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Newsflash

A new month and the 90th issue of Viewpoint from **Financial Partners**.

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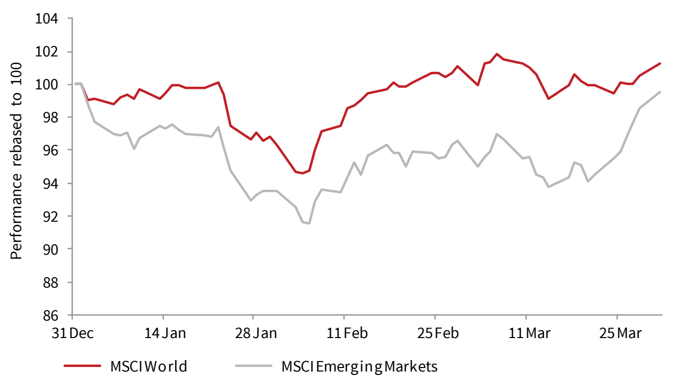
Market Commentary

Despite a news backdrop that gave plenty of reasons for caution - in the short term at least - equity markets overcame a nervous start to the month to finish in positive territory in March. When taken as a whole, the moves over the month were not dramatic but they mask a strong reversal in the second half, with equities in developed markets and, perhaps more surprisingly, emerging markets (EM) staging a recovery. Over the month the MSCI World index returned 0.1%, with the US (+0.8%) and Pacific ex Japan (+1.8%) leading the way, while the UK (-2.7%), Europe ex UK (+0.2%) and Japan (+0.2%) remained subdued (returns in local currency terms). Arguably the biggest surprise was the outperformance of EM, with the MSCI Emerging Markets index adding 3.1% in US dollar terms as EM markets and currencies rallied (+1.9% in local currency terms).

Figure 1: Equities rally into month end



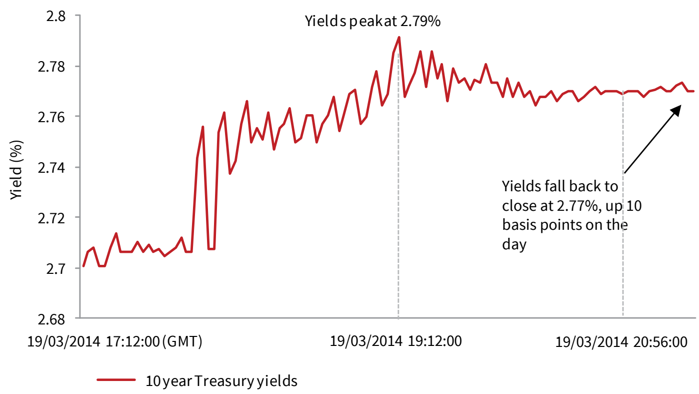
There were three main drivers behind markets last month: firstly, the continuing geopolitical crisis in the Ukraine; secondly, the Federal Reserve's first Federal Open Market Committee (FOMC) meeting under new Chair Janet Yellen; and thirdly the management of, and risks associated with, the evolving deflation of China's credit boom.

The crisis in Ukraine moved rapidly in the early part of the month. Having taken effective military control of Crimea, Russia rapidly engineered a referendum which resulted in an overwhelming majority of voters supporting a return to full Russian control. The West reacted to Russia's subsequent annexation of the region with much indignation and the announcement of a series of sanctions, mostly involving travel and financial restrictions on a number of high ranking Russians. It quickly became clear, however, that the West has no appetite for military action, and is equally unwilling to increase the level of economic sanctions since Europe in particular, with its dependence on Russian gas, would undoubtedly be the loser in the short term.

While real and serious risks remain, it appears increasingly likely that there will be a diplomatic solution, perhaps with the West accepting Russia's annexation of Crimea in return for assurances from Russia that no further moves will be made on other Ukrainian territory or any other ex-Soviet satellites; Ukraine will receive much needed financial assistance from the International Monetary Fund and will move closer to Europe, but will not become a NATO member. As the month progressed the crisis began to ease and investors shrugged off their earlier fears. The expected falls in growth in Russia and Ukraine arising from the crisis will have no material impact on global growth given the relatively small size of these economies (between them Russia and Ukraine are smaller than the UK economy in terms of aggregate GDP).

