DNCA INVESTMENTS

Market Commentary
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"The Fed changes its course while
ECB keeps going its own way"

THE MARKETS REMAIN A HOSTAGE TO CENTRAL BANK ANNOUNCEMENTS, WHICH HAVE MADE THEIR DIVERGENCE OF MONETARY POLICY OFFICIAL. AS CONCERNS LINGER AROUND US COMPANY PROFITS AND EMERGING MARKET INSTABILITY, THE EUROZONE REMAINS A REFUGE FOR RETURN SEEKING INVESTORS.

On 16th December, the Fed signaled the end of its zero rate policy by announcing its first rate increase after years of Zero Interest Rate Policy (ZIRP). This is contrary to the ECB which, although confirming its intention to maintain its accommodating monetary policy in the future, has since released communications tempering investors' expectations. This divergence, already partially reflected in the exchange rate, will have many consequences for asset prices on both sides of the Atlantic.

Despite the intentions of the Fed and ECB being well-documented, what will determine investor behavior in the coming weeks is how both banks communicate to the market. In Europe, the ECB's decision to extend its quantitative easing program by six months, but without increasing the amount of monthly purchases, caused a violent reaction on the stock and bond markets. Although monetary policy cannot resolve every issue, at least it has the benefit of delaying the pain caused by systemic risk, particularly in the Eurozone. Therefore, the valuation levels may increase with no guarantee of being always aligned with the evolution of microeconomic fundamentals.

In the US, investors may be in for a shock: mainly because it is never simple to face a rate rise which occurs late in an economic cycle. Furthermore, for US stocks, the tightening of monetary conditions, combined with a strong dollar, does not support valuations.

As the bright spell of European growth continues, the suffering across much of the rest of the world continues. Emerging countries are experiencing unsettled economic

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and political conditions, but this may ultimately prove beneficial. However, the United States must navigate through a challenging part of the economic cycle.

Recent statistics for November (automobile registrations, credit distribution and manufacturing PMI [Purchasing Managers Index]) show that Eurozone recovery is continuing. Nevertheless, not all European companies will benefit, as those engaged in global activities with an international footprint are likely to feel the impact of troubled markets elsewhere.

Engaged in political and institutional upheaval, many emerging countries (Brazil, Argentina, Venezuela) are facing challenging economic conditions. Nevertheless, the price of emerging countries' assets (specifically in China, Russia and Brazil) has already corrected significantly. A lull in the dropping oil price to the benefit of producing countries (Russia), and the resumption of Chinese growth, could further serve to attract long-term investors.

The US has already returned six years of positive performance. However, the level of indebtedness of American companies has increased, which represents a risk on the price of risky assets, should the Fed mismanage the rate curve. Global competition on prices through the general devaluing of large currencies is also limiting the profit curve of American companies.

To predict future risks is a skill, to warn investors is a duty, but to protect oneself is proving to be a much more complex exercise, especially in today's market conditions.

The drop in reference rates and in credit spreads can no longer be used to drive performance. Therefore, it is necessary to wait for the rates and/or spreads to increase significantly, before bonds can be massively back in the allocation game as an attractive asset class. In these market conditions, investors need to choose their bond assets carefully: at DNCA, we prefer to buy short maturity bonds, sovereigns in the South, indexed for inflation, convertible or offering a good yield-risk coupling on the credit segment in general.

Exchange rates are not offering any obvious trends, and there may be many opposing trends (i.e.: the surprise devaluation of the Renminbi and the recent weakness of the dollar). Thus, the strengthening of the dollar against the Euro has already been done or partially done. The improvement of the surplus balance in the Eurozone and continued macro-economic growth instead argue for an evaluation of the single currency over the medium term. Still political risk exists in Europe especially with such a heavy elections agenda.

In terms of stock selection, we look to identify attractive companies with strict valuation criteria across the Eurozone and other European countries through three key factors: companies with domestic activities exposed to European consumers; companies undergoing restructuring/in an M&A situation, and companies with growth profiles not correlated to the global economic cycle

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