ARTORIUS WEALTH

INVESTMENT OUTLOOK

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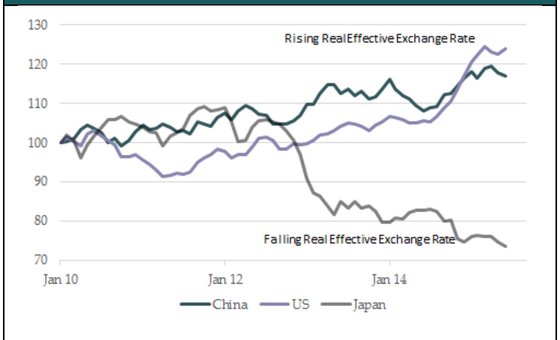
The cause of the pause

The Federal Reserve have delayed raising rates, for the time being. Financial market volatility and concerns over Chinese economic growth were implicitly stated as the cause of the pause in the interest rate cycle.

The Chinese economy is responding to the drive by the government to become less dependent on export and investment spending. This shift towards the consumer is a 'normal' process in the development of an economy as it becomes wealthier. This may mean that the metrics to measure the growth of the economy changes from the industrial to become more balanced. Of note residential property sales are rising and continued robust retail sales activity.

Since April 2015 the Chinese government has recognized that the economy is weakening and has stepped up the pace of fiscal expenditure. There is continued room to reduce interest rates. Chinese short term interest rates of 2.25% and 10 year bond yields of 3.5% are higher than those prevailing in the likes of the UK and US, indicating that monetary policy has room to be eased further. This should in turn influence the exchange rate.

Chinese exchange rate has risen steadily over the past 5 years



Source: Artorius Wealth, Thomson Reuters

The steady increase in the Chinese effective exchange rate of the past 5 years will have had an impact on the competitiveness of Chinese exports. This would have been a factor contributing to the slowing of the Chinese economy.

The global economy will revert to being dependent on developed market economies to contribute to growth. The good news in this regards has been the recent upgrades to expectations towards European economic growth prospects. In turn this background is increasing expectations of faster revenue growth in 2015-16 for Euro area equities.

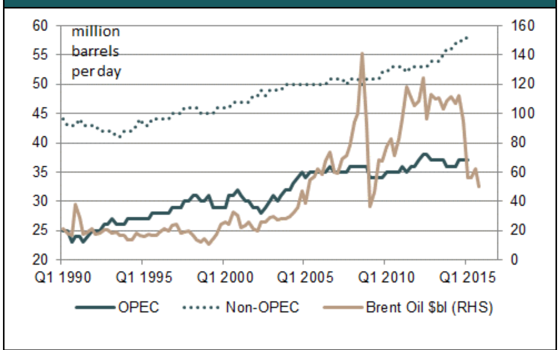
Better than expected economic growth in the Euro area has been combined with very low inflation. This has led some ECB board members to suggest that they are considering extending the QE program, to prevent deflation. If more QE, and bond buying does arise, we anticipate further weakening of the Euro and support for bond markets.

Oil price deflation

The volatile path of oil prices over recent years has not dampened investment into oil production. Non-OPEC supply has surged over the past decade. OPEC have maintained a relatively stable level of production reflecting perhaps their budgetary need for oil related tax revenues to meet domestic spending requirements.

As production has surged, especially from the US, oil prices have fallen. Although the financial strains of low oil prices are showing up in both shale and traditional producers, production is still yet to register a decline.

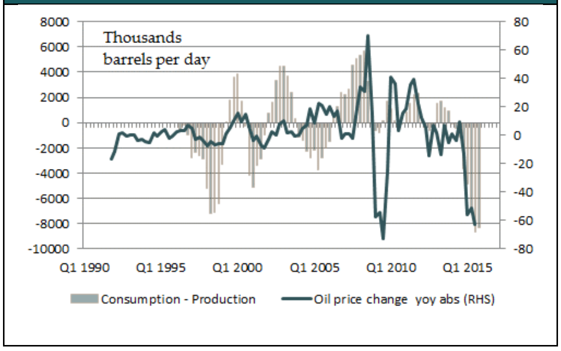
Oil supply has surged especially from Non-OPEC sources in the past decade



Source: Artorius Wealth, Thomson Reuters

The excess supply has resulted in falling oil prices, and until the demand supply imbalance is corrected then oil prices should remain depressed and run the risk of further falls.

Oil supply has outstripped demand and led to conditions for oil price declines



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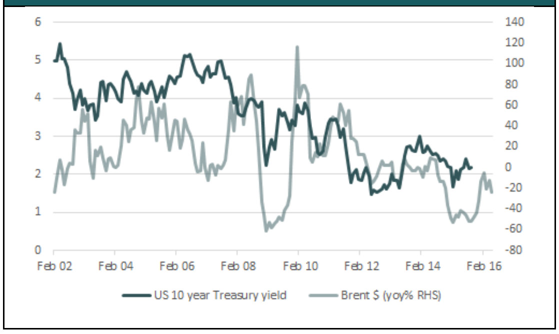
Low bond yields

The fall in oil prices has been a contributory, if not the main factor, behind the low level of inflation. This in turn is keeping bond yields low despite sound labour market data and resilient consumer activity in the US.

Are oil prices key to understanding bond yields?



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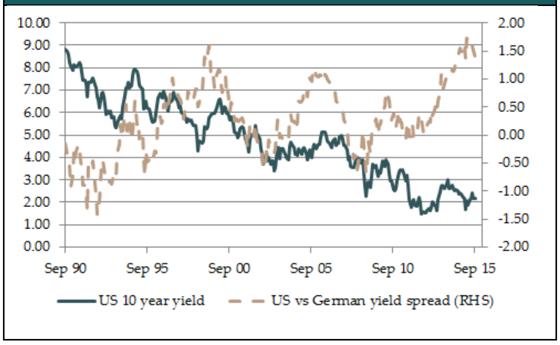
An additional factor to consider in bond markets is the international context. There are well grounded worries over China which is likely to depress global growth trends. This may well unleash a wave of deflationary pressure that the likes of the ECB will respond to by additional buying of Euro bonds.

This is likely to depress Euro bond yields, and with the spread of US treasuries relative to German bunds already wide, it is unlikely that the US bond market will experience higher yields in the near-term.

The US yield is likely to be kept low by the anchor of German bonds



Source: Artorius Wealth, Thomson Reuters

At the end of this year, the voting members of the Federal Reserve policy making committee will shift slightly more hawkish, as Chicago Federal Reserve President Evans will no longer vote and Presidents Mester, Bullard, and George will regain their votes. All three have consistently advocated for rate hikes. Our view is that a rate rise is likely in 2015, and almost certain in 2016, but runs the risk of being a policy error as global economic conditions remain fragile.

Together with low inflation, anchored by German bond, US bonds (and other bond markets such as gilts) are likely to remain bastions of stability for investors despite being unloved by the investment community at large.

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Our Contact Details

ARTORIUS WEALTH LONDON

Level 1, Devonshire House,

1 Mayfair Place, Mayfair,

London W1J 8AJ

+44 (0) 203 205 7140

ARTORIUS WEALTH MANCHESTER

2nd Floor, The Boardwalk,

21 Little Peter Street

Manchester M15 4PS

+44 (0)161 711 0730

ARTORIUS WEALTH ZURICH

Schlüsselgasse 3,

8001 Zurich,

Switzerland

+41 (0) 44 542 8334