The second key event in the month was Yellen's first FOMC meeting as Chair. It was no surprise that a further USD 10 billion was cut from the central bank's quantitative easing programme, bringing asset purchases down to USD 55 billion per month. Equally unsurprising was the decision to shift away from quantitative forward guidance - under which the Fed had committed to maintaining interest rates at their current floor until unemployment reaches 6.5% - to a more qualitative approach under which the Fed will rely on a broader range of information and data to inform its decision on the timing of interest rate rises. However, what was not expected was an upward shift in interest rate expectations and an implied earlier start date to the first interest rate rise. This more hawkish tone was confirmed in Yellen's first press conference as Chair, when she referred (perhaps unintentionally) to the first rate rise taking place six months after asset purchases end. The market took this to mean that rates could rise in the second quarter of 2015, earlier than most had expected. Whether the comment represented a slip-up on the part of the new Fed Chair, or was in fact carefully scripted, it initially served to spook investors. Subsequent remarks from various members of the FOMC served to play down these fears and, together with the sluggish data from the economy and continuing very low levels of inflation, this helped to allay investor concerns.

Figure 2: US Treasury yields spike upwards in response to the FOMC's statement

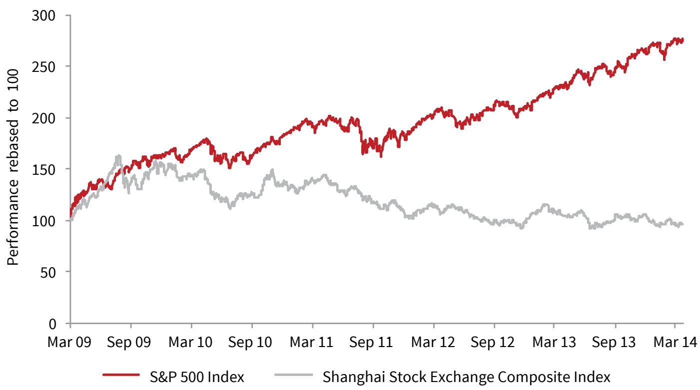


The third and arguably most important development in the month involved China. China's authorities are wrestling with the challenge of reining in an unsustainable credit expansion - with a debt to GDP ratio of over 200% - without triggering a credit crisis. They have also begun to liberalise interest rate and currency markets; a process likely to take several years. During the month the yuan was allowed to weaken further and the daily trading band of the currency was doubled to 2% from 1% previously. In practice this is now sufficiently wide to ensure that, if the authorities permit it, the currency can be determined predominantly by market forces at least on a daily basis. Also this month the authorities allowed the first ever onshore corporate bond default by a Chinese borrower. While small at USD 160 million, it was the message conveyed and not the size of the default that mattered and further defaults can now be expected.

These events unfolded as the Chinese economy continued to show signs of slowing growth. Trade figures were weak, with exports down 18% in February, and inflation fell to only 2% with PPI deflation running at 2%. Retail sales growth slowed to 11.8% year-on-year and industrial production to 8.6%. These signs of sluggish growth relative to China's recent history led to sharp falls in commodity prices, with copper (China accounts for some 40% of global consumption) down by 7% in the month and iron ore also weak. Forward indicators also suggested that growth in China will be relatively sluggish, leading to some talk from authoritative sources that the administration would be prepared to take action to stimulate the economy. This helped the stock market to rally towards the end of the month but it is notable that, five years since global equity markets bottomed post Lehmans, the US equity market has risen by over 170% while China's stock market is down.

Source: Bloomberg. Returns in US dollars unless otherwise stated. March 2014.

Figure 3: Chinese equities moving sideways since 2009



In other economic news there were mixed data from the US but the slowdown seen in the past few months could well have been weather related so the market is waiting for more clarity on the true underlying trend. In Europe the European Central Bank maintained monetary policy but with inflation falling in the euro area to only 0.5%, near post crisis lows, expectations are growing that the ECB will loosen policy again to try to avoid a deflationary spiral. Low levels of inflation globally are giving central banks room to maintain a very loose monetary policy for a considerable time without the fear of triggering an inflationary surge.

Against this mixed background, equities struggled to find direction during March but there was an encouraging return of confidence in EM currencies and markets, which rallied strongly in the latter part of the month. Brazilian equities rose by 7.9% over the month and India by 7.1%, while Russia was impacted by the Ukraine crisis and finished down by 5.2% (returns in local currency terms). Bond markets also made little progress, with government bonds and credit flat.

With the prospects for a steady pickup in the key US economy through the remainder of 2014 and with the Fed's tapering and interest rate policy now well flagged and discounted in the markets, a steadier performance from equities may now be in sight after the wobbles experienced during the first quarter. The encouraging return of some confidence in emerging markets also helps sentiment generally. However there are clear risks on the horizon, notably the impact of tapering in the US as reduced asset purchases continue through the rest of 2014, and the evident dangers of policy missteps and a disorderly unwind of the credit boom in China, meaning that a degree of caution remains appropriate.

