Mountstone Partners celebrates its three year anniversary with a small cheer, however the world around us is in turmoil, caused in no small part by declining oil prices, a momentous slowdown in China and fears of a bubble in equities. It wasn't too long ago that we were proudly sitting in front of our market screens admiring the view – FTSE 100 breaking through 7,000 for the first time ever. Now look at it – languishing miserably at 6300 level (although this is a welcome respite from the recent lows – 5898 on the 25th August).

But what about the future? In our three years of existence we've seen an extraordinary range of market conditions and some equally extraordinary political and global events. This month we look back at the major events that have shaped the world and also the stock markets since our inception. We also look to the future and perhaps more importantly ask what might shape the markets in the coming years.

From the first ever resignation of an incumbent Pope, the outbreak of Ebola to the crisis in Ukraine, the first conservative majority government since 1996 and the spread of Islamic State, it has been a remarkable three years.

Date	Most Searched for World Events of the past 3 years
03/09/2012	Mountstone Partners is born (!!)
12/09/2012	German Court agrees €500bn rescue fund for the EU
01/10/2012	US prepares for Presidential Election & the Fiscal Cliff
10/02/2013	Pope Benedict XVI resigns
14/02/2013	Meteorites injure hundreds in Russia
17/03/2013	Cyprus plans to tax bank deposits
20/03/2013	The rise of bitcoin
04/04/2013	Japanese QE announced
07/04/2013	Margaret Thatcher Dies at 87
16/04/2013	Boston Marathon Blasts
17/05/2013	Yahoo buys Tumblr for $1.1 billion
22/06/2013	Egyptian Army Ousts President Mursi
22/06/2013	London shocked after brutal machete attack
18/07/2013	Detroit files for bankruptcy
02/09/2013	Microsoft buys Nokia mobile phone - $7.2 billion
21/09/2013	Kenya Mall Attack
01/10/2013	US government shutdown
07/11/2013	Super Typhoon Haiyan devastates Philippines
04/12/2013	Nelson Mandela Dies at 95
18/12/2013	Tapering of US QE announced
05/01/2014	Record Cold Snap in US damages GDP growth
18/02/2014	Ukraine Crisis
19/02/2014	Facebook Buys WhatsApp for 19 Billion US Dollars
05/03/2014	Malaysia Air Plane Missing - 200 Passengers on-board
10/06/2014	ISIS Seized Large Regions
03/07/2014	Israel Conflicts with Hamas in Gaza
17/07/2014	Plane with 298 on-board shot down over Ukraine
30/07/2014	Ebola Virus Outbreak
12/11/2014	European Spacecraft Rosetta Landed on Comet
17/11/2014	World Oil Price Plunges to Historical Low
18/12/2014	US Cuba Relations Breakthrough
24/12/2014	Japanese Government re-elected
07/01/2015	Charlie Hebdo Attack at Paris
22/01/2015	European QE announced
03/04/2015	Iran and 6 world powers reach nuclear deal
24/04/2015	Earthquake 7.9 Magnitude hits Nepal
08/05/2015	Tories win majority in UK election
27/06/2015	Greece announces referendum on Europe
04/07/2015	Greece Vote NO to Bailout Deal
05/07/2015	Greece Crisis sorted (for now!)
10/08/2015	Chinese devaluation
30/08/2015	Migrant crisis of Europe
18/09/2015	Volkswagen emission scandal
25/09/2015	Flowing liquid water found on Mars

During this time equities have enjoyed fresh highs in some markets and some meteoric sell-offs in others. From the sublime to the ridiculous - over the period, the Japanese main market index has returned 101.74% whilst the Brazilian Bovespa has delivered a miserable -23.46%. However, perhaps more remarkable given the expected correlation between the two main markets in the US and the UK, the divergence in returns between these two giants has been huge, with the S&P 500 generating returns of 38.11% whilst the FTSE 100 has managed only 5.56%. This variance in performance just emphasises how important it has been over the last three years to be selective about the countries and regions to invest in and that a quick and nimble response to changing markets has been essential.

Take the example of Russia where the Ruble tumbled by 51% in the space of 6 months between June 2014 and January 2015 at the same time that the price of Brent crude fell from $106 per barrel to $56. Or the Chinese stock market, which plunged 26% in a matter of seven days. These examples demonstrate that good timing (both in and out) and sensible sector selection has added enormous value over the last three years however for those taking high risk in selected sectors the potential for underperformance has been huge, just because of the variance in returns between different markets.

