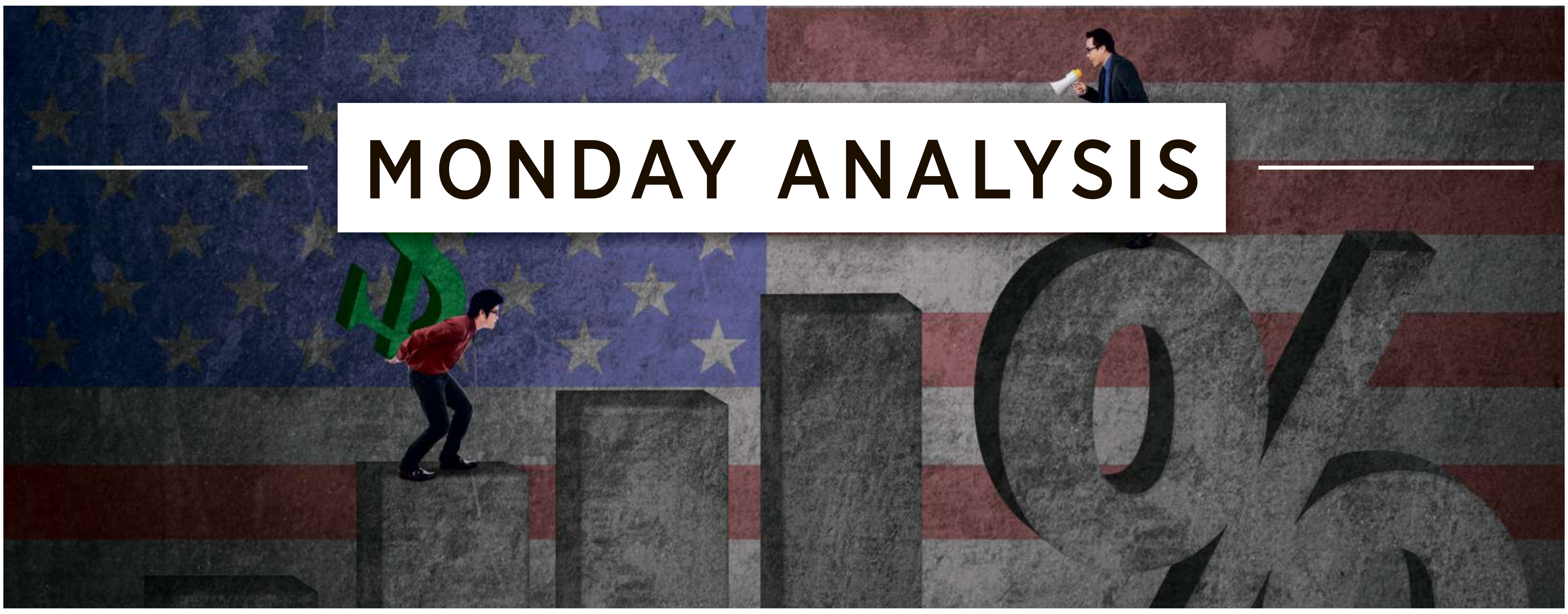

This time it will be different

The market expects an interest rate hike from the Federal Reserve (FED) at the meeting on Dec 16th. The probability of an interest rate increase is 80%. We are as well of the opinion that FED will increase the rate. We have never seen a rate increase when the market assigned probability of an increase less than 70%. We think that prevented FED from a hike back in September: the market was not ready for that. This time the probability is much higher. Moreover, the latest economic figures were quite robust and FED has no excuse anymore not to hike from 0-0.25% level. It would be a first rate hike since July 2006. In history the FED has never been so accommodating for so long. Global repercussions are simply enormous since the global economy got addicted to an easy money policy. Emerging Markets (EM) assets and commodities look vulnerable. For many years, an excess of liquidity was directed to EM. In certain parts of the world that created asset bubbles. Just a few years ago, a cup of coffee in Starbucks in Moscow was twice as expensive as the same cup of coffee in New York; restaurants in Sao Paulo were more expensive than restaurants in London. To an extent that has already been corrected by devaluations in EM currencies with the end of commodities super cycle; still we believe there are more adjustments to come. There are indications that credit cycle is turning at least in EM space. A ratio of rating downgrades to rating upgrades spiked in Q3 2015. That's a bearish signal. We are probably in for a new EM debt crisis, but this time it will be different from previous episodes. The problem will be more at the corporate level, as companies struggle to refinance their external obligations. It is quite clear that Chinese economy has been growing at a much slower pace. Both exports and imports are declining. Chinese firms no longer need the same amount of raw materials. The demand is still robust but the pace of expansion is much slower. Chinese real wages jumped 7.5% in 2014, making it one of the highest increases in the world. China is becoming expensive, and the price for basic services and real estate are becoming one of the highest in the world. That affects not only China but also a number of commodity producers from EM universe. In a case of Chinese slowdown, we see deflationary wave to other EM countries. According to IMF data countries that appear vulnerable on total external debt are Argentina, Turkey, Indonesia, South Africa and Brazil. At some point EM assets will become attractive again but we are not at that point yet. The other asset classes/sectors that will face headwind are Utilities, Telecom and Consumer Staples.

Historically US equities did not perform very well after the first rate hike. Indexes dropped on average by 8% in the first three months after the hike. The median S&P500 company currently trades at a historically high Price to Forward Earnings ratio. In 95 cases out of 100 the companies from S&P500 Index have traded at the lower relative level over the course of the last 40 years. Low interest rates have supported elevated equity valuations, but the S&P 500 Price to Forward Earnings ratio should begin to contract as the Fed raises interest rates. The other warning sign is declining profit margins. Although we do not expect to see recession in the USA in the next year we are not very optimistic on the performance of the broader US market.

What is interesting this time is the fact that FED is on a collision course with European Central Bank (ECB) and Bank of Japan (BOJ). We expect further round of quantitative easing from both ECB and BOJ. That would lead to strength of US dollar. That along with tepid global economic growth would prevent FED from aggressive rate increases in 2016. We expect therefore just one additional FED hike for the entire 2016.

What would be a reasonable allocation for a moderately conservative investor for the next 6-12 months? We think that investors should stick to US Treasuries, Treasury Inflation Protected Securities, USD vs Euro, Japanese and European stock. In the USA we see upside in financial sector and for companies with strong balance sheet and large domestic sales exposure.

> "We expect just one additional FED hike for the entire 2016"

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