Investment Note: Recent market volatility
August 2015

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Being the holiday season for many financial market participants, August is quite often a month of low transaction volumes and higher volatility. This year is proving to be no exception, with concerns about a possible Federal Reserve rate hike in September, Chinese currency realignment and a snap Greek election all adding to pressures. Right now, it looks like we're seeing something akin to the taper tantrum in 2013 developing, with global markets suddenly becoming very fragile. It's difficult to assess how much of the recent weakness is Fed related, and how much is to do with China and Greece. However, given that the odds of a September Fed hike are now fading fast and that the Greek elections are likely to see a Tsipras victory, we would suggest that China and the spill-over to other emerging market / commodity plays is the overriding driver.

The Chinese economy has been slowing for a while, putting pressure on its trading partners and many commodity prices. Over the last decade, China has become overly dependent on State funded infrastructure spending and exports, and, in response, the authorities have been seeking to rebalance the economy to give more emphasis to the private sector and domestic consumption. As this has been happening, one factor that has not helped has been the pegging of the Chinese yuan to a basket of other currencies, with the US dollar being the most prominent. As the dollar has risen through the last year, the Chinese economy has been becoming less competitive because of the currency peg, making the transition even tougher. On 11 August, China announced that in future the Chinese yuan would be fixed against the previous night's close, rather than a daily rate mandated by the People's Bank of China (PBOC). In practice, that opens up the possibility that the yuan can now fall or rise by up to 2% on a daily basis, with the close becoming the mid-point of the next day's range (note: it has always been allowed to fluctuate by +/-2% in any given day, but it would then be reset overnight to the pre-ordained rate). Post the announcement, the yuan subsequently fell by close to 2% on each of the following two days (c. 4% in total), prompting the PBOC to intervene and stem any further falls. Some have seen this move to be a competitive devaluation, but actually it is more likely to reflect China's desire to see the yuan recognised by the IMF as a reserve currency (alongside the dollar, euro, yen and pound), for which, it needs to be free-floating. In this sense, the move was welcomed by the IMF, and perhaps should be seen merely as part of the broader efforts of the Chinese to liberalise their economy.

Whatever their intentions however, the consequence of this move has been that other (mostly emerging market) countries have subsequently followed suit, either deliberately, or in response to market pressure. Kazakhstan has led the way with a huge 26% devaluation, although Russia, Colombia, Belarus, Turkey, Malaysia, South Africa and Algeria have also all seen notable falls in their currencies. These currency swings, along with some weak economic data releases from China have raised more questions about the outlook for growth across Asia and the broader emerging markets, especially for those that are dependent on commodity-related exports. It has also raised questions about whether the fall in oil and other commodity prices might cause an intensification of disinflationary pressures across advanced economies, as we saw in 2014.

The consequence of all this uncertainty at a time when market volumes are seasonally low is that volatility has risen sharply in a thin market, with riskier assets (equities, commodities, low quality corporate bonds, emerging market currencies etc.) selling off across the board, while safe haven assets (most notably government bonds) have been bid higher. Within equities, defensive stocks and sectors have outperformed, whilst cyclicals have been hard hit, especially energy and other commodity-related plays.

Another consequence of these events is that they will probably make the Federal Reserve much more cautious about an increase in interest rates. While we have long suspected that the Federal Reserve might delay, this has not been a widely held view. In this sense, a more dovish Federal Reserve could well become the catalyst for calmer markets and a trigger for the recovery of some lost ground.

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We do not think Greece should be the source of too much worry. After receiving the first €13bn disbursement of the €86bn new bailout package from the European Stability Mechanism (ESM), the Greek Prime Minister, Alexis Tsipras, last week called for snap elections to be held on 20 September. The move was expected, as his party (Syriza) has become quite divided, with a number of its hard left MPs voting against the recently approved €86bn aid programme and resisting reform commitments. As such, the government in its current form is not capable of implementing the necessary programmes, and by calling the election, Tsipras has sought a stronger hand for the next government. Tsipras has become much more pragmatic over his seven months in leadership and is very popular in Greece. For these reasons, we expect he will win a mandate to lead a new coalition government made up of loyal Syriza MPs, along with other parties that voted in favour of the reforms. While this event clearly adds to the uncertainty in markets right now, we do think it will pass and that the Greece will stay on the rails.

Finally, it's perhaps worth touching on some points with respect to how portfolios are doing. Below we lay out data showing how the sterling classes of the MultiFunds have performed over the month to date, and also since the beginning of the year. The data is through to close of business on 20 August (Thursday), and provides a good proxy for equivalent segregated portfolios.

	Income GBP B (Income)	Balanced GBP B (Low – Medium risk)	Growth GBP B (High Risk)
Month to 20.08.15	-0.75%	-1.45%	-2.59%
3Months	-0.95%	-3.27%	-5.46%
YTD	1.28%	-0.01%	-0.25%

Source: Nedgroup MultiFunds NAVs as at 20.08.2015

Additional points of note:

(1) <u>How are portfolios doing?</u>

(a) While it's never enough when times are tough, we had made reductions to portfolio risk ahead of this (eg. equity weightings are 7-8% lower across all portfolios since this time last year… the equity weight in High Risk portfolios / Growth was 86% and is currently 78%; the equity weight in Low-Medium Risk portfolios / Balanced was 45%, and is currently 38%).

(b) Diversification is helping. We don't just hold equities, and some portfolio holdings are actually up this month (eg. property and renewable infrastructure and core fixed income) which is serving to mitigate the losses from the holdings that have fallen in value.

(c) A number of our largest active equity fund holdings are doing much better than the market in August (eg. TOBAM and Nedgroup Global Equity, which are only down about -1.5% to 20 August (Thursday), even though the MSCI AC World was down -4.5% over the same period).

(d) Commodities are being hit hard, and although this asset class is within our investment scope, we have zero exposure to it. A number of our underlying managers are also underweight the Energy and Materials sectors, which is partly why they are holding up relatively well.

(e) On the other side of the coin, emerging markets have done very poorly, and it would have been better if we'd had no exposure. However, a sense of proportion is required in thinking about this, as the position size is only 4% in Low-Medium / Balanced, ranging up to 9% in High Risk / Growth. The overwhelming majority of client assets are invested in developed market equities, bonds and property. Even so, that doesn't change the fact that our more optimistic view on global emerging markets has detracted from returns over recent months.

(2) Is there any advice / action that clients should know about?

(a) Our cash positions are significantly overweight, and we may see a good opportunity to deploy this cash…but not yet. Right now we have 15% in cash in Low-Medium, 13% in Medium-High and 7% in High Risk.

(3) Why have we not made any changes to portfolio asset allocation this month?

While we try to mitigate bad periods, it is impossible to avoid all of the effects of occasional and often rapid market dips. It is also nearly always a mistake to respond to these spikes in risk aversion by selling. When markets have these periods of skittishness, they typically prompt some soothing words and / or policy response from central bankers, while buyers who have been on the side-lines will start to step into the market to pick up bargains. Often, recovery can be sudden and rapid. We've seen this many times before… October last year was the most recent example.

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