CONCEPT
VERMÖGENSMANAGEMENT

Interest rates turn around?

Annual Report

2015

INTEREST RATES TURN AROUND?

16.12.2008, New York - Following dramatic falls in US interest rates during the financial crisis, the US central bank lowers its key interest rate for one last time, namely to a range between 0.00% and 0.25%. – This took place exactly seven years prior to rates now being raised again for the first time on 16.12.2015. Even though we cannot or should not now expect seven years of plenty to follow the seven previous extremely lean ones, it is clear that this marks a change meriting closer inspection.

Remain overweight in equities but be prepared for high fluctuations.

Based on our experience, for the time being the "turning point" in interest rates remains primarily symbolic in nature. However, of one thing we are sure: this minimal pressure drop in the centre of the pecuniary climate system will bring about a change in the weather. The new directional impetus of the most important central bank in the world will probably have little impact on the real economy, but it will impact market expectations, a factor which is ultimately decisive for capital markets.
In the last two reports we already pointed to the high level reached by price quotations, both in equity and fixed income markets, and had begun - verbally - to take our foot off the pedal. This year we once again expect equities to make the biggest contribution to performance, but at the same time also expect an increase in already elevated levels of volatility. For this reason active portfolio management, combined with the courage to intermittently hold cash, will be crucial to the success of investment in 2016.

The year 2015 started out with premature high hopes, which many would have cashed in on. The IMF expected an increase in global gross domestic product of just under 4%; in the event it was only 3%. World trade, too, grew by just 2.5% rather than the expected 4%. The US is facing headwind from the strong dollar. Exports are declining and cannot currently be offset by domestic demand, which remains subdued. Last year both revenues and, to a lesser extent, US corporate earnings were lower than prior year figures. In the euro-zone, economic activity accelerated somewhat more rapidly than had been forecast and the recovery appears broader.

The growth engine is misfiring, whilst the debt crisis remains.

China remains dominated by a slowdown in growth. In 2015 gross domestic product grew by just under 7%, and is estimated at 6% for 2016. Even on a diminished basis, however, China remains the fastest-growing region. In contrast, the outcome of the Japanese experiment remains uncertain. The government is borrowing at a growing pace, while the Japanese central bank is buying up debt. Nonetheless, growth remains lacking. Despite an 8-year low of the yen against the dollar, exports are not increasing. Although the depreciation of the yen has been favourable for company profits, which have doubled since 2012, investment has stagnated.

The international debt crisis is also ever present: since 2010 debt has risen in all major industrial nations, with the exception of Iceland and Germany. In some cases this is a stated policy objective, for example in Japan, China and – albeit on the quiet – in the European periphery. As the OECD laments, appetite for reform, if such a thing even exists, has long since waned. The low interest rates encouraged government policy-makers to shower the general public with gifts, something for which Germany, too, has faced criticism (for example, lowering the retirement age to 63). Whereas the private sector in most countries has to a greater or lesser degree reduced debt levels, governments seem to be holding on to the illusion that this is sustainable, appearing not to realise that if interest rates rise, debt servicing could rapidly become a heavy burden.

IWF – economic forecast

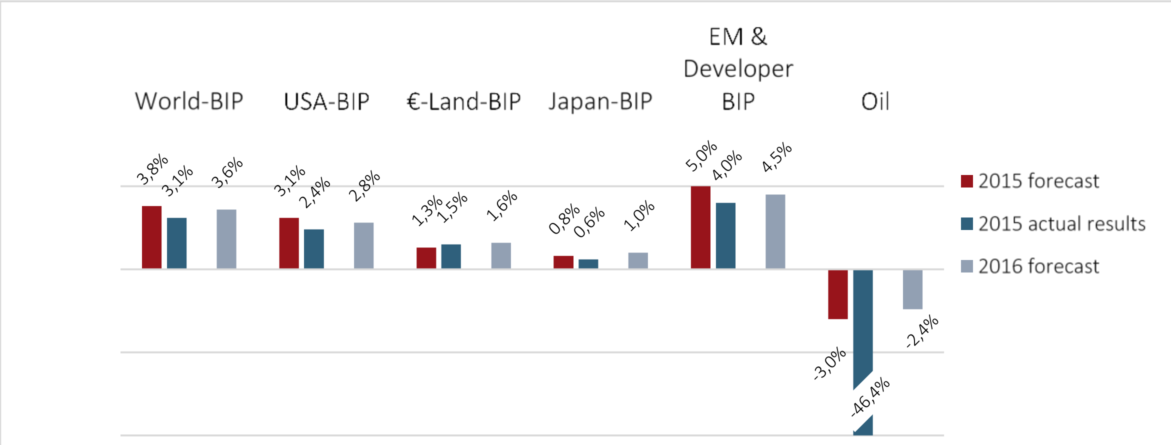

Figure 1 *Source: IMF*

FORWARD GUIDANCE?

