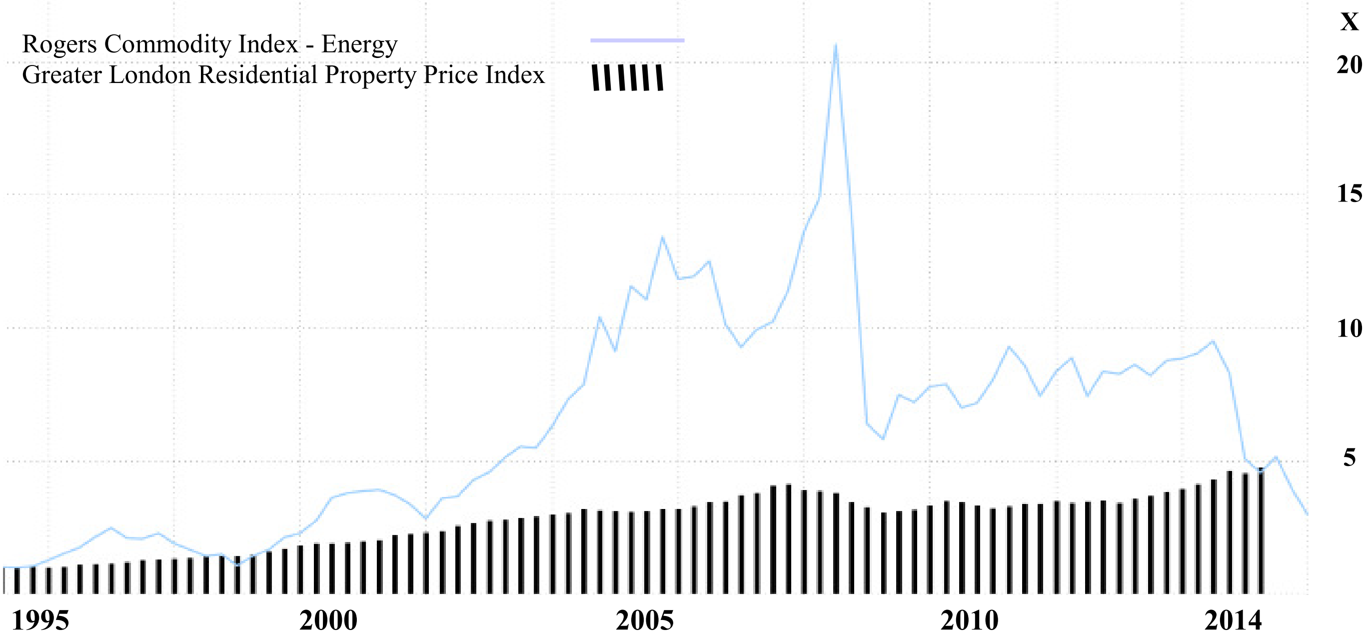
Analysts: Giles Rowe
Artur Baluszynski

One sector which typifies the immediate impact of the oil price fall is engineering. Before the oil boom, engineers had spent the past twenty years withering on the vine as their metal bashing skills slid down the value curve thanks to Asian competition and the declining pace of technology change. The Emerging Market and Commodity booms changed all that and engineers became stock market stars as they supplied the ‘picks and shovels’, conveyor belts, drill bits, trucks and widgets. This came to a halt as oil and other materials fell off a cliff. While narrow, the hit has been deep, and based on our conversations with small engineers like Senior, we believe that it has been more pervasive than macro commentators have realised, offsetting the immediate ‘tax cut’ benefit of lower commodity prices.

What has happened is clear from the long term commodity charts, which soared in the late 1990’s as China ramped up investment. Energy, shown in the Rogers Energy Index, which weights commodities by their share of world trade, (shown in the blue line below) soared to 20x 1995 levels at its peak in 2008, following which it plummeted to 5x 1995’s level by early 2009, and since 2014 has plunged to a mere 3x. With OPEC failing to control production volumes, the US now permitting oil exports and Iran planning to sell as much as it can pump, the outlook is hardly encouraging.

The Greater London Residential Property Price Index (black bars on chart below) can fairly be expected to show all the features of a bubble, but has only managed a 4.7x increase from the 1995 starting point. So if it is a bubble, it is a feeble copy of the commodity one and is now barely above Energy’s collapse point! Other major cities have similar profiles although property worldwide is more muted.

The forces driving urban property markets have not blown over yet, despite signs of softening recently, and in the absence of a leverage crisis it is easy to envisage the trend resuming as demographic and other pressures continue. As for commodities, although at some point there will be capitulation, the financial strains as whole markets trough are considerable and very volatile, so we are biding our time for now. Commodity cycles can be very slow burning.



Source: Bloomberg

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