![BEAUFORT]

2015 – A Year of False Dawns. 2016 – A Year of Mixed Fortunes?

Beaufort Securities Review and Outlook *– 14/12/2015*

Looking ahead into 2015 a year ago, the main concerns were the falling price of oil (then at $60 per barrel for Brent crude), the timing of Central Bank interest rate rises and the likely impact on global growth of economic restructuring in China. Twelve months later we can see that, while the rate of change at the macro level has slowed down, the pace of activity at the micro level has accelerated. The uncertainty engendered among investors by the U.S. Federal Reserve's inability to strike a firm pose and start to raise interest rates sooner has produced on occasions a form of 'Headless Chicken Syndrome' in markets. Most major market indices have been erratic, shifting between seemingly committed rallies and falls off a cliff almost within the space of a heartbeat – in essence, schizophrenic.

At the core of the problem for investors is that we are in uncharted territory. It is now seven years since the Federal Open Market Committee (on the 16th December 2008) cut the funds target rate from 1% to a 0%-0.25% range. Businesses have become accustomed to a new normal. No one in the bond or equity markets can be certain how they will react once the psychological ripples of higher interest rates begin to spread. Will bonds, amid concerns of tightening liquidity, have another '1994 moment' and, perhaps, unsettle equities with their downdraught ? The recent closure of two major New York bond funds is not helping sentiment.

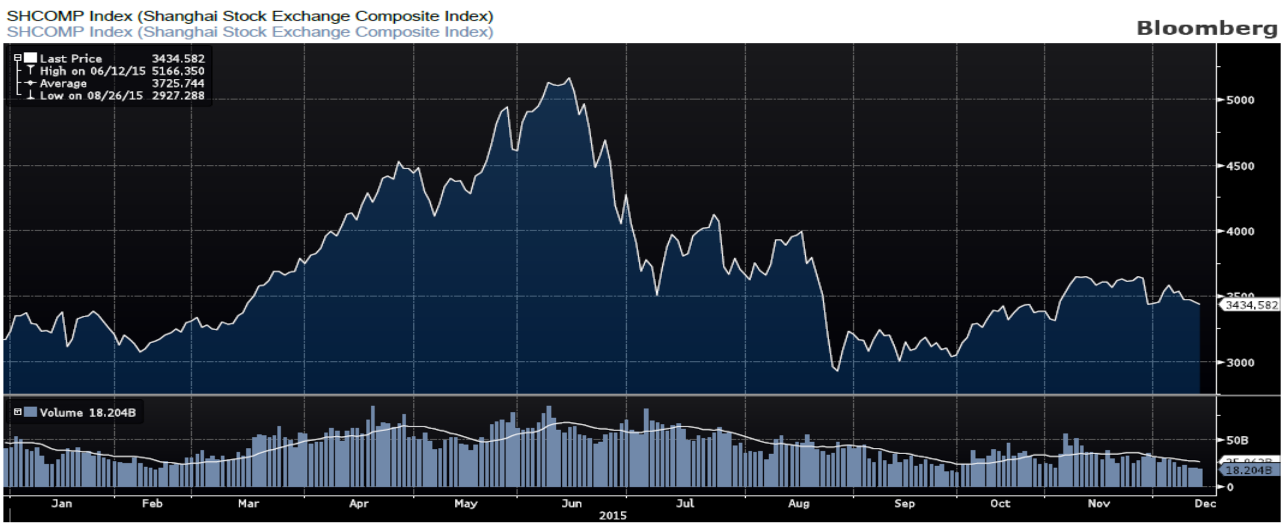
And what do we have to show for all this nerve-shredding anxiety? As this report goes to print, year-to-date the FTSE 100 Index has fallen by 8.7% and the S&P 500 Index by 2.2%, both in local currency terms. Helped by lower exposure to the Energy and Materials sectors, the FTSE 250 (which accounts for about 17% of the FTSE 350 Index) has gained by 5.2% since end-2014 while the FTSE AIM All Share has risen by 3.2%. The FTSE 100 Index and the S&P 500 Index peaked in April while the FTSE 250 Index hit its high in June. What can be revealing about the volatility of markets in 2015 which are closing the year with small net changes are the sizes of the intermediate swings as shown in the table below. It demonstrates that 2015 has been a year for trading and that accurate market timing has been essential.