Whilst many of the global issues that have influenced world markets have been very difficult or impossible to predict we feel that others were well signposted and should not have come as a surprise. In the former category, geopolitical and global risks such as Russia's annexation of Crimea, Cyprus taxing bank deposits when crisis hit, the Ebola outbreak and Greece calling a referendum on Eurozone membership all sent markets into a tailspin. Investors had no way of knowing that any of this intervention was on the cards.

On the other hand most investors were surprised when the Chinese economy started to slowdown (see our June 2014 market update), astonished when commodities performed poorly as a result and also amazed when the ECB were forced into QE. Judging by the markets not many investors thought that the US Fiscal Cliff would be avoided (Dec 2012 update) or that QE stimulus in Japan would lead to huge asset price inflation in the Japanese stock markets (Apr 2013 update). We believe that all of these "events", whilst by no means a certainty, were at least partly predictable and in most cases highly probable, yet at every turn, markets reacted as if they were completely unexpected.

We certainly can't claim that we knew that any of the first category of geopolitical events would occur but as investors we were aware of all of the probable outcomes of the latter category.

There has been a huge divergence in returns between various sectors leading into this summer (e.g the mining sector has been very poor, utilities have performed well recently) and therefore it has never been so important to select sectors carefully.

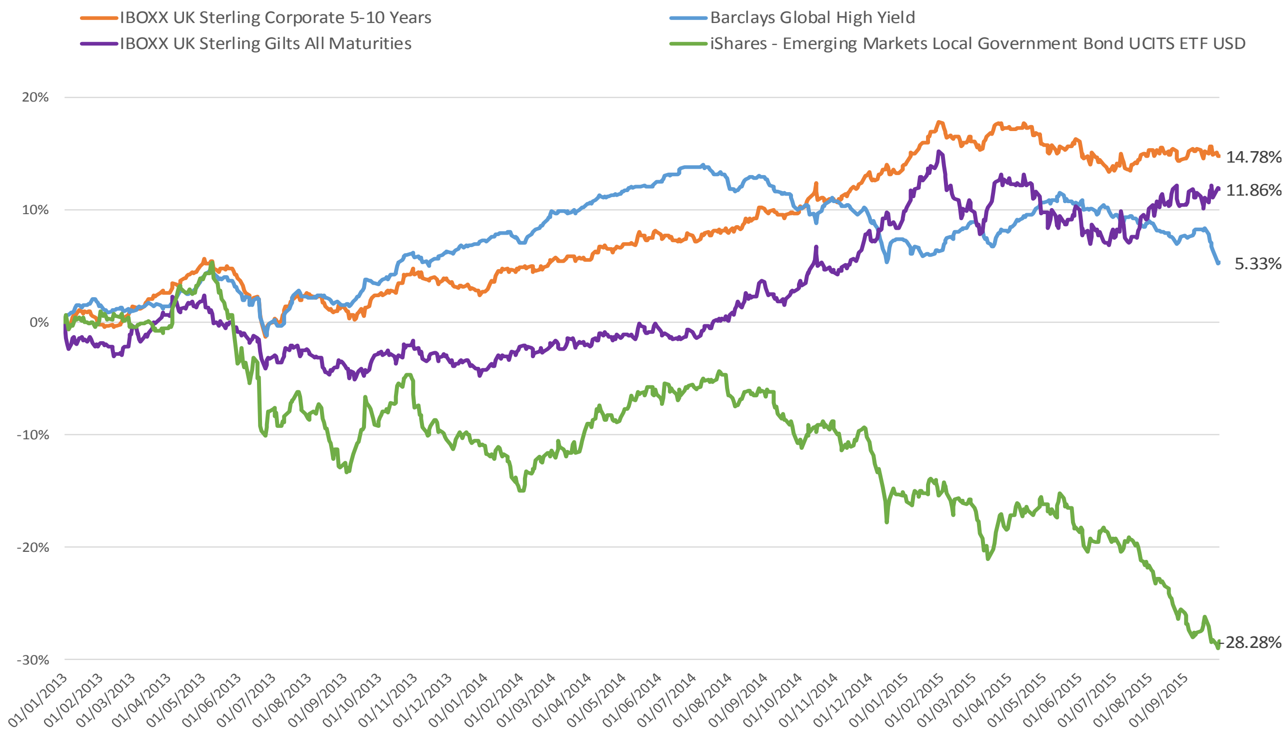
Then, ever since June 2015 we've seen a massive increase in correlations of returns across different asset classes. This tends to happen in a time of crisis, as with the credit crunch in 2008 when all assets with any risk associated with them were sold indiscriminately in a mass panic fire-sale. In this kind of market sell-off value is ignored and it is often impossible to find a safe-haven in the short-term other than cash or US government bonds.

