Forum Finance Group

since 1994

January 2016

Investment Perspectives 2016

INVESTMENT PERSPECTIVES 2016

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EXECUTIVE SUMMARY

***Global GDP growth for 2015 once again failed to match up to early-year expectations. EM was a weak spot**, with severe recessions observed in Brazil and Russia, while concerns over the slowdown in China affected the rest of Asia. U.S. GDP growth was well below the average January forecast of 3%, especially due to a weak first quarter. In contrast, **the Eurozone fared well** despite the Greek debt crisis, the slowdown of China and the ongoing tensions with Russia over Ukraine.*

*It turned out to be a very tumultuous year for financial markets. **Commodities were under severe pressure** for most of the year, mainly due to oversupply, high inventory levels and weaker demand. **EM assets also performed poorly** on the back of investor outflows and the prospect of higher US interest rates. **European and Japanese equities fared the best**, in local currency terms, mainly as the result of ultra-accommodative monetary policies. **The dollar appreciated against all currencies**, reflecting the relative strength of the US economy and the anticipation of higher interest rates, which were finally raised by the Federal Reserve during its last meeting of the year; this decision had been widely expected and was welcomed by the markets.*

***2016 global economic growth is expected to improve slightly**, as the recovery in Europe gathers more momentum and as global emerging markets should do a little better, in particular due to less severe recessions in Brazil and Russia and a stabilization of China. **The main central banks remain in accommodative mode**, even if the Fed has started to hike rates. Some of the main risks for 2016 include an extension of the rout of commodities, especially oil, political issues such as Brexit, the rise of populism in Europe and US Presidential elections as well as geopolitical threats including instability in the Middle East and a deterioration of relations between NATO countries and Russia.*

*Throughout 2015, **we gradually shifted the portfolios towards more flexible strategies**, including non-benchmarked fixed-income funds, long/short equities and global macro. **We increased our exposure to convertible bonds** and also reinitiated an investment into US high-yield. **We consistently remained very underweight EM assets and commodities**, while being **positively biased towards the dollar and DM equities**.*

*For 2016, **we remain positive on equities relative to high-grade bonds** and maintain our **overweight in developed markets equities over emerging markets**. Our assessment is that European equities should benefit from the region's economic recovery, reasonable valuations and the support of the European Central Bank's policies. **Our search for yield focuses on European loans and high-yield as well as investment-grade sovereign debt outside of Europe**; we also believe that **convertible bonds should perform well in the current market conditions** and help to limit portfolio volatility.*

***Our view on the dollar remains positive**, in particular against EM currencies, but also compared to the euro, whose value should continue to be impacted by the very accommodative policy of the ECB. **Gold will have to face headwinds**, including an appreciating dollar and higher US interest rates, **but its role as a hedge could prove to be useful during periods of stress** on other financial assets.*

2015: REVIEW OF OUR INVESTMENT THEMES

Developed market equities were our top pick in terms of asset classes

At the beginning of 2015, our key asset allocation decisions were to be overweight in equities of the developed markets, with a bias towards Europe and Japan, to be cautious on investment-grade bonds, to hold a very limited exposure to emerging markets' assets and to avoid commodities, with the exception of gold. Overall, these choices proved to be appropriate, especially when assessed in relative terms, even though it was still difficult to generate attractive returns at the portfolios' level as few asset classes produced positive performances.

We expected the dollar to perform well

In terms of currencies, our main call for 2015 was for the dollar to strengthen against other major currencies and commodity-related ones. Despite the well-documented hesitations of the Federal Reserve to start hiking interest rates, the dollar appreciated significantly against the overwhelming majority of currencies and ended the year at multi-year highs. Like most market participants, we were not expecting the Swiss National Bank to remove its 1.20 floor against the euro and this decision was the first of several FX-related events that triggered severe volatility across all financial asset classes.

We avoided commodities

Our call was to avoid any direct exposure to commodities, in particular due to deteriorating fundamentals resulting from excessive supply, weaker demand and a stronger dollar. The behaviour of oil prices proved to be very different from the consensual view that they should stabilise over the course of the year and ultimately end the year higher; OPEC's decision to focus on protecting their share of the market and US shale production well above projections meant that the price of oil ended 2015 at multi-year lows.

Returns of hedge funds were mixed

The performance of hedge funds has been mixed. Some of our managers produced solid returns with limited volatility and thus fulfilled their objectives, while others were unable to adjust quickly enough to challenging market conditions and frequent reversals of trends.

2015: ECONOMIC DEVELOPMENTS

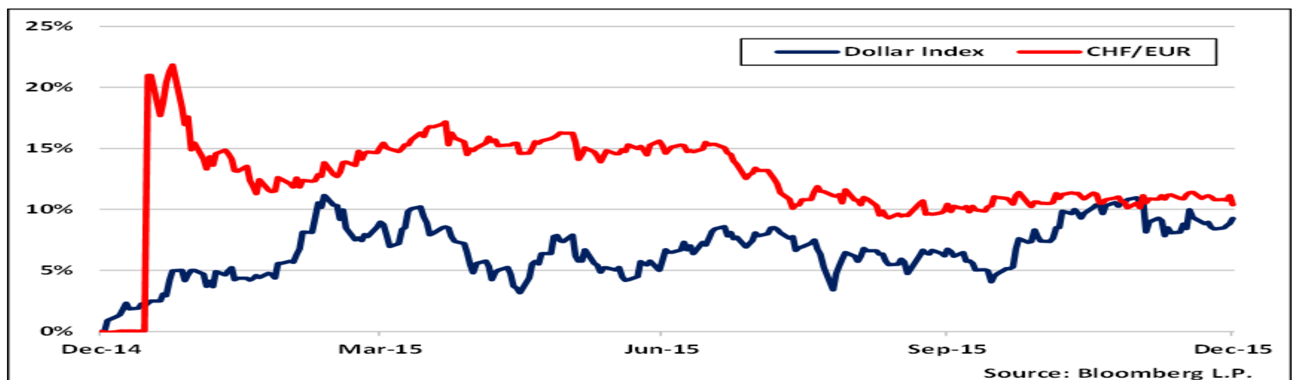
Monetary policies set the tone again

The Federal Reserve finally hikes rates

The Federal Reserve's resolve to start hiking interest rates was challenged by the appreciation of the dollar, low inflation and external factors including the slowdown of the Chinese economy and weak commodity prices. In order to maintain its credibility, the central bank finally made its move at its December 15-16 meeting by increasing the Fed Fund rate by 0.25%; further hikes are expected in 2016, but the bank still considers its policy to be very accommodative and it is most likely that the Fed will proceed very cautiously. It is clear, however, that Janet Yellen and her FOMC colleagues will look beyond US unemployment and domestic inflation before deciding on further rises. In a similar way to the Federal Reserve, the Bank of England has remained very cautious and refrained from changing its policy throughout 2015. It is likely that it will follow the Fed and also start normalising its monetary policy by raising its rates this year.

The ECB boosts its QE program

In contrast to the Fed, the ECB has taken additional easing measures to boost inflation expectations, to keep a lid on bond yields and to weaken its currency. The comments from different ECB board members have reflected a certain lack of unity, but Mario Draghi is clearly determined to convince the markets of his intentions and is prepared to do more if necessary. Without directly referring to the value of the common currency, Draghi is keeping the euro competitive in order to stimulate both exports and domestic inflation. It was not surprising that the announcement of additional measures followed a period when the euro had climbed from a low of 1.05 in March to a level above 1.15 in August.