INDEX	Intraday Change Open-to-High (%)	Intraday Change High-to-Low (%)	Intraday Change Low-to-Close (%)	Net Change YTD (%)
FTSE 100	8.8	-19.0	4.2	**-8.7**
FTSE 250	14.3	-13.2	6.0	**5.2**
AIM ALL SHARE	11.5	-10.4	3.7	**3.2**
S&P 500	3.7	-12.5	7.8	**-2.2**
Shanghai Composite	64.0	-44.9	23.5	**8.9**

After the years of economic recovery on the back of various forms of Quantitative Easing in the U.S., U.K., Japan and China since equity markets in the West bottomed in March 2009, 2015 has brought the gradual acceptance that a slowdown has been setting in. The Organisation for Economic Co-operation and Development (OECD), in November, highlighted a sharp slowing in the rate of world trade as putting global growth at risk. Their forecasts for real global GDP growth were reduced from 3% to 2.9% for 2015 and from 3.6% to 3.3% for 2016. In recession were Brazil and Russia whilst the highest growth economies were India, China and Indonesia.

Problems in China's banking (including shadow banking) and property sectors have been symptomatic of over-enthusiastic pump-priming early in the post-2008 global economic recovery as various chickens came home to roost. This has been against a background of China's economic restructuring as it shifts the emphasis from reliance on exports and frenetic infrastructure development to one that is more based on domestic consumer demand. Inevitably, China's lower level of demand for raw materials has continued to be felt around the world, knocking the valuations of mining companies yet further. Disastrously for British steel producers, China's over-production has led to the dumping of steel in foreign markets.

China was in the news this year for the spectacular boom and bust of the Shanghai stock market. Whatever evidence could be gleaned – making sense of the Chinese economic picture is sometimes tricky – suggested that the authorities were keen to stimulate activity in the broader economy by encouraging wider equity participation by the public.



Unfortunately, though not entirely surprising given the extreme nature of Chinese stock market activity in the past (if you include the singularly spectacular crashes of the Hong Kong stock market in 1973, 1987 and 1997) the bull market peaked in June and in August experienced a 26% drop over just seven trading days, an annualised rate of descent of 1,350% and a fall in value of $1.5 Trillion – equivalent to almost 8% of the $19 Trillion market value of the S&P 500 Index which, in sympathy, fell by 11% over the same few days.

Although the mood of the Chinese markets seems to have calmed down after some dramatic intervention by the authorities, the subsequent 'disappearance' of several high-profile people in the corporate and financial sectors has looked more reminiscent of Old-style Communism than the Emerging Capitalism to which China aspires.

Apart from concerns of contagion globally from the Shanghai market collapse– and there was some evidence of spill-over into the commodity sector – what might have been dismissed as a 'little local difficulty' worried the Federal Reserve enough for it to hold back from raising rates in September as had been expected and turned back the clock on the Federal Reserve's attempts to normalise the global economy. Some observers feel that this was an opportunity lost when a critical set of conditions existed. Though inflation cannot be regarded as a short term threat, there are an increasing number of signs of slowing economic growth globally. What the Federal Reserve would prefer to see, and indeed needs, is robust economic conditions as it applies the brake of higher interest rates.

If inflation is not troubling the U.S. or the U.K., helped by lower oil prices, the Eurozone continues to flirt with the spectre of Deflation. European Central Bank President, Mario Draghi struggles to sustain a pulse in the weaker economies of the Eurozone through yet more monetary accommodation. Many Eurozone bonds now carry negative yields, reflecting the penalty on banks in the region for holding cash / failing to lend. The situation in the Eurozone is widely described as 'fragile' and is not helped by (a) the seeming inability or unwillingness of some member countries to restructure or (b) by the background of slowing global economic activity.

