



Whilst we don't usually produce a monthly commentary that discusses how markets in general have performed, 2014 has been such an extraordinary year that we believe it is certainly worth taking the time to review. From geopolitical risk (Russia/Ukraine and the rise of IS), central bank policy shifts (Quantitative Easing coming to an end), Scottish referendum, a weakening Eurozone, various key elections and plummeting oil prices, there have been some major factors that have shaped investment returns over the year. We've therefore provided a general summary of these factors and given our views as to the prospects for various investment themes in 2015.

## UK

It was disappointing to see the UK market finishing the year lower than it started in 2014, with the FTSE 100 down 2.71% after a volatile year for UK equities. With c14% of the FTSE 100 made up of energy companies, the 40% fall in the oil price in the last 3-months has been a significant contributor to this underperformance. Late concerns surrounding the prospect of Scotland voting for independence also contributed to increased volatility despite continued strength in the domestic economic recovery.

Despite this, there have certainly been opportunities for investors in the UK market and the UK economy was one of the fastest growing in the G7. With falling unemployment and interest rates remaining at record low levels Sterling had been very strong against the US Dollar earlier in the year, however this trend reversed in the second half and our decision in 2013 to focus more on Dollar listed investments has finally been rewarded. We remain bullish on the prospects for US Dollar vs Sterling in 2015 but more of that later.

*The UK faces another vote this year as the general election takes place in May. This is likely to create major uncertainty, and therefore volatility, for both Sterling and indeed for UK equities in the build-up. We see the recent sell-off due to the decline of oil majors in particular as a possible buying opportunity but until we have more certainty surrounding the UK election we feel uncomfortable increasing our allocations to UK equities at this time.*

## US

In the US, all eyes were on new Federal Reserve (FED) Chairman Janet Yellen as investors tried to gauge the speed at which the FED's Quantitative Easing (QE) program would be "tapered" with the process having begun in December 2013. Yellen maintained a "slow and steady" stance, finally ending the process in October 2014. Removing the punch bowl didn't prevent a strong year for US equities as the S&P 500 broke through 2000 for the first time, finishing up 11.39% in local currency terms. This positive market move makes sense to us because removing QE demonstrated that the FED was confident that the US economy was in good shape to handle it. Certainly the flood of positive economic data emanating from the US backs up this move. A significant reduction in US unemployment was a key factor and this has now fallen to 5.8% as non-farm payrolls grew faster in 2014 than in any of the last 24 years. Corporate earnings were also strong with 74% of S&P 500 companies reporting earnings ahead of expectations in Q3 (compared with the long term average of 63%). This continued strength and positive outlook left investors wondering when interest rates might start to be raised in earnest and as a result the main beneficiary throughout 2014 was the US Dollar which gained 6.34% on Sterling over the year, helped in part by fears over currency sharing ahead of the Scottish referendum.

*We expect more good data over the months ahead and we also expect US corporate results to be strong. We remain supporters of the US Dollar and major supporters of US equities for the time being.*

## Europe

The Eurozone proved a major drag on sentiment in 2014 and was a significant contributor to the volatility that we experienced in the second half of the year. Germany narrowly avoided slipping into recession (2 consecutive quarters of negative growth) mid-way through the year with France also making a narrow escape. German GDP expanded 1.4% for the year while France could only manage 0.4%, dangerously close to contraction. Political quarrels over fiscal spending have helped to compound negative confidence in Europe as France and Italy sought leniency over their EU budget targets while Germany are still insistent on balancing their deficit in 2015.

The question of interest rate rises and tightening monetary policy in the US was in stark contrast to the problems facing European Central Bank (ECB) Chairman Mario Draghi. Draghi's concerns have centred on the stagnant growth of the Eurozone and solutions to prevent the region falling into deflation. Despite a series of interest rate cuts the most recent figures show that prices in December fell 0.2%. With benchmark interest rates now at 0.05%, Draghi appears to have run out of room and will need to focus on alternative measures to improve growth in the region. One such option unveiled this year was the new Targeted Long-term Refinancing Operation (TLTRO) which was set up to provide cheap fixed rate loans to banks in the hope that they would start lending more to credit starved smaller businesses. Unfortunately, take-up by banks in both September and December was poor especially in northern Europe. The struggle to find attractive investment opportunities and the prospect of housing idle cash with the ECB at negative interest rates is likely to be behind the lacklustre participation.