The chart above shows the 10% appreciation of the dollar relative to a basket of other major currencies (Dollar Index) in 2015; it also shows the trend of the Swiss franc versus the euro.

The bombshell of the Swiss National Bank

The decision of the Swiss National Bank in January to abandon its key policy, preventing any depreciation of the euro against the franc below a 1.20 level, was a major shock for the markets; in view of the consequences of the very accommodative policy actions decided by the ECB at the end of 2014, the SNB concluded that its balance sheet would disproportionately expand if it were to continue defending its 1.20 floor. The initial market reaction was extremely brutal as the franc appreciated to the parity against the euro. Following this knee-jerk reaction, the franc's value gradually gave back some of its gains against the other major currencies and during the last months of the year it has consistently traded close to a 1.08 level against the euro.

The People's Bank of China triggers summer volatility

Another major shock which triggered considerable market angst at the beginning of August was the decision by the People's Bank of China to allow the yuan to depreciate vs. the dollar. The Chinese currency had been under prolonged downside pressure and the bank's decision to intervene was initially considered as a way to regain competitiveness for its exporting sector in view of the decelerating growth of the Chinese economy. The Chinese authorities denied this was the main reason as they then intervened decisively to stabilise the currency. In fact, the main objective behind the PBOC's move was the inclusion of the yuan in the IMF's special drawing rights (SDR) basket of currencies; for this purpose, it had to allow more flexibility on its currency. Looking ahead, a further depreciation of the yuan in 2016 vs. the dollar could represent a serious risk for the markets, notably due to the spillover effects onto its main trading partners.

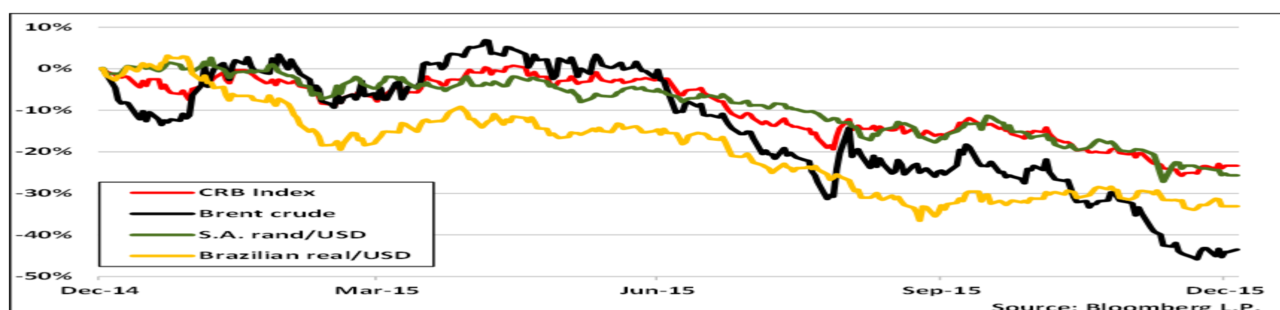
Emerging markets had a rough time in 2015

A tough year for emerging markets

During 2015 economic growth of emerging markets decelerated for the fifth consecutive year. This slowdown resulted partly from the impact of the ongoing rebalancing of the Chinese economy on other emerging markets, particularly due to the drop of manufacturing and industrial production as well as lower demand for commodities; the rout of commodity prices also had a major bearing on the countries mostly dependent on energy and mining exports. Furthermore, political instability in countries such as Brazil only contributed to worsen an already dire economic situation. A severe depreciation of emerging markets' currencies was the most obvious consequence of this economic slowdown as investors strongly reduced their exposure to the region's assets.

The rout of commodities

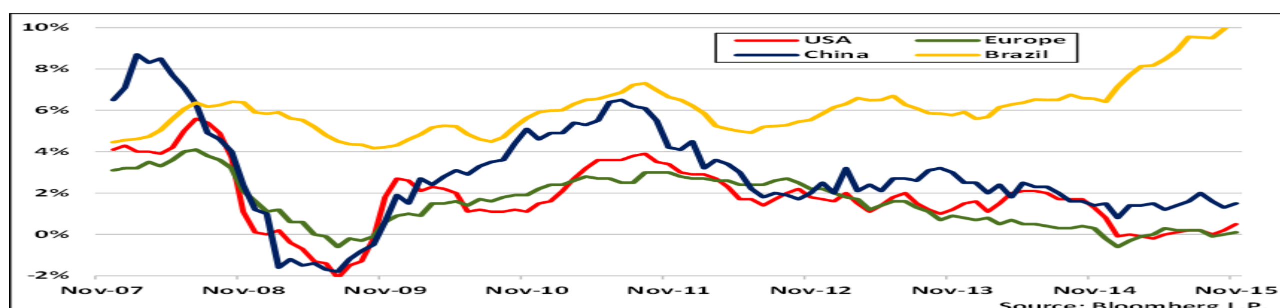
2015 will be remembered as an "annus horribilis" for commodity producers as prices continued to slide. In contrast to most early-2015 forecasts, oil prices failed to stabilise as both OPEC and non-OPEC countries maintained, or even increased, their levels of production to protect market shares rather than attempt to push prices higher. Production levels of US shale oil confounded most forecasts and the main swing oil producer, Saudi Arabia, decided to ramp up its production to apply more pressure on other producers. A similar situation could be observed in the mining sector, as major companies opted to maintain their activity and pressurise smaller competitors at a time when global demand was dropping, from China in particular.



The chart above shows the significant decline of commodity prices (CRB Index), and of oil prices in particular, during 2015 as oversupply continued to drive returns; one can also observe the extremely strong correlations between commodity indices and emerging markets' currencies.

Still little signs of inflation

When the Federal Reserve launched its quantitative easing program, expectations were that this would ultimately result into massive inflation as cheap money was overly available. So far, this has proven to be wide of the mark as inflation remains well below the levels targeted by the main central banks. There remains massive oversupply across most commodity sectors, with oil being a perfect example; labour capacity is also still abundant, even if job markets are getting tighter in Japan and the United States. So far, the significant improvement of US labour markets in terms of the number of new jobs created has barely started to translate into wage inflation.



Headline inflation rates edged higher during 2015 but remain very low by historical standards. After dropping to -0.6% in January, headline inflation in Europe turned slightly positive to reach + 0.2% in November, with core inflation, which excludes energy and food, at 0.9%. In the US, headline inflation was negative until April and has since risen to a level of 0.5% with core inflation at 2%. As shown above, inflation in China was recorded at 1.5% in November, the same level as the year before, whereas the massive depreciation of the Brazilian real has pushed inflation above 10%, the highest level since November 2003.

Conclusions

The main conclusions that we draw from 2015 economic developments are that central banks continue to exert a disproportionate influence on financial markets, the economic environment remains deflationary and emerging markets currently present more risks than advanced economies.

Central banks remain the key drivers of markets

More than seven years after the start of financial crisis, the role of central banks remains as paramount as ever; following the resolution of the timing of the first US rate hike, markets will continue attempting to decipher the Fed's next moves, especially considering that the markets are only pricing in two hikes compared to the Fed's projections of four. The ECB's path appears much more straightforward as the bank targets a weaker euro and higher inflation expectations, leaving the door open for more intervention. Altogether, global liquidity remains abundant and it is most unlikely that the main central banks will be able to fully normalise their policies anytime soon.

