NOTZ STUCKI

Notz Stucki Investment Conference
Tuesday 13 January 2015, Geneva

PRESENTERS

The Long Shadow of the Commodity Bust
Louis-Vincent Gave, CEO, GaveKal

Fixed Income Investing in a Low Interest Rates Environment
David Riley, Partner, Head of Credit Strategy, BlueBay Asset Management

European Equities: Why Go Active vs. Passive
Nicolas Walewski, Founder and Portfolio Manager, Alken Asset Management LLP

Energy Market Dynamics and the Role of Master Limited Partnerships in the US Energy Revolution
Michael R. Parker, President, Parker Global Strategies LLP

FINAL

Louis-Vincent Gave

CEO, GAVEKAL

After receiving his bachelor's degree from Duke University and studying Mandarin at Nanjing University, Gave joined the French Army where he served as a second lieutenant in a mountain infantry battalion. After a couple of years, he left the army and joined Paribas Capital Markets where he worked as a financial analyst first in Paris, then in Hong Kong. He left Paribas in 1999 to launch GaveKal Research. He is CEO of Gavekal and MW GaveKal and frequently contributes to the research.

David Riley

PARTNER, HEAD OF CREDIT STRATEGY, BLUEBAY ASSET MANAGEMENT

David Riley joined BlueBay in September 2013 as Head of Credit Strategy within the Asset Allocation team. He was previously global head of Fitch's Sovereign and Supranational Group responsible for more than 130 ratings of the world's largest fixed-income issuers. Prior to Fitch, he was a senior economist at UBS and at HM Treasury where he advised on international economic and debt issues, including representing the UK at international debt restructuring negotiations at the Paris Club of Official Creditors. He has a first class degree in Economics and was awarded an MSc from Birkbeck College, University of London.

Nicolas Walewski

FOUNDER AND PORTFOLIO MANAGER, ALKEN ASSET MANAGEMENT LLP

Nicolas Walewski is the Managing Partner of Alken Asset Management LLP, which he founded in July 2005. Previously, he was the fund manager of the Oyster European Opportunities Fund at Banque Syz. He began his investment career in 1993 with Credit Lyonnais in Paris as a currency options portfolio manager and then in Frankfurt as an index options portfolio manager. Subsequently, he was a buy-side analyst specialising in media and information technology across Europe and a fund manager responsible for the European equities portfolios. He graduated from Ecole Polytechnique, Paris, and holds a Master's degree from ENSAE (National College of Statistics and Economics).

Michael R. Parker

PRESIDENT, PARKER GLOBAL STRATEGIES LLP

Michael Parker serves as President of Parker Global Strategies. He guides the firm's strategic direction and manages the day-to-day business operations of the firm. Parker chairs the Executive Committee and is an ex-officio member of the Investment Committee. Prior to joining PGS in 2007, Parker held a number of senior management positions at Willis Re Inc. over a 17-year tenure. In 1993, he established Willis Re's Stamford, CT office. Parker earned his B.A. with honors in US History at Middlebury College. He is a 2012 graduate of Harvard Business School's OPM programme.

The Long Shadow of the Commodity Bust

Falling oil prices don't make growth impossible

EXTRACTS FROM A PRESENTATION BY LOUIS-VINCENT GAVE, CEO, GAVEKAL

I'll kick off where we left off, with the big surprises of last year. Obviously, one of them was the collapse in yield. The other, let's face it, was the dramatic drop in oil prices. I suspect that few owned oil puts at $55 for the end of 2014, and that by the start of 2015, few expected WTI to reach $45. On a large scale, to illustrate the magnitude of the recent move, such a collapse in a period of six months is obviously a multi-standard deviation event. It's a very rare occurrence.

When we look at a move of this magnitude, I think there are two possible responses. One of them would be to say there is a lot of information in this price move: it tells us that the world economy is doing a lot worse than people expected; we're facing a global recession, perhaps because of a slowdown in China, or a slowdown in other emerging markets, etc. This is one possible conclusion. The other possible conclusion when you look at a collapse of this magnitude is to say oil prices were in a bubble and the bubble has burst, and we have thus had a massive adjustment.

Let's look at the first possibility. Are we facing, today, a global recession? Now, the interesting thing, of course, is that when you look at the economic data, broadly you find a US economy that's finding its feet, a Chinese economy that is slowing down but not imploding, and a European economy which, after two or three very, very poor years, is also recuperating (at least in the north).

But, more importantly for me, the struggle I have with the idea that the collapse in oil prices reflects an absolute economic meltdown such as the one in 2008 is that equity prices are not at all behaving as if we were in 2008. There has been lately a massive dichotomy between Chinese equities that basically tells you the Chinese economy is finding its footing, and of course, the collapse in oil prices.

Which brings me to the second possibility: the possibility that oil was in a bubble, and that this bubble burst. As to why it burst now, I think you can find many possible explanations. The first, of course, is that the Fed has stopped injecting excess liquidity into the system. The other is that China, for the past 18 months, has been in the grips of a very strict and rigid anti-corruption crackdown. If you look at commodities, it's no secret that, for the past 10 years, China has been the marginal buyer, and here, I would quote Charlie Munger, Warren Buffett's right hand man. Munger often says, "Show me the incentives, and I'll tell you the outcome."

For 10 years, if you were a middle-ranking manager at a Chinese state-owned enterprise linked to commodities, you were basically told, "Go out and do a commodity deal, and we won't look too closely at the prices you pay." Lo and behold, as the anti-corruption crackdown unfolds, what do you find? You find that most people who've been put in jail were either related to the police, related to the army, or related somehow to PetroChina and the Chinese overall oil complex, because if you tell me you've got a blank cheque to go buy assets abroad, it's pretty easy to go to places like Indonesia, Angola, or wherever else and say, "All right, I'll pay a billion for this asset, and you send $50 million to my account."

This is potentially the second reason for the commodity bust: the fact that now that the incentive for Chinese middle managers to pay the wrong price for commodity deals has disappeared, now that you've had no commodity deals done by China over the past, really, 18 months, commodity prices start to collapse. But, for me, the real catalyst for the collapse in the oil price was Putin's visit to Beijing this summer, when Putin was on the ropes. Here, I'll quote another famous American investor, T. Boone Pickens. T. Boone Pickens always says, "If you want a deal real bad, you get a real bad deal."

This is exactly what occurred to Putin. Putin arrived in Beijing, on the ropes, sanctions from the EU, sanctions from the US, and he needed a deal real bad, and he needed a friend. Xi Jinping took him by the hand, treated him royally, said, "We can be Russia's friend." But, what deal, fundamentally, did Xi Jinping give Putin? He said, "I'll buy your natural gas from you, but I'll buy it at 40% below the price I pay today, and I'll pay for it in Renminbi, so whatever money I give you, you've got to come back and spend here", and Putin took the deal.

Now, this matters tremendously. It matters tremendously, if you think of the world as having two marginal energy producers, and these marginal energy producers being Saudi Arabia and Russia, and one marginal energy consumer, being China, the guy who's constantly in the market saying, "I need more, I need more." If a marginal supplier and a marginal producer get together and do a deal off the market, at 40% below market, then, guess what? That's the new market price.

Of course, since that deal was done, energy prices have looked one way, and that's been down, because what happened this summer – and this is, I think, a very important change in the world – is that China managed to transform itself from a price-taker in the energy market, to a price-setter. This transformation alone means that the dynamics in the energy market have been radically transformed. Today, when we look at the energy market and all of us want to pick a bottom, most of us think that this comes down to second guessing what the Saudis are going to do. Forget it. It's not about whether the Saudis are going to cut or not. The bottom will be formed by China, and specifically, the question we should be asking ourselves is, when will China decide the oil price is now low enough that I want to load up and import massively? If you want to figure out when oil makes a bottom, don't look at Saudi politics, because the odds there of figuring out what happens are slim to none; instead, look at VLCC (very large crude carrier) rates. This will tell you whether China is importing oil at today's low prices, which is what China did in 2008, and whether China is filling up to benefit from the current low prices. Until China does that, energy prices will remain low.

