**MARKET UPDATE - DECEMBER 2014**

**Fund Review**

We have generally been shorter duration than the market this year, which has detracted from performance. At 2.08% on the US Treasury 10 year as I write this piece, one would expect the path to be higher now that we are on a sustainable growth trajectory. Our credit selection has been extremely good and has significantly helped our performance during 2014. We sold most of our consumer exposure at the right time, and have not held any of the credits that have got into difficulties in Europe. Our peripheral exposure has been concentrated in Italy, Spain and Portugal in better quality credits and financials. We have had no exposure to Greece across the funds. Our increased exposure to the US was fine until the current oil crisis. Although we had 7% in energy in the Global High Yield Fund, which is quite light versus the market, the fund was still negatively impacted. We had less High Yield Energy exposure in the Global Strategic Bond Fund and of that only approximately 3.5% is exposed to the US oil sector.

We did increase duration as the year progressed on the Global Strategic Bond Fund, and our large underweight to Emerging Markets has also helped in the latter stages of the year.

We have continued to be positioned on both funds in a fairly conservative manner, but during bouts of risk off, as we are experiencing at present, we have still been impacted but less so than our peers. European High Yield given its lack of energy has outperformed the US this year, despite the more difficult economic environment.

Unfortunately the anticipated return target of approximately 5% for the year will not be met given the last few months have been negative as a result of the collapse in the oil price, which was not anticipated until recently.

**Market Update**

The fallout from the OPEC meeting at the end of November has been considerably more pronounced than anyone expected. We hedged into the meeting and expected things to stabilise in the mid $60s. The sheer rapidity of the continued drop in the oil price (over $10 since the beginning of December) has roiled markets and resulted in "risk off" just at a time when liquidity begins to dry up as we move towards the end of the year. December has traditionally been a strong month for performance and this will be one of the few negative months over the last ten years.

After grinding tighter during the first half of 2014 High Yield in The US is approximately 100bps wider YTD and more than 150bps wider from the June tights. We do not think that this is an indication that the credit cycle has turned and that default rates will begin to significantly increase, more that a large percentage of High Yield investors have suffered negative returns over recent months, which in the current low-return environment means that redemptions become more likely as risk appetite wanes, particularly from ETFs and faster money. Whilst the market dynamics are currently rather poor as the fall in oil continues to affect us all one must not forget that the market fundamentals are still very robust ex-energy.

As everyone now knows, the energy sector is the largest USHY sector at about 15%. If one includes coal and other commodities it was around 20% in June. Coal has also done very poorly this year. The Energy Sector has also been the most prolific issuer over the last few years given the explosion in the shale revolution. Given the previously positive industry growth dynamics, coupled with asset rich, lowly levered capital structures almost all investors have some exposure. The sector has on average dropped about 20% and this includes companies with both a high and low breakeven cost of oil. Most if not all of these companies are hedged for 2015, and so deciding on whether the current price of oil is temporary or more sustainable will be key to one's investment in energy for next year.

Is the current crisis demand or supply led? Much has been made of OPEC deciding not to cut production being the primary cause for the drop but a 40% decline as a result of just over a million barrels of excess capacity per day seems over done by any standards. The more concerning effect would be that this is a demand issue, or in other words demand is dropping as a result of a faltering of the global economic recovery led by China slowing down. Global growth is expected to marginally increase next year led by the US and the UK. We should also see some marginal improvement from Europe and Japan. China may also increase its oil reserves at these cheaper levels, so the argument can be made that some of the excess capacity will be soaked up as things improve.

The current market is ugly and there is no getting away from that fact. Liquidity is poor and being exacerbated by a general lack of interest in adding to positions before the end of what has been a difficult year by any standards. Events this year include: ISIS, Oil, the Ukraine, Ebola, Banco Espirito Santo, Greece, the Polar Vortex in the US, and last but not least the ending of QE.

Risk budgets will be re-set in January and it is likely that will provide a degree of stability to the market, but that will not help this month. There is a degree of short term panic going on and it is important to continue to look at the fundamentals of the market.

US High Yield is the most affected by the current volatility and there is little of no discrimination in the current sell off. We have talked many times in the past about the effects of liquidity driven volatility and unfortunately this is one of those moments. We continue to believe that this will be an opportunity to add value especially as we still think we are in the recovery stage of the cycle.

The good news is that the High Yield market has become more dispersed in terms of what is performing and what is not. What that means is that there is now the opportunity for active managers to make a difference and pursue different strategies...in comparison to this year where extremely low volatility has increased correlation and not provided any opportunity to add much value through credit selection.

**High Yield in 2015**

Our view is still positive despite recent market turmoil. The recent volatility has served to show us that the most appropriate strategy is to be cautious. As we have stated many times, reaching for yield, and ignoring credit risk is a highly risky strategy at this stage of the cycle. Returns in 2015 are likely to be higher given how the general market has re-set as a result of energy turmoil. If we look at a mixture of steady growth (in the US), low inflation and accommodative monetary policy then the base is there for continued top down demand for credit risk. Europe will need QE a la the Fed and Bank of England so there may be some credit volatility over the short term until we see the support that is needed. Better earnings growth in the US will also go some way to neutralising some of the credit deterioration we have seen recently.

The Energy Sector is going to be the swing factor in 2015. A lot will depend upon where the price of oil settles, whether OPEC can continue to put pressure on the price given the increasing problems it will have on a number of members economies and of course whether it impacts who it is supposed to - US shale E&P companies. It will have a positive effect on the oil that greases the economic recovery - transportation, consumer spending and of course those companies that use oil as a raw material.

It is likely that we will see the first interest rate rise from the Fed in 2015 but given the gradual trajectory of growth it is likely that the Fed will err on the side of caution. The ECB and Japan easing could outweigh the impact of the interest rate rise in the US for developed world bond markets. We do expect that the US Treasury curve will begin to gradually widen during 2015. This was also our view in 2014 yet the US Treasury 10 year is 80bps tighter than where it was at the beginning of the year.

The consensus view now is that interest rates will go up more gradually than expected by the Fed. Consensus was wrong this year and thus there is always the risk that the market will be wrong again and a rate rise happens sooner than expected. There is again talk of 2015 being

like 1994, with a series of aggressive rate rises from the Fed and a resultant sell off in Fixed Income. This is on the basis of the gap between the Feds dots and market expectations. With the information we have it is hard to see a 1994 scenario unfolding. We are in a wait and see mode and so the funds are currently positioned more cautiously from a duration standpoint albeit less hedged than we were going into 2014. We will gauge things next year and move our duration and credit risk accordingly as we get more data.

Given the recent sell off and in view of the still attractive fundamentals we have revised our performance outlook upwards in the US to something similar to Europe. Current yields are approximately 7%, which is a level that we have not seen since 2012. There could be some performance headwinds and volatility as a result of Fed action, but in Europe we see QE as being supportive for credit and also think that we will see credit improvement and thus performance from the better economic environment in the US.

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