Parallel
Investment Management

Quarterly Update – January 2016

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Market Backdrop

The previous quarter had ended poorly for risk assets as investors fretted over global growth fears, but equity markets recovered strongly in October to near record highs. This followed several central banks around the world either unveiling or alluding to more supportive monetary policies – in short, a 'repeat prescription'. More quantitative easing (QE) and a willingness to cut interest rates to fight off any indication of an economic slump have created both a dependency and an expectation among investors.

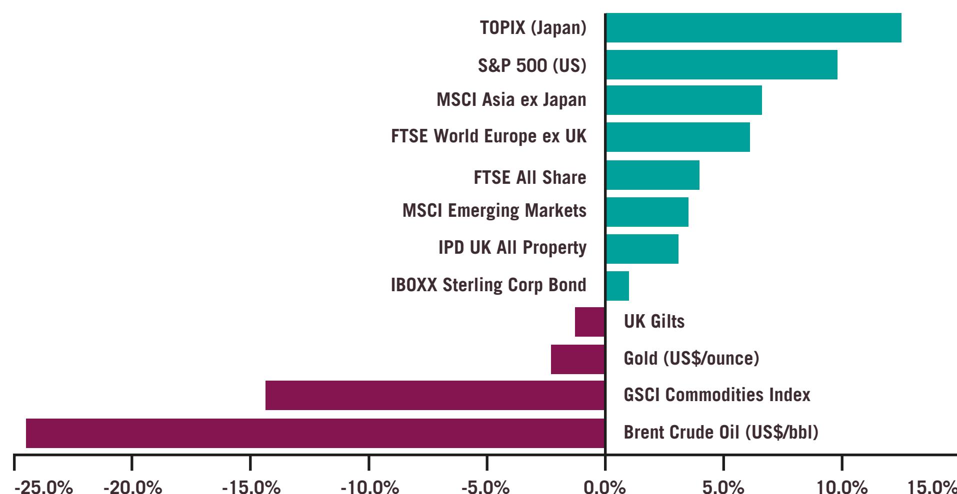
However, the relatively buoyant mood soon dissipated after a number of terror attacks took place in Paris causing investors to focus on the threat to global security. The ensuing uncertainty, together with the increasing divergence in monetary policy from the central banks, caused markets to be somewhat mixed in November. European markets began to anticipate what action the European Central Bank (ECB) would take in December causing the euro to weaken; meanwhile the US market was holding its breath ahead of what was expected to be the first rise in US interest rates since 2006. Commodities continued to have a torrid time as over-supply coupled with anaemic demand weighed on prices, with the price of Brent oil falling by a further 10%.

As dusk began to fall on the year two themes dominated: central bank policy and the continued decline in oil prices. After the long-running 'will they, won't they' debate, the Fed decided to raise interest rates by 0.25% in December. Meanwhile, and despite the increasing tension between Iran and Saudi Arabia, oil prices continued to tumble. The lack of desire from OPEC to reduce supply as it seeks to make the US shale oil industry uneconomic caused oil prices to fall to levels not seen since 2009.

Against this backdrop global equity markets were mixed. Eurozone equity markets were the most volatile as investors showed disappointment at the relatively conservative action taken by the ECB to stimulate the region's economy. This was evidenced by the euro jumping 3% against the dollar in complete contrast to what was anticipated given the previous rhetoric from the ECB.

By the start of the Christmas holidays most investors headed home hoping that 2016 would herald a recovery in demand (but not at such a pace to trigger too rapid a rise in interest rates) to dissipate the over-riding fear of secular stagnation taking hold – weak global growth and negative real interest rates.

Asset Class Returns – Q4 2015



Data source: FE Analytics – rebased in Pounds Sterling

Market Insights

The start of 2016 has shattered of any hope that the New Year would bring some respite for investors. Both oil and equity markets have had a torrid time with marked price declines often occurring within the context of huge intra-day price swings.

There has also been an unusually high degree of correlation with asset class prices moving upwards and downwards together.

This correlation can be attributed to two factors: the relatively large percentage of indices, such as the FTSE 100 and the S&P 500, made up by energy companies, and general worries about the slowdown in global growth dampening forecasts for future energy consumption.

These combine to create a general concern over whether deflation will take hold encouraging consumers to postpone their expenditure in anticipation of lower prices in the future. It is interesting that the fall in equity prices has been somewhat indiscriminate as evidenced by the inclusion of those companies which directly stand to benefit from lower energy costs.

We believe that what we are witnessing is rooted in four significant developments:

- the recent downward revisions in global growth projections
- the surplus supply of oil and other commodities in relation to the level of demand
- the potential fallout from the increase in indebtedness in developing economies
- the diminishing supply of ammunition for central banks to use in the event of another financial crisis

Given the gyrations in the markets in recent weeks we are sympathetic with anxious investors, but believe it is important to examine if there is sufficient evidence to support the predominance of bearish media headlines.