But it still leaves us with a very distinctively different investment environment. The first acknowledgement we need to make when we look at the low oil price is that a bubble has just burst, and bursting bubbles are, in and of themselves, profoundly deflationary. When bubbles burst, it means that capital has to move from weak hands to strong hands at lower prices. It also means that capital, and potentially a lot of capital, needs to be written off. Of course, this burst of the commodity bubble, I believe, explains why bond yields have been collapsing over the past six months.

Each burst bubble that we've had over the past 20 years has led to lower and lower bond yields, and to a six to nine-month precipitous decline in yields, pretty much all over the world. We've just had the six to nine-month precipitous decline in bond yields that comes, typically, with the burst bubble.

Having said that, we must also acknowledge that there are different kinds of bubbles. You have what we've called in our research good bubbles and bad bubbles. Bad bubbles occur on unproductive assets – think houses in Florida, or condos in Tokyo. Good bubbles occur on productive assets – think oil wells, or telecom lines, etc. Good bubbles and bad bubbles also distinguish themselves by the way they are financed. A good bubble is financed by capital markets directly, junk bonds, equities. A bad bubble is financed by commercial bankers, and when a bad bubble bursts, if the banks are the ones having to take the capital loss, you get a dramatic multiplier effect on the economy, contraction in bank loans, a collapse in the velocity of money, and the kind of outcome that we saw in 2008.

So when we look at the implosion of the commodity bubble, the first question we should ask ourselves is, "Who financed this? Who's going to take the write-off?" Is it going to be the commercial banks, or is it going to be junk bond and equity investors? This is where the good news comes in: when you look at most countries in the US, in Europe, most countries in Asia, banks' exposure to the overall commodity sector remains moderate. In all mining industries,

FINAL

including oil and exploration in the US over the past decade or so, what you find is, you have had an increase in debt over the past decade, but most of the increase in debt has really come from the issuance of bonds, much more than the issuance of bank loans. I think you see that in the market, with the high-yield market taking a bath on the back of the commodity sell-off.

Another way, I think, to monitor whether your burst bubble is affecting banks or not, is simply to look at the relative performance of bank shares. When a bubble bursts, interest rates collapse, and falling interest rates, logically, should be decent news for banks. So, in a falling interest rate environment, you would expect banks to at least perform in line with the markets. If banks underperform the market when a bubble bursts, then that's a sign that their exposure to the burst bubble could be problematic, that they've got impaired balance sheets, and that they'll need to raise capital.

If you look, for example, at the US, or for that matter, at most Asian countries in the past six to nine months as the commodity bubble has burst, banks have not underperformed. Most markets have performed in line with the market, and in some markets, they have underperformed. Interestingly, this cannot be said everywhere. There probably are countries where the banks are exposed. Take Brazil, South Africa, Russia, and potentially even Australia. I find it interesting that Australia, which is really a market dominated by two sectors – commodities on the one hand, banks on the other – in 2014, in a year where the commodities were such dogs, Australian banks did not manage to outperform their domestic markets, begging the question of, in a market like Australia, what is the bank exposure? Begging, also, the question as to why today Australian government bond yields are the highest bond yields in the OECD, aside from New Zealand?

You have an economy that is highly commodity-dependent, with a banking sector that is decently leveraged, both potentially to the commodity sector, and to a fairly overvalued domestic real estate market, and an economy that will now be slowing hard on the back of the commodity bust. Now, if we go back to the years before the commodity boom, you find that Australian bond yields were roughly just marginally above those of Germany, or marginally above those of the US. Today, Australian bond yields are six times those of Germany.

I think, in a world where making money on bonds looks increasingly challenging, one of the best trades you can make is to be long-dated Australian bond yields, hedged back either in Swiss franc or in US dollar or euros, or whatever your reference currency can be. This is one of the few bond markets in the world where you can potentially hope to have significant capital gains in the year ahead, as interest rates will likely continue to collapse. But enough of the bad news. Enough of the bad news, because at the end of the day, the drop in commodity prices, while it does represent an imploding bubble, also represents tremendous news, not least of which, for the countries where I come from, for Asia. It represents tremendous news on many fronts. Falling commodity prices, for most Asian countries, but also, for most European countries, represent an immediate improvement in the current account balances. Very simply, we have to export less money to buy the commodities we need. That, right there, leaves more money at home, and generates, if nothing else, all else being equal, stronger GDP growth numbers.

For Asian countries, though, that's not the only impact. In Asia, most governments still subsidise energy expenditures, so falling energy prices immediately mean not only improving current account balances, but also improving fiscal balances. If you take a country, for example, like India or Thailand or the Philippines, the lower commodity prices now mean that if you're the local central bank, you don't have to worry about current account deficits any more, and you don't have to worry about budget deficits any more, which means you don't have to worry about your currency coming under attack, and you can follow a much easier monetary policy than you've done thus far.

To go back to India, loan rates in India today are at 8%; who thinks they will still be there in 12 months' time? In 12 months' time, loan rates in India will be six, five… Who knows? And between the improving current account balances, the improving fiscal balances, the easier monetary policies, all of a sudden, you have an environment where the cost of capital comes dramatically down, which allows governments to embark on higher infrastructure spending, which in a lot of Asian countries is still needed, which triggers, by itself, higher productivity gains, higher consumption growth, higher employment, which has a positive feedback loop on better fiscal balance. Very quickly, you're in the kind of positive feedback loops, positive virtuous cycles that growth is all about. To make myself very clear, we should look at the drop in oil price, for most OECD countries and most Asian countries, as a tremendously positive exogenous shock towards higher consumption, higher infrastructure spending, and higher productivity gains.

Now, this lower oil price obviously invites all of us to look at our portfolios and reassess a lot of the analysis that we'd done over recent years, and the biases we have put in our portfolios. As we look through our portfolios, we should all ask ourselves, in a low oil price environment, is this particular investment still my best allocation of capital today?

I wrote a book a couple of years ago, a book called *Too Different for Comfort* (this is my plug – the book is available for free on our websites, gavekal.com). But, unfortunately, this book is increasingly becoming obsolete. It's becoming obsolete because one of the main theses of the book was that, when you're an entrepreneur, you really have five factors that drive your investment. The first factor is the cost of labour. The second factor is the cost of land. The third factor is the cost of government. Fourth, the cost of energy, and fifth, the cost of capital.

Now, one of the theses of the book was that, for most of the late 1990s and most of the 2000s, what differentiated different countries was the cost of labour. We lived in a world where Asia had a massive comparative advantage because, following the Asian crisis, the cost of labour was down at the floor in Asia, and was up here in the western world. So, if you were building a new factory, basically, you put it in Asia. This was the 2000s.

One of the theses of the book was that the cost of labour, because of advancements in robotics, because of advancements in software, mattered increasingly less. Increasingly, either labour was thinking labour, high value-added, etc, and that was an international price, or if it was – excuse my French – dumb labour, basically two strong arms; this was increasingly being replaced by machine. Asia's big comparative advantage was basically being taken away, and instead, what was appearing in the world was differences on the cost of energy.

What you had was that, all of a sudden, the US had a comparative advantage against everybody else, thanks to the shale gas revolution. The US had a cost of energy that was a fraction of everybody else's, partly because other regions – most notably Germany and Japan – were following boneheaded energy policies, with cutting back on nuclear, which drove up their energy price. So, the conclusion was, the marginal dollar of investment will go to the US, since they have a comparative advantage that nobody else does. This called for a stronger dollar; this called for an outperformance of US equities, etc.

The question is, is this still the case today? Because, with the collapse in energy, the one big comparative advantage that the US had is now being taken away. Everybody's got a cheap cost of energy now. So, the big comparative advantage, if it's no longer the cost of labour, if it's not the cost of capital (because everybody's got free capital now), if it's not the cost of energy, perhaps the way we should look at the next five to 10 years is through the question of the cost of government, and that this →

FINAL

is the one differentiating factor around the world. I would venture that, when it comes to the cost of government, the US doesn't have a big comparative advantage, for several reasons. First, in the US, people don't even agree on what the government is supposed to do, which ends up being costly, because you have big battles as to what you can do. The other big problem in the US is, you have a checks and balance system, and you've got different parts of government that have basically been taken over by lobbies. Given the checks and balance system, it's very hard to remove the power of these lobbies that end up costing the system a lot of money.