According to the International Monetary Fund, in current prices, at the end of 2014 the combined GDP of the Eurozone countries was in the region of $13.4 Trillion, putting it ahead of China at $10.3 Trillion but behind the European Union (which includes the United Kingdom) at $18.5 Trillion and behind the United States at $17.3 Trillion. Accounting for around 17% of World GDP, the Eurozone is a major player and, as such, needs to be making a solidly consistent contribution to the global economy.

The UK in 2015

Public opinion ahead of the 7th May UK General Election was highly polarised with the likely outcome difficult to call. Understandably, the mood of the market was skittish. In the event and contrary to the view of many polling groups, the Conservative Party, previously in coalition with the Liberal Democrat Party, emerged with a modest majority. The implied continuity in economic policy helped to calm investors' nerves and the FTSE 100 enjoyed a brief relief rally to over the 7,000 level. However, it became apparent subsequently that the year's highest close was at 7,103 in late-April.

For much of June and July Greece teetered on the brink of 'Grexit' before strained negotiations with the 'Troika', comprising the European Commission, the European Central Bank and the International Monetary Fund, led to a $90 Billion bailout as part of the total agreement. It is only a matter of time before the world will need to revisit this open-ended problem. In August the market dropped by 19% to the 5,800 level as commodity prices collapsed on further evidence of the slowdown in China and the implied reduction in demand for raw materials.

A review of the year-to-date share price performances of the FTSE 350 Index constituents shows a wide range of differences. In sector terms, Forestry and Paper (Mondi) has risen the most at over 40% followed by Software and Computer Services (+33%, heavily influenced by Sage Group). In contrast, Industrial Metal and Mining (Evraz) dropped by 50% with the Mining and Oil sectors down by 46% and 26% respectively.

In the FTSE 100 Index individual stock rankings, reflecting favourable Government policies, house builders have featured prominently at the top. Taylor Wimpey (+50%) was followed closely by Berkeley Group, Barratt Developments and Persimmon. With falls of around 70% year-to date, Anglo American and Glencore have performed worst as they struggle towards the year-end with restructuring woes in the face of weakening commodity prices.

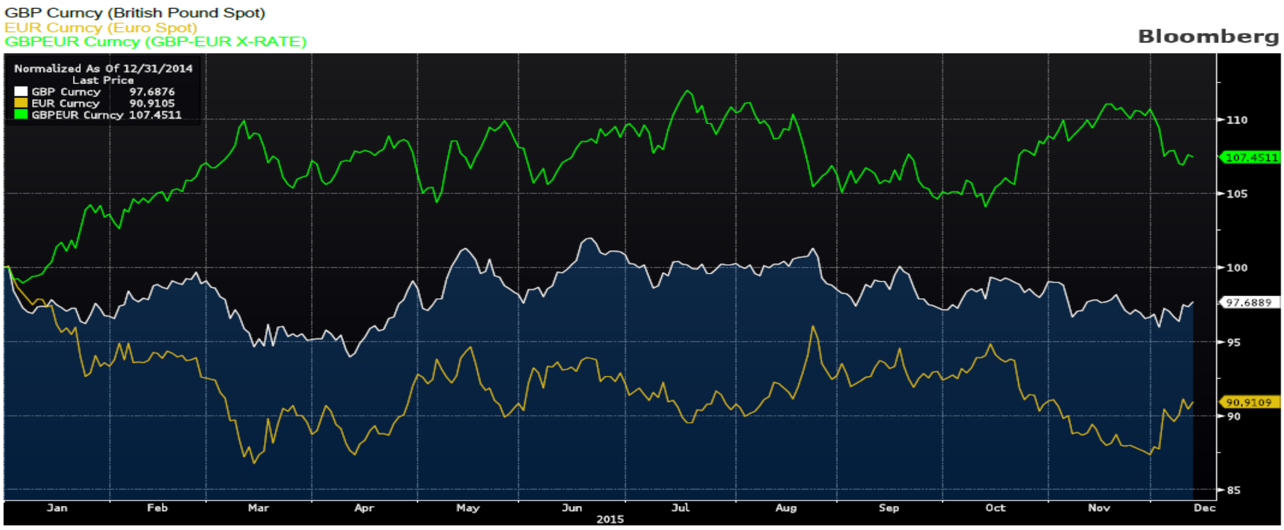
Of the FTSE 250 Index stocks, Betfair Group have emerged at the top (+140%) after bid interest from Paddy Power, followed by JD Sports (+110%). With price falls of between 55% and 65%, the bottom slots are occupied by Petra Diamonds, Premier Oil, Kaz Minerals and Tullow Oil. The evidence of increased Merger and Acquisition activity during the year has been symptomatic of the trend towards achieving greater commercial synergies and taking advantage of cheap finance before interest rates begin to rise.

