CHESHIRE
WEALTH MANAGEMENT

Global Markets Bulletin

Quarter 4: 2015

General Economic Overview

The final quarter of 2015 has continued the themes of the previous two quarters, delivering higher levels of volatility, with key concerns being the general progress of global growth and a mixed picture across different continents and regimes. The key factors of late have been the potential hard landing for the Chinese economy the continued fall in commodity prices, particularly oil, and the reluctance, until December, for the US to raise interest rates. Despite this level of uncertainty markets have improved from what seemed like a substantial sell off in the third quarter. The sell-off was perhaps too large and investors saw an opportunity to buy back in at subdued levels. Uncertainty remains economically however, helped by a divergence of monetary policy between Anglo-Saxon economies and the rest of the world and between the service-led economies and those more dependent on manufacturing. Many separate factors have combined to deliver this current picture of uncertainty.

The increase in interest rates by the US Federal Reserve ushered in the first period of monetary tightening in the United States since 2006. In recent years Central Bankers have been faced with a dilemma in that whilst the real economy has remained weak with a sluggish recovery, ZIRP (Zero Interest Rate) policies together with QE have led to buoyancy in asset markets and fears of a bubble. At times it may have seemed that the world's leading Central Banks couldn't win, in that tightening too early could plunge the world back into recession, whilst tightening too late could have further encouraged asset bubbles. A further factor behind the Fed's decision must be a view that with rates close to zero, there is little ammunition to deal with another downturn as and when it occurs in the real economy. Whilst this time at least the first Fed rate rise was well telegraphed and therefore caused little initial apprehension in markets, the debate will now turn to how fast and how far interest rates will rise. The Fed try and give forward guidance with their dot charts which forecast rises of 1% per annum over the next few years and a likely peak in the Fed funds rate in the current cycle of 3.5% or just below. In contrast stock market and fixed interest participants believe this level of tightening is more aggressive than will occur and the market is pricing in a much shallower path for rate rises.

There is also much talk of a China slowdown and how this will impact on the developed world. In October we discussed how China's rebalancing of its economy and the move away from fixed asset investment was likely to be seen in commodity exporting countries.

Emerging markets are now more important to the global economy than ever before, accounting for around 38% of nominal GDP, but over 50% of world GDP at purchasing power parity. One of the factors overlooked by investors in 2015 has been the impact on the developed world of an emerging market commodity led downturn. Terms of trade for all commodity exporters including those in the developed world such as Australia have worsened significantly. Many commodities such as iron ore and coal look likely to remain in significant surplus for many years to come.

The global economic outlook is one of the most important drivers of the stock market, and in 2015 one of the stock market negatives has been the pull back in earnings expectations for the current year. Both the US and UK started with consensus expectations at around +10% for company profits with the likely outcome flat to slightly negative in the States and a decline of 8% in the UK. Some commentators state that this is driven solely by declines in the resources sectors of oil and mining, arguing that excluding these company's profitability numbers makes the data look much more robust, but excluding the bits of the market that decline is always likely to see a positive earnings number.

One of the features of the last six months has been the divergence in data between manufacturing and services. It is services, not just in the US and UK, but also in places such as China that have seen the strongest growth. Overall, looking at the developed economies of the US, UK, Europe and Japan recession risk looks low. In China, whilst the manufacturing PMI has been declining this year and sometimes below the 50 level (which marks the difference between expansion and contraction) service sector purchasing manager indices have continued to show expansion. Within China a fine tuned, but modest stimulus programme has been put in place with some acceleration of well costed infrastructure projects that are expected to deliver a positive return on the capital spent.

Today, all investors are facing up to quite a different investment regime. The expected decrease in overall debt levels following the financial crisis has not occurred – this was highlighted in a study by McKinsey which stated global levels of debt were actually higher now than in 2007. The world is likely to continue the process of deleveraging, which means growth and inflation will be lower than in previous economic upswings - not necessarily bad news, as it is likely to result in a longer and steadier business cycle. Low interest rates have enabled markets to be comfortable with higher levels of valuation than have occurred historically, but growth is sluggish and even a small pull back in economic activity can induce recessionary fears and this is a factor behind today's more volatile stock markets.