When it comes to the cost of government, the countries with the comparative advantage today are in Asia, where the cost of government is very low, or probably in northern Europe, in Switzerland, in Germany, in Scandinavia and potentially in the UK.

Now, this isn't to make a very bearish case for the US, and you read a lot of things in the press as to how the collapse in capital spending in the US will now lead to potentially a recession in the US. If you look at total capital spending in the US on oil and gas, it represents just 7% or 8% of total capital spending. Even if we go back to the depths of the 1990s, the hit on the overall economy will remain modest.

More important, I think, is the impact that lower oil prices will have on US domestic consumption. With the price at the pump having fallen from just below $4, to somewhere around $2, the average US family will now save $800 a year in gasoline spending. The beauty of the US consumer is that we know that if he saves $800, he is going to spend $900. So, the consumption in the US – and let's not forget that consumption remains 70% of the US GDP – will be very strong going forward. Now, this is tremendous news. It's tremendous news for Europe, that needs the US to consume strongly to get out of its slump, and it's frankly tremendous news for Asia, which remains the US's number one trading partner.

Whenever we at GaveKal look at a country, we like to answer, basically, five questions. The first question we always ask ourselves is the question of growth. Is growth accelerating, decelerating, moving in negative territory? And, more importantly, what do I know about growth today that perhaps is not reflected in the overall consensus, in the overall view of the market? On this question of growth, it's obvious that the biggest shark to the system we have now just had is oil. Some countries' growth will be very negatively impacted by the drop in oil; some countries' growth will be very positively impacted in the short term, perhaps less in the long term. I think that's the case of the US. In the short term and the long term very positively impacted, I think that's the case of Asia, or frankly, Europe, but we have to review, all of us, our assumptions on growth, given the very different commodity environment.

The next question is, is the momentum of the market positive or negative? We all know that trend is our friend, and we typically want to invest in markets where the trend is moving in a positive direction. Now, when it comes to momentum, obviously in 2014 the US was very impressive, but the other big movement in 2014 was that Asia (which for all intents and purposes had been underperforming between 2011 to the end of the first half of 2014) started to outperform in the second half of 2014. Europe, which had done very well in 2013 and the first half of 2014, started to underperform, so we've had a passing of the baton between Europe and Asia in the second half of 2014, and for now, the momentum is with Asia.

Now, the third question is a simple question on liquidity: when you look at a market, let's say Hong Kong, trading at 11 times earnings, the question is, how do you make that market move from 11 times earnings to 13, to 15, to 19? You need excess money to come from somewhere. The money can come from central banks that print more aggressively; it can come from domestic commercial banks that expand their balance sheets; or it can come from foreign fund flows. Today, in Asia, I believe you have all three. You've got the Bank of Japan, the Bank of Korea, now the Bank of China, very soon the RBI in India, all easing monetary policies. You've got commercial banks that are expanding their loans, and you get foreign fund flows that are very positive.

Asia is now the one place in the world where you've got all three legs of the liquidity stool. In Europe, we have a central bank that talks a great game, but for a long time didn't do anything. We've got commercial banks that are still flat on their backs, and probably still need to recapitalise. And, we have foreign fund flows that, in Europe, remain very, very negative.

The fourth question is whether the market is acting rationally or not, and finally, the last question is the question of valuation. On the question of valuation, I think, very simply, that we have a quandary very similar to the one that we had in the late '90s where, on the one hand we have a US market that is extremely expensive, and Asian markets that are extremely, extremely cheap. The question is, where do you go? Do you go with the momentum and the high valuation, or now, with the momentum and the lower valuation?

For me, it's a no-brainer. If I put it all together, the green dots are mostly in Asia, and therefore, having an overweight position in a falling oil environment in Asia is where you want to be. **THFJ**

> "If banks underperform the market when a bubble bursts, then that's a sign that their exposure to the burst bubble could be problematic, that they've got impaired balance sheets, and that they'll need to raise capital."

FINAL

Next-Generation Fixed Income

Investing in a low interest rate environment

EXTRACTS FROM A PRESENTATION BY DAVID RILEY, PARTNER, HEAD of CREDIT STRATEGY, BLUEBAY ASSET MANAGEMENT

The start of the year clearly lends itself to taking stock of the year that's just passed, and we all engage in this kind of seasonal activity, of trying to make an assessment of the outlook and themes for the year ahead. So, the first part of my discussion will look at, briefly, 2014, pick up on some of the points that have been made, and then give some perspective on our views on the outlook, and then to move on to talking about some of the next-generation fixed income strategies that we think are a response to a low interest rate world.

You may well recall that, going into 2014, there was a very broad-based, very strong consensus, and that consensus was that equity would comfortably outperform fixed income. Within fixed income, short-duration credit would outperform long-duration, safe government bonds, and that emerging market assets, and in particular, emerging market debt, was actually the least favoured asset class amongst many strategies going into the year.

It didn't play out according to the consensus playbook. In fact, those who were invested in long-dated, long-duration US treasury bonds had a very good year, returning in excess of 24%, which was more than twice the best performing equity major which was the S&P 500. We can also see that emerging market debt (EMD) actually outperformed European equities, as well, and European equities were the favoured asset class of many strategists going into 2014.

But one of the big features of 2014, in the latter part of the year (and one that continues to remain a key source of volatility uncertainty) was clearly the development of commodities, and in particular, oil prices. If you were long commodities, that, generally, has not proved to be a very profitable position in the latter part of 2014 and going into 2015.

The great surprise of 2014 was that the core rates, short-term interest rates, and bond yields on safe government bonds, benchmark government bonds, ended the year significantly lower. So, at the beginning of 2014, as you know, the yield on the US 10-year was 3%. The forwards were actually pricing, at that time, that they would end 2014 yielding around about 3.4%, and a number of strategists had a higher yield target. As you know, the US 10-year is yielding somewhere below 2%. The miss on bunds was even more spectacular. The 10-year bund is supposed to be yielding 2.5% if we were using forwards as a guide at the beginning of 2014, and again, as I'm sure people in this forum are aware, it's yielding around 50 basis points.

Why did core rates earn significantly lower and why were yield curves overall flatter than had been expected? I think there are a lot of answers given to that question. I'm going to summarise what I think are, just very briefly, some of the key ones. Firstly, actually, global growth was weaker than had been expected. It was highlighted that there were a number of global growth scares and shocks, starting with the US at the beginning of the year, with the severe winter. But then, also, at the heart of concerns about the global economy, and increasing worries about deflation, has been Europe, and associated with that have therefore been other episodes of volatility, which have created a bid for safe haven assets. As the European economic recovery stalled and inflation fell, European government bond yields fell to all-time lows.

> "The focus has been on the near-term losers, rather than the broader, medium-term gains that we think do accrue to the global economy, from what is, de facto, quite a large tax cut."

Now, I think what this experience in 2014 has also illustrated is that, the usual rules of the game don't really play very well in an environment of quantitative easing and zero interest rate policies. Long end rates are supposed to be driven by the US treasury market; historically, that's been the case. But, actually, what we saw in 2014 was that the bund market was the driver of the US treasury market, and the driver of global rates more generally.

Then the third factor which has influenced this decline in core government bond yields during the course of 2014 and at the beginning of 2015 has been this notion of secular stagnation, which has certainly gained, I think, a lot greater traction amongst investors. As we start 2015, you have to recognise the way that investors are positioned, as opposed to some of the rhetoric.

Investors don't have any real conviction at this point in time, in terms of the global economy and the sustainability of global economic growth. And, as a result of that, the growth-sensitive assets (credit as well as equity) are pretty fragile and vulnerable at the moment, reflecting that lack of conviction. Now, the severity of the fall in global oil prices, and the absence of a floor, is clearly weighing very heavily on global credit and emerging markets in particular. Developed market, investment-grade and high-yield credit spreads have widened appreciably since July. Spreads on emerging market sovereign bonds have also increased.

Oil has actually fallen faster and further than the ability of markets so far to actually price what that means for different asset classes and for the global economy – and, frankly, faster than investors are able to adjust their portfolios. The speed and the severity of the oil price fall has meant that this is going to be a continuing source of volatility, and a headwind to risk assets, even as we get a stabilisation of oil prices.

