Butterfield Asset Management

Investment Views

Butterfield

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Equities	Turbulence, especially in commodity-related stocks
Currencies	Dollar strength, sterling weakness
Bonds	Still an attractive diversifier
Commodities	Bleak – and likely to remain so

GENERAL COMMENT

Global financial markets have begun 2016 with relatively substantial losses in January. The declines in equities markets have been remarkably broad-based across the developed markets, with no particular stand-out performer across the globe. Commodity prices, notably oil, also declined substantially intra-month, but recovered to "only" be down (-12%) for the month. When global asset markets decline in direct correlation with one another, does this impart information to us about the state of the global economy, or not?

The short answer for us, at present, is "no". Often, equity market returns do not correlate well with the global economic cycle and, indeed, until the last decade, there was little correlation between individual countries' economic performance and anything that could coherently be called the "global economy". In fact, the American economist Paul Samuelson once famously quipped "Wall Street indices predicted nine out of the last five recessions". Whilst it may seem like our interconnected world, made smaller by advances in communications infrastructure, is able to transmit the real effects of a decline in growth on the other side of the world, this is not always an accurate assessment of the situation. In order to come to an answer, one must look at the facts on the ground through careful parsing of the economic data in individual countries and regions and come to a decision about whether the markets are discounting fair value for the companies within each economic system.

Let's start with the US, which remains the largest economy in the world. The US economy is predominately driven by consumer expenditure, at roughly 70% of GDP and secondarily by the provision of services. Goods production in manufacturing and resource extraction, for example, are dwarfed by the service and consumption sectors. Of the angst over the direction of the economy in January, focus has squarely been on difficulties in the oil and gas extraction sector and the impact of the strength of the US dollar on US manufacturing output. Conversely, very little attention has been paid to the fact that US employment growth accelerated into the second half of 2015, wages improved at a reasonable rate above measured inflation, and the unemployment rate fell to 5%. Strong employment is the backbone of the US economy, especially as it relies heavily on consumption. Additionally, housing markets are strong and new automobile purchases are at record levels. The oil price declines mentioned above, far from being damaging to the US as a net importer, have given American consumers a major boost in disposable income. Americans are clearly not concerned about the well-being of the domestic economy and if they are concerned about stresses in oil exporting countries that stem from the decline in oil, their concern is not showing up in the hard data.

This brings us, naturally, to China. It is impossible to have avoided recent media reports that Chinese growth is slowing. The intention here is not to deny that the growth of the Chinese economy is slowing– it clearly is–but merely to discuss the ramifications and the scale of the decline. China is attempting to adjust its economy from an unsustainable pace driven by a long-term misallocation of capital. Over the last two decades capital was allocated to

massive infrastructure projects, to state-owned enterprises and to the build out of manufacturing capacity with little regard to efficiency or environmental impact. The Chinese government is attempting to rein in some of the worst excesses of that period of rapid modernisation, whilst supporting the burgeoning middle class and a shift to a more balanced economy. Indeed, at present, consumption represents roughly 50% of the Chinese economy, which is low by Western industrialised nations' standards, but represents a sharp climb over the past several years. Needless to say, achieving this balance has not been without difficulty and recent Chinese policy has been opaque at best and inept at worst. Still, it bears remembering that Chinese growth was 6.8% in 2015 and estimates are for 6.3% in 2016. This pace of growth is two and a half times that of the US and six times what the Eurozone is set to achieve, so when we talk about a "decline" in China's prospects, it should be taken in that context. China is at once a powerful engine of growth for the global economy as well as a risk for the world - the successful re-balancing of the economy is imperative to get "right".

At present, the financial markets seem content to wholly focus on the risk that China will exert negative pressure on trade and industry that will spill over into the broader emerging markets. Markets are pricing such that this phenomenon has the ability to stall the long and albeit somewhat unimpressive global economic recovery that has followed the credit crisis period. However, there is not a high probability of global recession without a disastrous outcome from both China and the US. Financial markets, and equity markets specifically, may be focused too much on the risks to the downside and not enough on the positives.