A deflationary environment

The issue of positive inflation developments appears difficult to predict, but central banks will struggle to meet their inflation targets. For inflation expectations to rise, wage inflation will need to become more established in countries where labour conditions are already tight. The prices of commodities will also need to stabilise somewhat to reduce the base effects of declining prices.

Emerging markets still in repair mode

Over the course of the last years, the main economic risks have shifted from the advanced economies to emerging markets. China continues to struggle to transition from a model based on exports to one more reliant on domestic consumption while emerging markets overly dependent on commodity exports are suffering from weak demand and a lack of reforms during the boom years. Also, a number of emerging markets that have allowed an excessive growth of money and credit after the financial crisis need to slow down and adjust; they will be unable to grow at the same speed until they have eliminated their debt and over-spending problems.

2015: THE FINANCIAL MARKETS

When assessing the performance of a wide range of financial assets in 2015, it appears clearly that it was another extremely challenging year for investors. The declines of assets such as commodities and EM currencies have been much worse than the modest positive returns recorded by the best performing assets such as Japanese and European equities. Also, the over reliance of markets on the support from central banks and the introduction of new banking regulations have created specific market risks, including lower liquidity in certain asset classes and investment flows increasingly based on momentum, resulting into bouts of volatility when investors decide to adjust certain exposures.

2015 performances

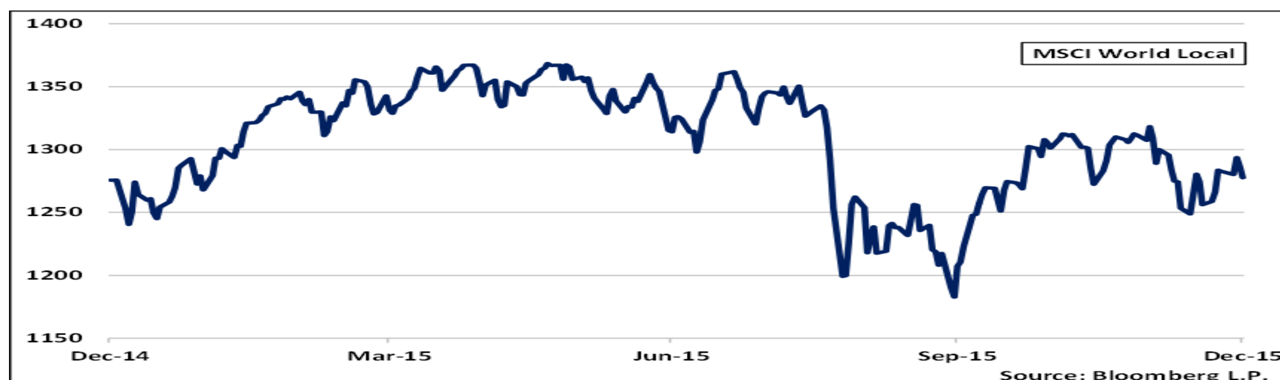
	End 2014	End 2015	2015 performance
Equities			
S&P 500	2058.9	2043.9	- 0.7%
Euro Stoxx 50	3146.4	3267.5	+ 3.8%
MSCI EM	956.3	794.1	- 17.0%
Yields			
UST 10-year	2.17%	2.27%	+ 10bps
Bund 10-year	0.54%	0.63%	+ 9bps
BBB EU	1.61%	1.75%	+ 14bps
Currencies			
EUR/USD	1.210	1.086	- 10.2%
USD/CHF	0.994	1.002	+ 0.8%
GBP/USD	1.558	1.474	- 5.4%
USD/JPY	119.8	120.2	+ 0.3%
EUR/CHF	1.203	1.087	- 9.6%
Commodities			
CRB Index	230.0	176.0	- 23.4%
Oil, WTI	$ 53.3	$ 37.2	- 30.5%
Gold	$ 1185	$ 1061	- 10.5%

Equities

Global equity markets ended the year virtually flat with positive performances provided by European and Japanese equities, while the US S&P 500 Index ended the year modestly negative and global emerging markets recorded another yearly drawdown as they significantly under-performed developed markets. The positive early-year trend, especially for European and Chinese equities, gave way to a summer correction largely due to the Greek debt crisis and concerns about a slowdown in China.

To a certain degree, the most important driver of equity performances was the behaviour of currencies. The removal of the EUR/CHF floor by the SNB in January resulted into a steep drop of Swiss equities, whereas European equities benefited from the weaker euro following the introduction of very accommodative ECB measures. Despite the resilience of the yen relative to the strong dollar, Japanese equities fared the best as they returned 10%. The breadth of the US market was poor. If it hadn't been for the strong performance of a small number of technology stocks (Amazon, Google, Facebook & Netflix), the S&P 500 Index would have ended 2% lower.

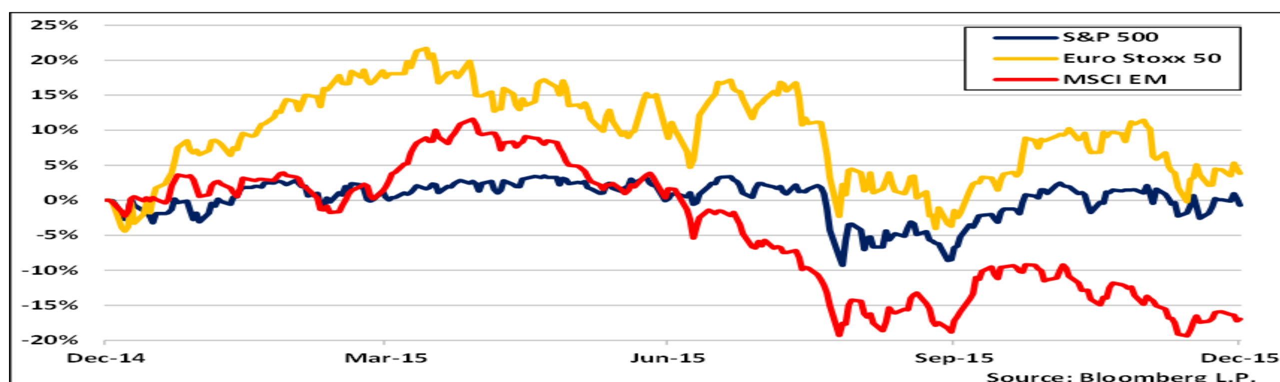
MSCI World Local



Until the summer, global equity markets performed positively under the leadership of European, Japanese and Chinese equities. However, the strong rise of Chinese equities quickly gave way to a severe correction, despite local authorities' attempts to stabilise the market. The spring and summer months also saw European equities abandon their gains as the euro appreciated from a March low of 1.05 versus the dollar to over 1.15 in August. Global equities were also badly affected by the devaluation of the yuan and markets experienced heavy losses in September.

The last quarter of the year proved to be volatile, with stocks rebounding very strongly in October as concerns related to the Chinese economy abated and as central banks reaffirmed their support. Following a relatively quiet month of November, the end of the year was much more volatile; markets initially dipped as new ECB measures failed to match expectations before regaining some composure as they reacted very positively to the Federal Reserve's decision to finally raise interest rates.