I think the other aspect is, investors have very much focused on the losers from lower oil prices; that basically leveraged US shale producers, and emerging market oil producers which already had relatively weak fundamentals going into this. It was already mentioned in terms of Russia, but also Venezuela and Nigeria are, for example, emerging market oil exporters with weak fundamentals, that are now under additional pressure.

So, the focus has been on the near-term losers, and the pain which they're suffering, rather than the broader, medium-term gains that we think do accrue to the global economy, from what is, de facto, quite a large tax cut. But it is that concern about the growth outlook and deflation, and the signals that lower oil prices are sending, that's actually dominating markets at this point in time.

If lower oil prices are reflecting lower global demand, then it is the proverbial canary in the coal mine, and the global economy is rolling over. And, if it's rolling over, then asset prices at current valuations are not going to be validated by growth through 2015 and into 2016. That's what many investors are fearing in terms of the signals being sent.

But actually most of the analysis suggests that it has primarily (although not completely) been a supply-driven shock; that's the conclusion also of the IMF analysis. They show that if you assume that 60% of the decline in oil price is basically due to supply, then the positive impact on global growth is anywhere between 0.3% to 0.7% of GDP in 2015.

FINAL

The lower figure reflects a faster response in terms of supply to the reduction in oil prices.

Fiscal and monetary policies, including central bank balance sheet expansion, underpinned the V-shaped recovery from the great recession in 2009 and 2010. But, thereafter, fiscal policy actually became contractionary. Governments did implement austerity, with varying degrees of success. Central banks had already gone to, effectively, zero, so there wasn't much scope there, so the only offsetting policy response has been in terms of central bank balance sheet expansion, and we saw that with QE2 and then QE3 in the end of 2012, going into 2013.

But the overall global policy mix has actually become more growth-friendly. Fiscal austerity has actually eased significantly over the last year or so, including even within Europe, reflecting, to some extent, austerity fatigue, and despite the end of QE3 by the US Federal Reserve, the expected acceleration in asset purchases by the Bank of Japan, and also by the European central bank, have meant that the overall level of central bank liquidity into the global economy was actually set to increase.

There is a qualification to that: we do think that you get a bigger bang for your dollar-equivalent buck, if you like, as a result of Fed QE, than you're going to get from ECB or BOJ QE, but nonetheless, central banks are more worried about inflation being too low, rather than too high, and monetary policies are still extraordinarily accommodative and supportive, both of global growth and of asset markets. I think, combined with lower oil prices and the strong momentum in US economic growth, we do think that the pessimism at this point in time around the global economic outlook and fears about outright and persistent deflation are somewhat overdone.

Now, the Eurozone, as I say, has been very much at the heart of these concerns and has consistently disappointed in recent years; you've consistently had this situation where economic growth forecasts, each month as you move through the year, have been lowered for the Eurozone. But 2015 might just be the year when the Eurozone surprises to the upside. There is so much pessimism about the outlook for Europe that, actually, it is not going to take too much to get some kind of positive surprise.

The headwinds to growth from fiscal austerity are easing. I think, following the ECB-led asset quality review and stress test, the level, or the intensity of bank-led deleveraging within the Eurozone is also starting to ease. It's not over yet; there still are pressures on the banks within the euro area, but not to the same degree that there were in 2012, 2013, and through the first half of 2014 in the run-up to the AQR and stress test.

Corporate loan demand in Europe is actually starting to pick up. This is very important: that we have some easing in the supply of credit, as well as in pick-up, and to meet this pick-up in corporate loan demand. We are starting to see a turnaround on that. Then, combine that with a lower euro, a weaker euro, and lower oil price, then again, we have quite a lot of tailwind for the euro area.

In early 2013, the ECB balance sheet was 1.4 times the size of the Fed balance sheet. That has since shrunk to about 60% the size of the Fed balance sheet, so while the Fed has been expanding its balance sheet through QE3, we know that the ECB has actually been shrinking its balance sheet as banks have been basically reducing their dependence on the ECB for liquidity support.

Investors and the FX market had actually responded to the €1 trillion expansion in the ECB balance sheet already with the weakening in euro/dollar. That, clearly, is one of the key channels and mechanisms through which QE is going to work, and to help to adjust in terms of expectations.

That being said, there clearly are some significant political and policy risks around this relatively bullish view in terms of Europe. Clearly, there are a lot of angry and frightened voters in Europe (that includes in the United Kingdom) and they are turning to populist and anti-establishment and extremist parties. So political risk is clearly on the rise across Europe.

In addition, we are somewhat concerned about the potential for policy complacency. We are a little bit disturbed by some of the reported thinking that has been coming out of Berlin, for example, with respect to the potential risks that would arise from a Greek exit from the Eurozone. We do think that that would be a systemic risk event; we are much less confident than some policymakers seem to be that that would be very manageable, and it's not something we need to worry so much about, or to the same degree as was the case in 2011 and 2012.

So, there is potential for policy mistakes, whether that's from the ECB or whether that's from policy more generally within the euro area and elsewhere, as well as from, as I say, political risk not just in terms of Grexit, but also, for example, the emergence of parties and the fragmentation of the political scene in countries like Spain as well. I mentioned that, in terms of the outlook for 2015, despite some of the rhetoric and some of the commentary that you're seeing, investors actually aren't positioned for stronger global growth; they're not positioned and pricing in the benefits of lower oil prices. Investors, at this point in time, are very fearful and defensively positioned, and we are seeing that reflected in the continuing rally in core rates and in quality credit.

We do actually think that the Fed is going to start hiking interest rates in mid-2015, and that actually, US 10-year treasury yields will reach 2.5% or more during the course of this year. The increase in rates in the US will be a source of market volatility, but we also think it will be a signal that growth and deflation risks are actually overdone. It will be a statement of the strength of the underlying US economy.

Despite QE, given the balance of risk, this is not an outright conviction call, but we do think it's increasingly asymmetric when we look at, for example, 30-year bunds yielding just over 1% – do we really think that Europe faces two decades of being the same as Japan? I think Europe either faces a better future than that, or I'm not sure Europe, as currently constituted, in terms of the single currency, will still be around over that horizon, if it has to experience two decades of effective deflation and stagnation.

It is consensual, in terms of the US dollar, but we still think that there's a lot of momentum behind the US dollar which will be supportive of US dollar assets more generally, and that actually includes emerging market dollar-denominated credit, which we think will remain relatively well-bid. Potentially, what will be, I think, an interesting contrarian view and opportunity for 2015 is actually in terms of emerging market FX, and in particular, local currency bonds, which have had a very tough time over the last two or three years, and actually posted another year of negative returns in 2014.

We are starting to express that view in some of our portfolios by actually going into local EM bonds markets. We're actually not funding that out of dollars; we're funding that out of euros. Euro investors into emerging market local currency debt did reasonably well last year, and also looking at some other G10 currencies, we do think that, with yields where they are in emerging markets, it's actually against a disinflationary backdrop. There's quite a lot of positive outlook in terms of rates markets within EM at this point in time.

In terms of developed market credit, the widening in credit spreads and higher yields, especially in the US, is creating some value. I have to say, we're pretty defensively positioned, and hesitant at this point in time, in terms of the US high-yield →

FINAL

market, including the non-energy segment. The reason for that is, we don't think that the energy segment of the US high-yield market, and the US high-yield market more generally, has actually priced in the level of default rate that we would get if oil prices stay at $50 or lower.

They're basically pricing in something like $65 as a sustainable medium-term oil price level, where you will get an increase in default rates on the back of that, but that will be manageable. At $50 or lower there are a lot of business models in the US energy sector that simply will not be able to sustain that. As hedges run off, you'll see them basically going into Chapter 11 towards the end of the year, and into 2016. So, until we get a settlement of the oil price, and a further re-pricing, despite the fact that we do think there's value in terms of the non-energy sector of the US high-yield, we are pretty defensively positioned.

In terms of European credit and high-yield, on a valuation basis, by historical standards, frankly it's not that attractive, but when you have five-year bunds at zero, or gone through zero to yield negatively, something like 4.5% yield on European credit, and the ECB entering into the market as asset purchasers, that reach for yield and that search for yield for euro-based investors is going to be a very, very powerful dynamic.