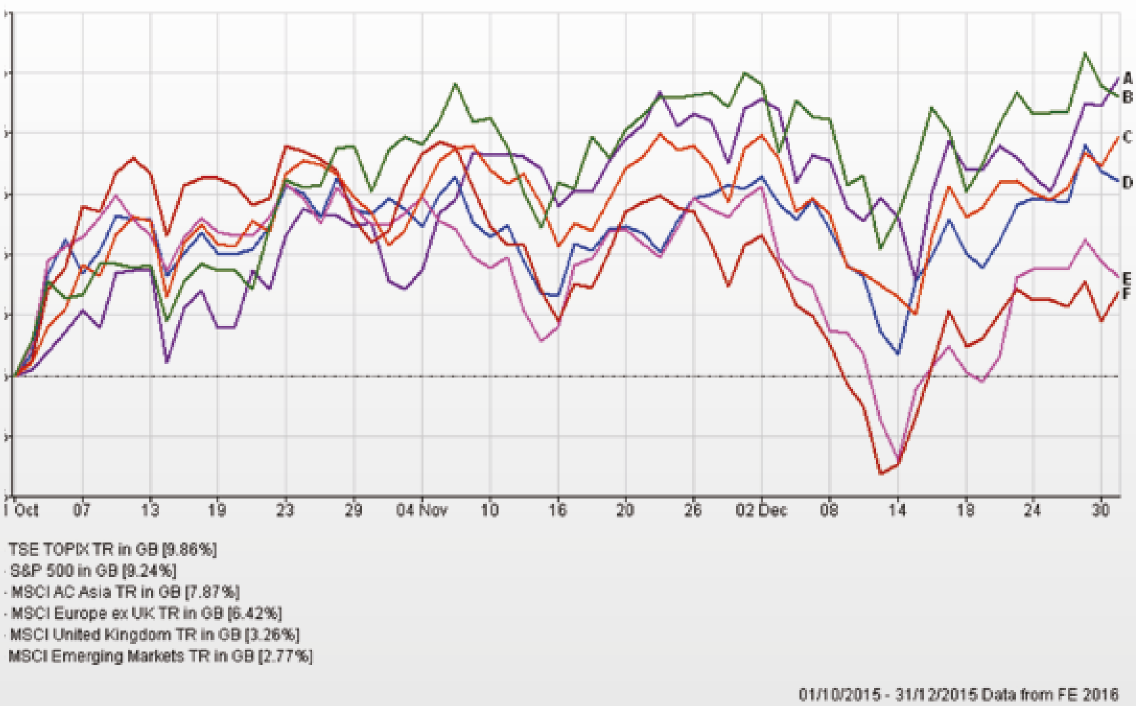
As we look forward into 2016 the last quarter of 2015 has been relatively unremarkable, short of the more recent rise in US interest rates. The issues at the forefront of investor minds at the beginning of the quarter remain, with question marks over the sustainability of global growth and the ability of central banks to create much needed inflation whilst reducing the dependence on QE. There are divergent monetary strategies being engaged as rate rises in the US contrast with reducing rates in Asian and emerging economies. Europe and Japan continue with QE whilst the US and the UK no longer apply the strategy. The effect of these changing policies will cause investors difficulty in selecting where to invest in 2016 not least of which will be the choice between equities and fixed interest holdings.

The final quarter of the year saw markets recover strongly with the influence of economic uncertainty reducing as investors saw value in what appeared to be an oversold market. Valuations are a key metric for most investors in judging whether to invest in a company, and at the beginning of 2015 markets generally looked fully valued, particularly western markets such as the US and the UK. This changed over the final three quarters as markets fell back on the economic uncertainties we have previously described. This can provide opportunities but today there are no really cheap valuations in western markets, although globally parts of Asia and the emerging world may offer more value. Looking at company level, the situation is complicated by the divergence in valuations for different types of businesses. Market participants

Equity Markets Overview

Chart showing 2015 year to date returns for major market indices:

Chart showing Q4 2015 returns for major market indices:



learned in 2007/08 that problems from one area of the market place (in that case it was property and corporate debt) can spill into assets that do not appear over-valued. In 2015 the impact on the global economy of the slowdown in export commodity producing nations was underestimated by market participants throughout most of the year. The strongest performing market in 2015 was Japan (+18%) the worst emerging markets (-10%) the remaining key markets were generally positive with the exception of the UK which was slightly negative given the main markets higher weighting to energy and resource stocks.