Growth prospects in Europe were further damaged by the conflict in Ukraine. Russia's annexation of Crimea led to demonstrations by pro-Russian and anti-government groups, which descended into armed conflict in Eastern Ukraine. The move triggered heavy sanctions on the Russian economy and the impact on markets was especially painful for the Eurozone. The ripples of the crisis were felt hardest in Germany, Europe's juggernaut. Germany obtains one-fifth of its coal and a quarter of its oil from Russia. Western sanctions on Russian conglomerates' oil exploration threatened to endanger Russian production and the retaliatory sanctions by Vladimir Putin on Europe – embargos on imports of consumer goods and second hand cars – added to German woes. Russia is Germany's fourth most important export market and exports to Russia declined by 26.3% in August 2014 from a year earlier. Although only accounting for around 3% of German exports overall, the crisis in Russia helped to instil fear in business confidence throughout Germany and the wider Eurozone. Russia saw its currency (Ruble) plunge 44% vs the Dollar and its stock market slumped 6.57% in 2014.

*There have been suggestions that Eurozone equities are now starting to look better value however the Euro continues to tumble and any further weakness in the outlook for the German economy may trigger fresh equity market falls. In addition, further escalation of the crisis in Ukraine will create more nervousness and we prefer to seek out other opportunities for investment because of the number of "unknown unknowns" in the Eurozone.*



## Japan

As Draghi debated the use of more extreme measures in Europe and the US ended its QE program without surprise, the export driven Nikkei 225, helped by a weakening yen (which fell 8.83% against the Dollar in 2014) increased by 7.12% in 2014. However earlier in the year, the misguided consumption tax increase in April led to second quarter GDP shrinking by 7.1% on an annualised basis and sparked concerns about whether Prime Minister Shinzo Abe's "Abenomics" would be enough to rid the country of decades of deflation. The move by the Bank of Japan to increase the annual pace of its own government bond purchases by around 30 trillion yen certainly helped and fearing the effects of an additional sales tax increase in October 2015 on an already fragile economy, Abe announced a delay to the tax in November and called for a surprise snap election as he sought renewed confidence in his ambitious plan. When the Japanese took to the polls in December it was a vote of continuity for Abe as he retained power and can now look to continue the implementation of structural reforms – dubbed the "Third Arrow" – in order to shake up Japan's rigid labour market and overhaul Japan's poor corporate governance going into the New Year.

Also helping sentiment in October and fuelling confidence in the Japanese stock market was the announcement by Japan's national pension fund that it would invest half of its assets in stocks, including a doubling of its weighting to domestic equities. This could all lead to more positive momentum in 2015.

*We took the opportunity in November to increase our exposure to Japanese equities and with the positive election outcome for Mr Abe in December our confidence on the prospects for the region have been further reinforced. Japan remains a key part of our investment strategy going into 2015.*

## Emerging Markets

After a turbulent 2013 for Emerging Markets (EM) there were a number of encouraging developments which helped the MSCI Emerging Market index to a positive – albeit low (2.55%) – return in 2014. With the election of Narendra Modi in April, India has embarked on an ambitious program of economic reforms as it looks to rein in inflation, stabilise the rupee and strengthen foreign currency reserves. On the news of Modi's election win, foreign investment in Indian listed equities surged, helping the Sensex (India's main stock market) to a 35.2% return in Sterling terms.

Another country facing an election in 2014 was Brazil. Throughout the summer the Bovespa (Brazil's largest stock market) helped contribute to EM returns as investors suspected an upset from the more business friendly Marina Silva (eventually finishing 3<sup>rd</sup>) and looked to buy early ahead of potential reforms. When incumbent Dilma Rousseff was crowned victorious the markets reacted badly losing nearly 3% on the day of the result.

The continued fears surrounding a slowdown in the Chinese economy have also helped to compound difficulties facing commodity driven countries such as Brazil. The Chinese economy grew by 7.3% in 2014, a far cry from the 10.4% it returned in 2010. However despite growth falling and fears over a property bubble, China's main stock market (Shanghai Composite) was up nearly 53% in local currency terms.

This is partly due to the Chinese government loosening monetary policy for the first time in 3 years in a bid to free up bank lending to fuel property investment, which we think is misguided. Also the Chinese unveiled "Stock Connect", a new system which allows foreign investors, who have previously been ineligible, to access domestic Chinese listed equities. China's move in the direction of more open capital markets encouraged foreign investors who were quick to pump money through the new scheme.

