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update

Knightsbridge Wealth

Last year was not an impressive one for equity investors. While European and Japanese stocks rose, the S&P 500 finished marginally lower and the commodities-heavy FTSE 100 had its worst year since 2011, losing almost 5%. Emerging-market equities fared three times worse. 2016 has started in panic mode, with more poor Chinese data causing another global slide.

So what next? America tends to set the tone for global markets, and the fundamentals are discouraging. Corporate earnings are expected to stop falling once the impact of lower oil prices drops out of the annual comparison, but profit margins are at historic highs, so it's hard to see them getting any bigger. Even if interest rates are cut (normally good news for stocks), this would imply a weakening economy, which would hit hopes for earnings.

That said, the US economy looks healthy enough not to slide into recession anytime soon. And, without a recession, huge market falls are unlikely.

Another key issue for markets is China, where it looks as though growth fears are overdone. Few recognise that the US and Europe's share of global GDP has fallen from 60% to under 40% in three decades. And for all its stock-market volatility, China's economy has quadrupled in size since 2005. Over those ten years, most Western economies suffered contraction and even stagnation.

But if China does continue to falter, it would be bad for Europe, where the recovery is already weaker than in the US.

Despite extreme volatility so far this year, it is worth remembering that, over the last 215 years, stocks have outperformed other assets. Importantly, and despite relatively short-term volatility, returns are also more stable than those on either bonds or gold.

UK property prices remain a popular conversation for international investor. Seemingly unnoticed by the press, UK house suffered a five-and-a-half-year slide after summer 2007. The average house today is proportionally the same price, compared to British GDP, as it was in 1953. The recent strength – which we read a disproportionate amount about – has been driven almost entirely by London, where prices look dangerously overextended.

2016 is likely to be a challenging year. It is a year when the quality of advice, service and active management will be vitally important for international clients. The team at Knightsbridge Wealth looks forward to working with you.

Our strategic partnership with UBS (Union Bank of Switzerland) gives the best of both worlds – personal service and the ability to react in a way that only a small firm can, partnered by one of the world's most prestigious brands.

Market Report

Bonds
The start of a shake-out

In recent years, income seekers have flocked to bonds issued by companies with lower credit ratings in pursuit of higher yields. But as interest rates begin rising, higher defaults are likely to hand heavy losses to unwary buyers.

The yield on the Bank of America Merrill Lynch US High Yield index has risen from 6.3% in April to 9% at the end of December as investors head for the exits, driving prices down. If bonds are to be held, a price correction is likely and the safest government debt has got to be the focus.

Property
London heading for a fall

UK commercial property had another good year in 2015, according to the IPD All Property index. The asset class delivered a return of 12.5%, with 7% coming from capital growth and 5.5% from rental income. Commercial property values are potentially vulnerable to higher interest rates or an economic slowdown. However, the asset class can be a useful addition to a portfolio, since rents would be expected to rise with inflation over the long term. London residential looks very expensive at current levels and falls are likely.

Cash
The Fed moves, finally

The US Federal Reserve raised interest rates in December, for the first time in a decade. The Bank of England is likely to take longer to act: markets are not pricing in a hike until the end of 2016 at the very earliest. And further increases in US rates are not on the horizon.

Cash continues to provide some security in a portfolio but real returns will remain negative.

Equities
A mixed year

Japanese and European stocks posted respectable returns last year. The MSCI Japan index was up by 8% in local currency terms, while the MSCI Europe, excluding UK, was up by 6%. These remain favoured major markets: both are reasonably valued and their central banks are in easing mode, which should help to support stocks. US stocks are expensive, while the FTSE 100 index in the UK is skewed by its exposure to energy and natural resources stocks. The FTSE 250 index of mid-caps offers a more balanced exposure to the UK economy.

Emerging markets, had another dire year. The MSCI Emerging Markets index was down by 12% in sterling terms. Russia was the only major market to post a gain (up 6% in sterling terms), but it's still down 30% since peaking in April. Nonetheless, long-term investors will continue to be drawn to potentially strong returns offered in emerging markets. They are one of the cheapest asset classes, and there is immense potential for long-term consumer demand growth in many of these economies.

