MARKET BULLETIN

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ST. JAMES'S PLACE
WEALTH MANAGEMENT

Records continue to tumble

- US and Japanese stocks continue their upward curve
- Inflows into Japanese funds from domestic investors reach record highs

Despite increasing debate over the long-term sustainability of the Federal Reserve's support, US stocks hovered around record peaks and the US dollar reached a three-year high against most other major currencies. Over the week, the S&P 500 rose around 1.5%, contributing to a rise of more than 16% in dollar terms for the year to date. The FTSE 100 also experienced a strong week, gaining almost 1.5%, but the big winners once again were investors in Japan. The Nikkei 225 Average rose 3.6% for the week and is now more than 45% higher than the start of the year in yen terms, reaching its highest level since December 2007 as it pushed through the 15,000 barrier.

From being one of the most unloved areas, Japanese funds are now seeing record inflows across the globe. Overall, $6.8 billion was invested into Japanese equity investments last week, comfortably outpacing the $3.4 billion invested into bond funds (source – EPFR Global). This recent surge highlights the demand for equities triggered by global central bank action, which has depressed bond yields and encouraged hopes of stronger economic growth. The Bank of Japan's aggressive bond-buying scheme has fuelled expectations that Japanese investors will shift funds into overseas assets, but 70% of the net weekly inflows into Japanese funds were yen-dominated, suggesting investors are bringing money home and committing it to domestic asset classes. Putting these figures into context, weekly inflows into European equities were a more modest $468 million which, while on the increase, is far below the levels for Japan or bonds. Despite the strong inflows into equities, evidence of a 'great rotation' out of fixed interest markets remains scant.

In conditions such as these, investors need to be careful not to get ahead of themselves and treat with caution newspaper headlines suggesting that stockmarkets could treble over the next 10 years. Whilst there is an obvious temptation to 'chase markets', a balanced investment approach that provides diversification, scope for capital preservation and appropriate exposure to risk is more likely to be in the best long-term interests of an investor.

King's Speech

- Sir Mervyn King predicts low interest rates and less persistent inflation
- Paul Read explains why he believes there is still opportunity within the bond market

Presenting his last Inflation Report as Bank of England governor, Sir Mervyn King stated his view that a recovery from Britain's slump is in sight, but offered little consolation for savers or income-seeking investors. He predicted interest rates would stay as low for another four years, although did add that inflation would not be as much of an issue over this period. This outlook offers little hope of respite for savers suffering from years of record-low interest rates and experiencing further pain from the Funding for Lending Scheme, which has reduced the need for banks to attract deposits.

In order to beat inflation and provide a real return, the primary solution is a diversified portfolio of income-yielding assets such as equities, bonds and property. In equity income markets, the scope for diversification continues to increase as the 'dividend culture', traditionally the preserve of the UK and US companies, now extends across the globe. In Asia and the emerging markets, companies' management are now fully aware of the benefits of offering sustainable dividends to shareholders, attracting additional investment from overseas.

Within fixed interest, high yields are proving harder to find than in previous years, with conditions normalising post-credit crisis. In 2009-2010, when bank lending had all but dried up, it was relatively easy to find quality bonds paying in excess of 5%. Achieving these yields now is more difficult, with most quality companies regaining enough trust so that 'investment-grade' businesses can borrow at far lower levels. Paul Read of Invesco Perpetual, recently commented, "High yield bond yields have fallen in the recent rally. We think there is less value in the market now but they remain relatively high compared to the low yields available on core government bonds, like UK gilts and German bunds, and the highest credit quality corporates. We believe we can still find opportunities, most notably in banks and other financials. Rising capital levels, ongoing structural reform and implementation of new, more conservative banking sector regulations should be supportive of subordinated bank debt for many years. In our opinion, aggregate yields on this type of debt offer value."

While unveiling the Bank of England's quarterly Inflation Report, Sir Mervyn said that he expected growth in the second quarter of this year to "strengthen" to 0.5%, following a 0.3% expansion in the first three months. Growth over 2013 is now projected by the Bank to come in at around 1.2%, up from its 1% forecast in February. Sir Mervyn also said that the annual inflation rate is likely to drop to the Bank's official target of 2% within two years, having previously warned that the rate would remain above this level over the forecast period. During Sir Mervyn's extensive media appointments last week, he was also hugely critical of Chancellor George Osborne's Funding for Lending Scheme. He said that he was sure that there was no place for such a scheme in the long run, and it was too close to being a guarantee of all mortgages. Sir Mervyn said, "We had a very healthy mortgage market, with competing lenders attracting borrowers before the crisis, and we need to get back to that."

There was, however, some disappointing news from the Office for National Statistics on the performance of the labour market. It reported that employment fell by 43,000 in the first quarter of 2013, while unemployment grew by 15,000. The jobless rate rose 0.1% to 7.8%, with 2.52 million people officially out of work. Analysts said that the strong performance of the labour market last year, when surprisingly strong jobs growth was recorded, seemed to be petering out. The report also revealed that average pay, excluding bonuses, rose by just 0.8%, well below the annual inflation rate of 2.8%. This means that most workers are still experiencing pay cuts in real terms.

Lloyds hit break-even level

- The government breaks-even on their bailout of Lloyds
- Adrian Frost and Adrian Gosden explain why they recently purchased the stock

Last week saw the share price of Lloyds Banking Group pass the 61.2p 'break-even' point at which the taxpayer is in profit after the much-publicised £20.5 billion bailout by the UK government in 2009. Investor sentiment has improved substantially over the intervening period, further boosted by expectations that the bank can return to profitability in 2013. While the Treasury is adamant there will be no immediate sale of the shares, most analysts expect some action before the next General Election in 2015.

Unsurprisingly, most major UK banks have been unloved by many investment managers, although for some this is changing. Adrian Frost and Adrian Gosden of Artemis Investment Management recently opened a new position in the bank, commenting, "At every juncture management is trying to return the bank to being a pretty boring entity which will generate a substantial amount of capital. Once it has achieved its regulatory ratios, Lloyds will have no other purpose for this surplus and dividends beckon. We can see why these shares could trade on a higher multiple to the book price. We see a pretty good total return over the next couple of years and in time a decent dividend. Although the market is fully aware of this possibility, we feel this is not recognised in the current valuation."

Invesco Perpetual and Artemis Investment Management also manage funds for St. James's Place.