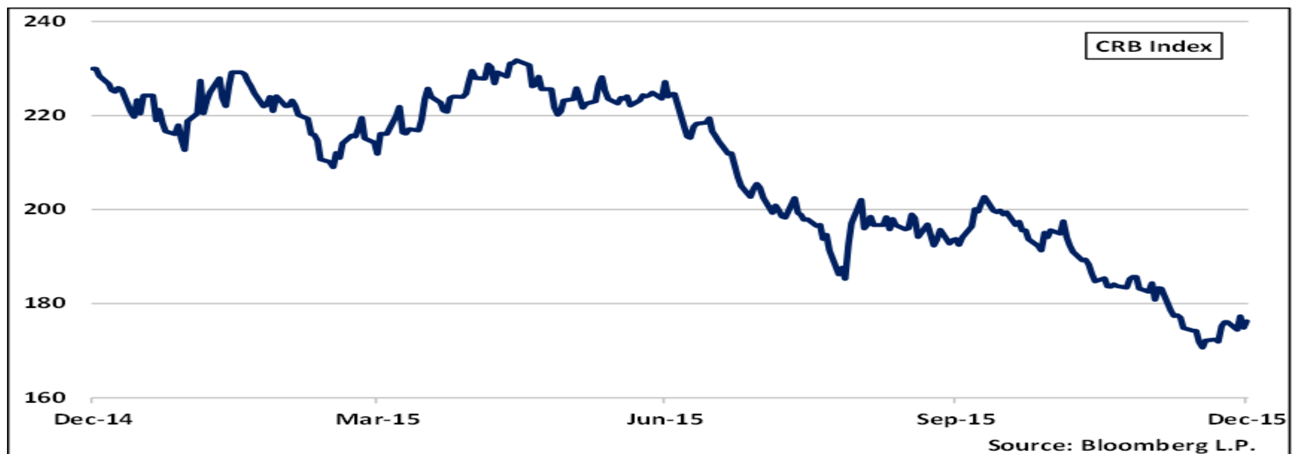
S&P 500 - Euro Stoxx 50 - MSCI Emerging Markets



The depreciation of the euro contributed the most to the outperformance of European equities during the spring and the end of the year; in between, US equities proved to be more resilient during a period when appetite for risk assets was low. The equities of emerging markets under-performed once again as investors reduced their exposure on the back of slower growth, depreciating currencies, weak commodity demand as well as political instability.

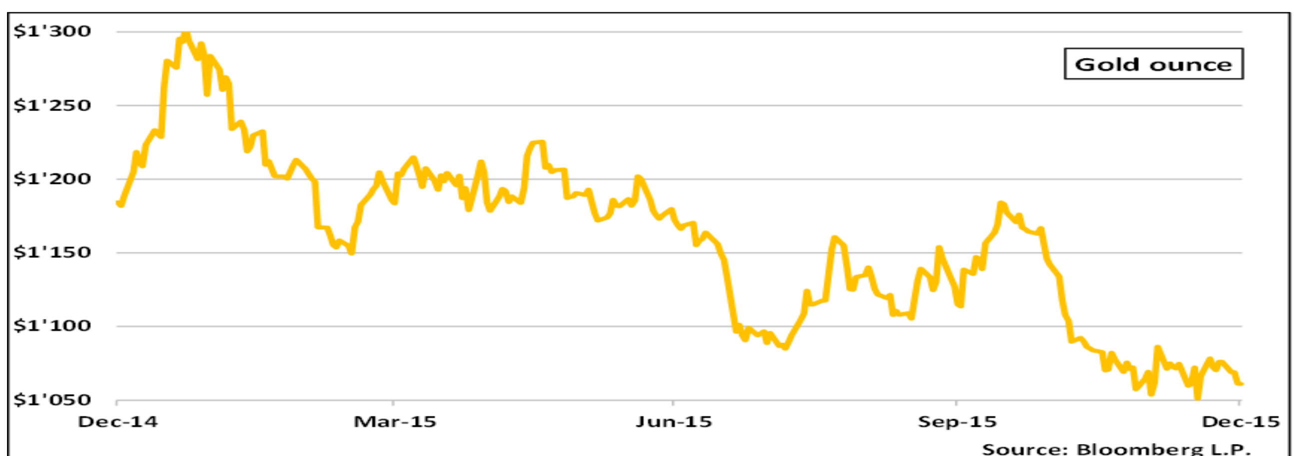
Commodities

CRB Index



Commodities were under constant selling pressure throughout most of 2015. The strength of the dollar, oversupplied markets, high inventory levels and lower demand all acted as unsurmountable headwinds for the asset class; the weakness of energy prices also translated into lower production costs and the maintenance of high levels of production, thus preventing any rebalancing of oversupplied markets. A war of contrition is currently under way in the energy and mining sectors as the most powerful producers prefer to protect their market share by relying on their stronger balance sheets rather than take measures that could support prices. The global CRB Index lost over 23% while the price of a barrel of WTI oil dropped by over 30%.

Gold

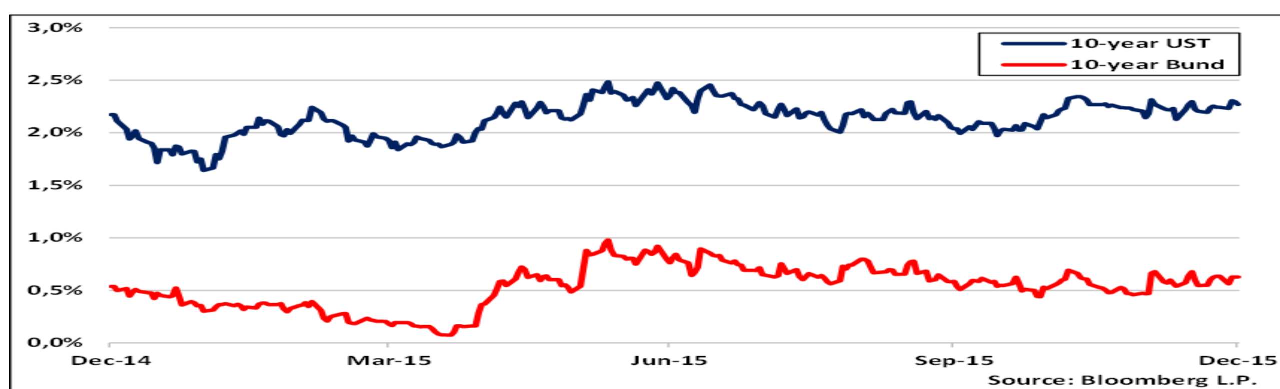


As for the whole of the commodity asset class, gold failed to shine during most of the past year as its price dropped by some 10%. The appreciation of the dollar, the prospects of higher US interest rates and lower retail demand were the main reasons for this correction.

