ARTORIUS WEALTH

INVESTMENT OUTLOOK

February 2016

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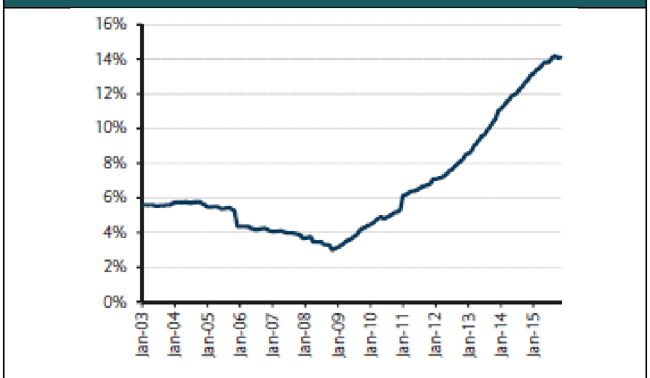
Ouch

Even though we are cautiously positioned with an underweight position in equities relative to our benchmarks, the degree of the sell-off in January has surprised us. The catalyst for the market volatility is difficult to identify, but this may be the first of the 'banquet of consequences' written about in the Quarterly Outlook.

The US economy grew at a slower pace than previously believed, and initial indications for 2016 are that the pace of growth has slowed further. China concerns continue, with lacklustre growth and concerning debt dynamics. The eventual outcome of the Chinese situation is difficult to determine.

In European equity markets, banks have become a focus of the bears. It is happening now because it has taken this long to build sufficient capital for information about the state of legacy bad loans to be released without causing a solvency crisis. The banks have also finally closed the wholesale funding gap so there is also less risk of a liquidity crisis. The consequence of on-going deflationary pressures and late-in-the-day honesty from the banks means that the ECB is likely to remain committed to Quantitative Easing for the foreseeable future, and may increase stimulus in an attempt to dampen volatility.

Non-performing loans as a ratio of the total loan book in Italy.



Source: Bank of Italy, Barclays Research

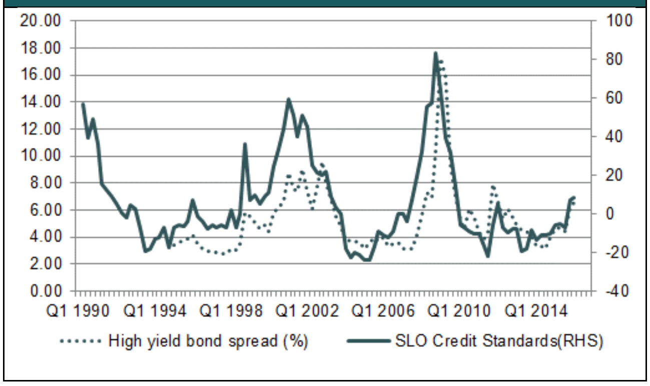
If the ECB does act then the recent rally in the Euro may fade, although the ultimate economic benefit of policy action appears to be falling with each phase of QE.

SLO: A sign of things to come?

An important but overlooked indicator for the US economy is the Federal Reserve Senior Loan Officer survey (SLO). The survey reflects bank lending conditions in the US economy. It measures the degree to which banks are changing covenants and borrowing terms. When conditions tighten via more demanding loan growth, employment and profitability slows.

The recent SLO survey points to a small but continued level of tightening. This is concurrent with the widening of high yield bond spreads suggesting that companies seeking to borrow in the US economy are facing higher interest rates via credit markets or more demanding conditions via the banks.

Senior Loan Officer survey points to tighter lending conditions which confirms the poor credit backdrop highlighted by the high yield bond market.



Source: Artorius Wealth, Thomson Reuters

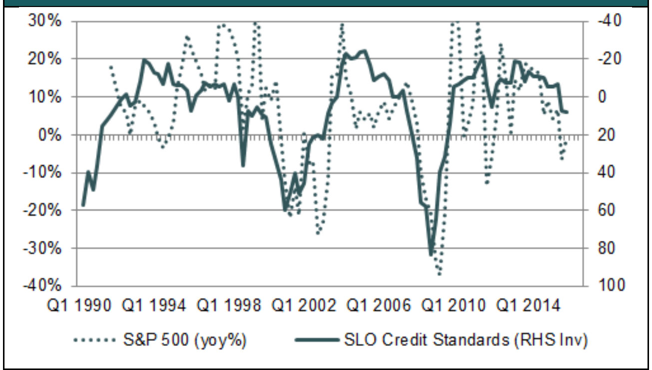
Tighter lending conditions will prove a challenge for the US economy. When the SLO increases, then the rate of growth in employment, investment and profits slow. The SLO survey is a key indicator and confirms that we are in the late stage of the economic cycle, and whilst too early to warrant a recession call, investors should be aware that the risk is on the downside for economic growth.

Tighter lending conditions prove a challenge for equity investors. The tougher borrowing environment makes a sustainable rebound in the US economy and equity markets less likely in our view.

