Caerus Portfolio Management

CAERUS Market Commentary – February 2016

Market overview

Markets continued with the risk-off theme into February. Equities across most sub-asset groups were down between 6-9% by mid-month, in the context of continuing concerns around a potential recession in the US (manufacturing Purchasing Managers Index data was weaker than expected), sagging oil prices and negative earnings outcomes, against a backdrop of elevated earnings multiples.

We then saw a change of direction. Whilst cash, bonds and property had successfully protected capital, most equity markets rallied midway through the month, on the back of expectations that central banks will continue to hold interest rates at sub-zero in Europe and Japan, whilst interest rate increases in the US and UK seem set to be delayed for the foreseeable future.

Following this risk-on rally, only UK investment grade corporate bonds (shown in blue in diagram below) finished the month in negative territory, falling 1.36%, owing to increasing concerns that default rates will rise on the back of high levels of M&A in 2015.

On a year to date basis, this means that UK Gilts and UK Index Linked Gilts are the best performing asset group (with returns between 4.5%-5%) owing to their negative correlation characteristics and 'safe asset' status in a risk-off market. Global Bonds are up approximately 2.3% with UK Corporate Bonds, EM and United Kingdom equities only slightly lagging with negative returns of -0.7%, -0.8% and -1.5% respectively, and all other asset groups being relatively flat over the period.

United Kingdom

The UK stock market has been one of the worst performing asset classes since the market peaked around June last year, with a negative return over the period of -10.49%. The UK market has suffered from a barrage of headwinds including volatile oil prices, concerns over dividend cover in the largest companies, uncertainty arising from a possible Brexit and concern over the impact of a relative rise in Sterling on exporters as the ECB continues to devalue the Euro, given Europe is such a significant trading partner.

The UK is particularly exposed to movements in the oil prices, as large oil, gas and commodity producing companies have a higher than average weighting in the UK market. Over the course of February, UK Equity fund managers achieved returns around 1%. Even as sentiment towards Oil and particularly Miners improved, Banks started to act as a drag. Nevertheless, smaller companies underperformed the FTSE-100 as rhetoric around the UK referendum on Europe grew louder. Sterling falling increases the value of offshore earnings relative to domestically focused stocks, making companies that earn overseas look relatively appealing.

Looking forwards, many Investors now seem to be increasingly optimistic. Valuations have become more attractive and Brexit negotiations may provide an opportune time to buy high quality companies with sustainable cash flows.

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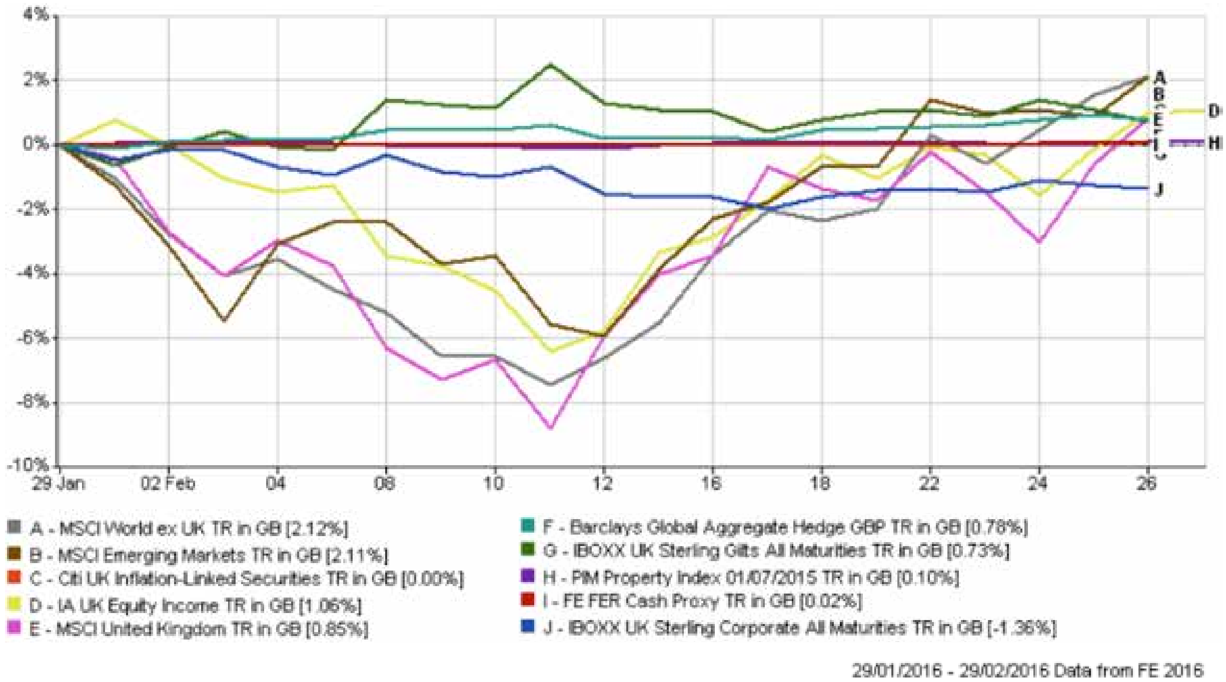