Debt instruments

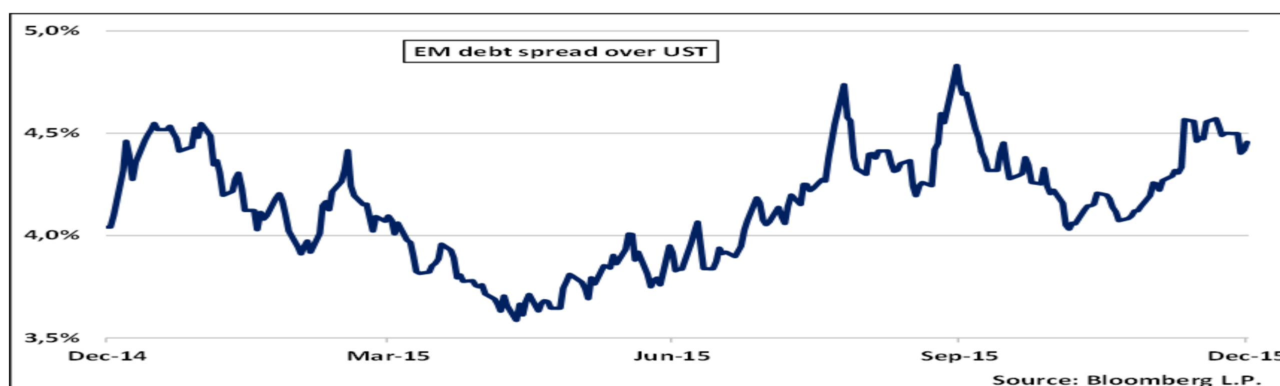
2015 was a complicated year for fixed-income assets as a period of record low yields in Europe was followed by a severe rout which pushed rates much higher (10-year Bund yields spiked from 0.1% in April to 1% in June). Uncertainty about the Federal Reserve's monetary policy path and the state of the Chinese economy contributed to cap US Treasury yields. European peripheral debt remained resilient during the summer months' Greek debt crisis while US high-yield spreads varied considerably, essentially due to the vagaries of the energy and mining sectors.

10-year US and German government bond yields



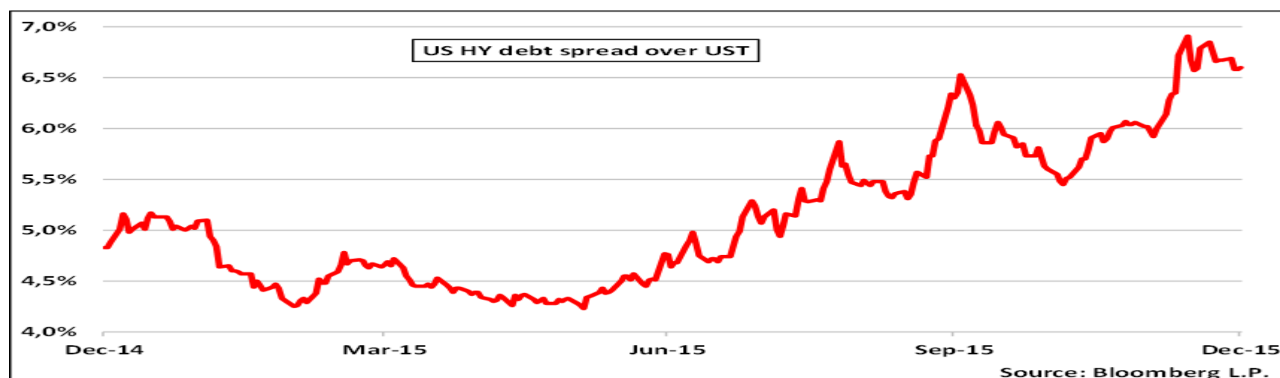
The yield spread between US and German sovereign debt widened considerably at the beginning of 2015 as Bund yields gradually dropped to record lows in April. Thereafter, spreads tightened due to a violent selloff of Bunds; the remainder of the year saw spreads widen again under the impact of divergent monetary policies.

Emerging Market Debt spread



The spread of emerging market debt yields over U.S. Treasury yields (JPMorgan EMBI Global Spread Index) initially widened by 50bps to 4.5% before contracting to 3.6% as the prospects of a first US rate hike no longer appeared to concern market participants. Thereafter, EM debt lost ground due to weaker commodity prices and worries related to China.

US High Yield spread



The second half of 2015 was a difficult period for the US high yield asset class due to its increasing correlation with commodity prices. As shown above, spreads tightened until early June before a collapse of oil prices triggered wider spreads as investors priced in a higher probability of defaults in the energy and materials sectors.

Debt instruments' market performance in 2015 (USD)

World Government Bond Index	*+ 0.9%*
U.S. Credit AAA	*+ 1.2%*
U.S. Credit BBB/BB	*- 1.9%*
Global Emerging Market Sovereign	*+ 0.7%*
U.S. High Yield	*- 5.6%*

Currencies

The US dollar appreciated against the vast majority of currencies on the back of anticipations of higher US interest rates and the divergence of monetary policies between the Federal Reserve and the other major central banks. The very dovish stance of the ECB contributed to weaken the euro during the first quarter as the EUR/USD exchange rate dropped by some 13% to 1.05 by mid-March; the euro then rebounded above 1.15 in August before the ECB's commitment to increase its policy support for the Eurozone economy resulted in a year-end parity of 1.09 for the common currency.

Foreign-exchange markets got off to a spectacular start in January as the Swiss National Bank unexpectedly removed its 1.20 floor on the euro versus the franc. This decision caused severe stress, with the euro temporarily dropping below parity. Thereafter, the SNB managed to stabilise its currency through a mix of market interventions and extensive communication.

EM currencies were under constant pressure throughout 2015; investors strongly reduced their exposure to EM assets while the currencies of commodity-exporting countries were hit by the slide of commodity prices.

Hedge funds

For most hedge funds, 2015 was another disappointing year as they struggled to produce positive returns; managers have complained about a lack of liquidity and volatile markets in explaining some of the worst performance since the financial crisis. The HFRX Global Hedge Fund Index ended the year with a negative performance of - 3.6% as most strategies proved unable to make money.

As always, there was a wide dispersion of returns with some large firms posting positive double-digit returns while other well-known ones, such as BlueCrest Capital Management, Fortress Investment Group, BlackRock and Bain Capital, decided to either no longer oversee money for outsiders or to shut down some funds due to redemptions and heavy losses. Overall, inflows into the industry were well below those of the previous year, especially from the third quarter onwards, with estimates showing a decline of roughly 40%.

HFRX Global Hedge Fund Index

Hedge Fund strategies' performances in 2015 (* end November)

HFRX Global Hedge Fund Index	- 3.6%
HFRX RV FI Convertible Arbitrage Index	- 0.1%
HFRX Multi-Emerging Markets Index	- 0.9%*
HFRX RV FI Corporate Index	+ 1.2%*
HFRX Equity Hedge Index	- 2.3%
HFRX Macro Multi-Strategy Index	+ 0.3%*
HFRX Event Driven Index	- 6.9%
HFRX Equity Hedge Short Bias Index	+ 0.1%*
HFRX Macro Systematic Diversified CTA Index	- 0.9%

2016: ECONOMIC OUTLOOK

An uncertain macro-economic backdrop in 2016

Expectations are for a slight improvement of global economic activity in 2016. Growth in the Eurozone should continue to be resilient due to stronger domestic demand, low energy prices, a weaker euro, recovering job markets and further improvement of credit conditions. US economic growth is expected to hover around a 2% level, with the support of the recovery of the housing sector, solid labour markets and a more expansive budgetary policy. The drag from emerging markets on global growth should decrease even if many headwinds remain.