The Outlook for 2016

Our starting point for next year is Brent crude oil just below $40 per barrel, interest rates in the US turning up and China striving towards adulthood on the World economic stage. A key tone-setter for markets in 2016 will be how the Federal Reserve follows up its first interest rate move in seven years. The guidance has pointed to a low initial rate followed by modest increments to take the Fed Funds Rate to around 1.2% by end-2016 and to about 2.1% by end-2017. Naturally, these indications will be heavily subject to the rate of GDP growth, inflation and the level and quality of the employment statistics.

Part of the Federal Reserve's caution about when to raise rates has been rooted in sensitivity about the possible impact on Emerging Economies. The property sectors in these areas – typically highly-geared on cheap bank finance – stand out as particularly vulnerable. In an extreme scenario, crashing property markets could be extremely damaging for the health of economies as they frequently effect all strata of society. Similarly, if banks begin to suffer widespread defaults the implications for the global economy would not be good. It is imagined, however, that Central Banks and Governments would begin to take counter-measures if such circumstances were to unfold.

Compared with the Federal Reserve, the Bank of England's Monetary Policy Committee is following a later cycle with UK interest rates generally expected to rise no sooner than the second half of next year and maybe not until 2017. In the Eurozone, the actions of the European Central Bank to stimulate economic growth through extending Quantitative Easing measures have helped to reduce the value of the Euro by a net 9% to $1.09 during 2015 although the rate has fallen to around the $1.05 level on three occasions during the year.



In early-December, ECB President Mario Draghi announced an extension of existing measures which disappointed the markets and caused the Euro-dollar rate to jump by a staggering 4% in the day. Normally, Signor Draghi has a good feel for likely market reaction but it appears that his original strategy for the Eurozone may have become compromised by opposition from Germany.

Reflecting the expected timing of implementation of the respective monetary policies, the US Dollar has been strong throughout much of 2015 relative to Sterling which, in turn, has been strong against the Euro. This relationship seems likely to hold broadly during 2016 but may continue to create a headwind for US exporters as it did in 2015.