The muddled communications from central banks could undermine confidence in their ability to take action.

The loss of central banks' sovereignty that could be seen in the year just ended was remarkable. First of all, China's government and central bank, driven by fears of an economic slowdown, conducted a few (monetary) policy experiments, which included the direct purchase of equities via state funds and a ban on sales for institutional investors. In a surprising step, in July the government intervened to devalue the currency, for years praised for its stability, by around 10%. It was not only the nerves of the Chinese population, forced to speculate, that were stretched to the limit by this. The Fed governors under Janet Yellen also proved to be so unsettled by the potential impact on the global economy, that to the surprise of the market they temporarily abandoned their first interest rate increase since the financial crisis, an increase that had been months in preparation. Meanwhile, Mario Draghi, head of the European Central Bank (ECB), never tired of assuring the market that his extremely loose monetary policy would be further expanded, and once again announced that all available means would be used to meet his inflation target. On the day of the December announcement, however, practically none of the expectations raised were actually met. Forward Guidance, which at one time represented promised, foreseeable central bank policy, would now appear to look somewhat different. The muddled communications of the large central banks undoubtedly caused confidence in their outlook and actions to be eroded, which in turn does not constitute a good omen for global financial markets. It is already apparent that whilst markets always get back to normal eventually, it takes a little longer each time for the shock of the surprise to abate.

The central banks are stuck in the familiar dilemma of scarcely being able to get anything right. On sober reflection, a feeling persists that although they prevented the worst from happening in the financial crisis, beyond that no economic stimuli were created. In the US and UK, the recovery period from the end of the crisis up until the return to the former level of economic output was more than twice as long as it had been following previous crises. On an inflation-adjusted basis, the pre-crisis level still has yet to be reached in Euroland, and also in Germany.

DANGER OF SECULAR STAGNATION

Real risk of long-term slowdown in growth.

It does not necessarily follow that in a time of falling interest rates, the propensity for investment and consumer spending or propensity for indebtedness automatically rises. Rather, the depressed compound interest means that more capital must be created for retirement provision. The unavoidable debt reduction in the private sector, indirectly triggered by the stricter bank reporting guidelines, has a similar impact. Both of the aforementioned phenomena lead to an increased withdrawal of the capital that would normally be available for consumption; the lower propensity to consume causes lower investment and - ceteris paribus - inflation approaching zero, which in turn impedes the propensity to consume. All of this constitutes an ideal breeding ground for so-called secular stagnation, a phase of long-term inactivity. At the same time, this encourages the accumulation of capital in the financial sector, investors