Although we're tending to be invested in more of the crossover and higher-quality names, both from the investment-grade and into the high-yield space, nonetheless, we actually do expect some reversal of the decompression trade that occurred last year, and some compression of credit spreads going through 2015.

Every market rally climbs a wall of worry. When investors actually stop worrying is when markets go parabolic, and that's actually when you ought to be de-risking, you ought to be moving into cash. We're not there yet; in fact, there are a lot of things to worry about, and investors are worried about many of those things. The geopolitical risk, the policy and political risks that I've already alluded to, the regulatory decline in secondary market liquidity, the one-eyed focus on risks that sit within the banking sector, which are also potentially pushing risks out into the non-bank sector as well.

More fundamentally, I could just be plain wrong. If lower oil prices are really telling us that global growth is rolling over, then 2015 is going to be all about capital preservation, because after $6 trillion plus of asset purchases, if the global economy cannot still sustain some level of growth, then asset prices where they currently are, particularly risk assets and growth-sensitive assets, simply aren't validated. So there are a lot of things to worry about.

Fundamentally, though, we think that those concerns, at this point in time, are exaggerated, and we have a continuation of the global growth recovery, which is going to be weaker, but more prolonged. Also, lower inflation means lower rates for longer, more generally.

Let me just now take a step back, as it were, from looking at 2015 and the near-term outlook, and actually just try to address how we're thinking, in terms of our clients, how to manage their fixed income and credit portfolios in a world where you think that interest rates are going to stay low for a prolonged period in time.

Clearly, the decline in nominal real interest rates has been one of the most profound secular shifts for a generation, and we saw that trend become more accentuated post the global financial crisis, but I think the key point to remember is that this has been a trend that predates the global financial crisis. It gave it an extra push, but it actually predates that. Again, there's a lot of debate and different reasons that have been given as to why we've seen this secular decline in real, as well as nominal, global interest rates.

Clearly, it has been reflecting, at least in part, a global shift in investment and savings, the emergence of China and developing economies in the 1990s, the reduction in overall investment rates in the developed world, which we saw at the same time, and also, a greater demand for safe assets that has tended to favour fixed income over equity, over this period.

At BlueBay, we do think that we'll remain in a low interest rate environment for the foreseeable future. That doesn't mean that we don't think we can get some increase in interest rates – I've already suggested that we are currently positioning for a hike in US rates from mid-2015 – but that, nonetheless, there are powerful forces at work that will keep interest rates near their historic lows for a prolonged period of time.

In response to that, I think, a lot of investors rightly fear that the returns on traditional government bond benchmarks will be much lower in the future than they have been in the past. Frankly, the beta returns on just being long, core fixed income, have been fantastic over the last two decades; we just don't think, unfortunately, as a fixed income investor, that you're going to get that repeated over the next two decades. So, in response to that, many investors are actively reviewing how they think, and how they manage their fixed income and credit portfolios. **THFJ**

"Every market rally climbs a wall of worry. When investors actually stop worrying is when markets go parabolic."

FINAL

Why to Go Active Versus Passive

European equities still offer opportunities

EXTRACTS FROM A PRESENTATION BY NICOLAS WALEWSKI, FOUNDER and PORTFOLIO MANAGER, ALKEN ASSET MANAGEMENT LLP

I'm going to highlight what we have seen lately, what we can do with it, and how we can implement in our portfolios a strategy that we believe should be rewarding. First of all, let's focus on Europe, the STOXX 600 sectors, returns last year. Healthcare was up around 20%; utilities, telecoms, consumer staples, discretionary, IT, and financials were in no-man's-land, hesitating; and materials, industrials and in particular energy were significantly down and underperforming.

I think there are two conclusions to highlight. The first one is that the oil price collapsed, and it was probably a surprise to a few. If not, it would not have come down like it did. This has an influence on energy of course, but also on materials, because it's influenced by energy in a way, by ricochet, and also on industrials. In industrials you have a lot of capital goods, and for capital goods, you have a lot of oil services, and so on. All these companies have been influenced by the collapse in energy prices. I think very few investors anticipated that at the beginning of last year.

The second point to highlight, if we know that most stock pickers last year – at least in Europe – have underperformed the benchmark, is that it's one of the worst years for alpha generators. I think it has been driven largely by the collapse in long bond yields.

The collapse in long bond yields has driven up the re-rating of many companies which have relatively stable cash flows, whether it's telecoms, utilities, or healthcare. There are other reasons, of course, but I think, underlying all kinds of things that have been happening in each sector, the collapse in bond yields is something that almost no stock picker was able to anticipate. That was a very strong driving force. That is why most stock pickers have underperformed last year; they didn't anticipate the collapse of the oil price, and they didn't anticipate the collapse in long bond yields.

How do we position ourselves? I don't really know what this means, but let's say, we're slightly underweight in defensive stocks; we'll be overweight in cyclicals, and we'll be underweight in financials. Why? What we know for a certainty is that the oil price has halved, and that will create a big shift in value from the oil producers to the oil consumers. It will also generate economic growth, especially in Europe, because Europe is importing oil. So that's why we are overweight cyclicals and slightly underweight defensives.

A number of defensive stocks have done well last year, because of the evolution of the bonds component, but I have no clue where the bonds are going, personally. Where I think we can monitor relatively well: oil prices, at least in the short term, and also it takes time for the equity markets to price in all the consequences of such a collapse in oil prices. Six months ago nobody anticipated that. Many people had flawed views, especially on shale oil; they were totally underestimating the increase in shale oil production. The oil price collapsed recently, just two, three months ago, and most people, they actually look at not spot prices but futures. Futures have been lagging on the downside. Futures, to start with, were lower than spot prices; they were sometimes around 90, where the spot was at 110.

Spot prices collapsed fast, to 90, 80, 70, and so on, but futures prices, three years, five years forward, and so on, fell – but much more slowly. Recently, of course, the three-year, the five-year is falling, but it highlights that it takes time for people to adjust their mid to long-term expectation on oil prices.

The other factor is that it takes time for such a move in oil prices to affect many goods and services. We all know that the price at the pump is folding fast, and that's what you hear in the news. You pay less when you go to the petrol station; that's adjusted relatively quickly, but the price of oil has an impact on almost everything we buy. It has an impact on plastics, on clothes, on food, and just about everything else.

But, it doesn't necessarily – or it almost never – affects the price immediately. It takes several months, several quarters, and this gives us a bit of time to take advantage of this. We believe that is a certainty, so this is big, and this is highly likely. That's what we have to take advantage of. Who are the losers which had not taken into account a low price, and who are the winners? We'll come back to that.

We try to avoid taking too big bets on things we don't really control, which are more murky. Interest rates are difficult, for us at least. European politics, or European monetary policy, is difficult. That is why we are relatively light on financials, because in theory banks, in particular, should be doing extremely well in such an environment, because a lower oil price should increase European GDP at least (everything else being equal) 0.8%. It has moved up a bit, the markets have moved up a bit, but the expectations on European growth were very low.

With such an impact on oil prices, I know European politics is often very disappointing, but it doesn't take much to be optimistic. That's why we're a bit more exposed to cyclical stocks. On financials, in theory, loan growth should increase; there should be a pick-up in loan demand – to buy cars, to buy consumer stuff, to invest for companies and so on.

In practice, however, it is a little bit murky, because we have been constantly asking all these banks for more and more capital. We're asking them for more and more liquidity ratios, for more and more compliance; if you talk to many of the large banks, they are very afraid to lend. They are telling you that the problem is that people don't want loans. We would like to lend to them, but they don't want loans. We don't think that's the case; we think it's the banks who don't want to lend.

They're afraid of lending; they don't have that much to lose if they don't lend, and they don't really know what's going to come, what's going to be the outcome with Basel III, with Greece, so they're a bit afraid. If you have some new banks with fine balance sheets, with no legacy assets, they're usually lending fast, but they are tiny. There are very few huge new banks in Europe.

So, at least for now, we are light on the financials, because there could be some unexpected bad news which we don't really control. In other sectors – the cyclical sectors – things are more simple and obvious. And many parts of the world are going to benefit from what just happened. There's going to be a shift of value from the oil-producing countries to the oil-consuming countries, wherever they are. It could be in Europe, but it could be Japan, it could be China, India, and others, and I think this will benefit a number of European companies.

