Butterfield

Investment Review

1st Quarter 2016

Summary of markets and outlook

To borrow a football cliché (American oblong kind and UK round ball kind), the first part of the year has really been "a game of two halves". Markets spent the first six weeks of the quarter seemingly very worried about China slowing and the potential for global recession, which caused risk assets to perform very poorly indeed. The second six weeks, however, saw the proverbial animal spirits revived as risk assets rallied substantially; more to follow in the discussion below on the broad asset classes.

The easy explanation for the celebratory second half of the quarter lies with the Central Banks. This is the narrative one is most likely to hear in the financial press. After all, in the span of a week, both the European Central Bank (ECB) and the US Federal Reserve (Fed) indicated that they were still in the business of supporting risk assets. The ECB attacked growth and deflation concerns with a four-pronged program of greater billions of Quantitative Easing (QE), a broader menu of corporate credit available for said QE, more long-term financing to EU banks and deeper negative interest rates. The Fed, for its part, refrained from following its December tightening with an interest rate increase in March and came out of their two day meeting with a statement that was long on global risk possibilities and short on the positives of the US economy. It definitely feels as though the Yellen Fed is overly concerned with financial market volatility as a proxy for whether the readers of financial tea leaves think it is "ok" for the Fed to raise interest rates.

Unfortunately, the "Central Banks to the Rescue" summary of the six week rally in risk assets has one problem: the timing. By the time the ECB supposedly rode to the rescue, the S&P 500 had already recovered over 8% of the losses it incurred in the first six weeks of the year. For a number of years, we have been vocal proponents of the theory that Central Banks and QE have mostly been what has mattered for asset returns since the credit crisis, but in this case, the turn in sentiment happened of its own volition. If anything, we believe that markets are beginning to come to the realization that global central banks' ability to influence prices is waning as we violate the "zero bound" of interest rates. This is likely to create volatility as we go through the year, as analysts begin to sharpen their pencils and decide just what their investment thesis is in an environment where QE and low rates cease to drive all returns.

For us, the thesis is clear. We never believed that the global economic backdrop supported a near-term recession and we don't believe it today. Growth is not spectacular, but neither is it disastrous and in particular it is relatively stable in the US, still the largest economy in the world. Remain neutral equities and own some portfolio insurance/ downside protection in the form of volatility dampening alternative assets or cash.

Summary of markets and outlook

Equity

The first quarter of 2016 was an extremely volatile period for equity investors, with the MSCI World Index posting a decline of 11.52% from the start of the year to mid February, before recovering to end the quarter just 0.35% lower, in US Dollar terms. Whilst this pattern was repeated across regional developed market indices, the final outcome varied quite significantly. The US and UK markets ended the period in positive territory, posting muted gains of 1.18% and 0.07%, in contrast, the Japanese and European benchmarks suffered sharp corrections, falling by 11.23% and 7.79% respectively. In our recent commentaries we had highlighted that we expected volatility to remain elevated as the market reacts to the recent interest rate rise in the US, the first increase in over a decade. While an increase in volatility was expected, the magnitude of recent market moves was in well in excess of consensus opinion.

The financial press attributed the fall in equity markets during the early part of the year to various factors, including declining oil prices, rising interest rates and slower growth in China. Although these macro factors may not have a meaningful impact on the outlook for corporate earnings directly, clearly they did have a negative impact on investor sentiment, which resulted in quite significant outflows from equity funds. The decline in the oil price may also have had a secondary effect on equity markets, as oil producing nations realised positions within Sovereign Wealth Funds to raise monies in order to help balance their budgets.

There was a wide dispersion in the returns from the ten sectors that comprise the MSCI World Index during the first quarter, with Healthcare and Financials lagging with declines of 6.82% and 6.30% respectively, whilst Utilities, Telecoms and Energy posted solid gains of 8.57%, 6.85% and 5.12%.