EQUITIES

Equities had a turbulent start to the year. Chinese markets fell heavily, a move triggered by the "PBOC" devaluing the yuan and the introduction of circuit breakers. This has a knock-on effect in global markets where, at one point, the MSCI World was down 11%. Then, as has become the norm, the central banks stepped in. Mr Draghi dropped a strong hint that the bank is ready to launch a fresh round of stimulus in March. Investors pushed out interest rate hike expectations and the equity markets rallied. Then the Bank of Japan surprised markets by adopting negative interest rates, reaffirming their commitment to fighting deflation. The MSCI World index recovered around half of its fall, finishing the month down 6%.

Geographically, the Shanghai composite was the worst performing index, dropping 22%. Japan was also weak with the Topix down 7%, whilst in Europe the Dax lost nearly 9%. The US markets fared better with the S&P 500 falling 5%, and the FTSE 100 which dropped "only" 2.5% as the index benefitted from the weaker pound.

The worst performing sector this quarter was materials (-10.1%) followed by financials (-9.8%) and healthcare. The best performing sectors were utilities and telecoms which returned 1.5% and 0.5%, respectively.

As we enter the Q4 earnings season, we still see significant distress within the oil/mining sector as commodity prices continue to tumble. Companies are contemplating whether to continue reducing capex, slash dividends, do a rights issue, or a combination of the three. A significant number of utilities companies have also surprised to the downside, although the sector has so far held up quite well due to its perceived defensive properties.

CURRENCIES

The dollar had another strong month in January and appreciated against all other major currencies, with the exception of the Norwegian krone. Whilst market expectations of further interest rate rises in the US have been scaled back, the weakness abroad and global market volatility meant that investors sought

the haven of the dollar. This was particularly the case versus the emerging market currencies and sterling. The dollar appreciated significantly in the 18 months prior to December's interest rate rise, causing a slowdown in the manufacturing sector. However, the key question for the dollar going forward will be how the more important services sector performs.

Sterling depreciated notably as expectations for interest rate rises have been pushed back; so much so that the markets are now pricing a higher probability of a rate cut than a rate rise in the UK this year. Whilst economic fundamentals have slowed a little in the UK recently, this does seem an overreaction given that the bank rate never went below 0.5% even in the financial crisis. The EU referendum is also a risk for sterling and, given that we can have very little faith in the polls, this is likely to cause continued volatility in the year ahead.

BONDS

The developed market sovereign bonds have provided a haven from equity market volatility as investors have sought safety and pushed yields lower. Bonds benefitted from both the uncertain outlook for global growth together with the disinflationary consequences of lower commodity prices. With interest rates so low in developed markets, the diversification benefits of holding bonds have fallen compared to the last few decades. However, markets continue to be surprised by just how low bond yields can go, which in an increasing number of cases is actually negative. In a world where there is now $7 trillion worth of bonds with negative yields globally, it is becoming increasingly difficult to get the benefits of diversification with an acceptable level of risk.

Whilst the continued falls in commodity prices put downward pressure on inflation rates in the short term, over the medium term the lower base for comparisons will mean that commodities will go from a being a deflationary force to an inflationary one. The fall in inflation expectations has left index-linked bonds looking like good value, relative to history, and are something that we are looking at increasing exposure to. In the credit markets, spreads have continued to widen in both investment grade and high yield. The volatile conditions have stunted supply from the sector this year and corporates raised only €5.6 billion-equivalent last month, the lowest January supply total in 16 years. Value opportunities are now increasing in the credit markets and credit provides an attractive risk/return profile relative to equities.

COMMODITIES

Declining commodity prices led The Thompson Reuters/Core Commodity CRB index to its lowest level since August 2002, after falling a further 5.3%. Energy and base metals remained the worst performers while gold advanced as the metal received a lift from the downturn in global markets.