We've seen a lower cost of capital in Europe recently. God knows where yields will go; it seems so far that the ECB has lost the ability to control inflation expectations – they have collapsed recently. They were close to 2%, which is the ECB target; they've collapsed to close to 1% recently, and all the meanwhile, the ECB has been talking but not doing much.

Having said that, you can see that peripheral bonds, Italy and Spain, have been converging fast with Germany and France. What is clear to me is that Spain, in particular, has implemented a number of reforms. The cost of labour in Spain has collapsed. It used to be too high, and now it's rather cheap. It's not the cheapest in the world, but it's much cheaper than it was. There has been a mega-adjustment. We talked to a number of industrial companies who have plants in, sometimes, 60, 70 countries around the world: in the last two years, where has the cost of labour improved the most in the world? Spain.

Spain also had put more flexibility in its labour markets and has reduced the cost of government. They fired hundreds of thousands of civil servants relatively quietly. They have restructured very strongly the banking sector, with a lot of mergers. The banking sector in Spain is relatively well provisioned (although not always capitalised, as we saw with Santander). And then something that is →

FINAL

often misunderstood by many investors: they also have restructured the energy sector, or the electricity sector. This is a huge cost to the community, and is often misunderstood.

For 10 years or more before, with previous governments, they implemented a very foolish policy driven by ideology – going into renewables – and this has led to a massive increase in electricity cost for the community, and it was highly detrimental to the Spanish economy. Rajoy very quietly has destroyed all this, and it's the change that matters, not the absolute level, and the change is dramatic.

The very worrying country on that front is Germany. Merkel has generated hundreds and hundreds of billions, if not trillions, of hidden liabilities for the German people with her energy policy. It's an absolute disaster. You can't see economic growth in Germany with this energy policy. So I think Spain will continue to converge and surprise on the upside.

Beware of political instability, but frankly, it's an open question. We don't invest in Greece; we have no clue what can happen. I don't know if anybody has. It's a guessing game, and it's very difficult to anticipate. We shall see.

We have seen the purchasing managers indices (PMIs) in Europe wobbly last year. Should we worry? Maybe, maybe not. I think part of this wobble was due to Russia invading Ukraine, which was a very negative surprise, very poor for sentiment, which has been hurting the German and the Italian economy, and also, definitely the lack of action from the ECB, who have wasted a year.

But again, the collapse of bond yields, the collapse of the oil price, the fall of the euro (which is not major, actually, if you look against the basket) all this, added to the fact that expectations had been very low recently, should be enough to drive positive surprises. And there are a number of other encouraging signs.

If you look at the ECB lending surveys, it's not great, but it's slowly improving. Why? Because in the last few years, with the 2011 great crisis, and so on, Europe was totally out of sync with the rest of the world; where many other countries were booming, had huge credit expansion, Europe was contracting fast. There were a lot of austerity measures, typically in countries like Spain and others. This is over. Even the Greek economy is actually doing well. If you exclude politics, Greece is doing great, and many other countries are actually doing well, quietly. Many of the eastern European countries, I think, are on the right footing as well.

These lending surveys and so on, they don't really take into account, I believe, what we've seen in the oil price, so it should continue. People should probably borrow more to buy cars, to buy whatever consumer goods they want to buy. Companies aren't sharing a lot of cash; people are very bearish on the euro, it's the flavour of the month, but Europe is exporting a lot at the moment. Actually, the world is short of euros; Europe's trade balance is very, very positive, and it's going to get dramatically better with the collapse of the oil price. All this should put money in the pockets of consumers, and probably companies as well.

So, what do we do? Again, we will try to be out of the stocks that have not priced in the fact that the oil price may be as low as $50 for a while. It could be oil-producing companies; it could be oil services companies; it could be some capital goods companies, some chemical companies, and so on. It should be a minority in the stock market. But some of them will be hurt massively.

Usually, when the oil price is collapsing, the pain is fast and is very concentrated in a few hands, while the gains are disseminated for the entire community; everybody benefits from lower oil prices, and the gains take more time to get through. So, the stock market is a little bit afraid these days, each time the oil price is going down, but over time, the winners will emerge.

It is true that, when oil prices go down, there are risks, as we have seen in the past: LTCM, the coup in Russia, and so on. One of the major risks is a liquidity event by a leveraged entity. Could it happen again? Possibly. We don't really see where that could come from these days. Hedge funds are not as leveraged as in the past (or we don't know it, at least) and we haven't seen any weak hand, and real strong forced seller recently, on this collapse.

It is true that Russia is in deep pain, but they still have some reserves. They don't have as many US dollar loans as 15, 20 years ago. Maybe they'll be in trouble in a year, but just not immediately. The rouble has collapsed, but is it going to trigger a sell-off in major markets? It doesn't seem to be the case.

So what do we buy? Well, we try to buy the winners, and the winners will benefit in many ways. They will benefit because their top line will probably be underestimated. They will benefit because their costs often will go down. There is a lot of oil in their cost, and there will be a multiplier effect.

Usually, when commodities are expensive, you have bear markets for equities. When commodities are cheap, you have bull markets for equities. This can last many years. The other thing I want to add is that, for us, the oil price was the last shoe to drop. If you look at most prices, the peak of the commodity market should have been 2008, but there was QE in the US, and there was a huge expansion programme in China, which led to a massive rebound in all these commodities.

Many commodities peaked around 2011 and have been falling ever since. Look at coal and many others – natural gas, nickel, amongst others. There hasn't been any new investment in all these commodities for a while now. Some of them are trading below the cash cost of almost half of the industry worldwide. Usually, these commodities that have been falling fast were a commodity where you couldn't speculate much. There was very little in the way of a futures market, and they could not really be stored; it was too expensive. So, it's just supply/demand.

In others, like oil, like precious metals, there was a lot of speculative money. You can store it, especially precious metals (oil, a little bit less, of course, but you can play a lot with futures). There was major activity around this. I remember talking to some Latin American pension funds, and they had an amazing portion of their assets – and these guys managed, at this time, around $1 trillion – full of Petrobras and things like that, and on top of that, they were full of oil and gold outright, through futures, ETS, etc. It was "the" bubble. And, that was already a few years ago.

But, for a number of years, you could see as well that the oil price should trade in a band of global GDP, and for the last few years, it was at a very, very high level. So, we thought that was just too expensive, but it was not dropping; there was no catalyst. People were expecting a strong demand from China that actually didn't really materialise, especially in 2014, but there was no real catalyst for new production. Usually, when you have a high price in a commodity, it encourages more investments, but there were not many new large fields.

We are looking at Brazil; we are looking at Argentina; we have looked at many places over the last few years, but it never really took off. Argentina because of Mrs Kirchner – she destroyed the outlook there; in Brazil, because of the massive inefficiencies of the Brazilian politicians, and Petrobras and so on, it's delayed and delayed and delayed forever. So, we had to wait for 2014 for shale oil in the US. What was striking for us during the middle of this year was how misunderstood this was, in Europe, at least. There are a number of reasons.

People were talking to the big oil companies in Europe, and all these big oil companies, they missed it like they missed shale gas 15 years ago. Shell, BP, Total, all these guys, they missed it again. So they're telling everybody, "Well, it's not very important," and there were a lot of misconceptions. The other

FINAL

thing is if you look at the depletion rate, it's falling fast. In two years' time, I think it's falling 50%, and so people are shocked, and they say, "Well, this is frightening; this is not going to last." They are used to different economics on the other oilfields.

We believe they just don't understand the economics. I read stories, 10, 15 years ago, about shale gas: that it was going to stop very quickly after two, three years. Well, I don't think that's the case. Natural gas in the US is doing fine. The price is still extremely cheap, and these guys are still pumping like hell. You can see the same misunderstandings on shale oil today. It's a little bit amazing, but it's true.

It's quite simple, at the end of the day. We will focus on consumer discretionary stocks. We'll focus on retail; we'll focus on technology; we'll focus on all the sectors that will benefit from a consumer resurgence, especially the mass consumer, not the very rich people, not the plutocrats, because it benefits more the middle class and the lower middle class, in relative terms. It's much more important for the lower middle class if he pays less for clothing, for whatever, than for millionaires.