US employment growth slows as credit conditions tighten

Source: Artorius Wealth, Thomson Reuters

Weaker equity markets are explained by tighter credit conditions



Source: Artorius Wealth, Thomson Reuters

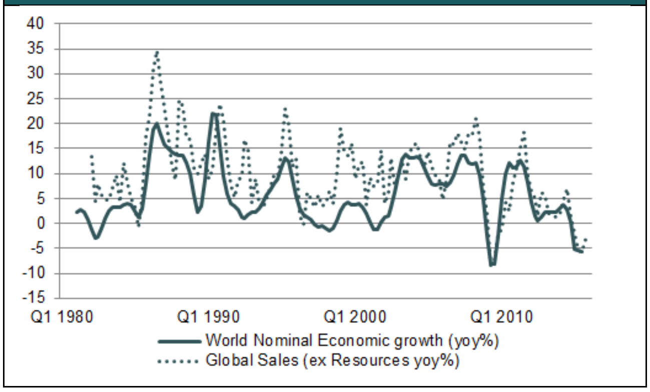
Nominal growth and real problems

Most economists talk about growth in terms of an inflation adjusted, or real, measure. This makes sense given that over time it's real economic growth that will create employment and wealth.

However, companies' sales are measured in nominal terms, i.e. current values. So the price of a service or good matters. If the price of a good halves then to achieve the same level of revenue twice as many need to be sold.

The low level of real economic growth and low inflation has resulted in low global nominal GDP growth – it is actually negative when measured in US dollars as the US currency has risen. This backdrop means that revenue growth for companies is especially difficult to deliver.

Very low inflation is a challenge for companies seeking to register sales growth



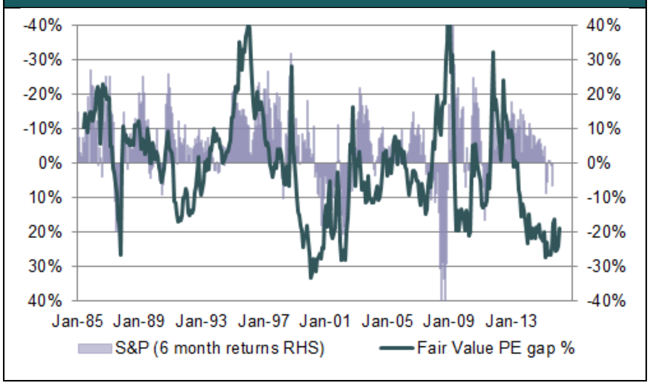
Source: Artorius Wealth, Thomson Reuters

It's not fair

As anyone with small children may testify, the 'it's not fair' line is often heard. Well we say the same about equity markets. Rather than a complaint about parenting, we think that the markets aren't fair value. We believe that they are expensive.

We estimate that the fair valuation of the US equity market is c13x Price to Forward Earnings (that is the expected earnings of the US equity market in 12 months' time). The US equity market has a forward PE of 15x. At around 15% above fair value and with challenging economic and credit conditions we see further downside risk to the equity markets, and remain underweight.

US equities remain overvalued and risk further losses



Source: Artorius Wealth, Thomson Reuters

Underweight equities

In clients' portfolios we continue to be underweight. Holding cash in a low interest rate environment is uncomfortable but better than losing capital.

Sharing insights from others

One of the wonders of our job, or life itself perhaps, is that the opportunity to learn from others. By reading and studying, as well as refining our own techniques, we hope to deliver an improving and evolving solution. We know from experience (both good and less good) that markets change, so being open to learning hopefully keep us from being static and stale.

The following passages was written by John Hussman on 1st February 2016.

Among the central lessons that investors should understand, before the completion of the current market cycle teaches it again, is this: the interpretation of nearly every piece of information - valuations, economic data, central bank action - is conditional on the status of market internals.

Investment returns over shorter portions of the market cycle are primarily driven by the willingness or aversion of investors to accept risk. Historically, the most reliable measure of investor risk-preferences is the behaviour of market internals across a broad range of individual stocks, industries, sectors, and security types, including debt securities of varying creditworthiness.

When market internals are broadly favourable, market overvaluation tends to be ignored over the short-run, and is typically followed by either flat returns or even more extreme levels of overvaluation. However, once internals deteriorate, signalling increasing risk-aversion among investors, the same market overvaluation is often associated with stock prices that drop.

When market internals are broadly favourable, weak leading economic data tends to be associated with only a temporary soft patch in economic growth. However, the same weak leading economic data, combined with deteriorating market internals, has a dramatically higher probability of being followed by recession

Reading it again highlights the need to have a view of the world, and ours is cautious given valuation and economic risk, but be aware that the market may have its own dynamic whatever the external fundamentals. The further the deviation of the market from the fundamentals, the larger the investment opportunity.