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United States

On the back of increasingly weak manufacturing Purchasing Managers Index data, the US market increasingly discounted the probability of the Federal Reserve's planned for interest rate rises for 2016. A growing consensus holds that economic growth is likely to be weaker than anticipated. This has led to movements in the yield curve leaving lower risk Investors increasingly vulnerable, should the Fed move to increase interest rates, as previously guided. So, in a display of confidence, the Fed opted to reassure markets by reminding Investors that consumer spending makes up close to 70% of the US economy and is doing well, whereas the struggling manufacturing sector is only responsible for 10% of GDP. With unemployment close to record lows and with increasing real wages, the consumer appears to be in a relatively strong position. This means the risk of the US entering a recession is lower than some expected and an increase in interest rates should still be considered as a distinct possibility.

Internationally, in a classic 'flight to safety', many Investors have moved to the US Dollar over recent months which continues to create demand for US Investment assets despite valuations that are high, relative to their historic trading range. The risk-off rally, led to a significant bounce in US equity market returns, with the MSCI North America index up close to 9% from mid-February to the end of the month.

Europe

A large proportion of the rise in value of European equities, in recent years, has come from an increasing earnings multiple, on the back of a strongly supportive central bank and continued loose monetary policy. These historically high multiples have come under significant pressure since June 2015 and despite a rally of circa 7.5% since mid-February, the market p/e ratio remains below its long term average.

Investors are increasingly optimistic that a fragile European recovery, low inflation and a more volatile macro backdrop, may dictate a further loosening in monetary policy, which could potentially be positive for riskier assets.

Japan

Japan's economic recovery remains elusive, as seen by a contraction in GDP of 0.4% in the last quarter of 2015. In reaction to this, the Bank of Japan reduced interest rates into negative territory at the end of January. Ironically all this has done is accelerate the flight to safety, which has placed upward pressure on the Yen, squeezing Japan's many large multi-national corporations ability to export. Until these large corporates are sufficiently confident of their long-term profitability to raise wages, Japan is likely to struggle to recover. Often it is in the hour of greatest need that tough political reforms are enacted which can help to spur an economy back to life. The Abe government has been contemplating a number of these for some time. Perhaps we are nearing the time for action.

Emerging Markets

Although the US Dollar has weakened somewhat in 2016, the capital outflows from Emerging Markets remains as strong as those seen in 2015 when over $730bn was withdrawn. This reflects not only the partial unwinding of 'tourist' money that entered the EM asset class with quantitative easing, but also structural challenges facing a number of the larger, emerging economies. Concerns over Chinese banking sector stability have been extensively aired, Brazil's dire corporate governance is well known and Russian oil price sensitivity has even started to filter into a more positive dialogue with OPEC. As a result, whilst valuations are never, by themselves, a signal to invest, at some point the lack of an appetite for this asset class will change, and for long term investors current valuations look increasingly attractive.

CAERUS Sentiment Indicator