One example is Ryanair. We already had Ryanair for many years, because since the IPO in 1997 the stock has delivered around 20% per annum, total return. If you actually adjust for the fact that they made a couple of mistakes over that period (they lost a lot of money on Aer Lingus; their buy-backs were usually not very well timed). The multiples today are cheaper than the IPO in 1997.

Ryanair has the best-in-class unit cost, which is the key competitive advantage, but when the oil price is high, this advantage is reduced, because their overall cost is growing faster than their competitors. So, the gap in cost is reduced. But, when the oil price is collapsing, their advantage gets bigger, so they're able to gain more market share, to make more money, and destroy competitors. Also, Ryanair learned their lessons from 2008 – they under-hedged. What matters is not what they are doing in absolute terms; it's what they are doing compared to their competitors.

Most airlines are hedged around 90% for 2015, so forget it. A lot of airlines are already hedged 80%, 85%, sometimes 90%, for 2016. Ryanair is not very much hedged for 2016. That is a gain of several hundred million euros. It's a one-off, but it helps. They spotted this one well. And, more structurally, while everybody was piling up to buy the new fancy planes from Boeing and Airbus, because they're consuming something like 15% less, and paying over the odds and being in the queue, quietly Ryanair went to see Boeing and extracted a very good deal for an old generation – new planes, but an older generation – and they made a calculation that, because they are paying such a low oil price, at \$110, it was still a very good deal for them. Imagine what it's going to be at \$50. It is most of the capital employed of these airlines, planes, and they have just locked in, for a number of years, a massive competitive advantage.

And, just recently, Ryanair was trading barely above 10 times earnings; it was such a compounder with such wonderful economics. Why don't people buy it? Why are they all piling up on Nestlé, or whatever? It's an airline. And, that's where the opportunity is. Simple. There are other airlines in the world which may benefit. The problem is, you have to find an airline that has strong internal dynamics, and as you probably know, it's usually not the case for most airlines. For Ryanair, it's a certainty, I think. **THFJ**

"We'll focus on all the sectors that will benefit from a consumer resurgence, especially the mass consumer, not the plutocrats."

FINAL

Market Dynamics and the US Energy Revolution

The role of master limited partnerships

EXTRACTS FROM A PRESENTATION BY MICHAEL R. PARKER, PRESIDENT, PARKER GLOBAL STRATEGIES LLP

Parker Global Strategy specialises in providing liquid US energy infrastructure investment strategy to non-US investors. The firm was originally founded in 1995. It now manages over $3 billion in assets with a strongly theme-oriented approach, leading to the formation of a multi-manager customised portfolio of various energy strategies and then to direct investing, with a very specific expertise in master limited partnerships. Parker is based in Stanford, Connecticut, with offices in Denver, Colorado, and a client service representative in Tokyo.

We've lost 50% of the price of crude oil over the last six months. It's primarily due to concerns over oversupply. The oversupply is being driven by the US shale revolution. In addition to the concerns of oversupply from shale, we certainly had some influx of production coming from Libya, the Gulf of Mexico, and Brazil, which then was also exacerbated by some demand forecast cuts, specifically from the International Energy Agency, which then made the market look at OPEC as a possible solution for propping up prices. Saudi Arabia did not. OPEC has basically gone silent; it's asleep, leaving the market to its own devices.

So, as you see, the price of oil just kept creeping down, searching for a floor. We had moments of thinking, in December, that there may be a chance that it might start stabilising in the mid-50s, but that was short-lived, especially when we started to understand, and the market started to realise, how much oil was being stored, and the glut was as big as it could be.

In the oil supply, as the Gulf was reducing, shale was just starting to pick up, and it's been year-on-year up a million barrels for over three years. So it's really ramping up, and could continue. Then, in 2014, the Gulf came back and Brazil showed up – Brazil was expected to increase production for some time, but it always got delayed. And then Libya also added to production in 2014, adding to the glut. We're going to have to rebalance oil, and it's going to take a couple of years before supply and demand can rebalance. There's going to be a slowdown in exploration and production (E&P) capital expenditure, for sure, and the market is looking for a metric to find this, and without OPEC and Saudi Arabia balancing out the supply.

Markets have to look at what the cost of production is, which would lead us all to believe that oil has further to go down before it stabilises. McKinsey – who study oil and gas a lot – did a global study basically saying that, at $50, 190,000 barrels are under water; in other words, it's costing more to get it out of the ground than what they're receiving. And, this is just the cost; it's not talking about the cost of putting in wells; it's just the production getting out of the ground. At $45, another 400,000 barrels are in play. If it gets to $40 a barrel, another million and a half get into play. I'm not saying they're all going to disappear, because every region, every producer has their reasons on why they're producing, but it's a factor that could play a role in balancing out the supply versus demand.

If we get to this, the other thing that we need to think about is the decline rates. It has been estimated that a million and a half barrels a day need to be created every year, to stay even with oil volumes. Before the price decline I and others were estimating that crude oil production could grow 1-1.5 million barrels a day. Now we assume that that's going to be adjusted downward, given what's happened to price. In addition to that, you have the idea that shale oil, as it is, does deplete faster, so you've got to have a situation where, if you're going to keep the shale oil going, you're going to have to keep drilling – that also will play a role.

So, you take the capital expenditure coming down; you take some of the ongoing production being reduced, plus this whole area of depletion, and we're thinking, and looking at the data, there is a good chance that we could actually see a shortage of crude oil by, maybe, the end of 2016, but really probably more by the end of 2017. It's going to be low; it's going to take a while; but there's data out there that would tell me that oil prices can come back.

Now, are they going to come back all the way to 100, 110? Probably not, but it's going to bounce, and there's going to be an equilibrium somewhere along the way. An interesting statistic: five times the price of WTI has dropped more than 50%, and five times the price increase in the following 12 months has been up an average of 52%. So oil is volatile, and there is opportunity both ways.

With regards to the US, they've already announced about 20% overall capital expenditure (capex) reductions. When I say capex reductions, I'm really talking about for 2015. We still assume that this is a postponement: it's not going to be eliminated going forward. We also think that the service companies, the Halliburtons of the world, that are servicing the oil rigs are going to have pressure put on them by the producers to reduce their costs.

In US natural gas, three of the largest natural gas producers in the Marcellus shale formation in Pennsylvania have already announced increases year on year on capex, and it has to do with how cheap the natural gas really is in the US. The other thing for the US and for shale (which is going to create more volume) is that there is approximately a six-month backlog of wells that have been drilled that need to be completed. So, they're in a stage of completion, and they're going to complete them because they've spent the money to drill; they've spent the money for fracking, and now it's time to hook them up, but it takes about a six-month lag, so you'll have some increased production there.

You have to be quite granular when it comes to production costs. In North Dakota, for instance, they've got lots of oil, shale oil: the Bakken shale. What's interesting is, the highest cost counties have also very low production. So, you have a county like McKenzie in North Dakota with cost bases of under 350, doing 350,000 barrels a day. So, at $50 oil, they're estimating that only 10% of the Bakken is below break-even. That's just a fact that you really need to understand, because if you look at the Bakken generally, people say, 'Oh, well, break-even cost there is $65'. Well, not really.

For the energy revolution in the US, we have the influx or the peak in 1971, and then a nice steady line going downward. Well, technology came to the rescue. It's really wild-cattish from Texas and Oklahoma, who didn't have the wherewithal or the money to go to the Gulf or go to South America or go to Africa; these guys had to figure it out at home, and they just experimented. They figured out, if fracking could work in shale, it could be producing wells that could make money. Then they coupled that with horizontal drilling, and off they went.

There's a lot of oil that was coming into the US that's having to find other homes. Again, the technology is really what has driven this revolution – fracking and horizontal drilling. It's also about land rights, legal systems in the US, that allow for private lands to be drilled, and I think that's the beauty of it.

To give you an idea of the timeframe on the infrastructure: the Marcellus, we're talking about 100 years of work. Utika is associated with Marcellus. Permian is going to be huge. So, this gives you an idea; this is not just a short-term play. I'm not looking at an infrastructure play that's going to be great for 15 and then sell it. This is a long-term play, and what's going to drive it is these efficiencies.

