HOVING & PARTNERS
WEALTH MANAGEMENT

QUARTERLY INVESTMENT VIEW

Issue No. 1/4 1st Quarter 2016

A challenging start

Only three weeks into the year and 2016 is already shaping up to be a chaotic year in global economics and geopolitics.

Global stock markets dropped by 8-12% in the first ten trading sessions and most of them are now 20% below their highs. Considering the speed and magnitude, the sell-off looks like panic selling. Forced selling by Middle East countries? Credit Suisse's "Fear" indicator now stands at its highest level since 2008.

Among the primary causes of the sell-off are worries about China's economic health and continued devaluation of the Chinese yuan, despite the recently published 6.9% GDP growth. Investors fear that the real numbers are worse and see the sharp fall in commodity prices, particularly oil, as evidence for further weak demand.

The low price of oil does not have the same economic benefits as it used to. Global capital expenditures have been hit by the low oil price which may not be compensated by the long-held assumption about the economic benefits of low energy prices. Consumers have high debt levels that need to be redeemed and governments tend to neutralize advantages by raising taxes (for example at the pump).

On the other hand, energy companies have been winding down $380Bn of capital expenditures, which could set the stage for less supply and higher oil prices in the coming years.

We know that 2016 global growth has been cut by the IMF from 3.6% to 3.4% and World trade has been sluggish. But we do not share recession fears provoked by China or economic storms in commodity producing nations.

There are plenty of old and new worries. Financial and credit risks are generally rising, caused by the spectacular plunge in oil and other commodity prices.

US interest rates are rising following the first Fed rate hike. Other markets fear the end of QE indicates the end of easy money.

Companies face earnings pressures as sales growth is lagging. A higher cost of capital with lower earnings is a toxic combination leading to higher risk premiums demanded by equity investors.

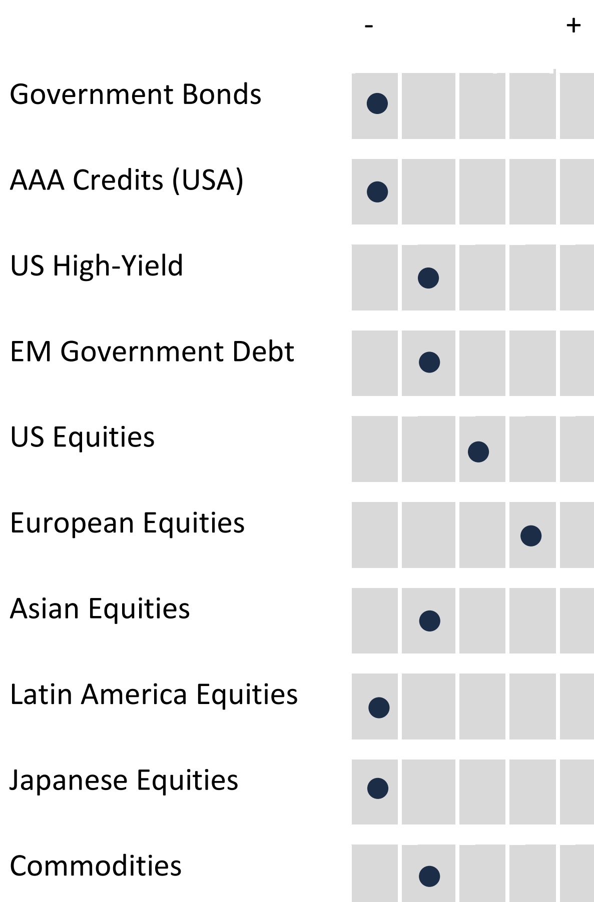
We believe many of the worries could be overcome during the first 6 months of 2016. This will have accomplished a "reset" of valuations, the monetary system and economic growth. From there on, expected returns should become attractive again.

Implications for our Investment Strategy H1 2016

In the second half of 2015, we have been raising cash in anticipation of higher market volatility and higher equity risk premiums.

For 2016, we think investors should have quite some Cash in the bank or means to raise it quickly. Cash is defensive in moments of strong and sudden down-turns and needed for rebalancing purposes.

Asset Allocation



From a regional perspective, we prefer European equities to US stocks. The US stock markets have significantly outperformed the MSCI World Index since 2010 and a correction is due from a relative perspective. The YTD January correction in US and European equities was about even.

From an Asset-Mix perspective, we would overweight equities and cash versus bonds. Bond returns are still negative and do not present value for mixed portfolios.

We would add high-risk profile equities such as well capitalized oil majors (Royal Dutch, Total) whilst the price of oil is falling.

