



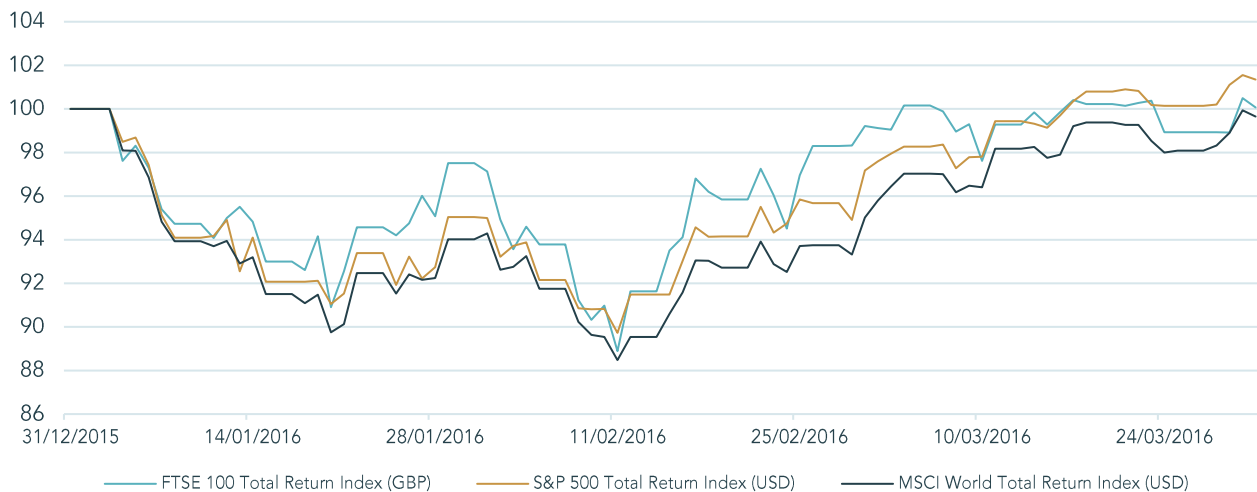
Investment Letter – Q1 2016

“And I'm floating in a most peculiar way...And the stars look very different today.”
Space Oddity, David Bowie

January 4th 2016: the first trading day of the year, and the date the market's downward descent began. For the second time in six months, Chinese authorities shocked market participants by decoupling their currency's peg with the US Dollar in another unanticipated devaluation. Already unstable following the Federal Reserve's December interest rate hike, markets collapsed. Up rose a great cry of “we told you so!” from negative market commentators, as their (very) long-held predictions finally looked to be coming good. The scaremongers hit the media hard, with talk of economic ice ages, the death of cash, and the end of capitalism itself. The negative news flow was accompanied by fire-sales across many asset classes as investors rotated into traditional safe-haven assets: government bonds, gold, and the Japanese Yen. February saw increased turmoil as Deutsche Bank's troubled balance sheet led to mass hysteria: surely not a second banking crisis in under a decade?

Over the quarter, we watched carefully; we debated and deliberated, and revisited every single position in client portfolios. But during the descent, we held firm. When markets are falling, when confidence is deteriorating, and when we are losing money for our clients and ourselves, it is easy to feel unnerved. But selling into this type of market and crystallising losses when a market selloff has turned irrational flies in the face of our primary goal of preserving capital over the long term. Instead, we took the opportunity to actively rebalance portfolios, taking profits from the defensive parts of our portfolio and recycling these into assets that had fallen too far. By quarter-end, many risk assets had rebounded to the level at which they began the year, with even commodities staging a substantial recovery.

Performance of FTSE 100, S&P 500 and MSCI World
Total Return Indices over Q1 2016



The key question to ask now is obvious: why are global markets so volatile, and does this volatility lead to a change in our stance? To us, the answer to the first part of this question has been largely the same for the past few quarters: the potential for higher interest rates in the US stands in stark contrast to the deteriorating global economy, and central banks and governments around the world are desperate to reignite stagnating growth. Since the global financial crisis a clear pattern has emerged. When solid evidence of flagging trade, sales and profits surfaced, markets dropped. When central banks talked up monetary and fiscal stimulus, markets leapt higher, as seven years of stimulus programs rewarded those who bought the dip.



