TAM INTERNATIONAL INVESTMENT NOTE

Our Outlook for 2016

It would be easy to convince anyone that 2016 is going to be more difficult than last year. The list of dreads threatening to derail stock and bond markets is pretty much the same as before but we are at least closer to understanding the end game of the post 2008 "Great Financial Crisis" as the US Federal Reserve start what they believe to be a year of interest rate hikes.

The economic backdrop is more challenging than a year ago and more difficult to predict. In recent years, we have grown used to the intervention of central banks and governments who have played a hand in the direction of stock, bond and currency markets around the world. But diverging policy between the US, UK and the rest of the world complicates the investment landscape.

However, we have found, and continue to find, investment opportunities despite the rather bleak outlook. Indeed, all of the TAM Premier risk portfolios made absolute gains of between 1.8% to 5.7% despite benchmarks down around 2.5%. Broadly this was due to a combination of good judgement and fortune by having invested in the right asset classes as well as the right investments.

TAM clients benefitted from strategic and well timed investments in Europe and Japan and the economic recovery in the UK was particularly good for the UK equity investments which had a more domestic bias as opposed to the large international household names that dominate the FTSE 100 index of Britain's leading companies.

But it was also a good year to avoid obvious pitfalls that ETF and "passive" funds, by their very nature, do not. We were underweight Gilts and other sovereign government bonds, which hardly moved, and client portfolio exposure to plunging commodities and emerging markets was very limited.

We also bought various investments at times of market distress where we saw that the opportunity outweighed the risk. We believe that a similar strategy will yield positive results in 2016. In a world of low and slowing growth, and low returns, this is the only strategy which we believe holds out the prospect of beating inflation and cash in the bank.

On that note, we recognise the investment world is fraught with danger and prone to setbacks from any number of geopolitical events. Some are important, many are not. And, as we saw in 2015, some headline issues barely made the footnotes by year end. For a number of reasons, the right investment approach has changed since the turnaround in the Spring of 2009. The rise in the use of passive or index tracking funds has often contributed to rising volatility when events force a market reaction. We have become used to significant indiscriminate sell offs that punish all stocks regardless of their merits. The flipside of this represents opportunity for those who believe they know when things are oversold.

Navigating this minefield requires a combination of making the right decisions for the long term whilst being cognisant of the short term opportunities to either buy or sell, whatever the asset class.

We lay out our thoughts below on the various regions and asset classes that were central to the plot last year and look set to determine 2016.

Europe - Draghi gets the party started

With an election set early in 2015, Greece's problems loomed large in the minds of investors as the risk of policy error could've seen Greece out of the Euro, a renewal of the eurozone crisis and the risk of contagion spreading to other peripheral eurozone states.

However, compromises were reached between the Greek government and eurozone creditors, leaving the field open for the ECB's quantitative easing program to have the desired effect. As we said in late 2014, the wait for some kind of stimulus had been hanging in the air for the best part of 2 years, but the collapse of inflation to near zero started to make a mockery of the ECB's 2% inflation target and the weight of expectation from the markets to act was overwhelming.

The final €1.1 trillion package was bigger than markets had hoped for, given the opposition from the German Bundesbank, and the prospect of €60 billion per month of bond buying for 18 months saw bond yields and the Euro fall to the lowest level for several years. Eurozone equities obligingly raced up to new multi-year highs. Of course, by year end and with eurozone inflation still stagnating and growth flagging, Draghi was force to act again and expand the program further. Unfortunately, markets didn't take his vague forward guidance, and handling of the situation, quite so enthusiastically and a bout of profit-taking brought the main European markets back to close to where they started the year which seemed to capture the mood perfectly.

But where's the after party?

As we predicted last year, most of the fears on Europe's list of dreads came to nothing. French, Spanish and Italian politics were interesting but largely ignored. Warnings over the conflict in Ukraine and Russian sanctions were easily passed by and even Greece faded from the headlines despite serious domestic problems being evident to those who continued to follow events there.