Within the Healthcare Index, stocks in the biotechnology and pharmaceutical industries led the sector lower, as investors grew concerned that earnings may be negatively impacted by political pressure to reduce drug prices in the US, an issue that is seen as a key vote winner in the Presidential race. Our focus remains on pharmaceutical companies that are well diversified from a geographic perspective, which should help insulate them from any price reductions in the US. We expect that sales growth for companies that operate within the Healthcare sector will be supported in the longer term by a combination of an aging global population, the continued advance of medical science, particularly in the fields of oncology and immunology, a supportive regulatory environment and the significant increase in the number of US citizens that have access to healthcare services due to the adoption of the US Affordable Care Act. Given these positive long term trends, we are maintaining an overweight stance to the sector.

The correction within Financials was led by a sell off in the large US diversified banks, as investors factored in expectations that interest rates may remain on hold in the short term, coupled with concerns that loans to companies within the energy space may become impaired. Our view is that loan losses within bank's energy portfolios will be manageable, particularly if the recent recovery in the oil price is sustained. Furthermore, although low interest rates lead to lower net interest margins, bank balance sheets

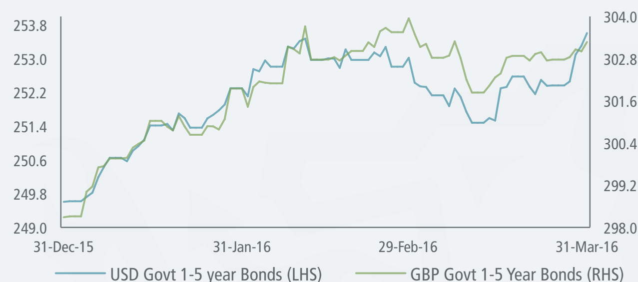
Summary of markets and outlook

are comparatively healthy, so broadly speaking they are well positioned to benefit from loan growth that usually accompanies a growing economy. We are therefore maintaining our neutral stance in Financials on the basis that recent concerns and headwinds have likely been overstated.

Looking ahead, we believe that economic expansion in the World's largest economies will continue, supported by the ongoing recovery in the US and the fiscal and monetary stimulus programs in Europe, Japan and China. This should help encourage companies to deploy some of their large cash balances into capital investment. A growing world economy should also lead to some much needed top line growth, which, when coupled with a continued focus on efficiency gains, leads us to maintain our base case for shareholder returns in the mid to high single digits over the medium term.

From a medium to longer term perspective, we continue with our "cautiously optimistic" view for global equity markets, but remain cognisant that we are likely to experience periodic bouts of heightened volatility such as we have witnessed in the first quarter. We remain of the opinion that companies with dominant positions that have been through these cycles before will continue to prosper and that on a relative basis, dividend yields remain reasonably attractive, despite the increase in stock prices during the last few years. While future returns are likely to be a little muted by historical standards amid increased volatility, we believe a "neutral" stance toward equities remains appropriate in the current environment.

Summary of markets and outlook



Fixed Income

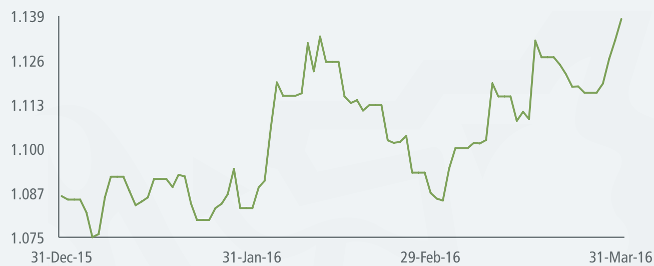
Fixed income markets have started the year in positive territory. Within the US and UK, bond prices have risen and yields fallen to the extent that longer dated bond yields traded through the previous low levels witnessed in early 2015 and mid-2012. It has been a similar situation within the EU, where ongoing quantitative easing (QE) and interest rates moving deeper into negative territory have seen bonds rally, with the 10-year Bund yield shift towards the all time low witnessed in April 2015.

The quarter has seen some interesting market dynamics play out. Through the first six weeks, bonds displayed their typical negative correlation to equity markets, by rallying as equity markets fell in volatile trading – a classic safe-haven trade. However, as equity markets found their footing through the latter part of the quarter and recovered broadly to where they had started, bond market prices stayed near their highs, suggesting that they are still largely trading upon the assumption that Central Banks across the globe will continue to act as a backstop to both financial markets and the global economy. In summary, we now see the market pricing the Federal Reserve to be somewhat more dovish than had been expected at the start of the year; the Bank of England to remain on the sidelines for a prolonged period yet; and the Bank of Japan and European Central Bank continuing to provide liquidity through QE and negative interest rates.