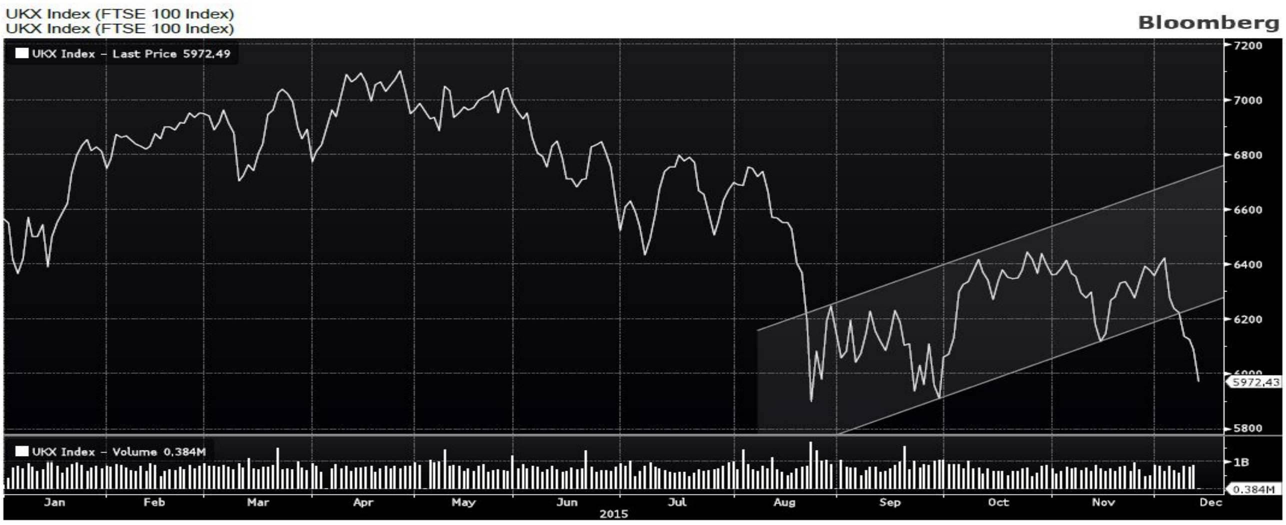
Reviewing the technical outlook, the S&P 500 Index remains in a bull market as it lies above the primary trend line in place since March 2009. However, the higher trend line in place since early-October 2011 was broken in late-August 2015 at the time of the Shanghai stock market crash. The 2009 trend line lies about 15% below the current index level of 2,060 so an assault on this does not look imminent. However, with signs of US corporate earnings slowing and interest rates rising, not to mention the concerns expressed earlier about the risk to property in Emerging Economies, the possibility of the S&P 500's near-seven year old bull market ending during 2016 cannot be ignored.

At the start of 2015 our strategy note suggested that the long term (monthly) chart for the S&P and FTSE 100 indices were showing the start of tops which bore similarities to those for 2000 and 2007 from which the markets declined by over 40%. In the event, both markets did peak during 2015 with the S&P's largest drop being about 13% while that for the FTSE 100 was 19%. However, the main difference between 2015 and the years 2000 and 2007 has been the intervention of the Federal Reserve's Quantitative Easing which appears to have had the effect of delaying or even eliminating the prospect of falls of nearer 40%. We shall see. Perversely, we did see a 40% market fall in 2015 but that was in the Shanghai Composite Index.

The March 2009 bull market trend for the FTSE 100 Index was broken in October 2014. The August 2011 trend line was broken in late-August 2015, as in the case of the S&P 500 Index, at the time of the Shanghai stock market crash. After bottoming at the end of August, the Index ranged in an upward trend channel before beginning to break down below the channel in early-December.

Although market relative strength suggests that the market may attempt to rally before the year-end, it is unfortunate that a stronger-looking trend is not in place for the start of 2016.

Given the near-20% weighting for Mining and Oil companies in the FTSE 100 Index it is not surprising that the Index has struggled in 2015. Until a floor is established for the prices for commodities such as iron ore, copper and oil, it will be difficult for the FTSE 100 to establish a new recovery trend. During 2015 we have seen the mixed blessings that lower oil prices can bring. Generally, the disinflation impact on economies has been welcome but it has come at the cost of jobs and, if projects have not been abandoned altogether, reduced investment into exploration and production. Delinquent borrowings create problems for the banking sector. In 2015, oil producing countries like Saudi Arabia and Norway have made withdrawals from their sovereign wealth funds to offset lower oil revenues, inevitably adding some selling pressure to bond and equity markets.



