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JANUARY 2015 INVESTMENT OUTLOOK

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NEW YEAR 2015 – INVESTMENT OUTLOOK

Dear Readers,

In October 2014 we published our investment outlook, "The (investment) world five years from now", in which we looked at some major long-term price trends and the investment opportunities that will likely be created by these trends. Today we would like to give you an update and look ahead to the next twelve months and see what important changes we might see in 2015. Of course, it goes without saying, these short-term outlooks are always a bit more difficult, but, what we can say here already is that we are in for a very interesting year with a lot of return potential but clearly also higher levels of volatility. The New Year looks like it is crucial turning point in many ways, for the global economy and financial markets.

2014 was a good year for equities just as we had expected but the year was also overshadowed by the conflict in Ukraine/Crimea and the international sanctions that were imposed against Russia as a consequence of the conflict. This is bringing back memories of the Cold War era and as a consequence higher levels of volatility could be observed in financial markets. In terms of global growth, 2014 was disappointing in many ways as the pace of growth once again was lower than expected; despite aggressive monetary policies by most central banks and the resulting record low interest rates. Despite slow growth and geopolitical concerns, most equity markets were able to move higher. We think this was a very remarkable market situation and that it will continue in 2015.

Our outlook for 2015 is mixed in terms of the economic growth and continued uncertainties such as the Russia situation or the renewed problems in Greece. However, in terms of equity markets our outlook is even slightly more optimistic than it was for 2014. The primary change that we expect is that international markets, including emerging markets, will start to outperform in 2015; most likely this will start in the second half of the year. The U.S. stock market will most likely also do well, but, given its outperformance in the last two years we think it will have lower potential in 2015. The positive drivers of equity markets in 2015 are still mainly the same. Interest rates close to record lows in most major economies speak for the relative attractiveness of equities and not for bonds. Compared with 2014, there seem to be two new factors that need to be considered as well. First of all, oil prices have seen a sharp decline in recent weeks and are currently trading around 40% below the average levels seen in the first half of 2014. These prices are likely here to stay for some time to come and clearly lower energy prices should have a positive impact on stocks; especially in an economic situation like we are facing right now. If anything, it will keep central banks on hold for longer in terms of plans for normalizing their monetary policies. Another positive factor for equity markets in 2015 will be the slowly improving global economy with, despite the slow pace, the chances for a small improvement in 2015 being good. This in turn, should allow companies to grow revenues and profit margins and to show an overall improved profitability in 2015.

Bond markets seem to offer limited value in 2015 as yields in most major economies are close to historic lows. We see some potential in a few selected emerging markets where yields have risen in the last couple of weeks in a reaction to

the Russia crisis. Also, most emerging market currencies have suffered as a result of the Russia situation and these investments are now offering highly attractive entry opportunities for global investors (especially U.S. Dollar based investors) as the price and yield levels of some of these emerging markets look very promising. Developed markets on the other hand, do not offer much value as yields in the U.S. and Europe are so low that investors just don't get adequate compensation for the investment risk.

We would like to make a special comment regarding currency markets and here especially about the U.S. Dollar and its recovery seen in the last three years. The U.S. Dollar Index is now trading around the 90 level which has been a major turnaround level in the past.

Going into 2015 and with the outlook for a first rate hike by the Federal Reserve later in the year, it certainly looks possible that the U.S. Dollar has some more upside versus most major currencies.

Trade weighted U.S. Dollar Index, Major currencies / for more information on index composition please see the following web link: http://www.federalreserve.gov/pubs/bulletin/2005/winter05_index.pdf

However, with the recovery seen in the last three years the valuation of the U.S. Dollar has moved to a level that makes a reversal look increasingly likely.