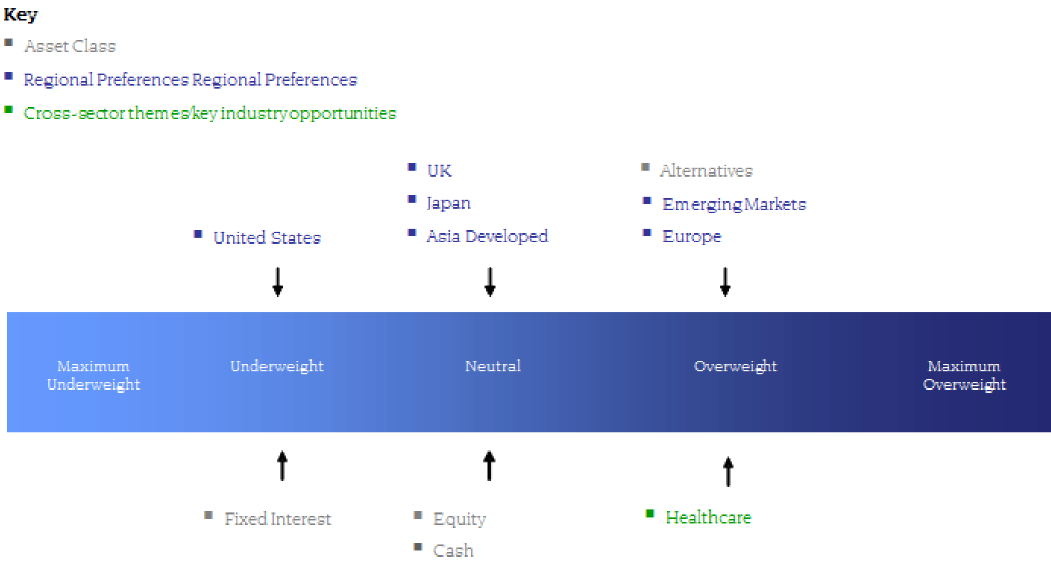
Crude oil prices touched a 12-year low, weighed down by the prospect of additional Iranian exports, diminishing global demand and a stronger US dollar. These negative fundamentals overshadowed speculation of a grand bargain between OPEC and Russia to cut production. As a result, the price of WTI and Brent oil ended the month down 9.2% to $34 and 6.8% to $35 a barrel, respectively. Looking forward, until there are clear signs of the oversupply being capped, it is likely any upside will remain limited.

The price of copper declined 3% to reverse the gains made in December, as growing concern over weakening demand, driven by a slowdown in China, outweighed optimism about supply cuts. China's official manufacturing index declined to 49.4 in January, leading to a sixth consecutive monthly reading below the 50 level that divides expansion and contraction.

These events have highlighted some of gold's credentials as a store of value. Gold, for immediate delivery, has risen by more than 5% to $1,116/oz. since the start of 2016 as the retreat in global equities and commodity prices have reinvigorated a flight to safer assets. Declining inflation, as a consequence of the latter, has also reduced the expectations on how aggressive the US Federal Reserve's ability to hike interest rates will be during the coming months.

POLICY SUMMARY CHART

The chart set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.



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MARKET PERFORMANCE

29-Jan-16

All performance numbers show % changes except for bond yields which show yield changes.

	29-Jan-16	- 1 mth	- 3 mth	- 12 mth
CURRENCIES (VS USD)				
GBP	0.70	3.4%	8.3%	5.8%
CHF	1.02	2.1%	3.6%	11.2%
JPY	121.14	0.8%	0.4%	3.1%
EUR	0.92	0.2%	1.6%	4.2%
BOND YIELDS (10 yr)				
UK	1.56%	-40bp	-36bp	23bp
US	1.92%	-35bp	-22bp	28bp
Germany	0.33%	-30bp	-19bp	2bp
Japan	0.10%	-17bp	-21bp	-18bp
EQUITIES				
UK. FTSE 100 (GBP)	6,084	-2.5%	-4.4%	-9.9%
US. Dow Jones (USD)	16,466	-5.5%	-6.8%	-4.1%
Japan. Nikkei Dow (JPY)	17,518	-8.0%	-8.2%	-0.9%
China. Shanghai A (CNY)	2,738	-22.6%	-19.1%	-14.7%
MSCI Pac ex Jap (USD)	1,032	-8.8%	-8.5%	-19.9%
MSCI Eur ex UK (Local)	1,140	-6.1%	-8.1%	-4.5%
MSCI Lat Am Free (USD)	1,744	-4.7%	-13.1%	-31.8%
MSCI World (USD)	1,562	-6.1%	-8.4%	-6.9%
MSCI World (GBP)	2,643	-2.4%	-0.3%	-1.4%
COMMODITIES				
Oil (WTI)	$33.62	-9.2%	-27.8%	-30.3%
Gold	$1,118.21	5.4%	-2.1%	-12.9%

Source: Bloomberg