With particular regard to the oil price, the outlook is especially cloudy. Accounting for around 40% of global crude oil production, the Organization of the Petroleum Exporting Countries (OPEC) does not appear to have the clout it once did. The rapid expansion of US shale oil and gas production in the past two years has had a profound effect on energy politics. The dominant OPEC member Saudi Arabia has been clear that it will not cut back production and lose market share. Other producers such as Russia and Indonesia, desperate to shore up their economies, are maintaining high production levels. Data from the International Energy Agency for the third quarter of 2015 show that the World supply of oil at 96.9 million barrels per day (mbpd) was outstripping demand by 1.6 mbpd (1.6%). Despite the expectation of a slight decline in Non-OPEC supply in 2016, it looks as if oversupply will continue to keep the oil price under pressure going into 2016.

Conclusion

The air of uncertainty feels particularly intense on so many fronts as we move into 2016. The fundamental bases for so many valuations – the cost of money (interest rates), the prices for commodities – are in doubt and that’s before considering the potential impact of geopolitical risk such as terrorist attacks. It is far from clear at what point rising interest rates may drive money in search of yield out of bond markets and into equity markets where slowing economic activity is causing companies to restrain or even reduce their rates of dividend distribution.

In the UK, the possibility of a referendum on Europe being brought forward from 2017 will be unsettling for investors. It is a moot point whether the general public should be expected to be able to make a sound judgement about such a complex and esoteric issue. That said, it must be admitted that it may have been more by luck than judgement that the politicians kept Britain out of the Euro.

On balance, 2016 looks likely to continue to be a year of transition and adjustment as in 2015. To borrow a popular footballing expression, 2016 can be expected to be a year of two halves. Until investors have begun to feel comfortable with the adjustment to the ‘New (Old) Normal’ and commodity prices have stopped falling, it is difficult to see how there will be enough confidence to give equity markets a sustained push higher much before the middle of the year. In other words, the moderate bear trends in place since April (FTSE 100 Index) and May (S&P 500 Index), albeit that they were punctuated by spirited rallies, look set to continue in the next few months.

For predominantly long-only investors, this does not mean that there will not be opportunities to generate investment returns. However, as in 2015, market timing and good stock selection will continue to be important in extracting value. The likely volatility may make setting full year forecasts particularly difficult so, except for longer term ISA and pension savers pursuing (appropriately in the current conditions) a pound-cost averaging strategy, a trading mentality will remain the right approach for some investors.

During the year we would expect to see greater caution applied by investors to highly-geared companies with the prospect of UK interest rates rising eventually. In recent months, the market has been fiercely unforgiving towards companies that have not met expectations but has driven up share prices for companies reporting above estimates. This looks likely to continue in volatile conditions and puts a large premium on stock picking. For clients who wish to have short term trading ideas we will continue to pursue a technical bottom-up stock identification approach. As in previous years, the investment teams at Beaufort will continue to strive to maximise returns for our clients in the face of variable market conditions, applying the methods described in the notes below.

Mike Franklin Chartered FCSI
Chief Investment Strategist
Beaufort Securities Ltd

Note

The research team at Beaufort Securities applies both fundamental and technical research principles to seek out relative value in the markets. This includes assessing Initial Public Offerings, small capital companies such as those quoted on the Alternative Investment Market (AIM), and large capital companies, particularly those comprising the FTSE 350 Index. Constant monitoring of global economic, political and social developments forms the basis for the Investment Strategy that Beaufort provides to its investment advisory team and, in turn, its clients as a framework for its investment recommendations.

As we have advised readers in the past, it is important to be aware that the fundamentally-derived investment conclusions Beaufort expresses for the longer term may not always coincide with our short term technically-derived recommendations which are provided to our Advisory clients by Beaufort's Investment Advisory brokerage team. In other words, since the long term is made up of several short terms, whilst we may provide short term buy or sell trading ideas to those of our clients who wish to try to time market moves in volatile market conditions, we hope clients will recognise that if we express a bullish or bearish view for the longer term it is not inconsistent with holding different views for short term trading.

Recommendations

During the three months to end-November 2015, the number of stocks on which Beaufort Securities has published recommendations was 350, and the recommendations were as follows: Buy - 85; Speculative Buy - 228; Hold - 36; Sell - 1.