From an economic perspective, it is anticipated that developed markets and in particular, the US, will remain the primary engine of economic expansion. Recent revisions have seen the prospects for global growth reigned in. However, we still anticipate that growth in both the US and UK will remain positive and in the region of 2% per annum, largely driven by the consumer. Within the Eurozone, the PMI is still positive and GDP forecasts remain around 1.5% for the year. With this in mind, we do not subscribe to the thesis that the developed world is approaching a recession. Furthermore, as oil prices climb from their February lows, it is important to remain cognisant to the potential for inflation to surprise on the upside.

Bond yields are at, or very close to all time lows and the market is forecasting little to no inflation over the next few years. We witnessed periods similar to this in the US and UK in 2012 and in Europe in 2015. On each occasion, a reversal in bond markets followed in relatively short order. Given this, we do not anticipate that now is the time to adjust our current strategy of being underweight to the asset class and short of benchmark duration.

Summary of markets and outlook



Currency

Despite supportive economic fundamentals within the US Economy on both a relative and absolute basis, the Dollar lost ground against all major traded currencies with the exception of Sterling during the first quarter. The Dollar fell by just under 6.50% against the Yen, by 4.74% versus the Euro and suffered a 4.09% reversal against the Swiss Franc. Ongoing uncertainty ahead of the UK's June referendum on whether it remains in the EU continues to weigh upon Sterling and as a result, the Pound suffered a 2.31% fall versus the Dollar during the quarter.

Having made solid gains during 2015, the Dollar has given back a little ground as investors attempt to second guess when, and by how much, the Fed will tighten policy during the year. The first three months of 2016 have generally seen a softening in sentiment towards the Dollar, as markets have interpreted recent comments from Fed officials, including those of Fed Chair Yellen, as signalling a more dovish strategy than had been anticipated previously. In her recent comments, Mrs Yellen sought to stress the need for caution in raising rates, highlighting external risks such as slower growth outside the US and lower oil prices.

Looking forward, we remain of the view that while the Fed continues to remain cognisant of the risks of tightening too quickly, it's likely that interest rate differentials, driven by more positive economic trends in the US, will ultimately dictate direction within global currency markets. As such, we expect that the Dollar will regain support once the market refocuses upon the stronger fundamentals in the US. While in Europe, the ECB looks set to continue to pursue an aggressive easing bias amid ongoing weakness and deflationary pressures within the Eurozone.

In the United Kingdom, political and economic debate has almost exclusively been dominated by claim and counter claim as to the implications of leaving or remaining in the EU. As a consequence, Sterling weakened across the board, losing 6.73% versus the Euro and falling below USD1.39 during late February after the date of the referendum was confirmed. While current opinion polls suggest that a vote to stay is most likely, recent experience shows that these are not always reliable indicators. At current levels, we should conclude that a vote to leave is not fully priced in, therefore would see the risks as still skewed to the downside in the near term. However, we would expect Sterling to recover if the polls suggest momentum towards remaining part of the EU.

In Japan, the recovery rally that began in the final quarter of last year continued into 2016, leaving the Yen the strongest performing of the major trading currencies in the first quarter. Even allowing for the Yen's recent rally, since the start of 2013 it remains almost 30% weaker versus the Dollar. In the wake of a steady decline over recent years, a period of consolidation is perhaps not entirely surprising. Looking longer term, we remain of the view that the Bank of Japan (BOJ) will continue take action to sustain economic growth and maintain a positive trend in core prices. Therefore as long as the BOJ and the Fed continue on divergent tacks, the likelihood of material appreciation in the Yen's value appears limited for now.