Following in the tracks of Japan? - A worldwide gradual slowdown in growth

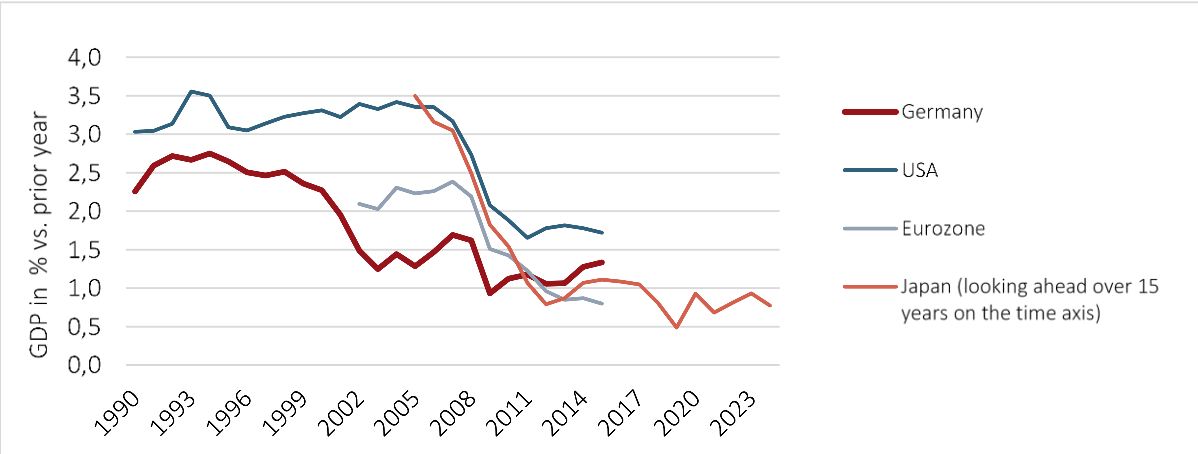

Figure 2 *Source: Federal Reserve Economic Data*

take more risk, and financial markets continue to balloon. After a certain point, monetary policy does not have sufficient force to counteract this. On the contrary, every measure falls flat or makes the symptoms worse: continuing a policy of monetary easing is tantamount to pouring petrol on the flames. On the other hand, withdrawal - that is to say a return to normal monetary policy - carries an acute risk of stalling an already structurally fragile economy.

It is our assumption that policy-makers are aware that withdrawal is the only possible response. A policy of "more of the same" would eventually lead to the collapse of the global financial system. We therefore consider the first interest rate increase by the US central bank in seven years to be logical and also, to a certain extent, consider that there is no alternative. With this mini turn-around in interest rates, the Fed is promoting confidence, signalling its awareness of the dilemma posed by cheap funding and taking responsibility for the security of the financial system. Their action also bears some fully altruistic traits, since a greater divergence in interest rates could allow the dollar to appreciate further against the euro and the yen, exacerbating today's already quantifiable damage to the domestic economy. Pessimistic observers consider the "turnaround" in interest rates to be premature, and are concerned that the central bank may quickly be forced to reverse it. We are more optimistic, since the Fed after all is merely adhering to the strategy it already started in December 2013 of gradually introducing economic agents to a normalisation in interest rate policy. The dollar has since risen by 20% against the euro, with the US economy performing sufficiently well to absorb this.

THE INTEREST RATE PARADIGM IS CHANGING

The Fed's interest rate increase was logical; there was no alternative.

However, the fixed point of "long-term" low interest rates, which has always been a support to stock markets navigating uncharted waters, is wavering. It is quite uncertain how stable the structure of global finance would really be, should the flow of money abate, removing the buoyancy provided by liquidity. Cheap borrowing has increased the market's risk tolerance and enabled financial models that would not have been viable in a time of higher interest rates. Last but not least, as a result of the low interest rates the level of global acquisition activity has peaked and US companies have allowed record amounts to be spent on buy-backs of their own shares instead of investing in plant, machinery, research and development.

The turning point in interest rates was overdue. The transition to genuinely rising interest rates will be undertaken with extreme caution.

Of course, it is particularly difficult to accurately interpret the impact of a paradigm shift. Even the question of whether this is already taking place cannot be answered unequivocally today: whilst interest rates are gradually being raised in the US, the Japanese and European central banks are pumping USD 120 billion into the market every month, keeping money cheap. On the other hand, for the last year the Chinese central bank has been reducing its currency reserves at an increasing pace, thereby supporting its own currency but at the same time absorbing liquidity from the international market. In aggregate, could this potentially amount to a zero-sum effect?

What impact a turnaround in interest rates has on capital markets tends to be affected by two questions. Firstly, were market participants taken by surprise? Secondly, will this first step be followed by further action in the near future? Certainly, seldom has an interest rate rise been more justified than last year's increase. It had thus been anticipated and took no-one by surprise. On the contrary, on the basis of the widely-recognised formula developed by US economist John B. Taylor at the start of the 1990s, the increase would have been opportune as early as 2012/2013, which would have implied a current interest rate level of over 2%. In order to be absolutely certain of the economic upturn, however, the central bank waited until the lagging indicator of employment figures signalled full employment. Market participants had thus anticipated an imminent interest rate increase well before its implementation.

Some suspect that behind the Fed and ECB's theatrics in December lies an internationally agreed central bank policy, whereby in order to end the zero-interest policy, seen to be harmful in the long term, it is the economically strongest party who makes the first move. The measure is accompanied by non-action on the part of other central banks, so as to avoid them taking conflicting actions that could weaken the economic position of the central bank making the first move (for example, through exchange rates). Viewed in this way, the fact that ECB President Draghi supposedly disappointed hopes of an interest rate rise appears in a different light, and works in harmony with Fed policy. This potentially suggests that the transition to genuinely rising interest rates will be undertaken with extreme caution and over a wide timespan. In particular in view of the high level of public debt and the associated interest costs, we expect it to be some time before the next interest rate change. So borrowing once again has a cost, but it will remain extremely low for some time.