There has also been a huge difference between economies and stock markets. Reinhart & Rogoff argued in their study of the Financial Crisis, that a financial recession always results in a lukewarm economic recovery, but we have seen extraordinary policies adopted by the major Central Banks ensuring that the world did not slip into a 1930's deflationary type scenario. Zero interest rates and QE have resulted in a fall in the discount rate applied to stocks justifying a higher present value for future company earnings. PE multiples have expanded faster than most investors would have expected and reached elevated levels at a fairly early stage of the current bull market. 2016 will be a year when the US stock market, which has considerable influence over all others, sees higher rates. At the fundamental level this is likely to lead to a contraction in the PE multiple on the US market as the discount rate for future company earnings moves higher. Whilst previous periods of US monetary tightening have, after an initial setback, seen further gains, the tightening this time round is first occurring when both the economic, and certainly the profit cycle, is much more mature. Also as the world factored in higher interest rates on stock market valuations in the second half of the year, this occurred at a time when earnings growth globally was negligible.

Stock markets need to see a validation of growth – reassurance that what we are currently seeing is merely an economic soft patch rather than the precursor to a fall into recession. It seems certain that the multiple expansion or higher PE ratios which have driven the gains in markets following the financial crisis, will not occur in 2016 in developed world markets. For markets to push through last year's April highs stronger evidence of company profit growth must be delivered. The last five years have been a lot better for Wall Street than Main Street and the next few years may see a reverse of this.

UK

The UK has been growing steadily over the last few years and has been robust in its resilience to economic uncertainty in other areas of the world. The one downside for the UK market is that the leading stocks in the benchmark FTSE index tend to be commodity related and therefore the market is over exposed to this area which in a commodity downturn can act as a drag on the overall market. The more domestically focused mid and small cap areas of the market have fared far better than the larger cap stocks. Company data remains positive although earnings data needs to improve to see markets move on from current levels. In the UK the PE multiple has increased from around 10x-11x at the time of the Financial Crisis in Spring 2009 to 15x today. In 2015 the market PE has risen as earnings expectations have been pulled back and this lack of clear profit growth that is contributing to market volatility. Historically this sort of level of valuation in the UK market has produced positive real (after inflation) returns of around 5% p.a. in most decade long periods, although there have been some outliers to the downside rather than the upside. The trailing PE ratio on the UK stock market in both 1999 and 2000 was over 20x – this level of valuation has never produced a happy outcome for investors over the next decade because, whilst at the time the economic news flow is positive, over a 10 year period economic cycles occur and investors suffer a de-rating from expensive levels when a recession occurs. The expected growth rate of the UK economy in 2015 is expected to be one of the highest in western economies which bodes well for 2016 but is like many, dependent on continued global growth and in the case of the UK, European growth.

US

Although the US waited until December to raise interest rates, economic data in previous months had already given them enough evidence to back this up - unemployment data continued to surprise in October and November indicating that rising wage pressure was likely to follow. The valuation on the US market is more expensive than the average, and this is especially pronounced looking at the Shiller cyclically adjusted PE ratio. Some powerful positives for US market valuation are now reversing such as the ending of QE and a turn in the interest rate cycle. The strength of the US market has been based on an increase in earnings coming from company buy backs rather than revenue growth, another trend which may reverse. There are some who

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argue that there is an unconvincing handover to self-assisted growth in the States. Even the US has had to contend with unexpected problems over the last twelve months - the decline in the energy price has resulted in a significant slowdown in that sector and a resultant fall off in capex amongst resource orientated businesses. Whilst this is good for the consumer over the long term, so far corporate capex outside the resources sector has not strengthened sufficiently to make up for the decline in resource oriented capex in 2015.

As is usual, there are plenty of economic doomsters that feel we are about to see the start of a US bear market. One of the factors behind this is that we have had a long bull run, and indeed the market upturn that commenced in 2009 has been one of the longest in history. This once again needs to be viewed within context. The 2009 upturn followed on from one of the most savage bear markets in history, a period now termed as the Great Recession, so from this a longer, but more subdued recovery was always a possibility.

