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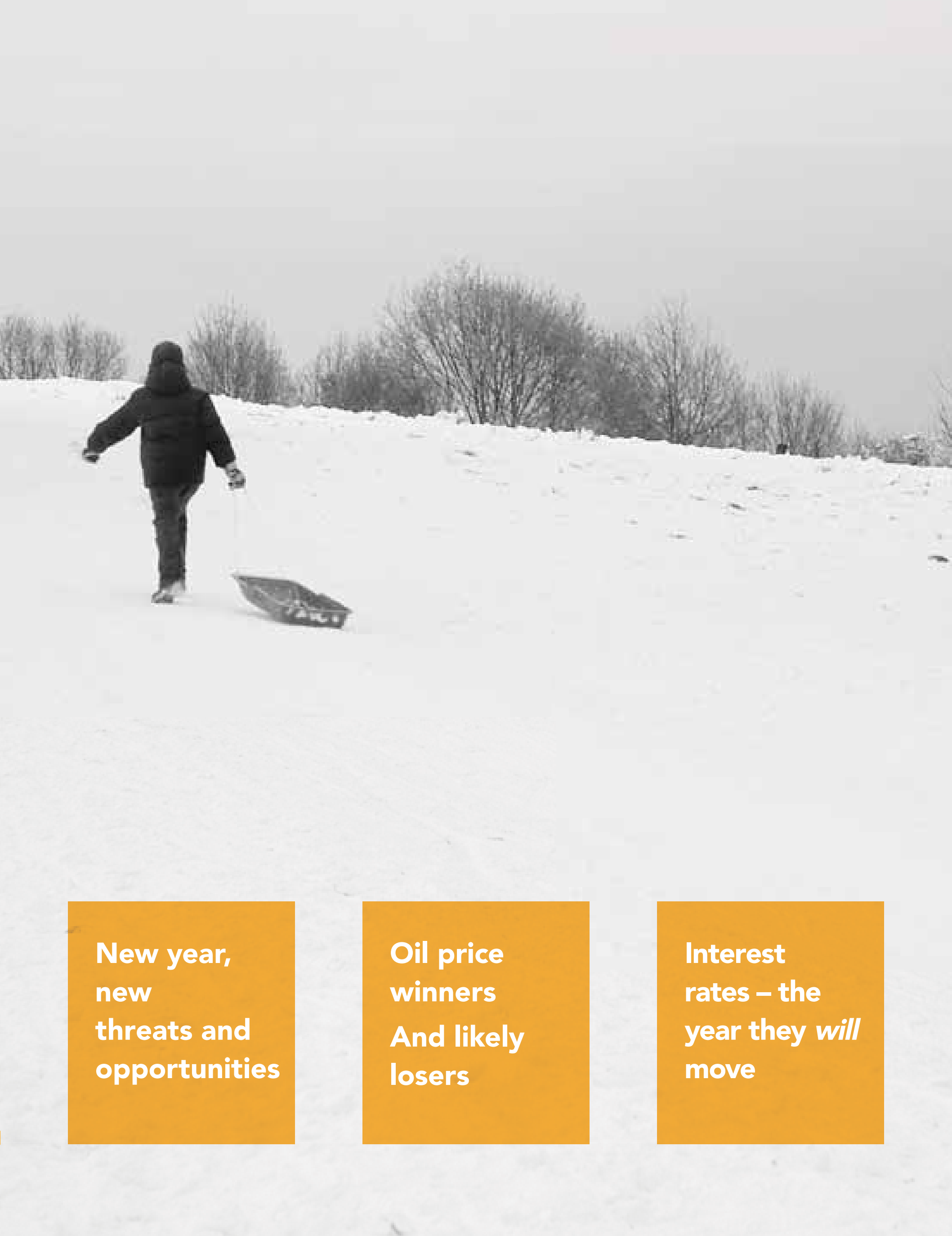
Investment Update

Winter 2015

Active Times



New year, new threats and opportunities

Oil price winners And likely losers

Interest rates – the year they *will* move

Overview

It has been a slightly exhausting year for investors, but somehow markets seem to have muddled through to create relatively modest, but perfectly acceptable, returns, particularly considering a world of exceptionally low interest rates and inflation.

