Annual Market Commentary

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Fourth quarter 2015 began with a combination of mixed economic reports and accommodative central bank policies. A spate of attacks by religious extremists spanned four continents from late October through early December, emboldening the West's involvement in a coalition targeting Islamic State in Iraq and Syria. Deteriorating conditions for U.S. energy companies raised concerns among high-yield bond investors, resulting in a sharp selloff that likely discouraged equity investors and kept a lid on performance as the year drew to a close. Major central bank policies commenced a long-awaited divergence late in the quarter. The Federal Open Market Committee (FOMC) raised the federal funds rate in mid-December for the first time since 2006, leaving behind a near-zero-interest-rate stance that had been in place since late 2008. The Bank of England's (BOE) Monetary Policy Committee made no changes and the European Central Bank (ECB) indicated a willingness to expand its quantitative-easing programme if necessary. The Bank of Japan (BOJ) expanded its asset-purchase programme by lengthening the average maturity of purchased Japanese government bonds and increasing purchases of broad equity-market exchange-traded funds.

The first quarter of 2016 was a quarter of firsts: the first instance of negative-yielding 10-year government bonds by a major economy (in Japan), the first time WTI oil prices — a key indicator of movements in the oil market — fell back to their 2003 levels (in January, and then again in February), and the worst first ten trading days of the New Year in history (as measured by the performance of the S&P 500 and the S&P 90, its predecessor, since 1928). Of course, conditions improved dramatically starting in mid-February, propelling the S&P 500 and oil prices to small full-quarter gains. The BOE and the FOMC — the less-dovish cohort of major central banks — lowered their sights on tighter monetary policy during the quarter. The BOE registered two unanimous votes to hold benchmark rates firm, a departure from prior votes that typically featured hawkish dissenters favouring an immediate hike. The FOMC tentatively confirmed market expectations for fewer rate hikes this year than previously projected. The ECB and BOJ — the more-dovish set — deepened their commitments to easy policy. The BOJ adopted a negative benchmark rate and continued asset purchases apace, while the ECB treaded further into negative rate territory and expanded its asset-purchase programme. Both, however, confronted unenthusiastic market responses as their currencies firmed relative to the U.S. dollar following their announcements. Finally, the People's Bank of China (PBOC) began the quarter by guiding the yuan-U.S. dollar exchange rate lower, and then making a significant capital commitment to its banking system. The PBOC also rebalanced its reserve requirement ratio during the quarter by ending preferential treatment for some banks and then lowering the broad ratio in an effort to stimulate bank lending. China's securities regulator was also busy in early January, first introducing, and then quickly discontinuing, circuit breakers intended to limit large intraday swings on its mainland stock exchanges.

The most prominent event of the second quarter of 2016 — a surprise result as U.K. citizens voted in favour of leaving the European Union (EU) — took place with roughly a week left in June. Market volatility had increased markedly ahead of the referendum, but not by enough to compensate for the unexpected outcome, as polls and bookmakers, while split, generally projected a victory for the "Remain" campaign. A sharp spike in global stock-market volatility ensued, yields were driven downward (yields move inversely to prices) to record levels on perceived safe-haven investments like developed-market government bonds, and the currencies at the centre of the developments — sterling and the euro — weakened substantially relative to the U.S. dollar and Japanese yen. Most stock-market losses were recovered within a week's time, however, suggesting the vote may not prove as detrimental to global health as initial reactions implied.

The third quarter of 2016 began with a boost as the post-Brexit-vote recovery rally continued in force across most stock markets around the globe. The trend levelled off by mid-quarter, with the S&P 500 index, representing U.S. large-company stocks, hitting an all-time high on 15 August before an early September selloff. The FOMC's decision to hold back from increasing rates was well-received, as stocks recovered and moved sideways through the end of the quarter. U.S. Treasury yields increased during the quarter (yields move inversely to prices), while U.K. gilt yields generally declined. Short- and intermediate-term eurozone government bond yields declined, while long-term yields increased. Oil prices hit their lowest levels in early August since the depths of the first-quarter selloff, before mounting a choppy recovery that was boosted at the end of the quarter by a tentative *Organization of the Petroleum Exporting Countries (*OPEC) production-cut agreement. The ECB joined the U.S, Federal Reserve (Fed) in holding firm during the quarter, while the BOE delivered a rate cut coupled with asset-purchase and term-funding programmes at its early-August meeting. The BOJ announced a novel policy change in late September: keeping the 10-year Japanese government bond yield at 0% with a commitment to alter its bond-buying pace as needed to meet this goal. The BOJ also expressed its intention not only to achieve, but temporarily exceed, its target inflation level (currently 2%) to increase inflation expectations.