It feels as though the market internals have deteriorated and investors are looking for safe havens. At some point these safe havens will become overvalued and mispriced. This typically happens as fundamentals (economic growth and profitability) starts to improve, and the assets to acquire will be those assets that are most vilified by the crowd.

Asset Allocation Views

Equities	⊖
US	⊖
UK	⊜
Europe ex UK	⊜
Japan	⊜
Pacific ex Japan	⊜
Emerging Markets	⊜

Fixed Income	⊜
Government	⊜
Investment Grade	⊜
High Yield	⊜
Emerging Market	⊜
Cash	⊕

Alternatives	⊜
UK Real Estate	⊜
Infrastructure	⊜
Private Equity	⊜

⊕ = Positive view

⊖ = Negative view

⊜ = Neutral

Source: Artorius Wealth

Our Tactical Asset Allocation (TAA) tilts to the SAA reflect our shorter-term cyclical views. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability of individual asset classes in different regions.

ASSET CLASS OVERVIEW

Equity	SAA	Commentary	TAA
US -3 **-2** -1 0 1 2 3	22%	We increased our negative stance on US equities from ‘slight’ to ‘moderate’ in early December. From a valuation perspective the US equity market appears fully valued and earnings revisions are weak. The risk of higher interest rates and tighter credit conditions, as seen in surveys, threaten the subdued economy.	-7%
UK -3 -2 -1 **0** 1 2 3	7%	We prefer mid-caps, implemented through exposure to the FTSE 250 Index, as they avoid the dominance of the commodity related companies found in the FTSE 100 index.	-
Europe ex UK -3 -2 -1 **0** 1 2 3	7%	We are of the opinion that the ECB’s commitment to its asset-purchase programme will remain intact and continue to support the region’s recovery.	-
Japan -3 -2 -1 **0** 1 2 3	0%	Following the Yen’s depreciation, the earnings growth of Japan has been robust but challenges remain longer term such as demographics.	-
Pacific ex Japan -3 -2 -1 **0** 1 2 3	5%	With economic challenges emerging in developed economies Asian and emerging market economies and their equity markets have already slowed and fallen respectively.	-
Emerging Markets -3 -2 -1 **0** 1 2 3	5%	The outlook is mixed as valuations are lower than in developed markets but the weakening momentum is a risk that we will look to manage in coming months	-
Global -3 -2 -1 **0** 1 2 3	3%	In contrast to our regional asset allocation we have a global equity theme of water. As the global population grows, water resources are stretched and companies in water industry should benefit from increased expenditure.	-

Fixed Income	SAA	Commentary	TAA
Cash -3 -2 -1 0 1 **2** 3	0%	We opt for cash in the face of unattractive opportunities, in other asset classes. Long term we look to deploy cash holdings in higher return generating assets, but in times of turbulence cash offers a safe haven.	+7%
Government -3 -2 -1 **0** 1 2 3	14%	We remain neutral on government bonds overall, as the inflation outlook appears subdued in the near-term. The prospect of further bond buying from the ECB is likely to keep bund yields low, which in turn should prevent yields in other markets rising too far too soon.	-
Investment Grade -3 -2 -1 **0** 1 2 3	9%	In the UK and Europe there has been a modest increase in credit spreads in 2016, but returns remain attractive in most scenarios relative to government bond markets.	-
High Yield -3 -2 -1 **0** 1 2 3	4%	High yield markets in the UK and Euro area are shielded to date from the US high yield bond market.	-
Emerging Market -3 -2 -1 **0** 1 2 3	3%	We believe that valuations are attractive and sufficient to outweigh the potential volatility caused by the Fed's rate rises.	-

Alternatives	SAA	Commentary	TAA
UK Real Estate -3 -2 -1 **0** 1 2 3	10%	Yields and rental growth of 3% should also make a useful contribution to robust total return in 2016. Valuations appear stretched in absolute terms limiting long-term returns.	-
Infrastructure -3 -2 -1 **0** 1 2 3	5%	Valuations remain full, with limited scope for disappointment, but cash flow generation is drawing fund flows.	-
Private Equity -3 -2 -1 **0** 1 2 3	6%	The asset class most correlated to the economy, in terms of risk. PE houses are expected to deliver positive returns until the economy slows markedly or credit costs rise to curtail private market activity.	-

Source: Artorius Wealth

Key: The numbers reflect a quantitative description of our tactical positions relative to the strategic benchmarks. Our Strategic Asset Allocation (SAA) solutions offer a blend of assets that over a medium terms (5-7 years) will, in our view, provided the optimal mix of returns and risk at a given level of risk tolerance. Our Tactical Asset Allocation (TAA) tilts to the SAA reflect our shorter-term cyclical views. The SAA and TAA positions reflect a medium risk sterling on-shore based client portfolio. Views are subject to change and implementation in portfolios will reflect specific client requirements.

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Past performance is not a guarantee of future performance and investors may not get back the amount originally invested. Investing involves risk, including possible loss of principal.

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