Of greater concern is the threat from deflation and a lack of economic growth. The eurozone is in a 7-year depression and output has still not recovered to the peak reached in 2008. The unemployment statistics beggar belief, particularly amongst the young (50% in Greece, 40% in Spain and Italy and 25% in France). However, this has long been known and it is the direction of travel for these various factors that is crucial for stock and bond markets. Mario Draghi tells us that he believes that QE is working and, on

the face of it, he is right if he means that things are either stabilising or improving. Certainly, the availability of credit has risen as a direct result of QE.

So we look at both the broader eurozone/EU economy and the markets with a mildly positive yet cautious eye. Europe ex-UK is not, in our view, set to be a rising tide that lifts all boats. In order to profit from the excellent opportunities on offer, we have approached investment in European equities with a selective stock-picking approach which can seek out overlooked and oversold quality investment opportunities whilst having the flexibility to avoid areas of obvious danger.

USA – The Farce Awakens

In their last act of 2015, the Federal Reserve finally bit the bullet and raised interest rates by 0.25%, to 0.5%. It was hard to get too excited. Relief would be a better description of the market reaction. Memories of last year's flip-flopping episode was still relatively fresh in the minds of bond market investors, and when the Fed included China as yet another reason for keeping rates on hold in September, there was an outside chance that it could be cited again. But another pass would've sent a terrible signal that all is not right with the economy or, worse, that the Federal Reserve knew something bad that we, the market, did not. After all, if the mighty US economy couldn't handle a quarter point hike, then we were all in much more trouble than we thought.

However, bond markets got to the point that a hike was all but a given and, when it was finally announced, stocks and bonds took the news in their stride. This wasn't surprising since there hadn't been, in our view, a whole lot of fundamental investment going on in the weeks leading up to it. Indeed, as if lending credence to the notion that markets can only think about one thing at a time, the falling price of oil preoccupied markets in the days following the hike.

Of course, the collapse in the price of oil feeds into inflation data which, in turn, affects the bond market. Even core inflation figures, which strip out fuel, fall as the cost of production and transportation of goods comes down. Since the precipitous fall in the price of crude happened in the October/November 2014 period, there had been some expectation that, mathematically, year-on-year inflation might start rising again due to the base effect. That was until Saudi Arabia decided at the OPEC meeting to keep pumping and crude fell again – lowering both inflation forecasts and, therefore, interest rate expectations.

Talk is cheap…

One rather unsettling assertion gathering momentum into the fourth quarter was that the Federal Reserve was as data dependent as the rest of us mere mortals when deciding the timing of a rate hike. There was nothing in the central bank forward guidance that told markets what they did not already know. In addition, almost all the economic indicators were flashing green with the obvious exception of inflation, which left everyone hanging on the last piece of the puzzle: employment and the monthly non-farm payrolls. What was clear, however, was that Fed Chair, Janet Yellen, wanted to see a favourable reaction from the stock market as a sign of affirmation and success. To this end the state of the economy was talked up and the stated intention of higher rates spun as a lifting of emergency measures and a return to some kind of normality.

It's an attractive scenario and hard to argue that it wouldn't be a whole lot healthier than zero interest rates forever. Indeed, part of our thinking on very low interest rates is that they are indirectly to blame, and the cause of, low inflation. They say "Don't fight the Fed", and we hope they're right, but their forecasts of another 0.25% per quarter for a full 1% rise by the end of 2016 seem, to us, overly bullish.

For now, the bond markets appear to agree with us although we are keeping a close eye on Q1 because, unlike the 3 previous years, the USA is experiencing a very mild winter. Construction is well up on previous years and could contribute to a mini-boom which would vindicate the current Fed outlook. Indeed, if both economic activity and corporate earnings are much stronger than previous years, the Fed could appear "behind the curve" prompting a significant stock and bond market reaction

"United" Kingdom

A majority win for the Conservatives ended the previous coalition and the stock market enjoyed a short lived honey-moon period as a result. But talk of interest rate hikes was already in the air owing to the economic recovery already underway in the US and UK and the prospect a firmer approach to austerity to balance the economy was evident in the weeks that followed.