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- **The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, returned ($) 8.83% over the 12 months ending 30 September.**

The U.S. dollar was mixed during the period as it strengthened significantly against sterling, especially in the wake of the Brexit vote, but weakened notably versus the yen and was little changed versus the euro. With the BOJ and ECB actively attempting to weaken their currencies through expanded asset purchases and negative interest-rate policy, it was somewhat unexpected to see the yen and euro strengthen. However, we would note that after a modest 0.25% interest rate hike at the end of 2015, Federal Reserve policy has become more dovish, with no hikes expected until late 2016 or early 2017. Most major bond markets finished the period positive in both local-currency and U.S. dollar terms. Riskier asset classes, such as U.S. high yield and emerging-market debt, struggled early in the period but have since rebounded strongly. Within investment-grade fixed income, government bonds outperformed corporates.

Emerging-markets debt (50%/50% JPM EMBI Global Diversified Index & JPM GBI-EM Global Diversified Index) gained nearly 17%, while the BofA Merrill Lynch US High Yield Constrained Index was up almost 13%. Global treasuries rose nearly 11%, as measured by the Bloomberg Barclays Global Treasury Index, while the Bloomberg Barclays Global ex-Treasury Index returned about 6.5%. U.S. investment-grade bonds, as represented by the Bloomberg Barclays U.S. Aggregate Index, gained just over 5%. U.K. bonds, as measured by the BofA Merrill Lynch Sterling Broad Market Index, suffered a modest loss of about 2.6%; this was entirely due to currency translation though as the index gained more than 13.5% in sterling terms.

- **The MSCI AC World Index (Net), used to gauge global equity performance, returned ($) 11.96 % in the period.**

Global equity markets, as reflected by the MSCI AC World Index (Net), returned nearly 12% in the period. The gains were not without volatility however as sharp declines to start 2016 and after the U.K.'s Brexit vote were followed by strong rebounds. Central banks generally remained accommodative, with the ECB and BOJ further easing monetary policy, while the U.S. Federal Reserve modestly tightened its policy by raising interest rates one time before reverting to a holding pattern.

Emerging markets (as measured by the components of the MSCI AC World Index) rewarded investors who stuck with the asset class and gained almost 17%. Developed markets were also strong with performance exceeding 11%. Country-level performance varied widely. Brazil benefited from positive political developments as well as improved oil prices as it gained over 57.5% to pace emerging markets. Much of the developed-market performance can be attributable to the U.S., which was up over 14%, while Japan gained 12%. Europe and the U.K. lagged, but were still generally positive despite concerns over the Brexit vote. European periphery countries, however, mostly struggled; Greece fell over 38%, Italy plunged 21% and Spain slipped a more modest 5.7%. The rally in oil and other commodity prices propelled the materials and energy sectors of the index to gains in excess of 24% and 18%, respectively. Technology was also up nearly 23%. The performance of other sectors was less robust, but still positive as financials, healthcare and consumer discretionary produced single-digit gains.

Our View

There are many things over which investors can lose sleep: Brexit-related stresses, disenchantment with free trade, ineffective monetary policy, pressure on corporate profit margins, severe debt burdens, and intense political uncertainty. But our over-arching investment stance remains unchanged. As long as central banks pursue aggressively easy policies in a world mostly characterised by slow economic growth (not recession) and mild inflation pressures, any pullback in the price of riskier assets should be limited.

In general (and especially as it pertains to the U.S.), we continue to view equity-market corrections as buy-on-the-dip opportunities. One reason for maintaining this point of view is our belief that the U.S. economy is on fairly solid ground. It's true that growth in overall business activity continues to disappoint, but household finances are in good shape as a result of expanding employment and incomes as well as the bull market in stocks, bonds and home values. There is little reason to expect a serious slowing in consumer spending. We also expect the change in business inventories — the most volatile part of GDP, which has slowed in recent quarters — to rebound in the quarters ahead, supporting a reacceleration in overall U.S. GDP into the 2.5%-to-3.0% range.

Our main concern for the U.S. is weakness in business investment, which has negative implications for productivity. Slowing labour productivity growth and an acceleration in labour compensation growth is a bad combination. Since companies have been unable to raise prices sufficiently, the downward pressure on profit margins appears chronic. As

this pressure intensifies, we expect companies will become more aggressive in their attempts to push through price increases.

This uptick in inflation, combined with the tightening labour market and slow-but-steady pace of economic growth, seems to have tipped the balance in favour of a hike in the federal funds rate, probably in December. At their latest meeting, Fed policymakers finally conceded that interest-rate normalisation will take years to accomplish, leaving little room to cut rates aggressively in the event of a recession. Investors remain sceptical that the central bank will even achieve its stated objective of pushing its policy rate to the upside. As a result, risk assets should continue to be well supported. Although equity valuations remain elevated, they still appear reasonable relative to those of high-quality bonds.

The U.S. presidential election will have an impact on the economy and financial markets in the months and years ahead. Yet, we firmly believe that it would be a mistake to base even a short-term investment strategy on picking a winner in November; this would require accurate predictions on the policies proposed by the new president, whether they become laws, and how they would impact the economy and financial markets.