As a result, our favoured markets have been at least partly exposed to the fall out in China and Greece, even though the economies that we have invested into in the main have had far less direct exposure to the culprits than was warranted in the sell-off. For example the UK and US stock markets have fallen significantly peak to trough (16% and 12% respectively) in-line with Chinese weakness and yet this week the IMF actually upgraded the forecasts for UK and US 2015 GDP growth.

An indiscriminate sell-off like this inevitably creates opportunities to invest in undervalued and unloved markets for those prepared to wait for that value to be unlocked. We think that developed market equities now display just such characteristics.

Index	3-year performance
Nikkei 225	101.74%
Nasdaq OMX Composite	55.14%
Shanghai Stock Exchange Composite	48.23%
S&P 500	38.11%
S&P BSE Sensex (India)	36.57%
Deutsche Bourse DAX 30	30.96%
Dow Jones Industrials	28.91%
Hang Seng	12.54%
FTSE 100	5.56%
Brazilian Bovespa	-23.46%
Gold	-37.11%
Brent Crude Oil	-56.72%
Barclays US Treasury Index ($)	3.89%
UK Property	28.30%
Barclays Hedge Index	15.52%
£/$	-6.20%
£/€	7.54%

Whilst there have been numerous events over the past three years that have led to heightened volatility and a disparity of returns in the equities, the fixed interest markets (with the exception of emerging economies) have enjoyed a relatively calm period. Bond market investors have been pre-occupied with just one thought – when will US interest rates start to rise? At the most recent September meeting the US Federal Reserve chose to hold fire yet again and investors are still uncertain about the timing of the first move. Consider that when Yellen announced at the meeting that rates would stay on hold this month, the equity markets reacted negatively to the news! The theory being that investors would have preferred a rate rise so as to know that the rate cycle had finally turned, uncertainty being the enemy of markets worldwide.



Fixed interest returns have converged over the last three years (excl. Emerging markets) in contrast to equities (see page 3)

To add to the confusion, Mark Carney (our first non-UK central bank governor) introduced “forward guidance” to align interest rate moves with economic indicators such as unemployment levels, rather than simply the prevailing inflation rate. However it took him only six months to move the goal posts associated with “forward guidance”, bringing new factors into the equation - income and spending – to sit alongside unemployment.

As a result of this confusing “guidance” on interest rate timings from both Janet Yellen and Mark Carney, bond market investors have been like rabbits caught in the headlights, on both sides of the Atlantic. This “Will they? Won’t they?” has meant that there has been very little real direction in the fixed interest markets for months now. However that might be about to change as pressure mounts for rate hikes to start in earnest.

The final asset class that requires review is alternatives. Commodities have had an appalling run recently (Aug 2015 update) because demand for natural resources is inextricably linked with growth in China. Commodities are a leveraged play on Chinese growth and so unsurprisingly raw materials have tumbled as China’s appetite (GDP growth) diminishes.

Gold, which was seen as a safe haven and often used as a “flight to quality” in times of stress (e.g in the credit crunch investors bought gold to protect against failing bank deposits) has also had an appalling three years. So often used in the past as a hedge (protection) against falling markets, the ability for gold to protect has broken down…