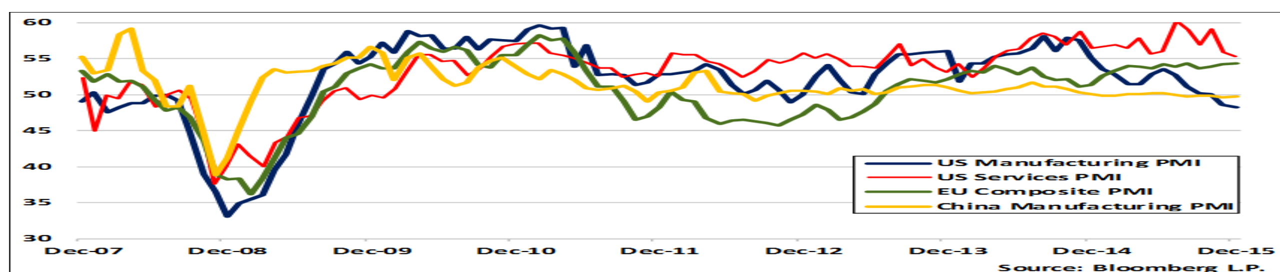
China and emerging economies are the main areas of concern

China's economy is having to face weaker demographics, high levels of debt and disinflationary pressures that could spill over onto its main trading partners. On the positive side, policy makers have the capacity to adopt a more accommodative budgetary policy and to ease monetary policy by lowering interest rates and reserve ratios. Across the rest of emerging markets, growth should improve but will remain below trend; political instability, weak commodity prices, higher levels of debt and the ongoing transition towards models more based on domestic demand are some of the key issues that emerging markets have to face.

The increase of risks

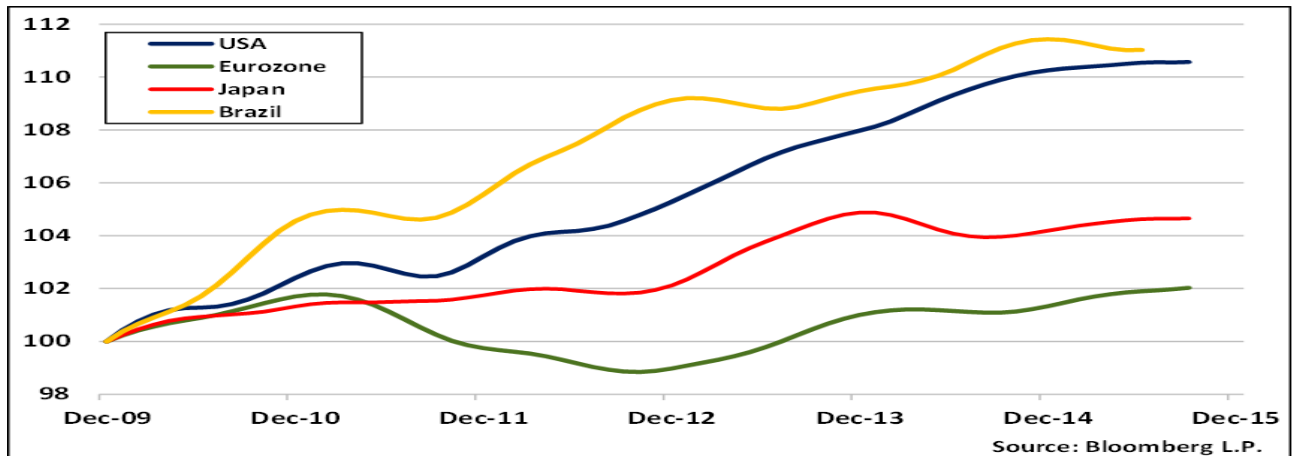
As ever, a number of risks could undermine the sluggish recovery. Investors will be concerned by the Federal Reserve's tightening cycle and its repercussions on financial conditions across the world. Political developments in Europe could hurt consumer confidence; risks include regional elections resulting in rising populism, an unprecedented refugee crisis, the threat of more terror attacks and the UK referendum on its membership in Europe. The US has to elect a new president from a list of underwhelming candidates while the impact of geopolitical risks, prevailing and unexpected, is always impossible to predict.

Leading indicators: Purchasing Manager Indexes



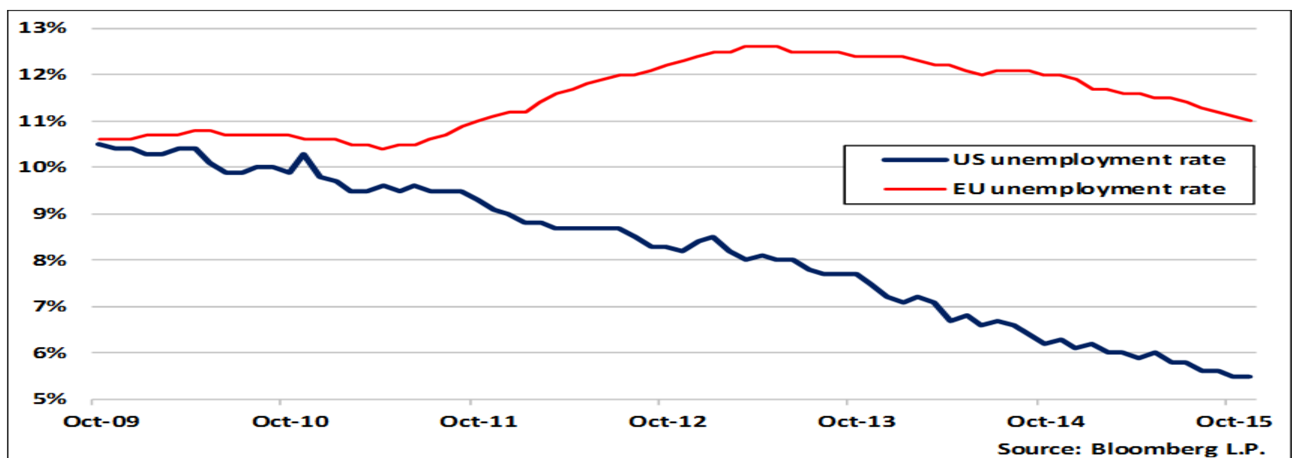
PMIs do not present a homogeneous picture across the world. Generally speaking, the services sector has been doing better than the manufacturing sector, notably in the US and in China. Services represent 85% of the US economy and sentiment remains at historically high levels; in contrast, manufacturing activity, which accounts for 12% of the US economy, has lost momentum due to a strong dollar, a cut of investment in the energy sector and slower global demand. Europe has been a bright spot and PMIs continue to indicate an extension of the region's recovery.

Leading indicators: OECD Composite Leading Indicators



The chart reflects the trends observed across the different regions; whereas the declining trend of the Brazilian economy is quite extreme, it does reflect the narrowing gap between growth rates observed in advanced economies and emerging markets. The improvement of the US economy observed during the previous years has tapered off in 2015 and its Leading Indicators are no longer showing the same strength. In contrast, the Eurozone has been picking up momentum throughout 2015, as shown by the improving trend of its Leading Indicators.

The labour markets: U.S. and EU unemployment rates



The chart shows that the unemployment rate in the US continued to decline in 2015 to a level of 5%, the lowest since April 2008; the civilian labor force participation rate, at 62.6 percent, has changed little during 2015 and remains well below its peak of 67.3% recorded in January 2000. In Europe, the jobless rate has declined by 0.9% during 2015 to 10.5%, its lowest level since January 2012 and 1.6% below its 2013 peak of 12.1%.