What are the risks for the U.S. Dollar in 2015? In our view, the risks come mainly from the current oil price correction that we have been seeing in the last couple of weeks. Oil prices having fallen more than 40% in just a few weeks, and the outlook for prices to remain in that range for a while, puts a lot of pressure on the domestic energy production. The U.S. has seen an energy boom in recent years like it would have been unimagi-

nable just a few years ago. The U.S. has become a net exporter of oil after being the largest importing country not long ago. New technology and production methods have created this domestic energy boom and the direct and indirect linked investment and spending has been a significant contributor to GDP growth in the last couple of years. It is very difficult to say how much the impact really was but current estimates are in the range of 0.7%-0.9% net contribution to GDP. That looks all good so far, the only problem is, that most of the domestic producers need oil prices that are 20% to 30% higher than what they are now. This means that many domestic producers are currently producing at a loss and it will not take long before some of the highest cost producers will need to reduce spending and likely cut production. However, it will take time until production will be reduced as many of the new producers have so called "sunk costs" (money they spent already). They now will try to produce as much as possible to increase much needed cash flow in order to reduce their heavily leveraged balance sheets. What if the positive impact from the energy boom in recent years is now reversing? This could impact the economic outlook in a very significant way and could even influence the rate decision of the Fed in 2015. The stronger Dollar and lower energy prices will certainly keep inflation under control.

Going into the New Year, it clearly makes sense to hedge at least some of the foreign currency investment positions, but, during the course of the year it might be time to gradually reduce those hedges as the U.S. Dollar might be moving closer to a turning point and then move lower again. For that to happen we would need to see an improving global growth picture as well as some improvement to certain other factors, especially geopolitical factors and here mainly the situation with Russia. Russia is and will remain the single most important risk going into 2015. The combination of international sanctions against the country, a loss of confidence from international investors and rapidly falling revenues from its oil and gas production will create more problems for the Russian economy and its currency the Rubble. In our view, Russia can only avoid a worsening of the situation if it starts to de-escalate the situation that it has created. Our concern is that this might be very difficult, maybe even unrealistic, but, the Russian Central Bank will not be able to defend the currency for many more months until eventually their currency reserves are used up and this will bring further pressure on the government to find a resolution. The recent collapse of their currency does not paint a very positive picture for the coming months and will certainly keep overall market volatility at elevated levels.

And what about precious metals prices? Gold and silver prices have remained stuck in a relatively narrow range and as we have said a number of times in recent months, it looks like these prices are in a final stage of "bottoming out". Therefore, we see an increasing chance that precious metals are starting to break out of the correction mode that we have seen in the last three years. We think precious metals could come back to life in 2015, especially with the existing geopolitical concerns in the short-term, which would be good news for long-term strategic investors in precious metals. There are many other factors which speak for higher prices in the future – please refer to our October investment update "The (investment) world five years from now" for further details.

Based on our comments and outlook for the year 2015, we recommend the following:

- Hold a significant long exposure to stocks and in stocks start increasing exposure to international markets, including emerging markets, in anticipation of these markets starting to catch up after a longer period of underperformance.
- Keep only moderate exposures to income

producing investments, especially bonds, as the extremely low yields do not provide adequate reward for the investment risks. Focus on a few selected international markets where the higher yields and the weaker currencies offer good upside potential for the coming years.

- Watch for the current U.S. Dollar recovery to reach its peak and use this to diversify internationally. Global investments and foreign currencies look very inexpensive at current levels and this looks like the perfect timing to diversify.
- Precious metals will come back to life in 2015, after a period of three years of underperformance, and an exposure to gold and silver should be an integral part of a well diversified portfolio.

Last but not least, while there are enough reasons to be optimistic for the investment year 2015, it is important to remember one factor in particular. With volatility being on the rise and likely to stay at elevated levels, investors need to be alert and ready to act if needed. This might require hedging certain exposures from time to time; especially in the event that a geopolitical situation like we have with Russia now could get out of control. Therefore, 2015 is not going to be a year to "buy and hold" markets. It will require active monitoring of global markets and investments to find new investment opportunities as well as active management to control these special risks.

We wish you all a very happy and prosperous New Year!

Kind regards,
Daniel Zurbruegg