Summary of sector views

1 Max underweight | 2 Underweight | 3 Neutral | 4 Overweight | 5 Max overweight

Sector	Rating	View
Consumer Discretionary	3	**Equal weight**: The sector has its attractions, including cheaper energy prices and a strengthening job market globally, both of which act as a boost for consumers. But valuations are extended and as a cyclical sector in a market that looks prone to renewed bouts of volatility and profit-taking, we consider a neutral stance remains appropriate.
Consumer Staples	3	**Equal weight**: We expect to see a pickup in demand, aided by lower fuel prices. The sector continues to be the "expensive defensive" play but given our focus on quality, income and balance sheet strength we maintain our support for an equal weight position.
Energy	3	**Equal weight**: The current supply surplus in global oil markets is taking longer to rebalance with total demand than we had initially anticipated. Sustained weakness in oil prices opens up increased risks for dividend cuts and share buy-back suspensions, with companies whose business models are more sensitised to oil prices most vulnerable. These include smaller and medium sized specialist Oil Services companies and more levered E&P companies. We expect volatility and uncertainty to remain elevated for now, however believe that the current global supply/demand imbalance will ultimately realign some time during the second half of 2016 and first half of 2017, providing a more positive overall backdrop.
Financials	3	**Equal weight**: Recent months have seen a strong sell-off in global financials, driven by fears of non-performing loans in Italy, energy related credit losses, deflation fears and potential contagion in inter-bank markets. We consider these movements as an over-reaction. Financials have worked hard to clean up their balance sheets, while increased regulation and a move back to domestic markets has reigned in risk, especially in relation to cross-boarder contagion. Energy-related losses remain manageable and the economic backdrop in the developed world remains reasonably supportive. Exposure is allocated globally, but with a bias towards the US. Valuations remain at a discount to the market and history which will support the sector as attention turns back to fundamentals.
Healthcare	4	**Overweight**: Positive long term trends should continue to support the sector, including investment in new discoveries, an easier regulatory background, continued expansion in emerging economies, and very supportive demographics. Although valuations in some of the higher growth parts of the sector give some cause for caution, on balance the strong earnings growth and positive long term secular trends continue to warrant an overweight position.
Industrials	3	**Equal weight**: Valuation and growth headwinds remain while pressure on deep cyclicals is intensifying. There is some evidence that broader-based capital expenditure (capex) is picking up, but the pullback from energy-related capex continues to impact near term earnings. Once this stabilizes, earnings growth should be capable of surprising on the upside and make valuations look more attractive, but in the meantime we shall remain equal weight.

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Summary of sector views

1 Max underweight 2 Underweight 3 Neutral 4 Overweight 5 Max overweight

Sector	View	Comment
Information Technology	3	**Equal weight**: Corporate spending on technology should remain well supported, particularly in areas such as virtualisation, security and outsourcing. Strong balance sheets can enhance shareholder returns through buy backs, and some of the larger companies within the group have also introduced dividend payments. The sector is attractive on a P/E basis but current margins may not be sustainable. Remain equal weight until we see signs of acceleration in top-line growth.
Materials	3	**Equal weight**: The sector has underperformed significantly since 2011 which is almost entirely due to the metals and mining sub sector. Weakness in commodity prices is expected to continue. While a considerable amount of bad news is already priced in, we expect further capex and dividend cuts, therefore remain comfortable with our equal weight stance.
Telecommunication Services	2	**Underweight**: Unattractive dynamics make it difficult to assess who the winners, if any, will be. The sector's historic defensive characteristics offer a haven from growth scares, but it remains vulnerable to a normalized interest rate structure. We therefore remain underweight.
Utilities	2	**Underweight**: High debt levels, exposure to interest rate rises, large capex requirements and significant regulatory oversight justify our continued underweight stance.