Precious Metals
Low expectations for gold

Gold does best during times of high inflation or crisis. Despite recent market volatility, neither are currently prevalent. So, gold has continued to perform badly. Gold prices are likely to remain very subdued for some time and most fund managers recommend allocating only a small part of a portfolio (5-10%) to gold, as an insurance crisis and since inflation will come back in the long term.

Like gold, silver was historically a monetary metal, as well as being used in jewellery. But it also has a number of industrial uses, so it is more volatile (both upwards and downwards) than gold, since demand fluctuates for its industrial use. Its value fell by 12% last year. However, if industrial demands remains reasonably robust, silver good outperform gold in 2016.

The supply glut in base metals saw prices continue to slide in 2015. The LMEX (London Metal Exchange) index tracks copper, aluminium, lead, tin, zinc and nickel. It dropped by more than 25%. Meanwhile, iron-ore prices fell by almost 40%, led by falling demand from Chinese steelmakers. Whilst prices may now be bottoming out, a recovery is unlikely on the horizon.

Tax changes threaten London property prices

International investors have been drawn to UK property for some time. Those who were not UK resident should always have bought their properties in the name of a Trust or an offshore company, to avoid 40% inheritance tax. However, recent changes in tax laws meant that virtually all buyers would have to pay inheritance tax, suddenly making property investment far less attractive than it previously was.

Buyers who aren't living in their property usually rent it out. One of the main drivers that give property decent investment returns is the tax relief on mortgage interest payments. Towards the end of last year, George Osborne, the UK Chancellor, announced this would be phased out. All the rent will now be counted as income, and a tax credit of only 20% of the cost of the mortgage interest will then be applied.

This came as a bombshell to the sector. But Osborne went further. He also announced that investors would no longer be able to write off 10% of their rent automatically as wear and tear: instead they would only be allowed to write off actual expenses.

Then, he used his Autumn Statement to tell us that capital gains on property sales would now be due in 30 days (rather than once a year) and that all second properties would now come with an extra 3% duty.

Rob Thomas, former economist at the Bank of England recently concluded that these taxation changes "will plunge buy-to-let profits into losses, and will leave many landlords with tax bills they cannot afford."

Taking into account all the changes over the last year, it seems like UK property investment is a bad idea. All this legislation is designed to knock small landlords out of the market, leaving the way clear for professional property investors.

Falling demand may well mean that London property prices continue their recent decline. This many mean property as a home, rather than an investment, becomes more affordable. We work with a number of property finders who advise clients wishing to buy a home in the UK, to ensure they receive the best, impartial advice.

Feature: Japan

In November, Japan slipped into recession for the fifth time in seven years. The economy shrank at an annual pace of 0.8% in the third quarter. There was a similar slide between April and June. That put Japan in a technical recession.

Yet, the Economist noted "under the hood, the Japanese economic engine is sputtering less" than it seems

Two areas that have struggled recently, net exports and consumption, which account for around 60% of GDP between them, both rose. The latter notched up an annual gain of 2.1% in the third quarter. Unemployment is just 3.4% and should keep falling – the number of jobs available per jobseeker is at a 23-year high. That implies higher wages and spending. The money-printing spree of recent years under Prime Minister Shinzo Abe drove corporate profits up considerably, as the Yen fell, making the economy more efficient, with exporters doing especially well.

The hope now is the flood of money will eventually shift the pattern of growth in a more domestic direction. The economy should see more corporate investment, as well as freer-spending households. Meanwhile, stripping out energy prices, inflation has finally returned to Japan, at around 1% a year. This is why the Bank of Japan didn't feel the need to step up quantitative easing (QE). It has already printed money worth around 70% of GDP, to stimulate the country's growth. To put that in context, the US and UK QE programmes were 25% and 20% respectively.

There has also been gradual progress on structural reforms to boost productivity and potential growth. The government has pushed for more women to enter the workforce and signed up to the Trans-Pacific Partnership, a free-trade deal that should open up sectors such as agriculture to more competition. A new corporate governance code has made firms more shareholder-friendly. A slowly improving economy, reasonable valuations and plenty of liquidity means Japan's stock market continues to look very attractive at current levels.