FUNDAMENTAL DATA MUST DELIVER

For stock markets, however, this perspective signifies a departure from their collective experience in recent years, whereby bad news for the economy always concurrently signified good news for stock markets, because it justified the expectation of a continued inflow of cheap funding. The US central bank needs to regain credibility and will clarify this misconception at the first opportunity. The markets will increasingly (need to) return to a focus on companies' fundamental data, while other influences that distort pricing will diminish in importance.

Greater importance is being placed on earnings that are expected to be sustainable and their likelihood of occurrence, whilst capital costs are once again a focus due to normalising interest rate levels. If US companies want to generate rising earnings in spite of declining margins, there is a need for further impetus from the real economy, which might reverse the week revenue trend of recent years. There are tentative signs to support this: the substantially improved situation in the labour market and an increase in (private) lending should lead to a boost in domestic demand. This is known to be of crucial economic significance in the US.

Europe is still developing little momentum despite favourable operating conditions

While the US economy has already turned a corner, Europe's recovery is still only moving at half speed. One reason for the reduced momentum lies with the lack of clear commitment to reform on the part of many countries, something we have already frequently bemoaned. It is thus all the better that countries such as Ireland and Spain, who took the necessary structural reforms seriously, are standing right at the top of the podium. Meanwhile, France, Italy and yes, even Germany, are developing little strength. Yet it would be hard to imagine more of a boost than historically low interest rates, low energy and commodity prices and a favourable exchange rate. Given the tailwind provided by these factors, last year's euro-zone growth of 1.6% looks exceedingly poor. This justifies concerns over what would happen if any one of the components mentioned were to lose its impact. In any case, it is positive to note that the recovery has broadened and now includes almost all countries in Europe. Lending has also revived significantly, whilst sentiment indicators are returning to positive terrain. In Euroland, in particular, interest rates will remain - and must remain - low for some time. All in all, we continue to expect that the impetus from reviving domestic demand, favourable financing and trading conditions and cautiously improving structural policies will continue to be felt in 2016.

Eurozone : The recovery is gaining in latitude

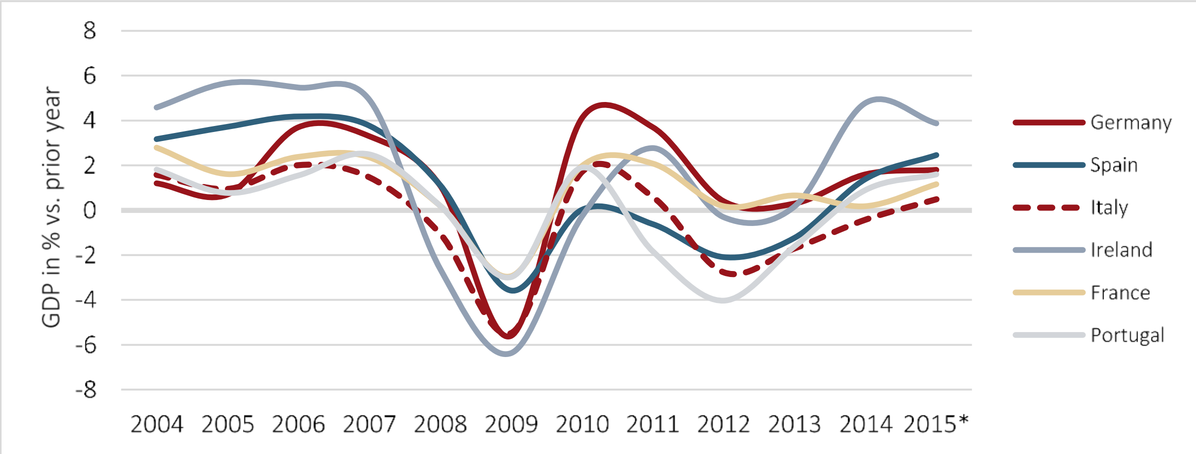

Figure 3 *Source: IMF*

Japan remains an experiment in economic policy.

