

Viewpoint

Monthly market update

February 2016



Contents

1. Market commentary	3
2. Market performance	5
3. Asset allocation dashboard	7
Important notes	9

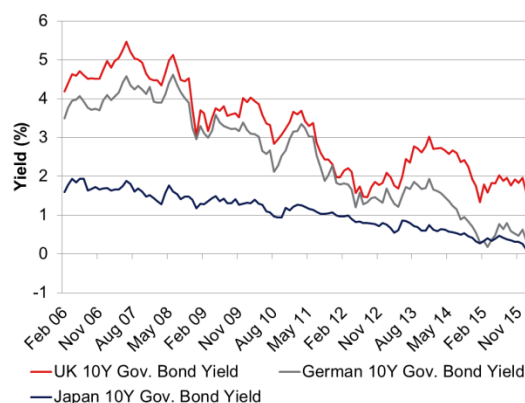
1. Market commentary

The market weakness seen in January continued into February with high levels of uncertainty and fear, notably affecting the financial sector and in particular European bank shares. However sentiment began to improve mid-month and markets have since recovered significantly; by month-end the MSCI World index was down by only 0.7% in the month, and is up over 9% from its 11 February low at the time of writing. Global emerging markets fell by just 0.2%.

The global sell-off in the past 3 months was triggered by a combination of factors: China, the collapse in commodity markets, and the strong dollar. These have had negative impacts on global growth and inflation, which spilled over into credit markets. In February, these were compounded by rising concerns that monetary policy is becoming less effective and may even work in the opposite direction to that intended as investors reappraised the longer term profitability of banks in a negative interest rate environment. The European Central Bank, which already had negative deposit interest rates, eased policy further at its meeting on 10 March. Despite growing concerns about the longer term effect and efficacy of such an extent of monetary policy, there is little doubt that it will provide support to asset values.

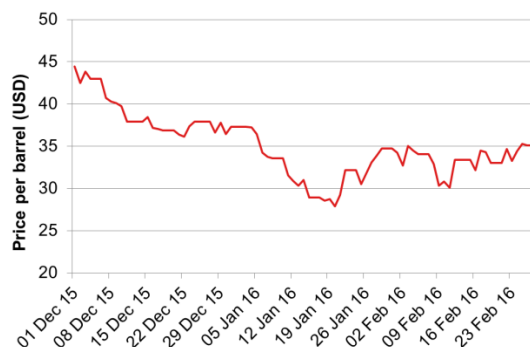
Against this background, safe haven assets continued to perform well. Government bond yields in Europe, Japan and the UK are at, or near, all-time lows, with Japanese 10-year government bonds now having negative yields, following the Bank of Japan's move to negative rates at the end of January. Despite a rise in yields in the second half of the month, as fear factors subsided, returns from government bonds were ultimately strong during February. In contrast credit continued to underperform, suffering from concerns over the slowdown in global growth and rising defaults in certain sectors, including commodities and emerging market debt. The more positive tone in markets as the month progressed, however, saw some recovery in corporate bonds, high yield and emerging market debt.

Figure 1. 10-year government bond yields, over 10 years



The market recovery from the worst period of performance since the global financial crisis can in part be attributed to a sharp turn in oil. Brent crude, having fallen to a low of circa \$28 per barrel in mid-January, has now recovered by over 45%. It is likely that several factors contributed to the turn, including IEA forecasts that shale oil production will fall by 600,000 barrels per day in 2016 and a further 200,000 in 2017. To date, there is no evidence that any production curbs are close to being agreed, with Iraq and Iran not prepared to participate. However the notion of tentative discussions on a production freeze, primarily between Saudi Arabia and Russia, provided a floor to prices. With shale production in decline and investment in high-cost production slashed, the prospect of a better balance between supply and demand is drawing closer. By early 2017 the current oversupply in the oil market is likely to be at or close to an end.

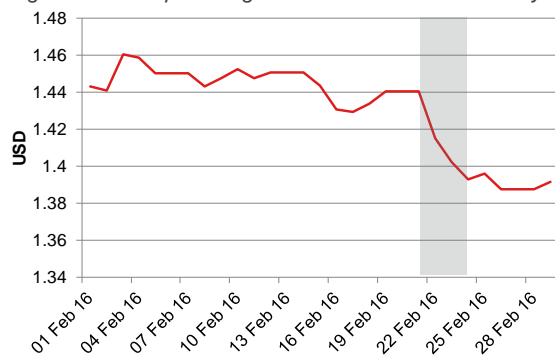
Figure 2. Brent crude price over 3 months



One main political development in February was the UK government's announcement of the EU stay/leave referendum for 23 June, leading to an immediate fall

in sterling and a prolonged period of uncertainty for the currency as a result. Despite the government's support for a stay vote, the poll is by no means clear cut. The leave campaign has some high profile cabinet ministers and a vote in favour of leaving would inevitably result in some short term selling of UK assets while the full implications are worked out. Although longer term the UK will prosper whether in or out, uncertainty is never the friend of investors in the short term.