In the past, Japan has been viewed as a high-risk market. Yet, with Western equity markets looking expensive, investors have to be very selective. While the UK's FTSE 100 trades on a prospective price-to-earnings (p/e) ratio of roughly 15, which makes it look reasonably priced, if not outright cheap, it is home to lots of oil and mining companies that will struggle enormously.

In comparison, Japan seems awash with cheap stocks – there are more companies with P/E ratio of less than 10 in Japan, than across China, the US and the UK combined. Abenomics – the political and economic changes under Prime Minister Shinzo Abe – has ushered in a genuine revolution that makes this one of the world's most attractive investment opportunities, after years of negative returns.

Commodity Carnage

The Bloomberg Commodity index, which tracks the prices of 22 raw materials, has hit its lowest level since the late 1990s. It is down around two-thirds from its 2008 peak. All but one of the 22 commodities fell in 2015. Cotton was up 4%. The worst performance was been natural gas, down 50%. Healthy supplies, lower demand, and a strong dollar, which weighs on raw materials because they are priced in dollars, have been the main problems. The prospect of higher US interest rates can also hamper commodities – they have no yield and thus look less appealing than other assets.

The mood is now so bad that some hope we could have hit the nadir. The American futures regulator has stopped publishing data on commodity index investments, apparently because barely anyone is interested any more. Many economists feel that dividends and budgets have now been cut so savagely, that it feels like industry executives are either at, or close to, capitulation".

The oil glut just keeps getting bigger, with Iranian and Libyan supply now looking set to return to market, and Opec pumping at full throttle to drown the American shale industry.

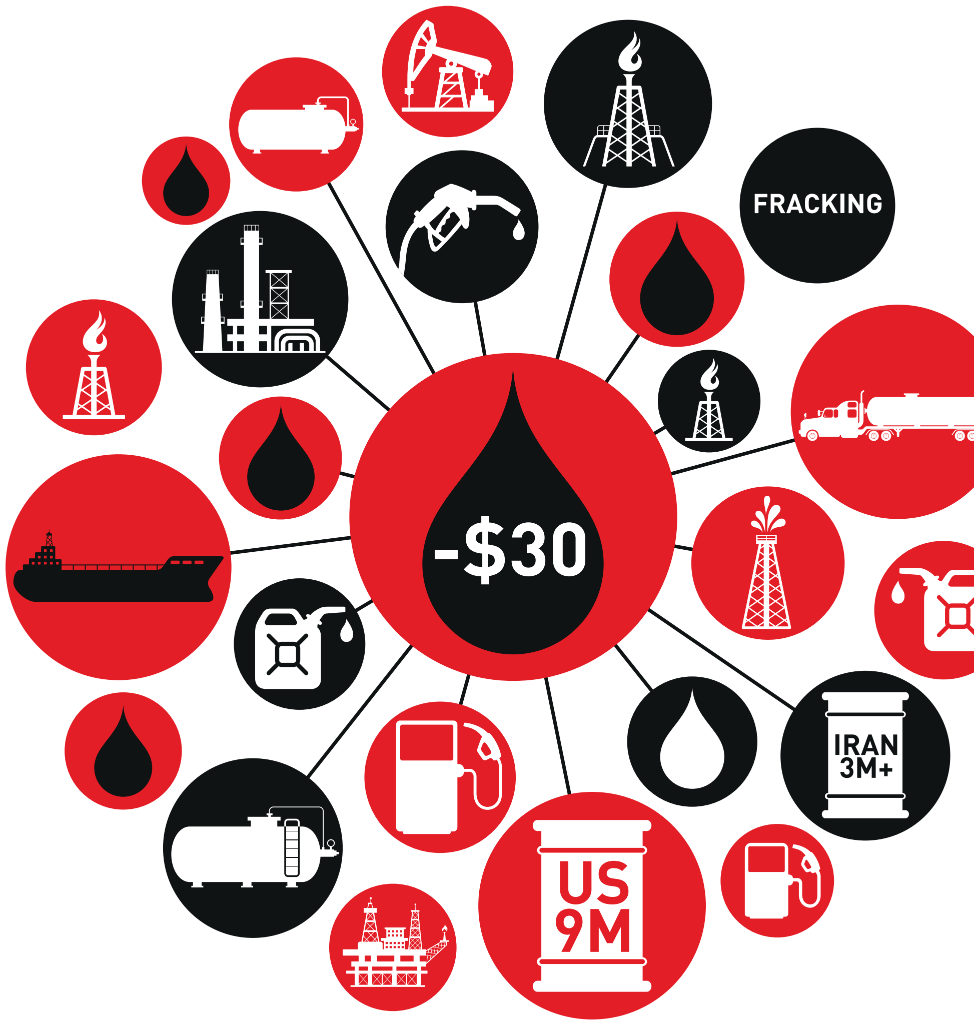
When it comes to the base metals, investors shouldn't get too excited either. Production cuts will take time to come through, and the magnitude of the cuts we have seen so far "is not sufficient to support prices", except potentially in the nickel market, according to Deutsche Bank. "We only expect a price stabilisation in 2017, when the markets start to look more balanced."