In our view, Japan remains an experiment in economic policy, which as yet has been unable to free itself from the gravitational pull of secular stagnation and as such remains a cautionary example for other industrialised nations. It clearly demonstrates the extent to which a country is affected by an ageing population. In order to counteract this demographic factor, Japan should take in 700,000 immigrants a year and integrate them into its labour market; in fact just 15,000 are currently accepted. For the last 22 years Japan has generated greater expenditure than revenues, because the budget is groaning under the burden of growing pension costs. Since the financial crisis, the budget deficit has averaged 8%. As long as the central bank continues to buy public debt and the weak yen benefits companies, the stock market has little to fear. However, whether these stimuli will be sufficient to genuinely accelerate economic growth remains doubtful. This strategy is, in any event, unlikely to win a sustainability award.

Commodity prices should bottom out.

In the coming year, the evolution of raw material prices will be of even greater importance to the global economy than interest rates. The subdued global demand for capital goods and sluggish growth in raw material consumption in China will continue to be factors that limit prices. Additional pressure will be placed on energy prices due to attempts by

OPEC nations to prevent new technologies, such as fracking and the exploitation of oil shale, from becoming viable. However, experience has shown that these factors will have shorter-term effects. Over the longer term, however, the close coupling of commodity prices with the US dollar needs to be monitored, since they are predominantly traded in this currency. A stronger dollar therefore generally puts pressure on raw material prices, whereas a weaker dollar provides some leeway for price increases. In our opinion, the evolution of the dollar will continue to exert the greatest influence on raw material prices, and we anticipate that the downward trend has now bottomed out.

OPPORTUNITIES ON ONE HAND, RISKS ON THE OTHER

The upturn following the financial crisis is now entering its eighth year and has reached a certain level of maturity. This naturally means that the risk of recessionary trends is also rising. For this reason, the risks impacting the markets merit more in-depth discussion. If in the process of doing so we frequently focus on the US, this reflects the fact that the gravitational force of US capital markets, by far the largest in the world, continue to make it the reference point for global markets.

Mature markets imply risks ...

- As it reaches the late phase of the cycle, the US has recently already seen signs of a slowdown in both revenues and earnings. The equity market is significantly above its pre-crisis high and has probably already anticipated the expectation of a continued upturn. It was unable to record further gains in the year just ended, and in fact was only able to maintain its level thanks to the might of powerhouses such as Amazon and Google as well as through company share buyback programmes. Taking into account buy-backs of own shares and dividend payments, US companies are currently spending 25% more than they are earning annually. Half of companies are financing this through cheap borrowing. This model would not be sustainable if the cost of capital were to rise. - On the other hand, this alone would not yet necessarily lead to a market correction. As a percentage, this difference was considerably greater between 1995 and 2002 and lasted for seven years, although interest rates doubled during this period.

Share buybacks and M&A transactions are becoming less attractive.

- In Europe, economic recovery, if it can be referred to as such, is only just under way. As a result European stock markets currently offer comparatively attractive valuation ratios. However, the question is how much potential can be tapped in the event that the upturn in the US comes to a standstill and at the same time earning expectations must be significantly reduced. - On the other hand, the analyst community has already revised their earnings forecasts in light of this. Across all industrialised nations, the most recent downwards revisions for 2016 averaged -4%. The forecast of nonetheless achievable growth in company earnings of 8% thus already takes into account this downward adjustment.

A residual risk that interest rates rise more rapidly than anticipated.

- On the one hand, the assumption "Interest rates will remain low for some time" could prove retrospectively to be wishful thinking. If consumer spending in the US were to rise due to a greater level of employment, but in addition, salary costs were also to substantially increase as a result of full employment, this could - contrary to expectations - trigger inflationary pressure and cause the central bank to raise interest rates more rapidly and sharply after all. This would put the asset class of equities at a disadvantage, due to rising opportunity costs. - On the other hand, in this scenario there would probably need to be a downward revision to economic forecasts, and also to revenues and lastly earnings. In fact, improved economic expectations during the last two periods in which downward trends in interest rates came to an end (1994 and 2004) did not lead to equity market

S&P 500 and DAX in four phases of interest rate turning points - Each 12 months before and 18 months after the Fed's interest rate rise