Conclusions

The observation of leading indicators and economic trends lead us to conclude that the outlook for 2016 points to a modest acceleration of global growth. Europe's recovery should extend at a faster pace and emerging markets' growth should improve if, as expected, recessions in countries like Brazil and Russia become less severe.

An unbalanced economy

From a regional perspective, advanced economies should remain resilient due to solid domestic activity, while emerging markets will continue to experience softness and grow at rates well below their historical levels. China should be able to adjust to a slower pace of growth but persistent deflationary risks could trigger a deeper than anticipated depreciation of the yuan and hurt its main trading partners. A stabilisation of commodity prices still appears unlikely in the short term due to a supply glut while an escalation of Middle East tensions would represent a major geopolitical threat. In this context, global monetary policy will remain accommodative, especially if inflation expectations fail to rise.

Many political/geopolitical risks ahead

In contrast to the previous years, political risks appear to present bigger threats than economic ones. In Europe, France and Germany will be preparing for crucial votes in 2017, while the recent results of the Spanish general election have shown that traditional mainstream political parties are losing support to the populist ones; the UK vote on EU membership could result in Brexit. The US presidential election will be held in November and the debates between the different candidates have been rather uninspiring so far. Also, a large emerging market such as Brazil is in the midst of political turmoil which has only worsened the current economic recession; finally, geopolitical risks such as a multi-sided conflict in Syria, tensions between Saudi Arabia and Iran and North Korea aberrations pose a threat to consumer confidence which is difficult to assess.

2016: FINANCIAL MARKETS' OUTLOOK

A fragile market sentiment

The behaviour of financial markets during the first trading sessions of 2016 reflects both an uncertain economic outlook and investors' low level of confidence. Global equity markets have experienced one of their worst yearly starts ever on the back of renewed concerns about the state of the Chinese economy, a rise of geopolitical tensions and a further collapse of energy prices. Throughout the year ahead, we expect markets to remain volatile and for tactical decisions to take on added importance.

A challenging environment

Whilst growth trends of the advanced economies appear relatively resilient, emerging economies represent a source of risk as they struggle to shift towards a model less dependent on exports and as some countries suffer from the consequences of weak commodity prices. Central banks will globally maintain their support to markets but policies have started to diverge and their impact is waning.

Debt instruments' outlook

G7 government bonds remain unattractive

The yields of G7 10-Year bonds have remained stable or even dropped compared to a year ago, with the exception of a modest rise for French bonds. We continue to consider these highly-rated investments as too expensive and their unattractive risk/reward profile leads us to prefer investing into other fixed-income assets for income purposes.

An uncertain path for US monetary policy

Following the Federal Reserve's first rate hike in December, 10-Year U.S. Treasuries are still trading around a low level of 2.1%; markets are currently pricing in two further rises of rates in 2016 which contrasts with the expectations of four hikes by FOMC members. We tend to agree more with the markets' view and believe that the Fed will act very cautiously, especially if markets were to remain volatile.

Corporate default rates should remain low

The current macro-economic conditions and the actions of the central banks make it likely that corporate default rates should remain at low levels with the exception of the US high-yield asset class; Fitch Ratings expect its default rate to rise from 3.3% in December to 4.5% in 2016 as weak commodity prices will continue to challenge energy and metals/mining issuers.

Equity outlook

Earnings will be key

A modest improvement of global economic growth and accommodative monetary policies should still provide a supportive background for risk assets despite gathering headwinds including unstable emerging markets, geopolitical tensions and weakening US earnings trends. The strength of the dollar and the issues faced by the energy sector continue to act as a drag on US earnings and a deterioration of this trend could impact support for US equities; in contrast, European equities should benefit from better earnings trends and a very accommodative ECB.

Valuations of equities are unlikely to expand much

The uncertain environment should limit any significant expansion of multiples, hence the importance of improving earnings for equity prices to move higher. From a valuation perspective, equities remain more attractive than most fixed-income asset classes, especially after the latest correction of equity markets. European and Japanese equities still trade at a discount compared to US equities and we expect them to outperform again this year.

Emerging markets equities could eventually outper-form

Emerging market equities fared poorly in 2015 and lagged the performance of developed market equities for the third year running. This has left their valuations relative to developed ones close to a ten-year low; while we think it is still too early to increase our exposure to the asset class, 2016 should eventually present a window of opportunity for buying EM equities.

Alternative investments

Hedge funds remain a key component of portfolios

Alternative investments add value to portfolios due to their ability to exploit market inefficiencies, reduce portfolio volatility, bring diversification and provide access to complex strategies. Some of our current focuses are on global macro and on long/short strategies which should benefit from the lower correlations between equities, rates, sectors and countries.

More opportunities due to diverging monetary policies

For certain strategies, the widening divergence of monetary policies between the Federal Reserve and some of the other major central banks will present a favourable background; the arbitrage of yield curves, rates and currencies is one area where managers could do well.

A higher volatility regime should favour alternative investments

Taking into account modest expectations for the returns of traditional financial assets in the year ahead and the probability of a regime of higher volatility, 2016 could prove to be a better opportunity than the previous years for investments into structured products. Furthermore, the performance of hedge fund strategies based on the trading of volatility picked up in 2015 and we expect this also to be the case in the year ahead.

Gold outlook

The outlook on gold is a tough call

On balance, the outlook does still not look overpromising for gold even if it has recently benefited from a rise of geopolitical tensions and market instability which could persist. The downside appears limited as the $1'000 level should offer strong support; the appreciation of the dollar and the prospect of higher interest rates represent the main headwinds, but we expect these factors to remain contained and not to push gold prices much lower from the current level.

The diversification role of gold

The modest short-term prospects for gold prices should not detract from the fact that gold is still considered a safe haven asset and a hedge against the more extreme risks. Low/negative interest rates and modest expected returns from other assets mean that the opportunity cost of owning gold is cheap, so we feel comfortable holding a small position.

Currencies outlook

Dollar appreciation to slow

As anticipated, the US dollar was the strongest currency in 2015; the market outlook for the dollar in 2016 is less consensual than a year ago, but we maintain a positive bias in the medium term. The prospect of higher US interest rates, solid domestic labour and housing markets and the willingness of other central banks to weaken their currencies should act as supports for the dollar.

The Swiss franc likely to track the euro

After the Swiss National Bank had stunned financial markets by scrapping a three-year-old cap on the franc against the euro, sending the currency soaring, it spent most of the year trying to convince markets that its currency was overvalued. Since the summer, the franc has been very stable and, looking forward, we expect the EUR/CHF to remain within its current 1.07/1.10 range.

The sterling could fall further against the dollar

The pound has recently been under pressure due to soft economic data and political risks related to the referendum on EU membership. The uncertainty about the result could see the Bank of England adopt a more cautious stance in the near term; while the GBP appears vulnerable, the prospect of higher US interest rates should translate into a further drop of the GBP/USD parity.

The depreciation of EM and commodity currencies to eventually abate

The outlook for commodity-related currencies remains bearish in the short term; as long as the trends of slowing demand and lower commodity prices extend, the value of currencies such as the Australian dollar and the South African rand will remain under pressure. However, the depreciation of emerging market currencies should eventually abate as EM growth stabilises and as upward pressure on the dollar peaks; the PBOC's management of the renminbi against a basket of currencies, rather than just against the dollar, could represent a source of risk.