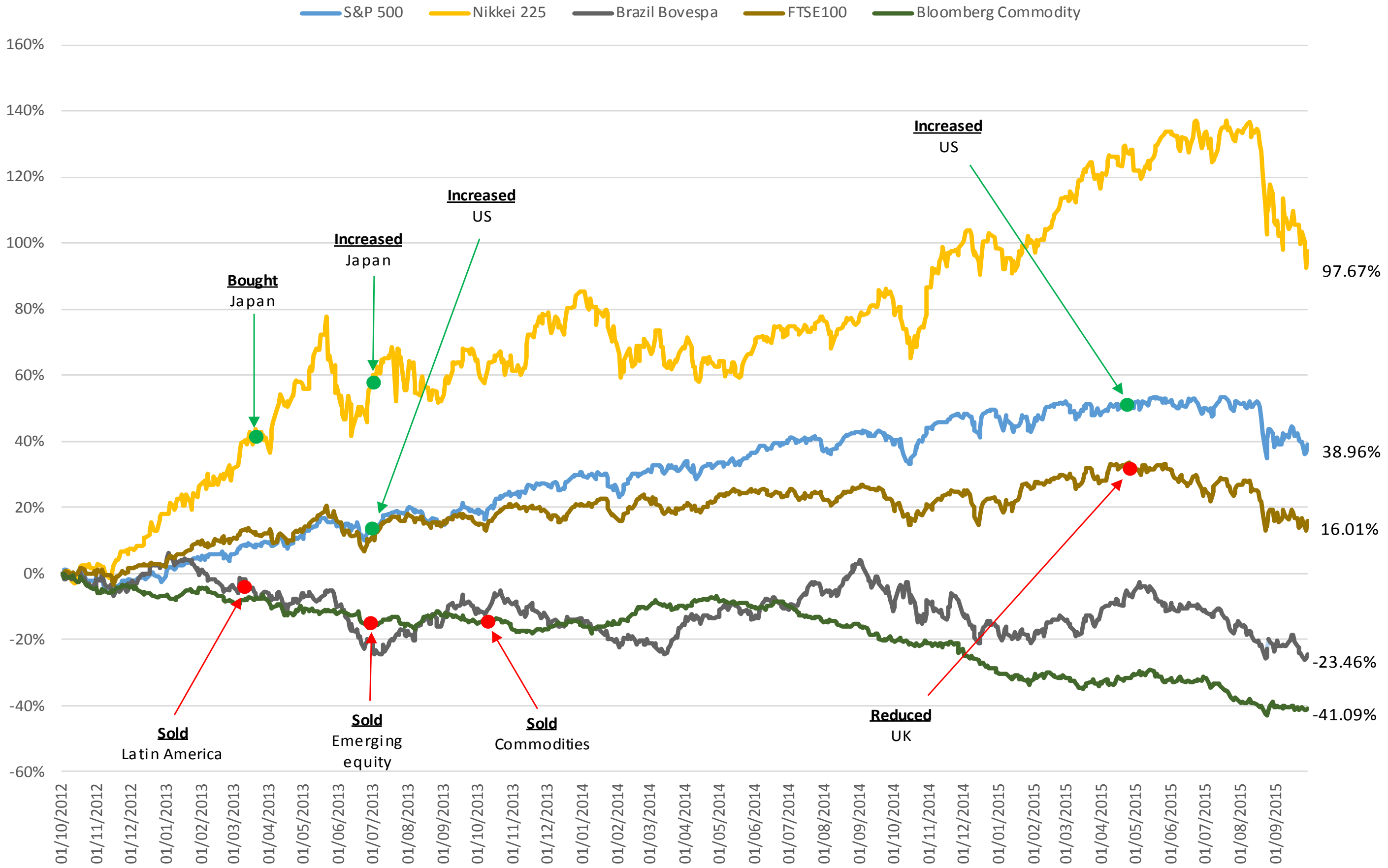
…over the last few years (May 2013 update). The precious metal has fallen in value by 37% over the last three years.

Oil has also tumbled in value (-56%) over the period as a supply glut, coupled with slowing demand, increased fracking, huge natural gas reserves in the US and concerted action by OPEC to maintain production levels have all forced prices to halve. Great news for importers (lower inflation) and terrible news for unhedged exporters, volatility in the price of black gold has been incredibly disruptive (Dec 2014 update).

Hedge funds have had mixed fortunes since 2012. Typically owned as a tool for diversification away from equity and fixed interest, some of the biggest hedge funds suffered their worst returns ever in 2014. They were mostly “long” the US dollar as were we, expecting that QE tapering would drive the world’s reserve currency higher. This trade only really started to come good midway through 2014 and not before the USD hit $1.70 against Sterling. Thankfully hedge funds have had a better run since and whilst returns have been far from exciting, they have at least held their own.

One of the star performers has been UK commercial property (Apr 2014 update). It has been the purest “play” on the UK economic recovery, and whilst the FTSE 100 has underperformed (partly due to oil, gas and miners exposure), funds investing into UK commercial property have prospered over the last three years. Low interest rates have played a major part.