Quarterly statistics

Equity Indices	3 month % change 31 Dec 15 to 31 Mar 16	6 month % change 30 Sep 15 to 31 Mar 16	9 month % change 30 Jun 15 to 31 Mar 16	12 month % change 31 Mar 15 to 31 Mar 16
Global				
MSCI World Index	-0.35	+5.13	-3.75	-3.45
MSCI World Index (Sterling)	+2.00	+10.52	+5.15	-0.44
MSCI World Index (Euro)	-4.86	+3.29	-5.68	-8.99
MSCI Emerging Markets Index	+5.71	+6.41	-12.63	-12.03
United States				
Dow Jones Industrial Average	+2.20	+10.07	+2.38	+2.08
S & P 500 Index	+1.18	+8.12	+1.00	+1.13
NASDAQ Composite Index	-2.43	+6.07	-1.45	+0.55
Europe				
Continental Europe - Dow Jones Euro Stoxx 50	-7.79	-2.55	-11.56	-16.72
France - CAC Index	-5.12	-0.87	-7.60	-10.02
Germany - DAX Index	-7.24	+3.16	-8.95	-16.72
Switzerland - SMI Index	-10.21	-7.00	-9.72	-11.71
UK - FTSE 100 Index	+0.07	+3.79	-2.57	-5.26
Far East				
Asia - MSCI Asia Pacific Index (US Dollars)	-1.68	+5.14	-10.25	-9.68
China - Shanghai Composite	-15.12	-1.60	-29.77	-19.85
Hong Kong - Hang Seng Index	-4.74	+0.42	-19.50	-13.76
Japan - Nikkei 225 Index	-11.23	-2.67	-15.76	-11.05
MSCI World Sectors				
Consumer Discretionary	-0.73	+4.51	-2.16	-1.06
Consumer Staples	+4.56	+11.01	+9.74	+8.70
Energy	+5.12	+4.36	-14.50	-15.49
Financials	-6.30	-2.34	-11.57	-10.13
Healthcare	-6.82	-0.32	-9.65	-8.28
Industrials	+3.46	+10.43	+0.33	-0.76
Information Technology	+0.96	+9.89	+4.25	+3.84
Materials	+4.45	+8.93	-12.40	-13.15
Telecommunications Services	+6.85	+13.61	+4.17	+7.70
Utilities	+8.57	+10.00	+10.08	+6.87

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Quarterly statistics

Equity Indices	3 month % change 31 Dec 15 to 31 Mar 16	6 month % change 30 Sep 15 to 31 Mar 16	9 month % change 30 Jun 15 to 31 Mar 16	12 month % change 31 Mar 15 to 31 Mar 16
Bond Indices				
Bloomberg Bond Indices - Global Bond Index (US Dollars)	+6.81	+5.12	+7.30	+5.27
Bloomberg Bond Indices - Global Bond Index (Sterling)	+9.44	+11.52	+18.29	+9.48
Bloomberg Bond Indices - Global Bond Index (Euro)	+1.87	+3.43	+5.30	+0.86
Bloomberg Bond Indices - US Govt 1-5 Year	+1.60	+0.89	+1.70	+1.68
Bloomberg Bond Indices - UK Govt 1-5 Year	+1.67	+1.50	+2.48	+2.02
Bloomberg Bond Indices - Canada Govt 1-5 Year	+0.12	+0.39	+0.54	+0.69
Bloomberg Bond Indices - Euro Govt 1-5 Year	+0.49	+0.89	+1.60	+0.95
Foreign Exchange Rates				
Sterling versus US Dollar	-2.31	-4.88	-8.46	-3.02
Sterling versus Euro	-6.73	-6.55	-10.31	-8.59
Sterling versus Swiss Franc	-6.30	-6.44	-6.15	-4.42
Sterling versus Canadian Dollar	-8.32	-7.87	-4.84	-0.75
Sterling versus Japanese Yen	-8.56	-10.57	-15.67	-9.05
US Dollar versus Euro	-4.74	-1.78	-2.04	-6.09
US Dollar versus Swiss Franc	-4.09	-1.64	+2.53	-1.43
US Dollar versus Canadian Dollar	-6.16	-3.14	+3.95	+2.35
US Dollar versus Japanese Yen	-6.41	-5.99	-7.88	-6.21
Trade Weighted US Dollar Index	-3.11	-0.86	+1.73	-0.67
Commodities				
Reuters/Jefferies CRB Commodity Price Index	-3.19	-12.00	-24.94	-19.51
Gold Spot $/Oz	+16.03	+10.54	+4.99	+4.10
Silver Spot $/Oz	+10.77	+5.86	-2.10	-7.26
Brent Crude Index (London)	+8.84	-16.47	-35.01	-28.49
Crude Oil Futures (New York)	+3.51	-14.97	-35.53	-19.45

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