2016: ASSET ALLOCATION

Debt instruments

Our allocation to the debt instruments asset class is underweight

Our allocation to debt instruments remains underweight as we consider the risk/reward profile of highly-rated G7 sovereign bonds unattractive; we have gradually been shifting our allocation from dedicated long-only benchmarked funds to more flexible solutions, including a hedge fund focusing on rates and currencies; the allocation to convertible bonds has also been increased during the past year.

We favour European leveraged loans and convertible bonds

Our portfolios are exposed to investment-grade sovereign debt outside of Europe and the US, investment-grade and high-yield credit, European loans and convertible bonds. We have recently sold our allocation into US high yield to reduce some of the portfolio risk in view of stress in the energy and materials sectors. We prefer to delay any investment into emerging market debt denominated in local currencies due to market instability and weak currencies.

Equities

We are equal weighted on equities

At the onset of 2016, we have reduced our overweight into the equity asset class and maintained our preference for developed markets equities over those of the emerging markets. The recent developments within the Chinese financial markets and the rout of energy prices have led us to reduce some of our exposure to equities on a tactical basis and increase our cash position. Over the course of 2016, we believe that equities should outperform bonds on the basis of more attractive valuations and an abundance of global liquidity.

Still premature to add to EM equities

We are heavily underweight towards EM equities due to an under-whelming macro environment, a negative trend of earnings growth and currency weakness. We are however expecting our allocation to this region to increase at some stage this year on the back of low valuations, a pick-up of growth and as investors' very underweight positioning should be partially unwound.

European equities should outperform

Our allocation to the equity asset class is concentrated on developed markets. We consider that European equities offer the most potential on the back of the ECB's supportive monetary policy, the recovery of economic growth and the positive trend of earnings growth.

Commodities

Commodity fundamentals could start to stabilise later in 2016

In 2015, ample supplies and weak demand, in addition to a stronger dollar, contributed to the continued slide of most commodity prices. Despite these lower prices, the levels of production have generally remained excessive and it still appears premature to call the end of this trend, especially given the outlook for energy prices, the dominant driver of the commodities' sector performance.

The pressure on oil prices is persistent

2015 proved how difficult it is to predict future commodity prices as the market consensus was for oil to stabilise around a $60 level; for that reason, we will refrain from making a full-year forecast! In the near term however, we continue to observe an oversupplied market with producers unwilling to reach any agreement that could support prices. Furthermore, market sentiment is not showing many signs of turning as oil prices continue to decline and oil storage capacity is increasingly becoming an issue.

We avoid a direct exposure to commodities

The conclusion from the above is that we continue to avoid holding any direct exposure into commodities in the near term. From an asset class perspective, we continue to believe that other asset classes offer more attractive risk-adjusted returns.

Gold

We hold a small position into physical gold

We hold a small position in physical gold as a way of containing some of the expected volatility and as a portfolio diversifier. For some portfolios, we remain invested into gold mining equities for diversification purposes, low valuations and industry consolidation.

Hedge funds

The allocation to hedge funds to remain overweight

Hedge funds will continue to play a key diversification role in the portfolios, especially when one takes into account the low yields of debt instruments and the modest returns anticipated for equities. The active management approach of hedge funds contributes to the diversification of investors' portfolios and their returns are less correlated to those from traditional assets.

Our hedge funds exposure is focused on liquid strategies

We will continue to favour liquid strategies such as long/short and global macro and also invest into hedge funds that can exploit market inefficiencies which we cannot access. Our search for high-quality hedge funds integrates the need to find those with the most appropriate structures and terms as to fit our requirements within an increasingly complex set of constraints.

FFG PORTFOLIO CONSTRUCTION

- *The construction of an investment portfolio and the selection of its individual components are the result of a well-defined investment process. This process begins with the determination of the client's risk profile, base currency and the chosen investment strategy. This framework will then lead to the tactical positioning of the portfolio within strategic asset allocation ranges for each asset class.*

- *The choice of the base currency is of particular importance as it will affect the way the investment strategy is carried out; firstly, through the determination of the most appropriate level of hedging of currency exposures (if any) and, then, by the selection of the best-suited underlying investments.*

- *The determination of the allocation to the different asset classes is the main driver of the portfolio's performance and serves as the keystone around which the other investment decisions are taken. The role of your investment manager at the Forum Finance Group is to build portfolios based upon all the relevant information and through the selection of investment products from a pre-determined approved investment universe.*

- *Each individual investment has a specific role to play and the selection of any product is based on both its inherent features as well as its complementary properties within the portfolio. It is necessary to fully understand each investment product in order to be able to predict to a large extent its behaviour depending on different market scenarios and to better evaluate its purpose in relation to the other assets.*

- *Therefore, the performance of any specific investment cannot be measured against its peer group without taking into consideration the remainder of the portfolio. Typically, the portfolios' risk budget will be spread across directional assets such as equities, commodities and high-yielding debt. The portion of the portfolios dedicated to the preservation of capital will be invested into assets less correlated to market trends, such as funds of hedge funds, highly-rated bonds and certain structured products.*

HEDGE FUND MANAGERS

- *The Forum Finance Group invests into Funds of Hedge Funds and, for the clients that have approved this asset class in their mandates, into Single Hedge Funds.*

- *Funds of Hedge Funds offer diversification and low volatility, while Single Hedge Funds focus on specialist strategies with an emphasis on risk management. We consider Single Hedge Funds to be genuine alternatives to the traditional asset classes, providing access to outstanding fund managers and improving the risk-return profile of portfolios.*

- *Whereas Funds of Hedge Funds will continue to be classified as a separate asset class, the majority of single manager hedge funds will be classified within the traditional asset classes. Therefore, as an example, the allocation to equities will not only include the direct equity positions and the investments into equity funds, but may also include strategies such as Long/Short equities or Event Driven equities.*

STRUCTURED PRODUCTS

- *From our point of view, structured products also provide an alternative way of investing into traditional asset classes such as equities, debt instruments and commodities. The different structures of these products vary considerably and the selection of a specific structure is not only a function of the prevailing market conditions and the outlook for the underlying asset, but also a function of the capacity of the product to mitigate risk within the global portfolio.*

- *Structured products are classified within the most relevant asset classes at any defined moment. This allows us to better analyse the overall levels of risk of each asset class than if structured products were classified separately. Structured products are, by nature, hybrid instruments and the evolution of their different components will determine whether it becomes necessary to reclassify a particular structured product into a different asset class.*

ASSET ALLOCATION GRID 2016

For our balanced accounts, we apply the following grid:

	Allocation	January 2016
Short-term deposits	***0 – 20%***	***14%***
Debt instruments	***15 – 55%***	***25%***
Investment grade bonds	*5 – 45%*	*6%*
EM & high-yield bonds	*0 – 20%*	*8%*
Specialist bonds	*0 – 15%*	*11%*
Equities	***20 – 60%***	***41%***
Developed markets	*15 – 50%*	*39%*
Emerging markets	*5 – 30%*	*2%*
Commodities	***0 – 15%***	***3%***
Physical gold	*0 – 5%*	*3%*
Other commodities	*0 – 10%*	*0%*
Hedge funds	***0 – 25%***	***17%***
		100%

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