SPECIAL INVESTMENT BULLETIN

ST. JAMES'S PLACE
WEALTH MANAGEMENT

Monday 24 June 2013

Equities: where next?

Investors have experienced a return of market uncertainty in recent weeks. Global equity markets have been subjected since late May to a level of volatility last seen in the aftermath of the financial crisis of 2007-2008. Following a seemingly continuous rise in equity prices since the beginning of 2013, investors have recently had to get used to very different daily news stories.

Equity markets have risen over the past 12 months on signs of recovery in the global economy and central bank action. A slow but definite improvement in the global economy, particularly in the US, is now emerging. And crucially, in the short term, central bankers have taken concerted and radical steps to avert an economic crisis to follow the financial woes of 2008/2009.

Trillions of dollars of liquidity has been pumped into developed economies over the last year, as central bankers take unprecedented steps to ensure recovery, from European Central Bank president Mario Draghi's promise in June 2012 to "do whatever it takes" to protect the eurozone, to the Bank of Japan unveiling its quantitative easing programme in April. The most significant, of course, has been the US Federal Reserve's commitment to pursue its $85bn-a-month asset purchase scheme.

And equity markets have responded well to this monetary policy stimulus. the S&P 500 index closed on 22 May at an all-time of 1669. The FTSE 100 rested at 6840 the following day, before its subsequent descent; as did Germany's DAX index, reaching just under 8531; and Japan's Nikkei 225 at 15627. However, the following days and weeks have brought a series of sharp sell-offs followed by modest gains.

The equity market correction was triggered by the US Fed chairman Ben Bernanke's hint at the end of May that there could be a scaling back of the third round of quantitative easing (QE3). Bernanke raised the possibility of a wind-down of the pace, or taper, of the programme on the basis of improved US economic data. Markets, however, heard the word tightening rather than tapering - and equities took a tumble.

Last Wednesday, Bernanke, following the Federal Open Market Committee's June meeting, confirmed that the beginning-of-the-end of QE3 is in sight. He said a gradual reduction of the monthly asset purchase programme would begin later this year, if the US economic outlook improves as predicted. And the tapering of QE3 would continue until mid-2014 assuming the US unemployment rate falls to 7%.

Bond yields rose and the US dollar strengthened on Bernanke's statement, while equity markets around the world took fright and underwent further corrections. The FTSE 100 fell 3% last Thursday, its largest dip since September 2011. The S&P 500 index was down 2.5% on the same day; while the German DAX index lost 3.3%.

The S&P 500 index closed the week down 2.7%, which was its largest drop this year. The FTSE 100 index fell just over 3.0% over the period to its lowest point for five months, while the Eurofirst 300 index fell 3.68% to its lowest level this year. However, the Nikkei 225 Average gained 4.28% over the week on separate factors, including a weakening yen and less volatility in the Japanese bond market.

Meanwhile, Chinese markets opened this week with a move into bear market territory as concerns grow over a credit bubble. The CSI 300 Index, which contains the largest firms on the Shanghai and Shenzhen stock

exchanges, slumped 6.4%. The fall came as Chinese authorities over the weekend pledged to fine tune existing monetary policy and blamed the shadow banking system for a rise in money market rates.

After last week's FOMC meeting, markets again misinterpreted the Fed's stance as a tightening of policy. The distinction between tightening and tapering is vital: a gradual reduction of a course of action on firm parameters is not a sudden abandoning of policy. The nuance, however, was lost on a reactive market.

Crucially, Bernanke last week gave no indication of plans to start to sell assets acquired during QE or that official interest rates will rise at any time soon. The Fed will pace its tapering of the bond purchase programme on the outlook for the world's largest economy. The US is timing its gradual reduction of QE on signs of improved economic momentum – and that is a good thing for the rest of the world.

'Don't fight the Fed'

The Fed's QE3 programme is built on a twin mandate of tackling unemployment and inflation. An improvement in the US economy is good for underlying business; and a tapering of QE a recognition that it is succeeding. Investors and markets need to remind themselves that the health of the world's largest economy remains crucial for everyone's wealth.

Past performance is not indicative of future performance.

US central bankers are performing a delicate balancing act. Too sudden an end to QE would risk creating market uncertainty, falling equities and rising bond yields. No exit schedule – an approach labeled last year as 'QE infinite' – would encourage a potential bubble in equity markets. The Fed's plan to taper QE on the right indicators will continue to ballast the economy as it pursues a gradual retreat to a clear timescale.

After the previous FOMC statement in May, Bernanke was criticised for the lack of clear guidance on his plans, and creating confusion over the pace and degree of policy change ahead. However, his message this month was his clearest signal yet on future policy, even if markets in Asia, Europe and the US reacted adversely. In our view, the clarity of this exit strategy makes talk of a market collapse or bubble sound increasingly misplaced.

The reaction of equity markets over the last month reveals, if anything, how they have come to rely on QE. The US Fed's monetary policy has its critics but there is broad support for the programme. Bernanke is taking a clinical, evidence-based approach to the difficult task of gradually easing the US and world economy away from QE.

Centre-stage whispers

Markets and investors will continue to hang onto any signs of where government and central bank policy will go next. Jamie Cumming of Aberdeen Asset Management identifies European policymakers' ongoing resolve in the debt crisis and Japan's QE programme as key policy moves driving equity markets in the second half of 2013.