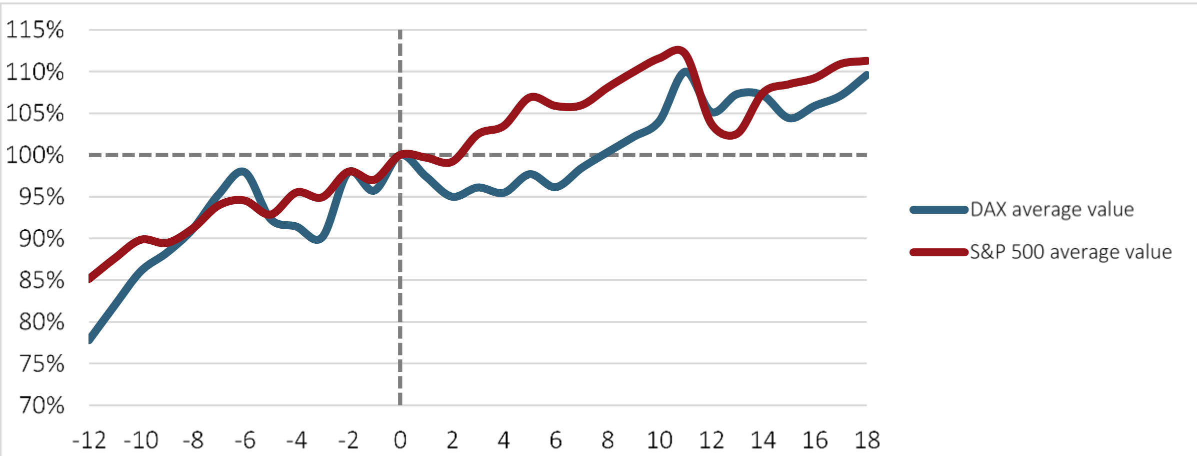

Figure 4 *Source: CONCEPT Research*

corrections at all. On the contrary, on average stock markets continued as they were for around another year.

- Naturally, interest rate policy exerts an influence over currencies. Given the expectation of further increases in US interest rates, on the one hand a continued upward trend in US dollars would seem completely logical. If this is the case, it could have an extremely negative effect on both the US (competitiveness, margins) and emerging markets (servicing their US dollar debt, rating downgrades), which would have the potential to trigger a global recession. - On the other hand, it is not necessarily inevitable that dollars will rise as a result of a period of rising US interest rates. In the past when the US central bank was alone in raising interest rates (i.e. 1994 and 2004), the currency had already begun to anticipate it well ahead of time and tended subsequently to weaken. In that case, this could result in a tailwind for the US market and relief for emerging markets.

- Emerging market countries, in particular those in Latin America but also Russia, are treated in many forecasts as doubtful cases, with sightings of 'black swans'. Indeed, many countries are suffering from the dollar-driven increase in servicing costs for US borrowings and from the erosion to revenues resulting from falling commodity prices. - On the other hand, emerging markets today hold substantially greater currency reserves than was the case during the last crisis in the late 1990s. This opens up further possible courses of action to alleviate payment difficulties and maintain credit ratings. In addition, lower exchange rates imply better export prospects. In this respect, many observers' assessments of emerging market countries may prove with hindsight to be excessively pessimistic.

It is not the Chinese economy that is the risk, but the unpredictable nature of Chinese policy.

- Currently China, the region with the greatest economic momentum, is causing concern. The shift from one-sided export-oriented economic activity to a more domestic focus and the dismantling of capital-intensive industries in favour of service-based sectors is weakening demand for capital goods. The growth of private sector domestic demand will be unable to offset this, especially as the working population is shrinking. As a result, growth is expected to be towards 6% or potentially less. However, all of this would already have been anticipated and as such would not come as a surprise. What cannot be predicted is the government's and central bank's attempts at state control, which increasingly cast doubt on the effectiveness of a policy of centrally governing the large country. The attempt to prevent the yuan from further devaluing had the knock-on effect of causing foreign currency reserves to shrink. For markets, the question is how long China will bear the cost involved in supporting its currency. Allowing the currency to float completely freely would be an alarming option, which in the short-term could cause further market shocks. - On the other hand, even on a diminished basis China remains the fastest growing region. Economic output is growing annually by some USD 1 trillion. This is more than generated by Denmark and Switzerland put together. China will remain a market with strong demand potential, including for Western products and services, and will open up as a market economy.

Europe's structural problems constitute both a risk and an opportunity.