Europe

Europe is a divergent economic landscape that has seen some of the strongest and some of the weakest recovery stories. Germany continues to be at the heart of European recovery but even here there have been some weaker than expected data. There have been some equally positive recovery stories, Spain and Ireland alongside struggling nations such as Greece and Italy. The continued need for QE from the central bank illustrates the conundrum for policymakers in the region but for the time being this is helping keep all boats afloat whilst the weakest move onto a more stable footing.

Overall we can see that the economy has continued to recover, and positive macro fundamentals are now finding their way into company profits. The recovery has been most pronounced in the periphery nations, but even core Europe has seen an improvement in economic data. The profit cycle in Europe continues to lag the US and UK and therefore cyclically adjusted PE ratios are much cheaper than in the markets that have led the recovery. As long as the world avoids recession European companies have the scope to further increase profit levels, which should continue to benefit investors. Today Europe has been one of the few major regions to see improvements in profit estimates, so it should be no surprise that European equities have outperformed the US this year

Asia

We would find it difficult not to focus on China in this section as much of the economic uncertainty we have experienced in the last six months has been because of worries over Chinese growth. The move from an exporting nation to a more domestically focused economy was clearly identified in the governments five year plan and it was also anticipated that the double digit growth rates would decline. The worry for many was that the slow down would lead to a hard landing rather than one that was carefully managed. At the practical level in China this number is not really that important as China it is a One Party state with the pre-eminence of the Party driving all policy decisions. In other words anything that could adversely affect the Party's control on power will be dealt with as a matter of priority. For the ordinary worker in China the world is not about GDP growth, but living standards, air quality, food safety and children's education. Wage growth, which has averaged 10% - 15% in recent years doesn't make up for all of these softer issues. The tackling of the corruption issue however has been a positive as people have felt the system was becoming unfair.

During the summer months external sentiment to China was not helped by the government mishandling of the exchange rate issue and interference in the 'A' share market. It now seems China has moved to a policy of following a basket of all major currencies including some in Asia, rather than a strict peg to the US$. In some ways this move to a basket seems a natural progression for the Chinese currency, as it becomes more convertible to enable it to become part of the SDR. The service sector still continues to grow strongly and the improvement in activity could actually be higher than 10% - services now account for close to 50% of the economy. Education, financial services, software and R&D are growing rapidly. This change of the composition in growth in China means the often looked at Li Keqiang Index may not be the most appropriate way to measure economic activity in China today.

As China continues to move over the longer term to a more service based economy, the sort of names that benefit from this are likely to be long term holdings in successful Asian portfolios. Next year in China there is likely to be a continuation of the trends of 2015 with a two speed economy, with a little more help from the export sector if the recovery continues in the US, Europe and Japan.

As China rebalances away from fixed asset investment driven growth, commodity exporters (many of whom are emerging market countries) will continue to find economic conditions difficult. Those Asian countries running current account deficits at a time of tightening US monetary conditions have, as one would expect, been worst hit. In general lower commodity and oil prices are a plus for the developed world and most of Asia. The ASEAN countries which have current account issues have seen currencies come under pressure and have therefore underperformed.

The stronger US dollar has not been a positive for many Asian economies especially those with higher debt to GDP ratios but this has been a theme for some time. India remains the most exciting long-term story in the region. Prime Minister Modi is continuing to drive the reform process forward and whilst there has been some disappointment with the pace of reform, India is a democracy and therefore decisions take time to enact. The most important reform bill is the nationwide GST (goods and sales tax) which will hopefully be passed in the first quarter of 2016. India continues to have the potential to be a global centre for low cost manufacturing and as the country continues to catch up with more developed countries in Asia the consumer remains an excellent long term story.

Markets in Asia have suffered as earnings expectations have been pulled back partly but not solely due to the slowdown in certain parts of the Chinese economy. Arguably the impact of the current change in China is far more negative for commodity exporting regions, with Asia a net importer of most commodities including oil. Returns for some markets have been depressed by adverse moves in currencies namely Australia and the ASEAN region. After the market setback valuations in Asia are trading at depressed levels offering value to medium term investors.

Japan

In Japan market volatility has continued, perhaps resulting from the lack of depth of domestic institutional buyers of Japanese equities. Despite the volatility the overall market environment continues to see an improvement in macro and micro fundamentals. The economy has weathered the effect of the first increase in the sales tax and also the slowdown in China. Micro fundamentals remain positive and Japanese companies are continuing to improve their corporate governance and attitude to minority shareholders. A new pension fund index includes measures looking at a company's ROE for inclusion, so the days of Japanese company management ignoring the needs of outside investors seem well and truly over. In marked contrast to the 1980s and early 1990s the valuation on Japan is no longer expensive when compared with other international markets.