We see a good potential for long/short equity managers and managers that can pick up investment trends early in the cycle.

We also see potential to buy deep value as this could happen in oil and commodity stocks declining further this year.

We see value in buying "dips" and selling on the "upside", generally trading stocks. We do not recommend any special leverage.

After currency devaluations, a slowdown in China, the general aversion to emerging markets or political fears, Asian markets are becoming more attractive as value is emerging. But we would not be in a hurry.

Growth has remained strong in India because of low oil price imports. However, inflation remains high (5%). High interest rates suggest that valuations at a P/E of 18 are dear.

Despite economic uncertainties, we expect the Fed to continue to hike Fed Fund rates until the Fed Funds have reached 1 percent. The Fed seems more hawkish than assumed by the market.

We anticipate US Treasuries to follow with slightly higher interest rates along the yield curve, but we do not see growth and inflation having a steepening effect on the USD yield curve in 2016.

10Y USD Treasuries are attractive for very defensive portfolios in times of high volatility.

We favor high quality (AA or AAA) USD Credits in the 5Y-7Y range.

USD High Yield Bonds (not investment grade) start to become attractive with yields above 9%.

We do not find EUR government bonds attractive as we expect real interest rates to remain negative for a while. The yield gap between the USD and the EUR may pull EUR bond yields up somewhat. This could be a

problem for EUR Bonds in the absence of inflation.

The big part of the USD appreciation against the EUR is behind us. At this stage (1.095), we would not hedge any currency. Contrary to what many market participants believe, the EUR may strengthen which would pose a headwind to European exporting companies.

Base scenario 2016

1. China leads the way

Over the past year, China has put its mark on the world economy and the direction of money flows. Its economic slowdown had adverse effects on energy and commodity prices and developed nations saw their growth restrained by China's slowdown.

Despite China's ambitions to develop the country's internal demand, the PBoC devalued the renminbi in the summer causing a collapse of the Chinese stock markets. This transition should take time and take some steam out of China's growth. Devaluations of the renminbi, China's reserve currency, continue to be likely as long as the USD value remains high (devaluations of the renminbi are very negative for Asian exporting nations).

We do not believe that China's leadership has changed its course for restructuring and modernizing the Chinese economy.

Perhaps the realities altered the speed of change.

We believe there is too much pessimism about China's immediate economic future. China's financial reserves are vast and they should be able to defend their currency. The most important is to avoid a full blown credit crisis as companies and municipalities have to write down part of their fixed investments due to excess capacity.

The Chinese government has had difficulties in handling the Chinese stock markets (this is new to them), but they have a strong hand in handling the local economy. China's centralized government has the power and the financial means to implement its new policies.

China has yet to release the private pools of money in China on an international scale giving scope to support stock market valuations in developed nations.

2. US Economy should avoid recession

We should get some comfort from the US economy with the lowest unemployment claims in four decades and a jobless rate, which has fallen below 5% for the first time in 2007. The higher minimum wage increase to $10/hour and the growth in positive wage deals (Walmart) has been boosting consumer confidence and overall demand. US housing is on sound footing and most houses have recouped their price fall caused by the recession. Detroit saw a huge increase in car spending in the USA with one of its best years on record.

This has led the Fed to make its first rate hike in eight years, a positive indication that in their eyes the US economy has become sustainable. There is doubt whether the Fed's path of four rate hikes this year will be realized; the market is predicting an increase of only 60bp. This difference creates uncertainties.

Manufacturing appears to have been hit harder than services. The PMI Index for December of 48.2 registered an accelerating contraction across the whole of American manufacturing. As a result, a wide range of American companies, not only oil

companies, face a squeeze in revenues and profit declines. The fall in investments and asset prices is all the more harmful because it is so rapid.

3. Positive growth momentum in Euro-area

The growth momentum in the Euro-area has improved markedly and may surprise on the upside. Interest rates should remain low well into 2017, supported by Mario Draghi's QE program. Demand for Credit and Bank lending has also come back in the latter half of 2015 supporting housing and small enterprise.

The amount of outstanding government debt in the EU has continued to rise due to lower tax receipts, except in Germany and the UK. With the current low interest rate environment, debt services are easily supportable. Governments have no financial incentives to execute structural reforms, the cornerstone of Frau Merkel's policies.

4. Weak Japanese economy

The Japanese economy remains weak with household spending and retail sales down. Japanese companies do much better than the local economy, but they are expensive (P/E of 18). The Yen, although very strong in 2015, may be vulnerable to Central Bank actions.

