

Market Commentary

July 2015

The strength of equity markets during the first quarter of 2015 spilled over into the second quarter but dropped off rapidly as the Greek debt negotiations resulted in general risk aversion. We had booked some profits in April and reduced risk by hedging part of our clients' equity exposure as we felt that markets were temporarily overstretched. We expressed this view in our first quarter report "As we launch into the second quarter, we believe that volatility is set to rise. In Europe, markets have rallied strongly due to optimism fuelled by the ECBs QE. As a result, they are vulnerable to any disappointments from Greece, the Ukraine or any other as yet unexpected source, however temporary they might turn out to be." The rebalancing of portfolios placed our clients' in a relatively favourable position as the Greek situation escalated. The scenario facing most investors in the past two weeks was that of a 10% plus or minus outcome. A agreement would mean European markets rally 10% based on ECB Quantitative Easing(QE) and better economic conditions in Europe. A failure to agree would probably mean a 5-10% drop in the short term. We therefore remained cautious and refrained from adding to equity exposure despite bouts of enthusiasm resulting in sharp rallies over the past two weeks. However, we did not wish to be too conservative going into the end of June in case an agreement was reached. The probability of an agreement seemed to rise and fall almost on an hourly basis and any extreme position was not advisable in our opinion.

During the first quarter, the average European market boosted by Mr. Draghi's QE announcement, rose 18% (Fig. 1) as the Euro fell 13% versus the dollar. The recent sell off has reduced European equity performance to 11% by the end of June, which is still a lot better than the flat performance of the US and Swiss Markets during the same period. The Nikkei Index has delivered a 15% performance this year which is reflected in the performance of the Japanese ETF in client portfolios.

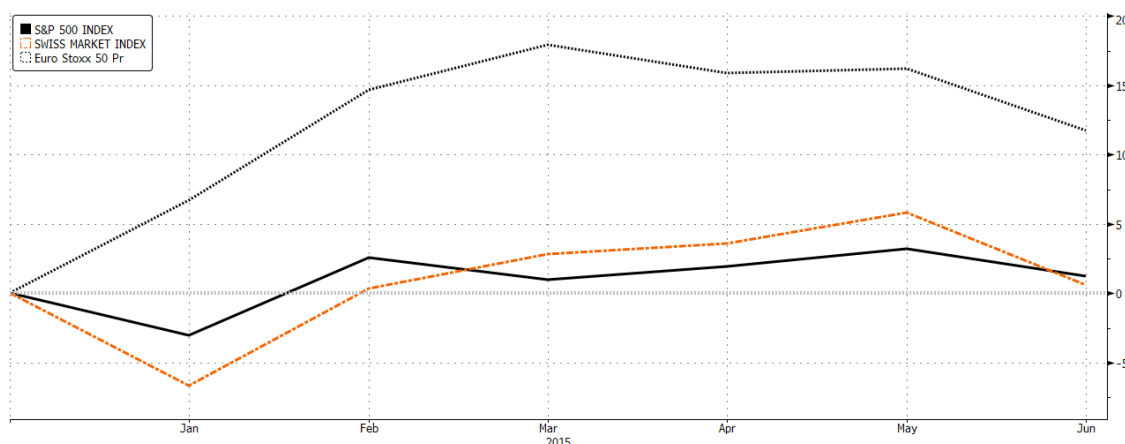


Fig. 1: H1 Equity Index Performance, European market average (dotted), US (black), Swiss (orange)

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Gold and oil prices were heavily influenced by the strength or weakness of the US dollar and remained volatile for most of the first half of 2015. In the bond market we believe that volatility is here to stay due to low yields and over exposure by most investors. When bond yields are as low as they are now, bond prices tend to become increasingly volatile. This is because most investors are over exposed to the bond markets and have sizeable profits in their existing positions. At current levels a 0.25% increase in bond yields which is very small in absolute terms may mean a 10-15% drop in the bond price depending on duration. Therefore as soon as investors sense any danger of a yield rise they tend to dump their bonds. This decision is made easier due to the fact that their over exposure allows them the leeway to reduce positions and their profits accumulated over recent years make the decision to sell a positive experience. We have seen several such bouts of volatility in the first quarter of this year.

On the currency front volatility remains elevated. If we examine the movements of just one currency pair, the EUR/USD, we observe that the EUR dropped from about 1.20 at the start of the year to 1.05 in March

and then made up half of the loss within six weeks. These are movements of approximately 10%-15% in each direction and in a very short period of time. We believe that the EUR may weaken in the short term if the Greece situation is not resolved. However based on our view that the European economy should strengthen into next year, we believe that the tendency will be for the EUR to strengthen into 2016.

The “no” vote on the 5th of July has considerably reduced the potential for Greece to remain in the Eurozone. The resignation of the finance minister Mr. Varoufakis might make negotiations between Prime Minister Tsipras and the other European leaders run more smoothly but rapid progress is difficult to envision at this stage. This news may temporarily induce a flight to safety which could be favourable for high quality bonds in the short term. The ECB has emphasised its ability to mitigate contagion if necessary and we believe that this is the reason the initial reaction of equity markets and the Euro to the Greek vote has been muted. We believe that equity volatility will remain elevated till the situation is resolved one way or the other. However, the Greek economy accounts for just 2% of Eurozone GDP and recent manufacturing, consumer spending and bank lending data all point to improving economic conditions in the rest of Europe. Additionally, the ECB recently stated that they are “determined to respond to disruptions” and “prevent an undesirable tightening of financial conditions or a renewed surge in macroeconomic uncertainty”. The statement issued on Sunday was, “the ECB has been clear that if we need to do more we will do more”. All of this makes us optimistic that European equity indices will rally after the initial turbulence has settled.

Outside Europe, the US consumer spending and employment figures remain encouraging and the FED could also respond to any Greek disruption by delaying an interest rate rise even further. The situation in China is not rosy but the government seems determined to prevent a major slowdown. The slower than hoped for progress shown by the Japanese economy implies that more will be done by the government and the BoJ. All of this liquidity should help contain volatility and support equity returns.

General Thoughts

In our last report we advised clients “to avoid extreme positioning and to rebalance portfolios regularly.” We also voiced our opinion “that this environment rewards investors who can tolerate volatility in the short term in order to reap rewards in the medium to long term.” Last quarter we rebalanced portfolios by booking profits and reducing risk after the strong rally. We now look for opportunities to add equity exposure after the recent setback but will do this gradually as the situation surrounding Greece is fragile.

To summarise, we are positive for equity returns over the next 6-12 months but remain cautious short term due to the uncertainty surrounding the Greek negotiations.

Gillian Hollenstein

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