Japan has been the focus of a number of investors' over-weights in 2015 and to a larger extent this investment will have paid dividends even without any currency hedging, which would have only had a small effect in 2015. The structural reform programme continues but needs to achieve greater acceptance across a wider base of companies and domestic investors to keep the momentum. Inflation has been achieved but not yet at the levels set by the government and this remains a goal that they need to maintain.

Emerging Markets

In the emerging world Asia Pacific is a major beneficiary of lower commodity prices, unlike Latin America or Russia. Valuations across the board came back in the summer sell-off and selectively value is appearing. There is a marked contrast between companies benefitting from the strength of the service sector such as outbound tourism and increased levels of consumer spending, compared to those countries/companies reliant on strength in commodity prices. In the previous section on Asia we looked in depth at China as a guide to the region - reflecting the impact that China has on the rest of the world which is now significant. The most obvious effect is on commodity exporting nations such as Australia or Brazil and many of these countries slackened off on the reform process during the commodity super cycle and are now having to re-trench more aggressively.

The most striking example is Brazil where the recent resignation of conservative Finance Minister Levy sent further shudders through both the stock market and currency. There are now fears an already ballooning budget deficit in Latin America's largest economy will deteriorate further. Brazil sums up what is at fault with many economies in the emerging world - a combination of over-reliance on strong commodity

Fixed Interest

Chart showing 2015 returns for major fixed income indices:

Chart showing quarter four 2015 returns for major fixed income indices:

prices (not recognising that in this market commodity producers are price takers not price givers) and the debilitating effects of high levels of corruption on economic activity and foreign investor confidence. Brazil's economy has suffered a dramatic decline in 2015 with economists now forecasting a contraction in economic growth of 3.6% and a further 2.7% in 2016 while inflation is expected to reach over 10% this year. This is well ahead of the Central Bank's inflation target of 4.5% +/- 2% which is likely to lead to further rises in interest rates.

Emerging markets are a significant part of world GDP and an ever increasing influence on global trade and therefore need equal attention when assessing the prospects for global growth. The fears of US rate rises and a slowing China definitely mean many areas will struggle but equally there are some strong areas of growth such as India or Indonesia. In India political strength and a reformist agenda look to transform what is termed the next China.

Emerging markets have become a net detractor to global trade growth in 2015 for the first time since the GFC and many that have seen a sharp depreciation in their currency do not have a strong enough export base to benefit from currency weakness. As a result they have capped imports as these have become more expensive. Interest rates have started to rise and have had a negative effect, particularly on those more indebted countries, but much of this was anticipated and markets only fell little on the news. It will be more difficult to predict how subsequent rises affect the strength of these economies.

2015 has been a bear market for UK and US government bonds with a rise in yields in most maturities. In contrast bond markets in Europe have benefitted from QE and the cutting of interest rates to negative levels, German government bonds now have negative yields out to six years, something that experienced fixed interest investors could never have contemplated pre financial crisis.

There has been reasonable stability in investment grade corporate bond spreads in the UK and Europe, but the US has suffered from companies issuing huge volumes of debt in anticipation of rising interest rates. US high yield bonds have had a poor year as the sector has around 20% exposure to energy - an area of the market where there are considerable levels of distress, and defaults are likely to rise significantly in resource companies during 2016. Local currency EM debt has also struggled as the Chinese rebalancing and slowdown has resulted in commodity exporting currencies taking the strain. Investors in this part of the market have also suffered currency losses as local currencies have seen significant declines. In the last month some US mutual corporate bond funds have announced closures and whilst the corporate bond market is not as liquid as it was, these particular funds were focussed on the riskier most illiquid names in corporate debt often in the junk bond sector. The lowest quality end of the high yield market looks a place to avoid.

The outlook for fixed interest in 2016 is challenging - in almost all developed countries, interest rates have bottomed and as a result generating sustainable returns from fixed interest will remain highly challenging. In a low growth economic scenario the prospects for tightening investment grade corporate bond spreads appears positive, although in high yield, investors need to approach the sector on a stock by stock basis.