The economies of many EM countries are heavily reliant on commodities to fuel growth. Of particular importance is oil, which as we discussed in December has had a torrid year. Down by over 42% in 2014 the price of oil is approaching levels where further investment in production, especially in expensive offshore drilling becomes uneconomical. In countries like Brazil, where 91% of its oil production is offshore in very deep waters, the plummeting price is a nightmare. The same can also be said for Venezuela, a leading supplier to the US and Argentina – whose economy defaulted for the second time in 13 years in 2014. Both economies are heavily reliant on Dollar revenues from oil to meet debt obligations but these revenues have been dwindling fast in 2014. Our decision to steer clear of Latin American equities throughout the year proved to be sensible as the sliding oil price only helped to compound the pain felt by a weakening demand from China on export driven economies.

*As we've highlighted, there were pockets of value in EM countries, notably India and China, where we missed the opportunity to participate in the upswing. Despite this, we still feel there are serious concerns surrounding the Chinese credit markets and the ongoing property market troubles which could destabilise Chinese equities. India is a brighter story. We believe there is an opportunity for positive fundamental economic reforms and we will be keeping an eye out in 2015 for signs of these policies coming through.*

## Fixed Interest

With investors "reaching for yield" in 2014, High Yield (HY) US corporate bonds looked attractive at the start of 2014, as they are less sensitive to rising interest rates and with the improved economic outlook likely to foster fewer defaults. However, the asset class suffered large outflows in 2014 amid investor expectations that a sudden turn in the cycle would lead to a large fall in asset values. In July Janet Yellen expressed her fears that valuations for high yield "appear stretched" and the bottle-neck of redemptions that ensued caused large mark-downs in high yield bond prices. As banks continue the process of deleveraging, many now hold far fewer credit inventories making trading thinner for those looking to sell. The announcement of Bill Gross' exit from PIMCO in September also spooked investors as many scrambled to front-run the anticipated redemptions of those looking to follow the star manager who ran the world's largest bond fund. The iShares \$ High Yield Corporate Bond Index could only manage a total return of 1.74% in 2014.

Contrary to intuition, US Treasuries (government bonds) posted their best year since 2011 and 10 Year US yields fell consistently, finishing the year at 2.17%. Longer-dated Treasury securities performed even better and 30-year Treasuries returned more than the S&P 500. Such a positive move completely wrong-footed most investors, who expected US Treasuries to perform badly in 2014 as pressure grew on interest rates and as the US withdrew QE.



Fears over the slow-down in Europe and sluggish growth prospects in China, coupled with a strengthening US Dollar in the second half of 2014, prompted low risk investors to seek solace in the relative security of US government bonds.

*Whilst risk-adjusted returns were very positive in 2014, investors in high yield are playing an ever more dangerous game of chicken because when interest rates do start to eventually rise, the biggest fear is that a mass rush for the exit will depress prices way beyond the sensible level. We began trimming our US HY exposure in the last months of 2014 as we believe investors are no longer being compensated for the added risk inherent in the asset class. Spreads between HY and US Treasuries have widened as borrowing costs have risen for energy companies amid lower oil prices. If oil continues its rout into the New Year, things can only get worse for HY, however this in itself might then present a good buying opportunity if mass redemptions push prices too far south.*

