Butterfield Asset Management

Investment Views

Butterfield

March 2016

Equities	The dogs of 2015 bounce, while the stars fall flat
Currencies	Brexit risk in focus
Bonds	Credit markets recover
Commodities	Gold starting to shine

GENERAL COMMENT

If anything, February has made us more confident that the US and global economies are not in danger of an impending recession. By no means, however, do we submit that the path markets have taken to reach a similar conclusion have been smooth. Within the month, equities markets fell substantially lower than where they closed in January, but the second half of the month was strongly positive as market sentiment improved. In other words, it was very volatile. The improvement in sentiment has correlated very strongly with the price of oil; WTI crude having bottomed at $26.11 the same day as the near-term bottom in the S&P 500 and continuing to rise through today as we write. To us, this correlation is counterintuitive for developed market economies, which have large consumer sectors and unquestionably benefit from a lower oil price.

To attempt to explain the phenomenon, we submit that the great and overriding fear that has gripped markets has been the negative feedback loop that surrounds the oil price rather than any substantive evidence that low oil prices are themselves "bad". The narrative goes something like this: The oil price is low because supply is too high. This must mean that demand is very poor, which people fear is China-related. The market then talks itself into worrying about China and the (worrisome!) knock-on effects to other emerging markets and the global growth picture. This sends oil still lower and…well one gets the point. We are not specific subject matter experts on the price of oil, nor do we forecast the price, but we do know a thing or two about equilibrium in supply and demand in economics.

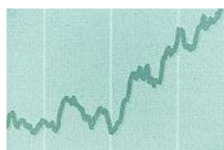
On the supply side, there was ample evidence of overproduction. The reasons for this oversupply are relatively well-known and well-reported, but include a lack of coordinated effort from OPEC to avoid excess supply and a sharp rise in American shale production. As prices have fallen, however, it is very important to understand that reductions in non-OPEC supply have more recently been sharp and capital expenditure for future projects has been slashed substantially. For example, one of the largest oil service companies in the world, Schlumberger, estimates that exploration and production spending in North America fell by 37% in 2015 and, based on first quarter company earnings calls, is estimated to fall another 33% in 2016. These types of production cuts and low spare OPEC capacity are estimated to create a small but growing deficit beginning in 2017 or even in late 2016.

On the demand side, it is equally important to understand that demand is growing! The International Energy Agency (IEA) estimates that global oil demand will be 1.2 million barrels per day larger than 2015. Oil demand growth for 2015 was the best in 5 years and increased by 1.6 million barrels per day. To put that into perspective, total global demand for 2015 averaged 94.4 million barrels per day, so 2015 demand - the best year we have seen since 2010 - increased by 1.7%. In 2016, the rise in percentage terms is meant to be 1.3%. China may be slowing to a more sustainable pace, but demand is clearly still growing. Unfortunately, that is not exactly the way the headlines read. One

was more likely to see something along the lines of "Oil demand to fall 400,000 barrels per day in 2016" in large font on the front page of the business section.

Overall, the point we are trying to make here is that this particular "low oil price" fear is both strangely counterintuitive for developed market economies and also something that corrects (and is correcting) at a spectacularly rapid pace. We expect decent, if unspectacular, global GDP in 2016, similar to what we have seen over the course of the recovery that began post-financial crisis; no more, no less.

EQUITIES



February was a repeat of January with a sell-off in the first two weeks and a bounce thereafter. That said, there were some significant differences.

February witnessed sector rotation, with some of the unloved sectors outperforming and some of the loved sectors underperforming. It was a similar story with the regions, with some formerly unloved regions bucking the trend.

Despite all the volatility the MSCI World finished the month down only 0.7%. The S&P 500 fared well, finishing the month relatively unchanged. European markets were weaker dropping 3.2% with Italy and Greece underperforming, falling 5.5% and 6.5%, respectively. The UK market did well, rallying 0.9% as sterling weakened. Boris Johnson's announcement that he would support a Brexit triggered the largest one-day fall in sterling since the hung parliament outcome in 2010.