Source: Bloomberg. Returns in US dollars unless otherwise stated. March 2014.

Market Performance

Asset Class/Region	Index	To 31 March 2014		
		Currency	Month	Year to date
Equities				
UK - All Cap	MSCI UK NR	GBP	-2.7%	-1.5%
UK - Large Cap	MSCI UK LARGE CAP NR	GBP	-2.6%	-2.1%
UK - Mid Cap	MSCI UK MID CAP NR	GBP	-3.4%	1.4%
UK - Small Cap	MSCI SMALL CAP NR	GBP	-3.1%	2.8%
United States	S&P 500 NR	USD	0.8%	1.7%
Continental Europe	MSCI Europe ex UK NR	EUR	0.2%	3.5%
Japan	Topix TR	JPY	0.2%	-6.7%*
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	1.8%	1.0%
Global developed markets	MSCI World NR	GBP	0.4%	0.6%
Global emerging markets	MSCI EM (Emerging Markets) NR	GBP	3.4%	-1.1%
Bonds				
Gilts - All	BofA Merrill Lynch Gilts TR	GBP	0.0%	2.3%
Gilts - Under 5 years	BofA Merrill Lynch Gilts TR under 5 years	GBP	-0.1%	0.4%
Gilts - 5 to 15 years	BofA Merrill Lynch Gilts TR 5 to 15 years	GBP	0.1%	2.5%
Gilts - Over 15 years	BofA Merrill Lynch Gilts TR over 15 years	GBP	0.1%	3.4%
Index Linked Gilts - All	BofA Merrill Lynch Inflation-Linked Gilts TR	GBP	1.5%	3.2%
Index Linked Gilts - 5 to 15 years	BofA Merrill Lynch Inflation-Linked Gilts TR 5 to 15 years	GBP	0.8%	2.5%
Index Linked Gilts - Over 15 years	BofA Merrill Lynch Inflation-Linked Gilts TR over 15 years	GBP	2.1%	4.0%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	-0.1%	2.5%
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.3%	1.6%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.1%	2.9%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.2%	3.0%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.9%	3.8%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.4%	2.4%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	0.5%	3.0%
Global Government Bonds	JP Morgan Global GBI	GBP	0.1%	2.0%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	GBP	0.2%	1.7%
Global Convertible Bonds	UBS Global Focus Convertible Bond	GBP	0.2%	3.0%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	GBP	1.7%	2.7%

* *estimate*

Source: Bloomberg

Market Performance

Asset Class/Region	Index	To 31 March 2014		
		Currency	Month	Year to date
Property				
UK Direct Property	UK IPD All Property TR	GBP	0.0%*	2.3%*
Global Property Securities	S&P Global Property USD TR	GBP	0.9%	2.8%
Currencies				
Euro		GBP	0.2%	-0.5%
US Dollar		GBP	0.5%	-0.6%
Japanese Yen		GBP	-0.9%	1.3%
Commodities & Alternatives				
Commodities	RICI TR	GBP	1.1%	4.2%
Agricultural Commodities	RICI Agriculture TR	GBP	5.9%	11.6%
Oil	ICE Crude Oil CR	GBP	-0.6%	-3.9%
Gold	Gold Spot	GBP	-2.9%	5.8%
Interest Rates			**Current rate**	**Change at meeting**
United Kingdom	6-Mar-14	GBP	0.5%	-
United States	19-Mar-14	USD	0.3%	-
Eurozone	3-Apr-14	EUR	0.3%	-
Japan	12-Mar-14	JPY	0.1%	-

** estimate*

Asset Allocation Dashboard

Positive | Neutral | Negative

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Neutral
European equities (relative to developed)	Neutral
US equities (relative to developed)	Negative
Japan equities (relative to developed)	Neutral
Emerging market equities	Positive
Fixed Income	
Government	Negative
Index-linked (relative to government)	Negative
Investment grade (relative to government)	Neutral
High yield	Negative
Loans	Positive
Emerging market debt	Positive
Convertible bonds	Neutral
Alternatives	
Commodities	Neutral
Property (UK)	Neutral
Currencies	
Dollar	Neutral
Euro	Neutral
Yen	Negative

For more information, please contact your adviser or alternatively contact:

Financial Partners Ltd.
泛柏資產管理有限公司
24/F, Kinwick Centre
32 Hollywood Road
Central, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
client.services@f-p.hk
www.f-p.hk
A Member of Wealthnet

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