Full definitions of the recommendations used by Beaufort Securities in its publications and their respective meanings can be found on our website here.

This report is published by Beaufort Securities ("Beaufort Securities"). Beaufort Securities is Authorised and Regulated by the Financial Conduct Authority and is a Member of the London Stock Exchange.

This research is non-independent and is classified as a Marketing Communication under FCA rules. As such it has not been prepared in accordance with legal requirements designed to promote independence of investment research and it is not subject to the prohibition on dealing ahead of the dissemination of investment research in COBS 12.2.5. However Beaufort Securities has adopted internal procedures which prohibit analysts from dealing ahead of non-independent research, except for legitimate market making and fulfilling clients' unsolicited orders.

RELIANCE ON THIS NOTE FOR THE PURPOSE OF ENGAGING IN ANY INVESTMENT ACTIVITY MAY EXPOSE AN INDIVIDUAL TO A SIGNIFICANT RISK OF LOSING ALL OF THE FUNDS, PROPERTY OR OTHER ASSETS INVESTED OR OF INCURRING ADDITIONAL LIABILITY.

By receiving this document, you will not be deemed a client or provided with the protections afforded to clients of Beaufort Securities. When distributing this document, Beaufort Securities is not acting for any recipient of this document and will not be responsible for providing advice to any recipient in relation to this document. Accordingly, Beaufort Securities will not be responsible to any recipient for providing the protections afforded to its clients.

Beaufort Securities may effect transactions in shares mentioned herein and may take proprietary trading positions in those shares, and may receive remuneration for the publication of its research and for other services. Beaufort Securities may be a shareholder in any of the companies mentioned in this report. Accordingly, this document may not be considered as objective or impartial. Additionally, information may be available to Beaufort Securities or the Group, which is not reflected in this material. The remuneration of the author of this report is not tied to the recommendations on any shares mentioned nor to the any transactions undertaken by Beaufort Securities or any affiliate company. Further information on Beaufort Securities' policy regarding potential conflicts of interest in the context of investment research and Beaufort Securities' policy on disclosure and conflicts in general are available on request. Please refer to http://www.beaufortsecurities.com/important-info.

This document is not an offer to buy or sell any security or currency. This document does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The appropriateness of a particular investment or currency will depend on an investor's individual circumstances and objectives. The investments and shares referred to in this document may not be suitable for all investors.

Past performance is not a guarantee of future performance. Investments may go down in value as well as up and you may not get back the full amount invested. The listing requirements for securities listed on AIM or ISDX are less demanding and trading in them may be less liquid than main markets.

This document is based on information Beaufort Securities has received from publicly available reports and industry sources. Beaufort Securities may not have verified all of this information with third parties. Neither Beaufort Securities nor its advisors, directors or employees can guarantee the accuracy, reasonableness or completeness of the information received from any sources consulted for this publication, and neither Beaufort Securities nor its advisors, directors or employees accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection with this document (except in respect of wilful default and to the extent that any such liability cannot be excluded by the applicable law). This document is not to be relied upon and should not be used in substitution for the exercise of independent judgment.

This document includes certain statements, estimates, and projections with respect to the anticipated future performance of securities listed on stock exchanges and as to the market for these shares. Such statements, estimates, and projections are based on information that we consider reliable and may reflect various assumptions made concerning anticipated economic developments, which have not been independently verified and may or may not prove correct. No representation or warranty is made as to the accuracy of such statements, estimates, and projections or as to its fitness for the purpose intended and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only and may change without notice. Other third parties may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views, and analytical methods of the analysts who prepared them. This report has not been disclosed to any of the companies mentioned herein prior to its publication.

The information contained in this document is confidential and is solely for use of those persons to whom it is addressed and may not be reproduced, further distributed to any other person or published, in whole or in part, for any purpose. Other persons who receive this document should not rely on it. Beaufort Securities, its directors, officers and employees may have positions in the securities mentioned herein.