The extent of the slide in equity prices does not seem to be justified by the economic fundamentals. In January the International Monetary Fund (IMF) stated that global growth is projected to be 3.4% in 2016. Over the period of the last 8 years developed equity markets have only fallen to current levels on two occasions. These are the meltdown caused by the sub-prime mortgage market in the US in 2008 and the near collapse of the Eurozone in 2011-2012. So, given that the chances of a recession in advanced economies would seem to be unlikely based on growth projections, the gap between equity prices and what is happening, together with what is forecast, in the global economy seems excessive.

Of course China's slowing economy continues to be the source of much concern. The pace of growth has been slowing since around 2011 and this reflects the challenges of transitioning from an economy based on manufacturing to one more driven by Chinese consumers. It is akin to changing the direction of a super-tanker and, despite the doom and gloom following a sharp drop at the beginning of 2015, recent estimates indicate that growth in China has more or less stabilised over the course of last year, with the non-manufacturing section of its economy performing relatively strongly.

The slump in oil prices is not an indicator of weak global activity. Demand for oil has continued to grow at a fairly rapid pace and it is the volume of supply that has caused prices to fall.

The fall in oil prices has the effect of making oil producers worse off and consumers better off, but the pace and extent of the slide has added to uncertainty about the global economy where the costs to producers have been disproportionately larger than the benefits to consumers.

Recent data from the International Energy Agency shows that the surplus of oil production over oil consumption is falling, so we expect that there will be a turning point and we will see oil prices begin to recover.

In summary, assuming that demand for oil continues to grow we believe that a time will come when the positives from lower oil prices will begin to outweigh the negatives.

It is true that the loosening of monetary policy in the advanced economies post the 2008 financial crisis may have resulted in the rapid growth in credit in emerging markets. However China's debt/GDP ratio is lower than that of a number of advanced economies, a fact that is also true of emerging market economies in general.

That said, because of current currency weaknesses we are not yet out of the woods, but the higher growth rates of developing economies and the capacity of their central banks to further loosen policy, if required, means that they should be able to sustain high debts.

The divergence in monetary policy of central banks moved from discussion to fruition at the end of 2015 as the Fed hiked interest rates for the first time in nine years. Further rate increases will depend on data showing that the US economy is robust and the employment market continuing to strengthen.

In contrast both the ECB and the Bank of Japan (BoJ) continue with QE and interest rate reductions in an attempt to stimulate the region's economies and cultivate some inflation. In advanced economies the risk of a central bank mishap is a key concern.

The Fed may tighten too aggressively and stifle the recovery, or not be aggressive enough resulting in too rapid a pace of tightening in the future. Some commentators argue that increasing rates has given the Fed some room for manoeuvre in the event that they need to cut rates, albeit at the risk to its credibility.

In Europe excessive monetary easing could lead to inflation rising higher than anticipated, although there is perhaps as yet sufficient slack in the labour market to benefit from continued loose policy. In Japan the BoJ has recently introduced negative interest rates on banks' excessive reserves to stimulate lending to the economy.

In summary, there may yet be more pain to come, especially until there is some stability in oil prices, and the very short-term outlook is likely to be one of uncertainty, somewhat akin to the 'risk on-risk off' period between 2010 and 2012.

Patience will be essential, but selective opportunities will continue to arise where the reward for taking risk is attractive over the medium to long term.

Investment Views

Asset Class	Current View	Comment
Equities	+	Despite the rout in the global equity markets we believe that equities still offer significantly higher prospective returns than other asset classes, especially bonds. We do not believe that the world is on the cusp of a global recession, although deflationary pressures currently present a risk. However, the authorities are aware of this risk and will take whatever action is required to avoid the threat.
Fixed Interest	×	Relatively benign inflation, slow anaemic growth and highly accommodative central banks would normally be positive for the fixed interest market. However, recent strong demand and ongoing liquidity concerns make the outlook for bonds unattractive. We expect the asset class to deliver positive if unexciting returns, beating both cash and inflation, but nimble management and skilled security selection is required to avoid disappointment.
Property	+	Investor demand for property remains high, attracted by the lack of correlation to other asset classes and the current income yields. Although the highest returns may well be past, the outlook in both the UK and Europe remains positive with strong demand set against limited current supply and banks willing to lend at relatively low interest rates.
Commodities	×	Commodity prices continue their steady decline reflecting the surplus of supply over diminishing global demand as growth slows and the US dollar strengthens. We expect an extended period of low oil prices, which in time should lead to a better supply/demand balance. We expect some industrial and precious metals to gradually improve in 2016, but in the short term the risks remain on the downside.
Absolute Return	+	This sector offers the potential for a positive return combined with some downside protection and this combination is attractive with the current heightened market volatility, supporting continued inclusion in our portfolios.
Cash	×	Cash continues to offer a defensive quality, but with the date for any rise in UK interest rates being pushed further out the return from cash is unappealing in relation to the potential return from other asset classes. We think that the timing of an interest rate increase could be before market expectations but in any event rates are only likely to rise very slowly.