When it comes to natural gas, we've been growing demand within the United States, which is much to the benefit of the US. Of note: first one, power generation. We had a lot of utility plants that are fired by coal, and they've been changing over to natural gas, one, because it was cheaper – though, coal keeps coming down, so that's not as true – but regulation is forcing them to do it because the greenhouse gas emissions from coal are so much worse than natural gas, and the government, the

FINAL

EPA, has been putting on standards that are coming true. That's a real boost to demand for natural gas.

The industrial chemicals, the liquids coming off of natural gas liquids, are the feedstock for plastics. Not only are the plants in the US growing, but it's attracting plants from outside the US, coming to the US because it's so cheap.

So, what's the impact? The impact is investment opportunities in infrastructure, for sure: plants and equipment, new technologies, service technologies to help make the oil and gas flow faster and cheaper. It has been great for the US economy, and again, one of the cheapest hydrocarbons in the world.

When we talk about infrastructure, what we like to invest in is midstream energy. These are the pipelines, storage tanks, processing units, the logistics of energy that are required to get the energy out from the ground to where it's needed. Most of what we do is through our MLPs that basically are not subject to commodity risk; there are a lot of "reservation contracts", 10 years, 15 years, where they actually reserve the pipe for a producer for a flat rate. And, if they use it, great; if they don't use it, they still have to pay.

MLPs were started in 1986; they were from a tax act, and it was the governments that really wanted the private sector to build this infrastructure. At that time, it was about rebuilding old infrastructure. It was a boring business; it was boring, but great. It had a nice yield; it traded like a high-yield bond, but with the advent of the revolution, all of a sudden, we have this huge growth piece to it. So, you have good yield, and good growth of yield, and that's really the play.

They get a tax advantage in that the taxes flow through, and that helps their cost of capital. That's really the key; their cost of capital is less, which puts them in the front row of getting those jobs to build the infrastructure.

All we trade is publicly traded MLPs – that way, we can have the kind of liquidity that you would want, i.e., daily. It's worth something, and the capitalisation goes up, somewhat, with the infrastructure need. We expect that to continue; we expect more IPOs.

MLPs have performed extremely well, relative to other asset classes. The primary driver of MLPs is stability of distributions, and in order to have stability of distributions, you've got to have good cash flow coverage.

MLPs, historically, have basically distributed their free cash flow, and so when they're doing new projects, they go to the capital markets, equity and debt. Their balance sheets are about 50/50 debt to equity, and they've been big players in that market. But that's the key driver; you want to have the guys with the least leverage that you can with regards to the cash flows.

Most MLPs are limited partners, so when you buy an MLP, you own the assets. Then there's the thing called a general partner, which actually manages the assets. The general partner (GP) is incentivised to grow those distributions for the limited partners, and to incentivise them to do that, they're given rights based on the volume growth. So, if they start out, a new GP might start out with 5% incentive distribution rate (IDR); they could grow that to 40% or even 50% over time as they grow the MLP.

"We have the peak in 1971, and then a nice steady line going downward."

So, as the old adage goes from us, if you like the MLP, you should love the GP, because the GP is really a leveraged play on the assets and the footprint of that MLP. There are 11 sectors that we look at – the large cap diversified ($20 billion plus type market caps). They're highly diversified, and they've got very strong balance sheets. They tend to do well in times of stress, so clearly, we like them now.

So, what we like, we like the general partners; we like the drop-down story. And we really do like the MLPs that are involved in the whole export LNG area, and ethane.

We see real value in very large integrated oil companies, like a Marathon, let's say. Marathon has MLP-eligible assets; that is, they have pipelines, they have storage. They could be an MLP if they chose to, but it's not; it's in Marathon. So, what they did, they created a general partner internally; they created an MLP, of which they kept 60%, and IPOed 40%, so they control the whole thing.

Then, they take those assets in the C Corporation; they get a higher valuation, because in the MLP structure, there's no corporate tax. So, they drop them down, they get cash to do other things, and while they're doing that, they're going to the market, to investors, and saying, "We're going to grow this MLP at 15% to 20% a year for the next three years." We know they have the assets; we know that if they put the assets down, their IDRs and their GP will go up. So, there's a terrific synergy. In three years there may not be, but we'll probably be long gone. These ones yield pretty low – they're yielding closer to 3% – but you're looking at 20% growth of that distribution pretty much in the bag, regardless of what happens to oil prices at the moment. This is one of the reasons why we like this so much.

To give you an idea of that GP, how valuable they can be, Plains All American had a GP that they IPOed – Plains is a huge midstream large cap diversified MLP that was worth about $20-25 billion. When they IPOed, they sold the GP; it sold for $20 billion. We look at these carefully, and we like to participate in these.

Ethane as an export: ethane is a by-product of natural gas liquids. Enterprise Partners, one of our names, just started exporting it, so they did 5 million barrels a day, and looking at this, I think there's a huge growth opportunity.

In a long-term view of performance of MLPs by the proxy of the Alerian index, it has performed through bull markets, bear markets, and the financial crisis. Lehman Brothers had $3 billion of MLPs and their administrator sold them in around four days, and that was back when the daily market value was $300 million. So, you can imagine what that did to our market: it created some interesting buying opportunities, and it has gone up.

They trade daily, so they have volatility. We have had corrections every year, and it keeps recovering. We're obviously in the midst of one right now, because they have been selling off in sympathy for oil, primarily because people are looking at the capex cuts and saying, "Well, wait a minute, how's that going to affect them?" Frankly, the good ones are being sold with the bad ones; we've seen indiscriminate selling. This is a highly retailed product in the US, so there's a lot of emotional selling and buying. We've seen some pretty indiscriminate selling lately, which obviously gets us pretty excited for the future.

Correlations are relatively low, through most things (although clearly, in times of stress, these things change). Yields are currently about 6%. Our fund is more like 4%, because we like the growth names, and the growth names have a little less yield. But it compares very nicely to other high-yielding assets. So with a compounding return of almost 16%, outperforming equities, that's a good alternative to other high-yielding securities. It's a high-yielding product with a lot of growth, and that's what makes it so interesting. →

FINAL

On the outlook, we're defensively postured right now; we have a lot in the large cap, large diversified. We want to wait and see what happens, when oil bottoms. When oil bottoms, then we'll have a better sense for which MLPs we feel are best positioned, and we'll get an opportunity to not only do those, but really go into opportunistic types of scenarios that we like to do, so we're defensively postured.

But, going forward, the Alerian is cap-weighted, and that's what most of the ETF-type products are like. We don't think the large cap is really where all the growth is going to be. It doesn't include those IPOs that we like, but we think the fastest-growing MLPs are going to probably be the smaller ones, but it's a dangerous time to be playing a lot in there. So, we think there's value there.

The indexes don't even take general partners in. That's not part of their purview and we think that general partners are going to continue to be a very strong and important part of the programme.

There are risks, yes: price, price of oil. There are MLPs that have exposure to oil; we have actually stayed away from them consistently, like the E&P names, but obviously, with capex coming down, that's going to affect it. So we're going to see some volatility with price, but ultimately, value finds value.

As far as volume goes, I think that some of the shales, like mid-continent, are vulnerable. It's a higher costing shale, but not the Permian, Eagle Ford, Marcellus. The US shale revolution isn't over, and frankly, wherever oil ends up, this market is going to balance, and it's going to be competitive, and it's going to be there, which is all I care about because I just want to see that infrastructure built. And I think it's going to happen.

Obviously we care a lot about balance sheets: that's why we don't like the E&P companies. There are a lot of little E&P companies, and some of them are MLPs that are levered. They are going to be hard pressed to survive two years. In fact, as oil prices bottom, you're going to see the strong companies start buying them up. They're going to pick them up on the cheap, because there's a lot of value there, but there were some guys that were a little bit too much the West Texas cowboy – they were going for it a little bit.

Lastly, Morgan Stanley did an investor survey in December. It gives you an idea of where the investors in the US are looking at MLPs, and the expected total returns are looking for, for 2015. Obviously, we think MLPs have been oversold, and we think there's going to be a nice balance. **THFJ**

FINAL