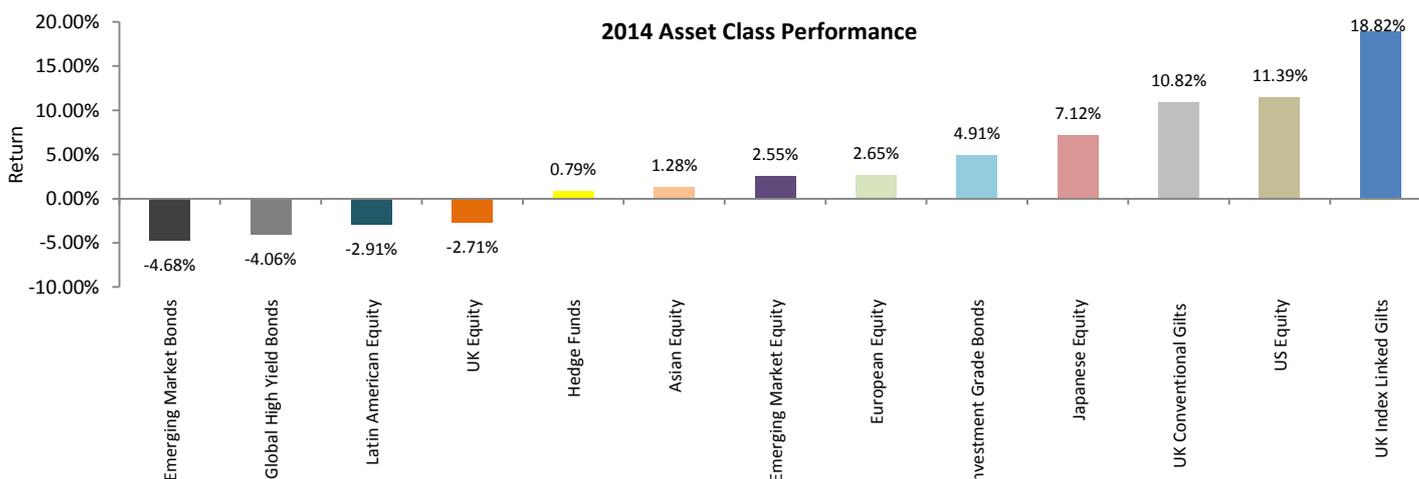
### Hedge funds

The hedge fund industry had a difficult year, due in large part to a suppression of volatility as a result of central bank stimulus. This makes life difficult for managers of hedge funds in certain strategies to trade effectively, especially those relying on momentum and directional markets. Even the smartest managers who were actively seeking to exploit long-term trends in financial markets were wrong footed in 2014. Trend followers love surprises that only they have predicted and they loathe surprises that catch them out. Predicting the outcome in Ukraine, oil prices and the Scottish independence vote amongst other things proved impossible in 2014 and hence returns from most hedge funds were mediocre at best.

*We have diversified our exposure to the sector by buying a fund which looks to build large positions across a very small number of companies with the aim of obtaining representation on company boards and directly influencing management so as to unlock shareholder value. This kind of fund is not so sensitive to the vagaries of the markets and is governed more by the direct action that can be taken at company board level. In the absence of any long-term trends (which we expect may actually materialise in 2015 anyway), we expect this kind of fund to lead hedge fund returns in 2015.*

### Property

When fund managers all start talking about the fantastic prospects for their own asset class, often this is a sign to head for the exit as quickly as you possibly can. However UK commercial property, which was talked-up by most of the big property managers early in 2014, has certainly bucked that trend.



Returns have been very solid in 2014, as investors recognised the relative strength of the UK economy but also realised that interest rates were unlikely to rise any time soon, almost a goldilocks environment for property investors. Also with so much uncertainty surrounding other asset classes during the year (see above!), steadily compounding growth and decent income from an asset class that is not correlated with equities was a very compelling proposition. London commercial property space is in hot demand, reflecting the positive growth story in the capital. Serviced office demand outstrips supply and as a result rents are increasing (we have direct first-hand experience of this phenomenon!).

*We believed the hype at the beginning of 2014 and therefore thankfully participated in this period of strong returns. We also expect that 2015 will be favourable for investors in commercial property in the UK and we will be looking to at least maintain if not to increase our exposure throughout the year.*

### Summary

Each year investment analysts are asked by journalists to predict the outcome for markets over the next 12 months and every year the average return expectation is laughably the same...7% growth, regardless of the obvious economic outlook or the corporate landscape. Perhaps this expectation should not be a surprise given that markets have actually delivered c7% per annum in the very long-term but it doesn't prevent an analyst being very wrong when equity markets fall c30% (as they did in 2008).

In 2015 the economic outlook is far from obvious although arguably the corporate landscape in certain economies (the UK & US particularly) looks favourable. We continue to focus on the markets that make the most sense to us and where we believe that the growth prospects are the best. The upcoming UK election makes it difficult to justify committing more to UK equities at present but the FTSE's poor relative performance last year gives cause for further consideration once we know what kind of government we are faced with in May. As with last year this leads us to the US economy, currency and stock market due to the fundamental growth story and to Japan because of the major interventionist policy of the Abe government.

We can only hope that the range of unpredictable factors that led to so many twists and turns in 2014 is greatly diminished in 2015. Whilst we hope that it will be a fantastic year for our core markets (geopolitics allowing) and whilst we're not going to follow the crowd in predicting a 7% return, we'd be perfectly happy to take that now if given the choice.