Equity Regions	Current View	Comment
UK	−	We expect the UK economy to be supported by a strong labour market and continued loose monetary policy. We acknowledge the lack of 'wriggle room' for the Chancellor and the uncertainty of the forthcoming 'Brexit' referendum is likely to put sterling under pressure, but we expect UK equities to soon find a floor and begin a recovery phase.
US	−	There is a fear that the US economy is heading for trouble but to date there is little evidence to support this view. We do not expect the dollar to climb a lot further, but believe that earnings will grow more slowly as the labour market strengthens and productivity growth remains sluggish. We believe the equity market will recover from its current level but, given its still fairly high valuation, gains will be limited.
Europe	−	Corporate earnings are expected to fare better given the benefits of a weaker euro, low energy and commodity prices as well as a recovering European economy. If global growth does not fall off a cliff, commodity prices show signs of recovery, and the euro weakens against the US dollar, we expect the region's equity markets to stage a marked rebound. Our outlook only remains neutral given the breadth of influencing factors.
Japan	−	Prime Minister Abe continues to make efforts to stimulate consumer spending to boost GDP. Meanwhile the BoJ is expected to expand monetary stimulus in order to achieve its 2% inflation target. Despite recent falls in the equity markets and the 'slow-burn' of effecting cultural change we believe Japan continues to offer excellent potential.
Asia Pacific & Emerging Markets	−	Commodity-exporting countries continue to struggle and despite the attractions of Asian and Emerging Market economies based on the size and demographics of the population, we believe that the markets remain vulnerable to periodic sell-offs. Investors continue to focus on the Chinese economy and as such we believe the short term risks remain on the downside.

Portfolio Overview

Performance (%) for the period ending 31 December 2015

Portfolio	Descriptor	Quarter	1 Year	2 Years	3 Years
Parallel Multi Asset A	Defensive Growth	1.57	1.54	5.43	7.59
Parallel Multi Asset B	Conservative Growth	2.27	2.86	9.02	15.17
Parallel Multi Asset C	Cautious Growth	3.93	4.64	11.13	20.92
Parallel Multi Asset D	Balanced Growth	5.54	7.46	14.29	29.61
Parallel Multi Asset E	Adventurous Growth	6.36	6.91	12.96	29.11
Parallel Multi Asset F	Global Opportunities	7.35	5.65	11.76	26.91
Parallel Multi Asset B Income	Conservative Income	2.43	2.41	7.95	8.03
Parallel Multi Asset D Income	Balanced Income	4.71	2.98	9.61	18.79
Socially Responsible Growth		5.77	3.33	8.28	27.42

Figures quoted net of management fee. Source: FE Analytics

Fund Selection: Contributing Funds

Legg Mason Japan – This was the best performing fund in the Parallel portfolios over the quarter and for the year as a whole, returning an impressive 18.7% and 44.2% respectively. The Fund comfortably outperformed the index and the IA Japan sector.

Artemis US Select – This Fund outperformed both the sector and the benchmark S&P 500 index over the quarter and for the full year, being ranked in the top 10 of the IA North American sector funds in 2015.

Jupiter European – Strong stock selection led the Fund to out-perform its benchmark and sector over the quarter as its highest conviction names performed well. Continued strong performance resulted in the Fund being ranked 4th in the sector for 2015.

Fund Selection: Detracting Funds

Threadneedle Global Opportunities Bond – This was the biggest detractor in the portfolios, falling a disappointing 3.4% over the quarter, largely due to currency positioning and the restructuring of Novo Banco in Portugal which impacted significantly the price of its bonds.

Baillie Gifford Corporate Bond – This Fund fell 0.45% over the quarter, underperforming its comparative index, largely due to stock selection effects, with the biggest detractor being a holding in a US shale gas producer.

Jupiter Strategic Bond – Although this Fund is positioned quite defensively, it was negatively impacted by the volatility in government bond markets and widening credit spreads.

Portfolio Activity

A summary of some of the main changes during the quarter:

Increased exposure to property – In November we added a new holding in the Kames Property Income Fund, which invests predominantly in ‘direct’ real estate and has an attractive yield of around 5%. This acquisition was funded by a reduction in the TwentyFour Monument Bond Fund as, on a relative basis, we believe that in the medium term returns from property are more attractive than those from bonds.

Changes to Japanese fund holdings – Whilst we are positive on the Japanese market, we have had growing concerns about the investment philosophy of our holding in the Neptune Japan Opportunities Fund. This Fund has a bias towards the large, export-orientated companies that should be well placed to benefit from a weakening yen, however this this has so far failed to be borne out and performance has been disappointing, leading us to question whether it is the best strategy for continued investment in the region. We therefore decided to sell our holding in this fund and reinvest the proceeds into the AXA Framlington Japan Fund.

Risk warnings

Investors should be aware that past performance is not a reliable indicator of future results and that the price of shares and other investments, and the income derived from them may fall as well as rise and the amount realised may be less than the original sum invested. The content of this newsletter is for your general information and use only, and it reflects the general market view of Parallel Investment Management Ltd., and should not be interpreted as recommendations or advice. The content should not be relied upon in its entirety and shall not be deemed to be, or constitute, advice. Although endeavours have been made to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No individual or company should act upon such information without receiving appropriate professional advice after a thorough examination of their particular situation. We cannot accept responsibility for any loss as a result of acts or omissions taken in respect of the content. The value of your investments can go down as well as up and you may get back less than you invested.