With regard to the U.K., many observers have been surprised by the resiliency of its economy, although it is way too soon to sound the all-clear. The BOE has pre-emptively cut its base rate to the lowest level in the multi-century history of the central bank, and restarted its quantitative-easing programme and previously successful funding-for-lending scheme. On the fiscal policy side, the new Chancellor of the Exchequer scrapped his predecessor's austerity plans and is expected to introduce a new budget that abandons any notion of achieving a budgetary surplus by the end of the current parliament. In all, U.K. economic policy has shifted dramatically toward easing well before the negative effects of Brexit can be felt. However, while no one knows what a final Brexit agreement will look like, we suspect it will be nowhere near the position being pushed forward by various U.K. leaders. Given this uncertainty, we think investment is likely to slow in the months ahead.

Eurozone exports and imports are in decline. Household spending is growing faster than other areas of the economy, as is the case in the U.S. and the U.K., but Europe's consumer rebound remains considerably less robust in comparison with these two countries. Although the labour market has certainly improved over the past three years, the country-by-country levels remain wildly disparate. This is especially so for the youth unemployment rate.

We're concerned that it's just a matter time before another crisis tests the cohesion of the eurozone. It's possible that the Italian constitutional referendum, to be held 4 December, could provoke such a crisis. If the vote goes against the government, Prime Minister Matteo Renzi may be forced to make good on his promise to hold elections. Unfortunately for him, polls show that the Italian electorate is in a cantankerous mood.

If the Five-Star Movement, currently the most formidable Italian opposition party, were to win power, the impact would be far more earth-shaking than the Syriza party's January 2015 victory in Greece. Italy's economy is some seven times greater than that of Greece, so one can only imagine how markets will react to the possibility of an Italian threat to leave the euro framework. ECB President Draghi knows he has a potential problem on his hands. He continues to reassure investors that the central bank has the will, the tools and the ability to improve the eurozone's fortunes.

The Japanese economy still lacks momentum despite fiscal stimulus packages, structural reforms and extremely aggressive monetary policy initiatives. Industrial output has trended lower over the past three years, hurt by the slowdown in global trade, and although the country's merchandise trade balance has turned positive, this is merely the result of imports falling faster than exports.

On the positive side, housing construction is running near a cyclical high. The unemployment rate, which is structurally much lower than in other developed countries, dipped to 3.1%. Nominal wages remain stuck near zero, however, and inflation expectations have been nearly impossible to nudge to the upside. Our Asia-focused portfolio managers are heartened by improvements in corporate governance and the use of capital. Additionally, the latest fiscal-policy initiative is a significant one, with new spending amounting to ¥7.5 trillion. In the current fiscal year, stimulus is expected to reach 4.5% of GDP.

We think China's economy will continue to reaccelerate in the near term. Although the country's growth rate remains below trend, we are beginning to see an improving trajectory following two and a half years of slowdown. The renminbi has depreciated steadily in the year to date, falling 7% against a basket of currencies and less than 3% against the U.S. dollar. While the depreciation of the renminbi has not reinvigorated exports, it appears to have stopped its two-year decline. Domestic economic growth in China has been relatively stable this year, with retail sales growing around 10% on a year-over-year basis and industrial output running at a 6% rate. Importantly, the country continues to evolve into a services-oriented economy, with that sector now accounting for more than half of GDP. Housing activity also has picked

up. The question now becomes whether government economic policy flips back toward structural reform and economic rationalisation and away from stimulus, given that business activity looks to be in a less fragile state than a year ago.

Before the global financial crisis, the U.S. and China were the primary growth engines of the world. Those engines are sputtering when compared to their pre-crisis performance. We think it's possible that India eventually will become a third major engine of global growth. In the past year, its GDP growth was greater than China's. While its population is nearly as large, India is growing faster and is much younger. As India institutes economic, financial and legal reforms, it has the potential to grow rapidly for a long time.

Our inclination is to favour equities and higher-yielding debt securities at the expense of developed-economy sovereign bonds that have extremely low or negative yields. Within equities, we prefer value and aggressive-growth characteristics over stability. In bonds, we favour securitised credit, bank loans and other credit-related trades.

Glossary of Financial Terms

- Bull market: A bull market refers to a market environment In which prices are generally rising (or are expected to do so) and investor confidence is high.
- Dovish: Dovish refers to the views of a policy advisor (for example at the Bank of England) who has a positive view of inflation and its economic impact and thus tends to favour lower interest rates.
- European periphery countries: European periphery countries are those nations in Europe's common-currency area that were hit hardest by the sovereign debt crisis (most notably Greece, Ireland, Italy, Spain and Portugal).
- Federal funds rate: The Federal funds rate is the interest rate at which a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight in the U.S.
- Hawkish: Hawkish refers to a policy advisor, for example at the Bank of England, who has a negative view of inflation and its economic impact and thus tends to favour higher interest rates.
- High yield bonds/securities: High yield bonds are rated below investment grade and are considered to be riskier.
- Quantitative easing: Quantitative easing refers to expansionary efforts by central banks to help increase the supply of money in the economy.
- Securitised debt: Securitised debt consists of a portfolio of assets, such as mortgages or bank loans, which have been grouped together and repackaged as individual securities.

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