The gloom on China, the key driver of metals demand may, however, be overdone. Longer-term, its demand growth is dwindling as the economy shifts away from capital investment. But for now, the outlook is improving. In volume terms, commodity imports rose by 17% year-on-year last month, the biggest jump in two years, says Capital Economics. Recent monetary stimulus and infrastructure spending is "feeding through into domestic demand".

All this suggests that there could be scope for a rally in metals this year. But given the supply picture, the high dollar and relatively subdued demand growth outside the Middle Kingdom, any rally seems unlikely to mark the start of the next long-term up-cycle.

The fund managers we work with remain negative on commodity prices, but will be watchful for opportunities as they arise.

Oil: Lower for longer



From the Arab oil embargo of 1973, people have learnt that sudden surges in the price of oil cause economic havoc. Conversely, when the price slumps because of a glut, as in 1986, it has done the world a power of good. Generally, a 10% fall in oil prices boosts growth by around 0.5%.

In the past 18 months, the price has fallen by 75%, from $110 a barrel to below $27. Yet, this time the benefits are less certain. Consumers have gained but producers are suffering, with the effects spilling into financial markets, damaging consumer confidence. The benefits of ultra-cheap oil may still outweigh the costs, but markets don't seem to think so.

The world is drowning in oil. Saudi Arabia is pumping at almost full tilt, wanting to drive out higher-cost producers from the industry, including some of the fracking firms that have boosted oil output in the United States from 5m barrels a day in 2008 to over 9m now. Saudi Arabia will also be prepared to suffer a lot of pain to thwart Iran, its bitter rival, which has just rejoined oil markets, as nuclear sanctions have been lifted, with a potential output of 3m-4m barrels a day.

Despite the Saudis' efforts, producers remain resilient. Many frackers have reduced their costs to remain competitive. They are unlikely to stop production as long as prices cover day-to-day costs, in some cases as low as $15 a barrel. As supply exceeds demand, the glut will continue to grow, especially if demand slows by more than expected in China and the rest of Asia. Few expect oil prices to start rising before 2017.

Cheap oil has boosted importers, from Europe to South Asia. The euro area's oil-import bill has fallen by 2% of GDP since mid-2014. India has become the world's fastest-growing large economy.

Yet the latest fall is also a source of anxiety. Collapsing revenues could bring political instability to fragile parts of the world, such as Venezuela and the Gulf, and fuel rivalries in the Middle East.

In the past cheap oil has buoyed the world economy because consumers spend more. That is less obvious today. American consumers may have been saving more than was expected and, with regard to government spending, Russia has announced a 10% cut in public spending Even Saudi Arabia is slashing its budget to deal with its deficit of 15% of GDP.

Cheap oil also makes it senseless to spend on expensive exploration projects. As prices have tumbled, so has investment. Projects worth $380 billion have been put on hold. In Brazil, for instance, the harm to Petrobras, the national oil company, from the oil price has been exacerbated by a corruption scandal that has paralysed the highest echelons of government.