For a number of years now, fixed interest markets have enjoyed the benefits of QE which is the process by which Central Banks inject cash into economies by buying huge amounts of government debt. This has also had the effect of lowering bond yields in an attempt to drive down the cost of capital for businesses. At some stage, although not in 2016, investors will have to face up to the prospect of an end to QE globally and Central Banks at the aggregate level selling bonds and shrinking their balance sheets - labelled by some as an eventual move to quantitative tightening. There is also the prospect of further selling of, for example, US Treasuries by emerging market sovereign wealth funds in a bid to gain access to dollars at a time of slowing economic growth and currency weakness.

All in all a cautious approach to fixed income looks sensible, with the potential for a modest tightening investment grade credit spreads for longer term investors. At today's levels exposure to credit seems a prudent option for investors in fixed income, but due diligence needs to be completed on the fund groups selected as, particularly in high yield, defaults are likely to impact negatively on the passive index.

Property

The UK commercial property market continues to produce good, consistent, positive returns, although the monthly returns are slightly moderating from those seen in 2014 and earlier in 2015. Returns are expected to remain strong through into 2016, although the absolute number for this year is likely to be lower than 2015. Investors may still be looking for an income alternative to their fixed income allocation but the strong returns may also be due to the relative stability of the UK economy. Direct property should continue to be a good diversifying asset class during these uncertain market and economic conditions with returns driven mainly by the yield. Capital growth returns may remain strong over the short-term but this is expected to weaken with rental growth becoming a larger driver of total returns. There are continuing concerns that the highest quality assets are looking overvalued, particularly in London, but they are likely to continue being a relatively safe haven due to continued strong demand for this type of asset. There is increasing investor interest in secondary markets with the yield gap versus prime property looking attractive but individual property selection will remain important here.

The property securities sector will continue to be influenced by the outlook for interest rates, economic growth levels and the outlook for property and equity markets in general plus investor sentiment is likely to be another factor over the short-term. That said, local market factors typically have a larger influence on this sector than for the main equity indices and these should also be taken into consideration.

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Summary

The final quarter of the year has been more positive for overall market returns but the concerns with which we entered the quarter still remain, the exception being that we have finally seen interest rates start to rise in the United States. The rate rise itself was much anticipated by markets but the progression of rate rises that follow will have a more significant effect on markets in 2016.

At a time of rising interest rates, stronger earnings growth is required to reassure equity markets and allow sustained progress from current levels. Whilst during the summer markets suffered a general concern about the levels of economic growth, volatility in recent weeks has been the result of lower commodity prices and the prospect of higher interest rates. Company earnings growth needs to be strong enough to absorb the likely losses from PE multiple contraction. Whilst the developed world recovery will continue, corporates are already enjoying margins at record peak levels and higher wages may eat into this. In the UK in particular, companies will face significant increases in the level of the minimum wage over the next five years. Inflation today remains benign, but this partly reflects the masking of service sector inflationary pressures through lower commodity prices. A stabilisation, or a hard bounce in commodity prices, could see a more rapid pickup in inflation than market participants expect.

Overall, for most stock markets, and especially those trading at a premium to historic valuation levels, stock market gains at best will only match earnings growth. Some regions of the world offer better value than others - Europe, where the profit cycle still has a long way to catch up with the US; Japan where reform at the micro level and a weaker currency will aid profitability and Asia Pacific where valuations have fallen - offer investors the best equity market prospects. Overall valuation levels and a move from highly accommodative to merely accommodative monetary policy in certain areas suggest cautious positioning by investors is warranted. Volatility in markets means it may pay investors to be more tactical than at the start of the economic and stock market cycle in 2009.

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Most asset classes have both challenges and opportunities which continues to promote portfolio diversification – for example, it is not clear whether a more rapid tightening of monetary policy than expected would impact more negatively on bonds than equities due to the high level of valuations today. Selective exposure to equities, especially focusing on managers with a strong record of stock picking, gives a reasonable prospect of returns ahead of cash although with greater levels of volatility than in recent years. Within fixed interest, government bonds are likely to remain under pressure as monetary policy in the States tightens, but the prospect for a reduction in credit spreads suggests strategic bond funds still have the potential to deliver returns ahead of cash.

The next few years may indeed usher in an era where slow but solid economic growth continues, but also a time when Main Street can prosper at the expense of Wall Street.

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