Figure 3. British pound against the US dollar in February



It is evident that some of the post-crisis structural headwinds, in particular the high levels of debt globally, will keep growth subdued for some time. Similarly, the structural slowdown in China and the

severe cyclical downturn in many emerging countries and commodity markets have sent a negative pulse across the developed world, slowing growth further and increasing risks of deflation. These risks have re-priced very quickly into bond and equity markets however, and more recent data from developed economies has held up reasonably well; the US, UK, Europe and Japan should continue to grow modestly through 2016. Furthermore, some of the big factors hitting markets in the past year, including the oil rout, are showing signs of stabilising. For these reasons we believe that market fears in recent months are overdone. Central banks have become more accommodating and have made it clear that they will take further action to prevent economies falling into a deflationary spiral. While there are risks posed to the financial system by a slowdown in growth and deteriorating credit conditions, banks across the world are in a much stronger capital position than ahead of the global financial crisis, such that it is extremely unlikely that today's problems will cause a global systemic crisis. With valuations across many markets at much improved levels after the sharp falls of the past nine months, we believe that this represents a good opportunity to add to equity positions.

Source: Bloomberg. Returns in US dollars unless otherwise stated. February 2016.

2. Market performance

		To 29 February 2016	
Asset class/region	Index	Currency	Year-to-date
Developed markets equities			
United States	S&P 500 NR	USD	-5.2%
United Kingdom	MSCI UK NR	GBP	-1.5%
Continental Europe	MSCI Europe ex UK NR	EUR	-8.9%
Japan	Topix TR	JPY	-16.1% ^e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	-8.7%
Global	MSCI World NR	USD	-6.7%
Emerging markets equities			
Emerging Europe	MSCI EM Europe NR	USD	-1.6%
Emerging Asia	MSCI EM Asia NR	USD	-8.5%
Emerging Latin America	MSCI EM Latin America NR	USD	-1.0%
BRICs	MSCI BRIC NR	USD	-11.8%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	-6.6%
Bonds			
US Treasuries	JP Morgan United States Government Bond Index TR	USD	3.2%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	2.7%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.2%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-1.0%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	5.4%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.9%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	2.9%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.1%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-1.7%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	3.5%
Australian Government	JP Morgan Australia GBI TR	AUD	2.9%
Global Government Bonds	JP Morgan Global GBI	USD	4.4%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	3.1%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	-4.5%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	2.6%

Source: Bloomberg. ^e denotes estimate

		To 29 February 2016	
Asset class/region	Index	Currency	Year-to-date
Property			
US Property Securities	MSCI US REIT NR	USD	-3.8%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	3.0%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	-6.8%
Global Property Securities	S&P Global Property USD TR	USD	-4.2%
Currencies			
Euro		USD	0.2%
UK Pound Sterling		USD	-5.6%
Japanese Yen		USD	6.7%
Australian Dollar		USD	-2.0%
South African Rand		USD	-2.5%
Commodities & Alternatives			
Commodities	RICI TR	USD	-5.7%
Agricultural Commodities	RICI Agriculture TR	USD	-4.5%
Oil	Brent Crude Oil	USD	-3.5%
Gold	Gold Spot	USD	16.7%
Hedge funds	HFRX Global Hedge Fund	USD	-3.1%
Interest rates		Current rate	
United States		0.50%	
United Kingdom		0.50%	
Eurozone		0.05%	
Japan		-0.10%	
Australia		2.00%	
South Africa		6.75%	

Source: Bloomberg. e denotes estimate

3. Asset allocation dashboard

Positive	Neutral	Negative
Asset class	View	
Equities		
Developed equities		
UK equities (relative to developed)		
European equities (relative to developed)		
US equities (relative to developed)		
Japan equities (relative to developed)		
Emerging market equities		
Fixed Income		
Government		
Index-linked (relative to government)		
Investment grade (relative to government)		
High yield		
Loans		
Emerging market debt		
Convertible bonds		
Alternatives		
Commodities		
Property (UK)		
Currencies		
GBP		
Euro		
Yen		



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