But the past seven years may no longer be a good guide to the next; the useful life of the monetary policy tools utilised by central bankers appears to be coming to an end. The effectiveness of quantitative easing, the printing of money by central banks to weaken its currency and improve its country's terms of trade, has diminished as confidence in the benefits of the policy has waned. And interest rates are already at rock bottom, with many countries already experimenting with negative interest rate policies, where savers are effectively punished for holding capital. Yet even with weakened currencies and rates at historic lows consumers are not spending, earnings are not increasing, and growth has not materialised.

In the past, this year's volatility would have been easily quelled. The period following the financial crisis has been characterised by brief downturns and swift recoveries, lulling investors into a false sense of security that *any* trouble could be resolved with dovish guidance from the closest central banker to hand. Markets became so distorted that bad news about the global economy became good news for investors, leading as it did to expectations of further stimulus. But now uncertainty over the effectiveness of central bank policies has caused the sands to shift. During January and February of this year, the Federal Reserve (Fed) was in a quandary over its next policy move. Throughout 2015 they had set themselves certain key pieces of economic data on which to base their own favourable assessment of the US economy: a steadily falling unemployment rate, the emergence of some wage growth, and improving inflation data. Their December rate rise then sparked a global bear market and the volatility that we witnessed this quarter. But a delay or U-turn in further rate hikes would indicate that the central bank's first rate rise was a mistake; that the US economy was far weaker than previously thought, and the unthinkable idea that the Fed was hostage to the market's whims.

But by March, Federal Reserve Chair Janet Yellen's conundrum became too much. Despite the fact that, at least according to the Fed's data, the US economy is about to hit full employment, Yellen had to find an excuse to avoid adopting too steep a flight path for rates, lest the dollar should soar causing commodities to plunge anew and trigger massive outflows from emerging markets, with knock on effects in the US. With no way to justify an accommodative tilt based on US inflation, which looks robust on a relative basis, Yellen did the only thing she could: she admitted that the Fed's actions are now inextricably linked to international financial markets. She followed this up with an incredibly supportive speech at the Economic Club of New York. The message that she sought to drive home was simple: it would not matter if the unemployment rate dropped to 1% and inflation expectations spiked above the FOMC's target overnight - it is simply too dangerous out there for the Fed to even lean towards a less cautious stance. Markets rose to the end of the quarter on the back of this, but the rally was lacklustre at best.

And so to the second part of that question – does the change in the market environment lead to a change in our stance? Looking ahead to the second quarter and the rest of 2016, while our central view is that markets will move forward, we do not think this will be a year for outsized returns. With uncertainty expected to linger into the next quarter, we began to reposition portfolios during March as a modicum of calm returned to the market. Alongside a move towards safe-haven assets, we took a first step in decreasing our exposure to equity markets by reducing our long-held overweight to Japanese Equities. Over the long term, our conviction in the Japanese equity market remains the same, but over the shorter-term the strength in the Japanese Yen will damage earnings and weigh on equity prices. For once, Asian and Emerging Markets appeared to have missed the memo, and we expect these markets to continue to outperform over the medium term.

In the developed world, investor caution has thus far focussed on fears over US interest rate rises, low oil prices and China. We think it likely that Europe moves up the pecking order, with the EU referendum in the UK a plausible catalyst for a short term increase in regional volatility. The ongoing migrant crisis risks eroding political cohesion over the medium term. The likelihood of social unrest in the periphery continues to rise, with the inevitable spectre of a Greek debt repayment due this summer and troubling political landscapes in Spain and Portugal. We are likely to reduce our exposure to these markets in the very near term, and expect an opportunity to re-enter this market to arise later in the year. And in the US, while valuations have come down slightly, tech remains extremely expensive. We noted in particular the launch of Tindog, a dating app for dogs and their owners: it is oddly (and ominously) reminiscent of the dog hotels which launched at the end of the tech boom in the late 1990s, when all manner of bad ideas were able to raise capital from investors desperate not to miss out on the next big thing.

Food for thought this quarter came from an icon and iconoclast, the late David Bowie, a man who was fully aware of the power of reinvention. After this quarter's events, in our view the story is now fundamentally different; investor confidence in the ability of central banks to stimulate growth continues wane, and we expect flows into traditional safe-haven assets to continue. We will continue to rotate portfolios to best position them in line with this environment.

Fred Hervey



Lincoln Private
Investment Office
London

31 March 2016

Chief Investment Officer