Huge disparity of returns across equity markets and some of the major investment decisions that we have made over the last three years…



The chart above shows the performance of some of the relevant stock markets over the last 3 years and we have superimposed the major asset allocation calls that we have made over that time. This chart makes it look like we got everything right (!) which of course we didn’t. For instance we held some EM debt, we were long US dollar far too early and we didn’t own China when it was booming. However this chart does demonstrate our most significant asset allocation decisions compared with our peers, particularly our overweight in Japan and US equities. Owning no commodities or emerging markets also helped.

We began our first ever market note with a quote from Donald Rumsfeld: *"There are known knowns. These are the things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. These are the things we don't know we don't know."*

Mr Rumsfeld was clearly confused by the global economic outlook at the time (!) but we do feel that the general economic picture is now a great deal clearer. We've reviewed the past three years and hopefully demonstrated that returns have been very inconsistent across different sectors and asset classes.

More importantly though, how will things pan out over the next three years?

Notwithstanding the unknown risk of a Brexit (which cannot be underestimated), the UK economy looks a great deal healthier than three years ago and is now showing consistent, albeit boring, growth rates. It is a similar story in the US, where unemployment has fallen to very low levels and growth is creeping up. These two economies have been a major focus for us over the last three years and remain the best source of consistent, stable growth.

We also like Japan and continental European equities, but for very different reasons to the US and UK. Japan is two to three years behind the US and UK in terms of recovery but is now aided by extensive QE and we see Japanese assets continuing to inflate in value over the coming months.

For similar reasons we recently supported European equities after a brief sell-off and having announced its own massive QE programme feel more confident that artificial central bank stimulus in Europe will boost equity markets over time, although we have less conviction about returns in Europe than in Japan due to pressures on the likes of Greece to toe the line.

Our minimal exposure to emerging markets has proved beneficial and our only exposure currently is via India where a new Prime Minister (Modi) has pledged to implement wide ranging economic reforms. He has an overwhelming majority which has helped him drive these far reaching reforms and we hope that this will translate into increased corporate profitability.

We continue to avoid Chinese equities, expecting that projected growth rates in the world's second biggest economy will continue to fall and fearing that the official GDP numbers may be overestimated, either intentionally or due to poor information gathering. As previously reported, whilst there will be a tremendous buying opportunity in both Chinese equities and commodities as a result, our developed market equity bias will be extended into the final quarter of 2015 and we wait for a safer entry point to emerging market stocks.

When it comes to the bond markets the short term picture is unclear but the end result is obvious – higher interest rates eventually. As Janet Yellen stated on 24th September:

"I anticipate that it will likely be appropriate to raise the target range for the federal funds rate sometime later this year and to continue boosting short-term rates at a gradual pace thereafter as the labor market improves further and inflation moves back to our 2% objective"

Whilst the predictions are that it will be the Spring and Autumn of 2016 before we see the first US and UK rate rises, we are starting to position our fixed interest weightings within portfolios for the inevitable turn in the cycle. This means buying assets that are less sensitive to interest rates and in some cases assets that will benefit from a hike in interest rates. One thing is certain – investors are going to have to work much harder to find good sources of returns from fixed interest investments over the next five years, having enjoyed a pretty much uninterrupted 30 year bull market in bonds.

That is why we have reduced exposure to fixed interest in general and increased our allocations to alternative asset classes such as property and hedge funds. These two will remain our focus within alternatives. UK commercial property will start to run out of steam as interest rates rise but we feel that returns will still be good as we enter 2016. Finally we've shunned commodities ever since QE tapering was announced and can't yet see a sensible re-entry point with China in decline.

The last three years have been favourable for equity investors generally, particularly for those who have focused on US and Japanese markets, despite the disparity in returns across other regions. We expect more of the same from Japan and a return to favour for the UK markets. Investors who are "chasing yield" from fixed interest are either brave, foolish or both and we have positioned ourselves to be underweight fixed interest and invested in assets that are less exposed to a turn in the interest rate cycle. Finally we expect that alternative asset classes, which we have increased exposure to of late, will help to generate some of the returns lacking in the fixed interest markets in the years ahead.

Here's to more "known knowns" and far fewer "unknown unknowns" in the years ahead.