It was always going to be difficult for Bank of England Governor, Mark Carney, to convince us that the independent Bank would and could get in front of the Federal Reserve and raise rates if the UK economic data justified it. There were few who doubted that it was going to follow the Fed. So at times the situation was rather awkward and, whether Mr. Carney believed it himself, he did open himself up to accusations that he was blowing hot and cold on economic pronouncements and often reining in previously bullish talk lest it looked like he was getting ahead of events. MP for Wolverhampton South East, and Treasury committee member, Pat McFadden, even likened him to an "unreliable boyfriend".

UK plc is doing rather well and the economy remains in reasonable shape with modest economic growth accompanied by low inflation. UK GDP for the third quarter came in slightly worse than expected at 0.4% and the Office for National Statistics forecast a lower annualised figure of 2.1% to take into account an anticipated slowdown in the financial sector. However, we remain upbeat about the prospects for equities throughout 2015.

There was very little progress in the main stock market index. The FTSE100 Index was down nearly -5% due mainly to the heavy weighting in oil and mining companies exposed the slowing Chinese economy. However, the UK exposure in TAM portfolios had a more domestic UK bias which favoured small and medium sized companies less exposed to international volatility in currencies and slowing global growth generally.

We expect to stay with this as a core strategy into 2016 but have recently taken a view that the energy and mining sectors are starting to look oversold in the short term. Where appropriate, we have added to UK equities with investments that will perform should our rather more positive view of the economy and investment landscape prevail.

Brexit

It is early days in the Brexit debate but it is apparent that investors here and abroad are waking up the possibility of an exit from the EU and its ramifications. It would appear that polling, if anyone still trusts them, is broadly balanced between getting out or staying in. For the moment, the focus is on the new deal Prime Minister David Cameron is trying to achieve with EU partners. Expectations here are already very low and a cynic would assert that he is pretending to get a better deal whilst the EU pretend to listen.

The Conservative party has a natural split on the issue which Cameron has, for the moment, allowed to run, presumably in the hope that he can come back from Europe with a deal that convinces the British voters to stay in. However, the out campaign appears to be off to a better start, helped by issues on immigration and welfare already filling the national media.
There is every chance that a failure to secure any material changes to the UKs relationship with the EU to lead to Cameron kicking a referendum into 2017. But in the meantime

the uncertainty, which markets hate more than anything, has been one element putting downward pressure on Sterling which finished the year at $1.48, down 7.5% from the peak in the summer.

Japan and Asia

Whilst we have maintained some modest exposure to Asia ex-Japan, our main strategic investment was in Japan itself. The program of reform, known as Abenomics, has been around a while and been prone to setbacks. As we have said throughout, the first two of the "three arrows" policy was relatively straight forward to implement, namely monetary and fiscal policy. The third of corporate reform is far more complicated. However, as we wrote earlier in the year, we believe the best way to invest in Japan has shifted from re-flation to investing in the companies most likely to benefit from an unprecedented co-operation between the Bank of Japan, the government and the big global corporates of Japan's leading companies.

While concerns over China linger, it can be a hostile environment for stocks anywhere in Asia and Japan in particular. However, we believe that Japan, governmental, corporate and central bank, have no option but to align their interests in a determined effort to dig Japan out of two lost decades of deflation. We believe we have invested in the right strategy and that there is, from an opportunity perspective, much to justify being invested here against the risk of being out altogether.

Emerging Markets - Could the EM Buyer Strike Back?