5. The price of oil in 2016

Moves in the price of oil will dominate financial markets in 2016.

Critically, the supply side and not demand factors drove down the price of oil in 2015. Last year the world produced 96.3m b/d of oil, of which it consumed 94.5m b/d. The difference (1.8m b/d) went into storage tanks (on-shore tanks or sea tankers). Annually, this represents an excess in production of about 650m of barrels of oil.

Iran is expected to add a production of 500'000 b/d equal to about 30% of existing over-supply. Off the coast of Iran (Kharg) some 50m barrels of oil sit in tankers waiting for the embargo to be lifted. This overhang will keep a lid on the price of oil for a while.

Iraq and Saudi Arabia are pumping at record levels. It is hard to imagine that the three producers can agree on quota this year (if ever) that OPEC has used to rescue prices in the past.

Low oil prices do not cause companies to reduce output or stop oil fields producing oil. Mothballing oil fields is very expensive. Oil companies need the cash flow and the motto is "pump what you can".

The price of a barrel of oil may drop further to $20-$25 later this year. Nothing goes in a straight line and probably there should be a technical rebound in the price of oil before the next leg down, if any. Short coverings (by shale gas producers) can easily put the oil price back to $40-$45 range. Any rebound, depending on when it takes place and with what magnitude, should trigger a relief recovery rally in stock prices.

Projections for a meaningful and sustainable recovery in the price of oil have been pushed back to 2017.

6. Stock markets

Valuations of global equities have now come down to 13.5 x forward earnings, near the 10-year median. But "Angst" is back on the agenda and the Yale Hirsch Barometer seems to be very realistic at the moment. As a result long-term equity investors will demand higher risk premiums before entering the market. Volatility will

increase, but so will be short-term buying and selling activities. Markets have probably come down too fast and technical rebounds are probable.

7. Asset Allocation re-balancing

January 2016 has seen the largest monthly gap between stock and bond returns since October 2008 (around 11%). As a result stock/bond allocation set on the outset of 2016 is generally now off-benchmark, raising the question of portfolio re-balancing flows initiated by pension fund institutions.

8. Exchange rates

In 2015 the USD was strong against the EUR, appreciating 11%, largely the result of ECB monetary policy. With this policy (buying 60Bn of Gvt. bonds per month), announced in January 2015, the ECB aimed to support European exports and thereby economic growth. This policy was successful as evidenced by the improved growth outlook of the EMU.

American exporting companies suffered from USD strength with lower revenues and reduced profits past year. Competitive devaluations engineered by Central bankers (Japan, China, EMU) are ad-hoc solutions only. Without fundamental or structural changes their effect over time are limited.

We doubt that the USD strengthens much more in general as the FED could be forced to limit interest rate hikes due to lower growth. A weaker USD should take the pressure of the Chinese and EM currencies

As the differences in economic growth and the interest rate differential between Europe and the US become smaller, there's also less of a rational for the USD to appreciate much further without external shocks.

The Swiss franc has the potential of weakening against the euro as exports are suffering and the SNB took of the ceiling of 1.20.

Pound sterling seems vulnerable as an interest rate hike has been delayed and a possible Brexit could further dampen sentiment.

9. Less political stability

North Korea says it has successfully set off a bomb in a nuclear test. Saudi Arabia and Iran confront each other with increased hostility. In the European Union, migrants are pouring in, political extremists are on the rise and Britain may vote to drop out.

Political stability in the Euro area has gotten worse from the moment Frau Angela Merkel has welcomed 1'000'000 immigrants to her country, without discussing this with her EU partners. Although this may make economic sense, immigration divides the local populations. Right wing parties across Europe profit from this unstable situation. It may even cause the downfall of Frau Merkel, the most respected European politician and one of the few capable of holding the Union together.

The large scale of the US shale gas industry has made the USA independent of oil imports. Long term, this is of tremendous strategic importance. This has led the US to be less dependent on Saudi Arabia which could change the political landscape in the Middle East (Israel has also become an energy exporter after discovering huge gas reserves of their coast).

Oil producing nations such as Russia, Brazil, Venezuela or Nigeria face very precarious financial situations and social unrest if

subsidies in food and energy prices are not maintained.

Saudi Arabia, which initiated the fall in oil prices by maintaining full capacity output, suffers from large budget deficits (15% of 2015 GDP). Although the Kingdom still has vast financial reserves, the country has started to borrow from the international bond market and there are rumors that chunks of Saudi Aramco, the huge domestic oil company (10 times the size of EXXON) could be put up for sale.

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