In Japan, Prime Minister Shinzo Abe's 13 trillion yen ($150 billion) move to salvage the moribund domestic economy, known as 'Abenomics', has driven the strong growth of its equity market in 2013. The Nikkei 225 index has delivered the strongest performance among the main developed markets this year, before doubts about the 'Abenomics' experiment triggered a fall of more than 20% from its peak. Bizarrely, Tokyo's index entered 'bear market' territory in mid-June, despite having risen 26% since the beginning of the year.

In Europe and the UK, two major policy moves in July 2012 preceded the almost year-long steady growth of equity values: Draghi's unconditional promise to protect the eurozone and the Bank of England holding to its £375 billion asset purchase programme. The ECB's stance has eased financial tension in Europe, despite its recession. Osborne's QE programme proceeds steadily, even if the public deficit remains largely undented.

Europe's financial markets have shown robust ability to brush-off uncertainties such as Italy's protracted general election and Cyprus' financial restructuring, says Stuart Mitchell of SW Mitchell Capital. "The ECB has struck the right balance for recovery with a mix of austerity, monetary action and regulatory and fiscal harmonization", says Mitchell. And he remains positive that the region still offers value despite the recent strong performance of its equity markets.

Meanwhile, the Bank for International Settlement (BIS) at the weekend called on central bankers and governments to focus on inflation and economic growth. The Basel-based international organisation for central bankers said that the global economy was heading towards recovery and that "forceful and determined" policy had bought time and averted crisis. The BIS believes the time is right for a gradual move away from quantitative easing measures.

But, the broad church of opinion is that, for now, loose monetary policy is the right approach to global economic ills. The proof of its success will be whether or not the Fed and other central banks can continue to steer the US and the world economies to a safe distance from the financial crisis.

Recovery signs?

A strong economy is, of course, a mutual goal for investors, business and policymakers. George Luckraft of AXA Framlington says an improved economic environment has to be good for companies. "Equity markets appear attractive as long as investors are able to look through the inevitable bursts of volatility which occur when policies change", he adds.

Stock markets, however, have been running ahead of both earnings and economies. Europe, for example, experienced a fall in real GDP at an annualised rate of 0.9% in the first quarter of 2013, while the MSCI Europe index was up 81% from March 2009. However, Peter Oppenheimer, chief global equity strategist at Goldman Sachs, argues that the dislocation between global economic and equity performance is "not as crazy as it might seem". He believes that weak economic activity is likely to be temporary. "The global economy is showing clear signs that it is moving towards a recovery later this year with inflation controlled, despite the concerns surrounding a slowdown in quantitative easing."

Sheep-walking?

Despite the recent correction, the fact remains that equities have had a strong run. QE has driven investors into higher-risk assets, yet equities still offer good value and income opportunities relative to other asset classes. Bond yields are still low and cash is offering effectively zero returns. With inflation rising to 2.7% in

May, Moneyfacts reported last week that not a single standard savings account in the UK is delivering a positive after-tax real return.

Current volatility is still a blip in the wider sweep of markets or recent financial history but inevitably can lead to investor nerves and uncertainty, talk of bubbles, quick exits and makeshift alternatives. "Like sheep, markets are volatile at the best of times, and all the more so when distorted by $7 trillion of quantitative easing, but today's equity markets show very few of the characteristics associated with bubbles", is the view of Artemis Investment Management.

Shares are no longer cheap, but nor are they expensive in comparison to previous peaks. Initial public offering and merger and acquisition activity is muted and trading volumes are low. "This is not the stuff of a crash", adds Frost. Indeed, a lack of liquidity is one of the key factors driving market volatility. Stock market volumes have halved in the last three years, as the banks have reined in their trading activity in the aftermath of the financial crisis. These lower volumes are seen by many as the new normal.

In these conditions it is easy to be swept up in the daily and weekly shift in market sentiment. Investors should step back and take the long view on both the recent rally and correction in the last few weeks. They need to recognise that pockets of value still exist and remember these can be exploited within a diversified portfolio.

"The 'stock market' is a 'market of stocks'", reflects Ian Lance of RWC Partners, "therefore our portfolio is usually made up of a mix of the expensive, the fairly valued and the cheap at any point in time", he adds. Lance quotes Warren Buffett, the grandee of US investment, to explain why he looks to companies not markets when building the fund, "Mr Market is there to serve you not to guide you".

Lance explains: "So long as you are invested in good quality, well-financed businesses with the ability to compound cash flows over long periods of time, do not worry too much about the day-to-day volatility in the share price, other than to possibly add to your investment when 'Mr Market' is feeling gloomy and prices get marked down."

On the back of the wise words of the 'Sage of Omaha', "Try to sit back, relax and let the miracle of compounding work its magic," adds Lance. Volatility or no volatility…

Back to basics

In a volatile market it is important to keep focused on long-term objectives and avoid the destruction of value that can come from reacting to market fluctuations. Markets and investors over the last year have had a phenomenal run. With a shortage of alternatives for growth and income in current markets, equities still offer value.

There are signs that the US and UK economies are in recovery. Weaning markets off a reliance on central bank intervention is necessary to restore normal investment conditions where fundamentals drive returns. With interest rates likely to remain low for an extended period, a judicious combination of equities, bonds and property with attractive yields is likely to deliver returns for disciplined long-term investors.

Jamie Cumming, George Luckraft and Ian Lance also manage funds for St. James's Place.

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