Mark Robinson
Director
Chief Investment Officer

Sentiment has waxed and waned in numerous short bursts of optimism and nervousness: geopolitical issues, renewed eurozone troubles, a slowdown in China and the uncertainty over the timetable for policy change, (particularly in the US), have jostled with a relatively benign corporate backdrop and a wall of money still trying to find a more rewarding home than a bank deposit. It has not been an entirely comfortable ride at times, but staying invested has, yet again, proved to be the right policy to benefit from the sharp rebounds that have occurred – in the US, for example, the S&P 500 Index closed at an all-time high on almost fifty separate occasions during 2014!

We expect many of last year's challenges and opportunities to express themselves again during 2015. But in the short term there is a new distraction - a near 50% decline in the oil price for markets to grapple with. This has both positive and negative connotations but could cause the US and UK authorities to dither even longer about when to begin applying the monetary brakes, and accelerate the need for stimulus in places like the eurozone. Despite several risks, a further period of general upward market momentum is therefore quite possible in 2015.

Mark Robinson

1 January 2015

New year, new threats and opportunities

Earlier in 2014 it was the threat of an oil price spike (caused by geopolitical tensions and potential supply disruptions) that was the main concern for investors and various economic and monetary authorities; policymakers did not want to begin tightening the screw too early if certain economies were about to see their recoveries stall due to higher energy costs.

Now, however, a sharply declining oil price threatens to alter mindsets, creating speculation that the root cause may have more to do with a sharper slowdown in demand from energy-hungry emerging economies (such as China) than the fast changing dynamics of oil supply, particularly in relation to the production surge from Canadian oil sands and US shale. Certainly there should be some concern about China's ability to engineer a softish economic landing-consensus estimates for its economic growth rate have now shifted to below 7% for the coming year, a level investors seem to be coming to terms with. China could still upset the apple cart in 2015, but current signs are that a nasty slowdown in Chinese demand is not driving the recent slump in the oil price. The situation is, however, still unfolding and requires close monitoring.

Our view is that the large declines in oil and other energy costs are likely to replace monetary policy as the next stimulant to global growth, effectively redistributing income and wealth from oil-producing nations to oil importers, and onwards to consumers. Generally it is accepted that each $10 per barrel drop in the oil price translates into an uplift in global GDP of around 0.4%. If sustained, then we could be looking at a boost to global economic growth of around 2%, or even higher if the oil price continues to slide. There are some parallels here with the late 1980s surge in global economic growth, which was fuelled, in part, by the massive reduction in the oil price during the 1986 oil glut.

The full repercussions of a sustained low oil price on certain economies will become clearer as 2015 unfolds, but we are happy to have eliminated our emerging markets equity exposure in late 2013. We have not been lured in by the headline returns from high-yield or emerging market debt, preferring instead the relative security and slightly less exciting returns from actively-managed strategic bond and developed stockmarket funds. We expect to maintain this stance for the foreseeable future.

Oil price winners
And likely losers

Consumers, particularly American ones, are likely to be the main beneficiaries of the energy price slump as disposable incomes rise from this effective tax cut. Retail and auto sales are likely to see a boost, as will housing and (further down the line) inflation. In the shorter term, it should provide a further boost to US companies that are exposed to domestic demand.

Far from being vulnerable to a major setback after being one of the best performing stockmarkets in 2014, the US could actually deliver strong relative returns yet again in 2015 as it becomes more self-sufficient on its energy needs and puts clear distance between itself and other developed economies. For this reason we are content to retain, or even increase modestly, our commitment to the US stockmarket.