- Europe continues to face the problem of unresolved issues in relation to the debt crisis. Where this view is generally accepted and is thus being addressed, the electorate is responding by voting out reformers. Spain now faces a complicated scenario in the formation of a new government. Extremist parties are gaining significant ground in France. The whole of Greece seems to have turned into a protest party and in the case of England, the possibility of an exit from the European Union has become a very real risk. - On the other hand, an improving economic situation opens up more scope for the eventually imperative implementation of reforms and consolidation. Visible successes such as those in Portugal and Ireland may increase the willingness for reform. This is particularly true against the backdrop of the additional challenge posed for Europe by the integration of millions of refugees.

Never has debt been as high nor interest rates as low as they are today.

- Furthermore, the contradiction between an unstable global financial system without room for manoeuvre and the nevertheless increased risk tolerance of the market requires urgent resolution. Debt has never been as high nor interest rates as low as they are today. - Nevertheless, capital markets, as if driven by a flywheel, may be able to "withstand" such gaps for longer than we suppose. After all, if every discrepancy were immediately priced correctly by the market, none would exist; consequently there would be no risks, but also no opportunities.

- Added to these are existential risks, which make it difficult to imagine possible alternative scenarios. These are primarily widespread geopolitical tensions: the continued crisis in Ukraine, the unresolved conflict between Israel and Palestine, or recent sabre-rattling in Syrian/Turkish airspace. Above all else there is the seemingly irreconcilable tangle of interwoven interests in connection with the radicalisation of Islamic ethnic groups in Asia and Africa. This arguably poses the greatest challenge to the international community; overcoming it will require new ways of thinking that are still considered taboo. The potential for worldwide conflict is ever increasing, with its "side effect" being acts of terror targeted at just about anyone. To date, past experience - namely the terror attacks in New York in 2001, Madrid in 2004, London in 2005 and most recently in Paris - has shown that even these horrific events triggered only short-term shocks in each case, but did not influence fundamental economic trends. It is impossible to predict how the behaviour of economic agents would change if the number and frequency of attacks were to increase.

Recommendation

The markets are aware of the risks; there is no trace of euphoria.

The future of capital markets cannot be predicted with certainty. What we can do is evaluate likely developments based on comprehensive analysis, compare our estimates with the expectations of other market participants, and provide a suitable recommendation, then implement this recommended action in a disciplined manner, that retains the flexibility to react to changes. Overall, risks have risen which does not make it easy to formulate our forecasts. We can see, however, that other market participants are also identifying and managing these risks. There are no signs of euphoria and dangers being ignored; significant concerns over more serious setbacks remain. It is only possible for participants to immunise themselves against these risks if they give up the opportunity to make a return, which is not an appropriate option for long-term asset management.

The greatest contribution to returns is once again expected to come from equities. Fluctuations over the course of the year should offer buying opportunities.

Given the estimates presented here, we consider it highly probable that investing in equities will continue to make the greatest contribution to returns in 2016. As a result of the surrounding risks, however, the level of equity market volatility may be so extreme that investors prefer not to fully participate in the ups and downs of share prices. Although holding cash promises little return, it may nonetheless appear preferable not to experience potential market price corrections invested in full. For this reason we recommend that cash also be used as an important strategic resource.

We anticipate buying opportunities to be on offer throughout the course of the year and from a regional perspective, we continue to consider the catch-up potential of the euro zone attractive. As far as the US is concerned, however, we would advise a reduction, since the economic and earnings cycle already appears well advanced. Provided that energy and raw material prices bottom out, which we expect to be the case, we consider investment in them to be attractive, due to strongly discounted prices. Emerging market countries are generally being avoided at the moment, and are therefore attractively priced. There is thus an opportunity for the much greater risk to be adequately compensated. With respect to the bond segment, we continue to see good investment

In the event of an accumulation of individual risks, gold will prove its worth.

opportunities in European corporate bonds with good names. In this instance convertible bonds should be designated as an addition to equity investments, since their asymmetric risk profile should act as a buffer against some of their greater drawbacks.

The risks that surround us are diverse, which increases the probability that individual scenarios could occur. In our opinion, although the markets have taken this into account, they have not recognised the danger of an accumulation of several individual risks. This issue, too, supports our cautious stance towards equities and as a result, we also continue to advise that a nominal, constant portion of investment volume be left in precious metals. Experience has shown that the occurrence of extreme events is reflected in rising precious metal prices.

Bielefeld, 14 January 2016
Matthias Steinhauer