Despite government assurances to the contrary that emerging markets are in better shape than in the aftermath of the 1998 Asian currency crisis, foreign investors withdrew money from emerging market funds at a record rate. This is an area that we have been well to be out of but we are conscious that opportunities are starting to present themselves. We have grown used to talking about Emerging Markets as a group, such as BRICS: Brazil, Russia, India, China. Other markets enlarge the basket further and many have eliminated themselves as being investible due to over exposure to commodities or rising nationalism, or a combination of both, such as Brazil or Russia. India and Mexico have been relative success stories but this story is well played out and, generally speaking, these countries are no longer cheap.

China is the biggest of all the EM group and affect Asia and Japan as well as the rest of the world. For now, US dollar strength, appears to undermine the case for investing in emerging markets but we may, as the year unfolds, revisit this area because the opportunity could justify the risk.

Conclusion

As we noted in our outlook note for 2015, the year ahead was summed up in a list of concerns as long as your arm ranging from ebola and Italian politics to the Chinese property bubble and the falling price of oil. We dismissed most of them as not being materially important to stock and bond markets and chose, correctly as it turned out, to focus on the likely impact of the prospect of a stronger US dollar on the back of rising interest rates, eurozone deflation and China.

It is true that both stocks and bonds appeared relatively expensive against recent history and, for the most part, we remained close to benchmark weight in equities whilst staying with alternatives to bonds, such as property. However, noting the low volume and value of shares being traded on a daily basis, we expected that markets would be vulnerable to bad headlines with volatility being an inevitable consequence.

In this regard, we have exercised our stated strategy of taking advantage of oversold situations in bonds, equities and currencies and have invested where we believe the opportunities outweigh the risks. These opportunities arose principally out of the so-called "Black Monday" sell off in August which came about from slower than expected growth in the Chinese economy and the Chinese central bank's action to weaken their own currency. In essence, this news should not have come as a surprise to anyone but such was the fragility of market sentiment that the resulting sell-off was bigger than many expected.

The reality of an actual 0.25% rate hike from the Fed in December has taken some of the short term speculation out of markets for now although one expects that the interminable "will-they-won't-they" media commentary to come back to haunt us every couple of months throughout 2016.

On the face of it, we believe the Federal Reserve's forecast that rates will rise by a full percentage point per year until it reaches 3.25% in 2018, to be overly bullish and overestimates the rate at which the US economy can recover. For the moment, bond markets appear to indicate a level of scepticism which matches our own and we may moderate our underweight stance on bonds as the year unfolds.

In Europe, where company earnings growth appears to be outpacing that of even the USA, we continue to stay invested in selected eurozone equities and have, for now, removed the

hedge against the prospect of a weaker Euro despite the prospects for accommodative loose monetary policy from the ECB for some time to come. However, whilst we believe investment here is justified, we are awake to the political risks in the eurozone, including the UK referendum, as well as the structural risks to the EU which are compounded by unilateral changes to Schengen among member states and growing gulf between north and south, east and west and Euro vs non-Euro states.

Of course, the loosening of monetary policy in the eurozone is not unique. The Bank of Japan has undertaken a truly enormous QE program of their own in order to weaken the Yen and have a chance of reflating their economy once and for all. TAM client portfolios had already benefitted very well from their Japanese exposure but with the ambitions of the Bank of Japan and Government being so unambiguous, we decided to have some degree of hedging on the Yen as well.

Flat is the new up

This could well be our mantra for 2016. In the same way that a year ago we expected little from bonds and equities from the main stock market indexes, we were confident that a stock picking approach would yield a modest return above inflation. Broadly speaking, we can cite many of the same reasons for a similar outlook in 2016. The US economy continues to grow and falling unemployment, with some wage growth, paints a positive picture. However, for a couple of years now, company profit margins have been running at record levels as companies cut costs to cope with flat sales growth. This is impressive but something that only gets harder to repeat, particularly in the face of a pick up in wage growth which has been stagnant since the financial crisis in 2008.

We expect to keep investments in very selective themes where we are pursuing a specific strategy while maintaining only a mild overweight to equities where appropriate. This strategy has worked well throughout 2015 and we continue to provide above benchmark returns across all risk profiles with lower volatility than the related benchmarks.

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