The fall in investment and asset prices is all the more harmful because it is so rapid. As oil collapses against the backdrop of a fragile world economy, it could trigger defaults. Oil plays a central role in a clutch of emerging markets prone to trouble. With GDP in Russia falling, the government could well face a budgetary crisis within months. Venezuela, where inflation is above 140%, has declared an economic state of emergency.

Central bankers in rich countries worry that persistent low inflation will feed expectations of static or falling prices.

Policymakers' ability to respond is constrained because rates, close to zero, cannot be cut much more.

The Economist recently concluded that the "oil-price drop creates vast numbers of winners in India and China. It gives oil-dependent economies like Saudi Arabia and Venezuela an urgent reason to embrace reform. It offers oil importers, like South Korea, a chance to tear up wasteful energy subsidies—or boost inflation and curb deficits by raising taxes."

But this oil shock comes as the world economy is still coping with the aftermath of the financial crash. It is important that investment strategies are reviewed to make sure they benefit from prices being lower for longer, rather than punished by it.

Uncertainty in the US

On Wall Street, companies are lining up to deliver their earnings reports for the last quarter of 2015. Solid earnings growth has been a key driver of the bull market that began in March 2009, but recently the momentum has faded. And this quarter will be nothing to write home about, forecasts suggest. The profits of S&P 500 companies are expected to fall by 5% year-on-year. If that proves accurate, it will mark the first time since 2009 that earnings have fallen for two quarters in a row.

One problem remains the strength of the US dollar. Unless it weakens significantly, it will continue to squeeze US company earnings. S&P 500 firms make around half their sales abroad. Meanwhile, the energy sector, which accounts for around 8% of the index, is dragging overall earnings down as the oil price slides. The slowdown in China and emerging markets is another hurdle.

But a new problem is falling profit margins. Since the crisis, companies have slashed costs, put off investment in infrastructure and borrowed at historically low rates. This prompted several quarters of higher profits, even as sales stagnated. The "bumpy, below-par and brittle" recovery, as Morgan Stanley puts it, has kept a lid on sales growth. Now "the margin story is crucially important to the earnings outlook because we're not expecting a ton of revenue growth", says Matthew Peron of Northern Trust.

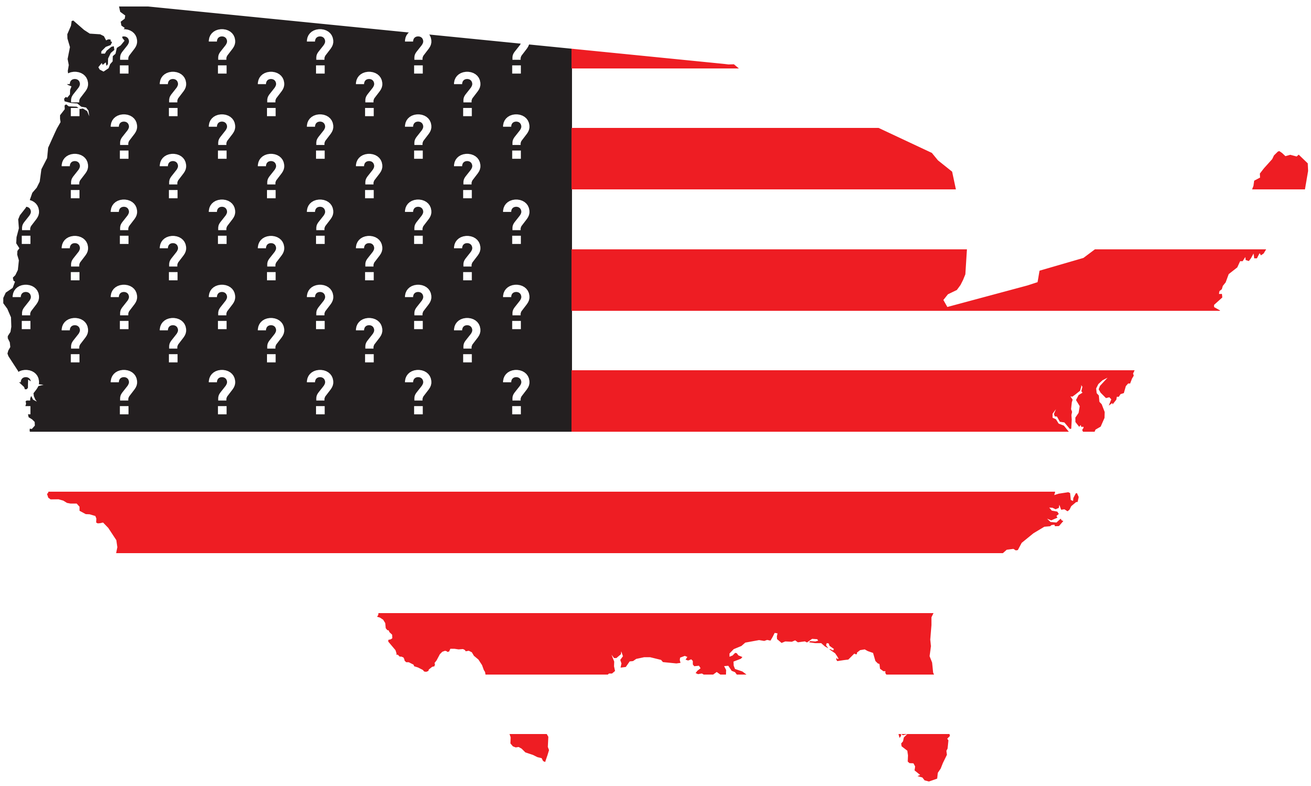
That's something of an understatement. Many economists do not expect any revenue growth. Sales are projected to fall by 4% year-on-year. There's also a limit to how much profit growth firms can squeeze out of tepid sales.