The Chinese markets behaved and held up surprisingly well after the sharp sell-off in January. The Topix on the other hand was weak after the yen rallied. Emerging markets reversed course and outperformed developed markets. This is after many banks touted emerging market equities in their 2016 outlook reports and PIMCO Adviser called it the trade of the decade.

As for sectors, the dogs of 2015 outperformed and the stars fell. The best performing sectors were materials, industrials and telecoms, returning 6.3%, 2.4%, and 1.2%, respectively. Materials rallied on the back of low valuations and some metal prices bottoming. Gold rallied significantly, with gold miners outperforming. The worst performing sectors were financials, IT and healthcare which returned -3.5%, -1.3% and -1.2%, respectively. Financials have had a very poor start to the year for various reasons including energy-related credit losses and changes in interest rate hike expectations. Healthcare, which has been a sweet spot for many fund managers, also underperformed.

CURRENCIES

At the end of January the Bank of Japan surprised markets by introducing negative interest rates, only to then watch with dismay as the yen strengthened significantly versus all other major currencies.

The yen continues to be seen as a safe haven currency due to the current account surplus, high level of private savings and tendency of Japanese investors to repatriate funds back to Japan during volatile markets. Efforts to reflate and rejuvenate the economy have had the implicit aim of weakening the yen, so this currency strength is an unwelcome development in their battle against deflationary forces.

One of the major topics in currency markets has been the UK's referendum on EU membership, scheduled for 23rd June. Boris Johnson and Michael Gove have added impetus to a campaign for the UK to leave the political and economic union. Sterling has seen the most immediate response to the uncertainty and has depreciated versus other major currencies. Whilst it is going to take a lot to convince the electorate that the long-term benefits outweigh the short-term economic uncertainties, we can be more confident that a vote to leave will lead to difficult questions on the future of Europe.

For this reason it is somewhat surprising that sterling has come under so much pressure but the euro has held up relatively well versus the dollar.

BONDS

Volatility has not been confined to equity markets so far this year, with government bond yields and corporate credit spreads also experiencing notable price swings.

Markets have struggled to price in the timing of further interest rate rises in the US, largely due to market-based price signals. The Federal Reserve has made it clear that it is their intention to increase interest rates at a steady pace, but one which is less steep than previous rate hike cycles. The strong rate of job creation and subsequent strength of the consumer side of the US economy supports such a view that further interest rate rises are warranted throughout the rest of this year. Overall, economic data have actually improved since the last rate rise in December.

Complicating matters are both market-based price signals and developments outside of the US. Central bankers are right to consider market conditions such as costs of capital for both debt and equity financing. However, a mentality of not raising rates because the stock market is volatile produces a dangerous feedback loop. A more legitimate point of debate is to what extent monetary policy in the US can diverge with the rest of the world. Global growth has slowed as growth rates in emerging economies have slowed and growth in the eurozone and Japan remains fragile. There is, therefore, a concern that tightening of monetary policy in the US could have negative effects for monetary conditions globally, although these concerns have eased recently with significant inflows into high yield bonds and good performance from emerging market and investment grade bonds.

COMMODITIES

The Thompson Reuters/Core Commodity CRB Index declined a further 2.1% during February on growing concerns pertaining to global economic growth, while precious metals maintained their upside momentum.

As other commodities contest negative market influences, the price of gold gained 10.3% for a rise of 16% year-to-date. Gold in particular has been supported by the revival in investment demand as the downtrend in global equities has prompted the US Federal Reserve to signal that it will likely hold off raising borrowing costs in the near term, while other central banks have adopted negative interest rates.