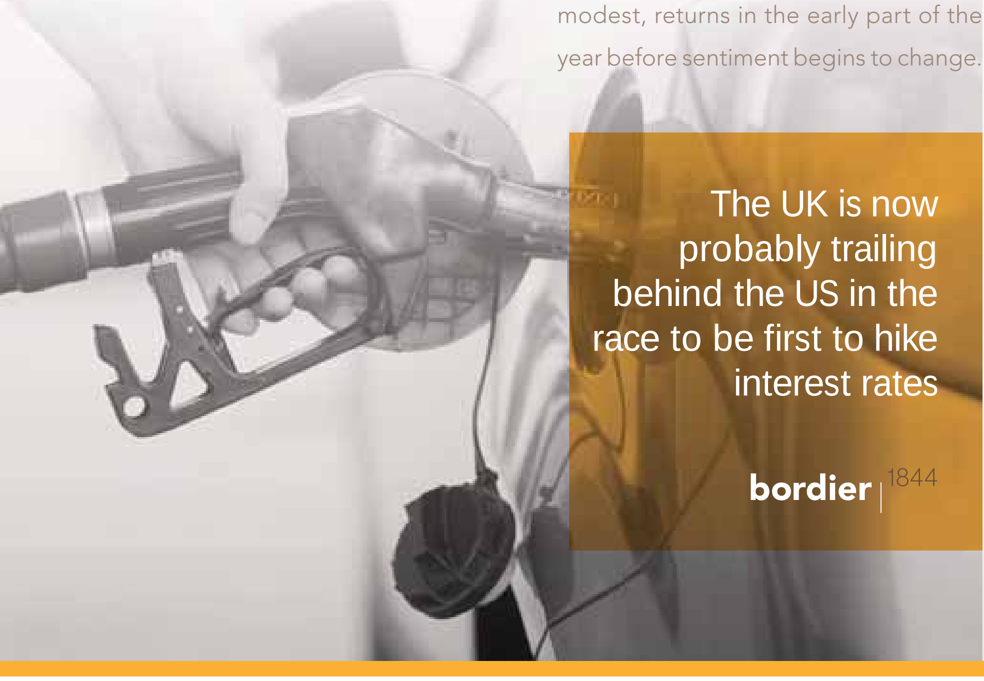
It is hard to direct the same positive sentiment towards the eurozone, where problems appear to have escalated in recent weeks: It is hard to direct the same positive sentiment towards the eurozone, where problems appear to have escalated in recent weeks: for example, Greece appears to be heading on a political collision course which could cause it to default on its financial crisis bailout obligations. Greece may only represent around 2% of the eurozone's GDP, but any loan default and exit from the bloc is not beyond the realms of possibility and could trigger wider social, political and market unrest within the region in the year ahead. Furthermore, the slump in oil prices also does little to assist the European Central Bank (ECB) in its quest to attain its 2% inflation target: it actually deepens the potential deflationary troubles within the eurozone and drives a further political and economic wedge between the stronger and weaker nations. It seems increasingly likely that the ECB will need to embark upon large-scale Quantitative Easing in the early part of 2015 to stimulate activity and fight deflationary forces, but somehow it will need to find sweeteners to appease or overturn the cautious mindset of key politicians, many of whom are thinking more about parochial issues than the eurozone's broader economic picture. To us there are good reasons why eurozone stockmarkets remain cheaper than most of their developed market peers – whilst the expected unleashing of QE should bring some much needed economic stimulus, just as it has in the US and UK, there are some fairly lengthy and tangled strings attached to this action, including a weaker currency. We are therefore less confident about the eurozone's recovery potential and its stockmarkets, and are inclined to reduce exposure slightly.

Interest rates - the year they *will* move

The issues surrounding the oil price and troubles in the eurozone have become a neat distraction from what is likely to be the main event in the first half of 2015, that of a hike in US interest rates. It seems that the period of speculation really is about to end now that the US economy is growing at a decent pace and the labour market has improved.

In theory, markets should take the eventual announcement in their stride, particularly since it has been signposted so well; markets also seem to have warmed to the US Federal Reserve's guidance and reassuring vocabulary that it will take things steadily. The past year, however, has shown just how fickle markets can be - we can still expect markets to remain quite nervous even though any small hike in interest rates will essentially be a symbolic one, marking the start of the next phase of this rather unconventional and drawn out economic recovery.

The UK is now probably trailing behind the US in the race to be first to hike interest rates: consensus has now shifted to late 2015 or early 2016, largely due to a meandering economy and a wavering Monetary Policy Committee. As May's General Election draws closer, the MPC may find it hard to retain its independent thinking, with politics subconsciously becoming another excuse for delaying a rate rise. Whatever the reason, the UK could enjoy another year of stimulus and relative stability on the interest rate front. This could allow bond investors to generate further respectable, albeit modest, returns in the early part of the year before sentiment begins to change.



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Our plan for the year

As we enter a phase of divergent monetary policy and potentially face some new uncertainty thrown up by lower energy prices, retaining a flexible approach to investment remains our mantra for 2015. This extends beyond owning actively managed funds to taking active decisions on asset allocation. For the time being we are content to stay with as full a commitment to stockmarkets as risk parameters allow, although we are fine tuning portfolios to reflect some underlying market strengths and weaknesses. However, we are also prepared to rein in stockmarket exposure if valuations become too stretched or changes to the economic or geopolitical landscape suggest a more prolonged period of market weakness than we currently anticipate.

Bordier & Cie (UK) PLC

79 Pall Mall
London
SW1Y 5ES

Telephone: +44 (0)20 7667 6600
Facsimile: +44 (0)20 3427 5400
Email: enquiries@bordieruk.com
Website: www.bordieruk.com

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