Dwindling margins don't exactly bode well for justifying current US stock market levels. Pricey stocks and falling earnings are an unappealing mix.

At the end of 2015, the Federal Reserve chief, Janet Yallen, increased interest rates for the first time in nine years, promising that further increases were likely as the US moves on from its long period of emergency low rates.

The Federal Bank wants to "normalise" – and raise interest rates back to about 4%. It wants to be a responsible steward of the US economy by ending the distortions caused by its own cheap-money policies. But it knows it must proceed slowly. A quick move to "normal" would be disastrous.

Whatever the Federal Reserve says publicly, US rates are unlikely to see significant increases in the foreseeable future.



Knightsbridge Wealth's senior team and support staff have over 200 years experience in the world's largest Banks

Alexander Wade

Alexander is one of the most experienced London advisers in the international market, specialising in this field over the last 17 years at HSBC, consistently recognised as one of its most accomplished advisers. He has over 21 years' experience in financial services. He is particularly interested in the Middle East market and understands the specific issues which are relevant there.

Stuart Poonawala

Stuart has worked in financial services since 1998. In 2003, he helped to found HSBC's specialist London arm advising international clients which quickly became one of the bank's most successful UK divisions. In 2009, he launched Kubera Wealth, our sister company, focussing on providing quality advice to the UK market.

Graeme Cowie

Graeme is responsible for building our professional connections with international lawyers and accountants, as well as co-ordinating our relationship with key fund managers at a number of international Private Banks and Discretionary Fund Managers. He has spent over 20 years in financial services and investment management, most recently spending more than six years at UBS where he led the Strategic Partnership team.

Adam Young
is the team's Senior Strategic Financial Planner. He previously spent 25 years at Dragonfly Planning and Trust Services, the last three years as Managing Director.

Chris Salacinski
is Strategic Financial Planner and brings to us a high level of technical experience. He is particularly interested in pension planning and is responsible for writing many of our technical articles.

Kelly Kular
is Personal Assistant to the Partners. She previously worked with HSBC for 27 years, latterly as Personal Assistant to the Regional Director for Central London Region.

Kellie Lewis
is our Client Relationship Manager. Before joining us she worked for HSBC for 26 years and has extensive banking and wealth management experience. She spent eight years as a Premier Relationship Manager, looking after a portfolio of High Net Worth Clients.

David Barnard
spent 35 years at HSBC before leaving in 2011. He is our Office Manager, and works closely with our compliance support and partner companies to ensure our rigorous standards of advice are maintained.

Contact us

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