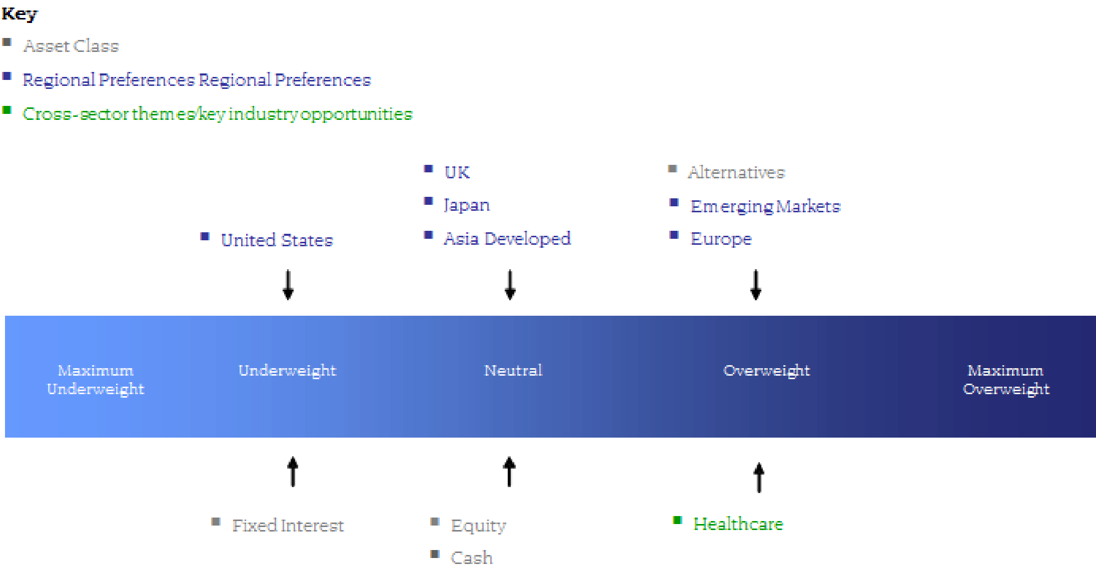
In this respect, inflows into gold-backed funds during January and February have risen more than the level of outflows during the entire of 2015. Holdings in the world's largest gold ETF (SPDR Gold Trust) are now reported at 777 metric tons, which is 135 tons more than the levels at the onset of this year.

While Chinese growth concerns have also lifted the safe haven appeal of gold, producers of base metals have been rewarded for cost cutting measures that have helped buoy the profit outlook and prices for metals mined such as copper. As a result, the price of copper gained 2.9% over the month.

After a volatile month for crude oil, the price of WTI crude remained broadly unchanged at $34 a barrel. A further pullback in the number of active US oil rigs to the lowest since December 2009 helped to alleviate concerns related to excessive supply. An uneven recovery in Brent crude to its first monthly gain since October helped drive the premium between Brent and WTI out to $2.2. The announcement that OPEC and Russia have agreed to hold a meeting as soon as March, with the plan to freeze production at January levels, led the price of Brent up 3.5% to $36 a barrel. With OPEC member Iran raising output after years of sanctions, signs of co-operation have supported the market.

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-Feb-2016

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

	29-Feb-16	- 1 mth	- 3 mth	- 12 mth
CURRENCIES (VS USD)				
GBP	0.72	2.4%	8.2%	10.9%
CHF	1.00	-2.4%	-3.0%	4.6%
JPY	112.69	-7.0%	-8.5%	-5.8%
EUR	0.92	-0.4%	-2.8%	3.0%
BOND YIELDS (10 yr.)				
UK	1.34%	-22bp	-49bp	-46bp
US	1.73%	-19bp	-47bp	-26bp
Germany	0.11%	-22bp	-37bp	-22bp
Japan	-0.06%	-16bp	-37bp	-40bp
EQUITIES				
UK. FTSE 100 (GBP)	6,097	0.2%	-4.1%	-12.2%
US. Dow Jones (USD)	16,517	0.3%	-6.8%	-8.9%
Japan. Nikkei Dow (JPY)	16,027	-8.5%	-18.8%	-14.7%
China. Shanghai A (CNY)	2,688	-1.8%	-22.0%	-18.8%
MSCI Pac ex Jap (USD)	1,025	-0.7%	-7.6%	-23.5%
MSCI Eur ex UK (Local)	1,104	-3.2%	-13.3%	-13.9%
MSCI Lat Am Free (USD)	1,804	3.4%	-6.0%	-32.0%
MSCI World (USD)	1,547	-1.0%	-8.7%	-12.7%
MSCI World (GBP)	2,664	0.8%	-1.4%	-3.2%
COMMODITIES				
Oil (WTI)	$33.75	0.4%	-19.0%	-32.2%
Gold	$1,238.67	10.8%	16.3%	2.1%

Source: Bloomberg