MARKET BULLETIN

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WEALTH MANAGEMENT

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Sun shines on markets

- Signs of economic recovery prompt UK and US equity markets to extend their winning streaks

The records kept tumbling for equity markets last week after news of the lowest US unemployment rate in four years fuelled hopes that the world's largest economy was on the road to recovery. This was despite mounting concerns about the wider global growth picture and dovish signals from the US and eurozone's central banks.

US non-farm payrolls increased by a bigger-than-expected 165,000 in April and there were upward revisions to figures for the preceding two months, bringing the jobless rate down to 7.5%, the lowest since December 2008. The figures went a long way towards assuaging fears of another 'spring slowdown'. "Today's report unequivocally corroborates our view that the period of slower growth that the US has entered at the end of the first quarter is merely a temporary breather, rather than the beginning of a lasting downward trend," said Harm Bandholz, chief US economist at UniCredit.

In a further boost to sentiment, in April the UK's dominant services sector recorded its strongest growth in April since last summer's Olympic Games, providing a further indication that the slow economic recovery may be gaining some traction. This news followed similar surveys earlier in the week showing that both the manufacturing and construction sectors had also surpassed market expectations.

The S&P 500 powered through the 1,600 level for the first time ever, while the Dow Jones Industrial Average also entered new territory as it traded above 15,000. The US jobs news on Friday also sent the FTSE 100 to its best intraday level since December 2007 before closing at 6,521.46, a rise of more than 1% over the week. Before then, and by eking out a gain of 0.3% over the course of April, the UK's benchmark index had risen for 11 consecutive months, marking its longest winning streak since its inception in 1984. Similarly, the S&P 500 has closed higher every month since November – its best run for 15 years.

European equities also got in on the act. Further boosted by the European Central Bank's decision to cut interest rates (of which more later), the FTSEurofirst 300 rose 1.85% on the week to its highest level since June 2008. German equities crested all-time highs as the benchmark DAX Index jumped 3.9%.

Asian markets though were unable to complete a full house. Concerns about domestic earnings and the outlook for the global economy dragged Japan's Nikkei 225 Average down 1.37% by the end of the week. That said, the index has risen 58% since November.

Centre stage for central banks

- ECB cuts interest rates as eurozone recession fears deepen
- Central banks' policies continue to signpost markets

The news from the UK services sector led economists to speculate that the Bank of England (BoE) would resist a further round of quantitative easing at its two-day policy meeting which begins tomorrow, given the better-than-expected GDP figures and allowing more time to see whether the newly extended Funding for Lending Scheme is having the desired effect of encouraging small and medium-sized enterprises to expand and invest.

In a speech in Canada on Wednesday, incoming governor Mark Carney reaffirmed his desire to change the way the BoE controls the economy by assuring households and companies that borrowing rates will remain ultra-cheap until economic

conditions improve, even though inflation might remain above target for longer. Michael Saunders, an economist at Citigroup, said the speech was "a breath of fresh air" because it showed Mr Carney would seek to correct widespread misperceptions that interest rates might rise soon.

However on Thursday, in response to below-target inflation, rising unemployment and the likelihood of deeper-than-expected recession this year, the European Central Bank (ECB) was, as expected, prompted to cut interest rates for the first time in 10 months. In announcing the lowering of its main refinancing rate by 0.25% to 0.5%, ECB president Mario Draghi said the bank remained "ready to act if needed" and also that he had an "open mind" about imposing negative interest rates, under which commercial banks would, in effect, be charged for depositing money at the central bank.

"In terms of markets, fears that the ECB would fumble in the Great Global Central Bank pass-the-liquidity-parcel game were eased as Draghi kept his options open more than he perhaps might have been expected to do."

Jim Reid, strategist at Deutsche Bank

Interestingly, such an arrangement already exists in Denmark, where the central interest rate is 0.2%, but to encourage banks to lend, certificates of deposit with the Nationalbanken return -0.2%. Doubts remain about the consequences of negative rates and, whilst the ECB's decision to cut rates should provide troubled banks in the region's periphery with some much-needed support, it will not be sufficient to drag the eurozone out of recession on its own. Meanwhile, Mr Draghi continued to stress that the ECB could not engage in monetary financing by buying governments' debt, which leaves it still lagging far behind other central banks in its support for the economy.

In the US, the Federal Reserve stepped back from previous hints that it might slow the pace of its asset-purchase scheme, saying that it would raise or lower the level of its buying as economic conditions evolved. But the healthier the US economy becomes, the more inclined the Fed will be to trim its asset purchases. What remains to be seen is what threat that poses to a stock market which has undoubtedly been supported by the continued liquidity provided by the Fed.

What central banks around the world want is for companies to borrow and investors to buy riskier assets. Their actions, or indeed merely suggested actions, and the ensuing low interest rates appear to be sufficient to sustain the rally in stocks, bonds and credit. With rates so low, investors will buy stocks, particularly if they are among the 55% of S&P 500 stocks that pay a dividend higher than the yield on 10-year treasury bonds.

And they will also, it seems, continue to buy bonds. At $80 trillion, the global bond market is double the size of the global equities market. In the aftermath of the ECB's announcement to cut interest rates, eurozone bond yields fell further. German 10-year yields fell to within a whisker of last summer's record low and Italy's 10-year sovereign yield fell below 4% for the first time since late 2010. Despite crippling unemployment levels and an economy on the floor, even Spanish yields dropped to 3.96%, down from a euro-era record of 7.75% in July last year. There are also investors willing to lend to Mongolia for 10 years at 5.12%, Zambia at 5.62% and the Dominican Republic at 5.87%. Buying such high-yield bonds at record-low yields illustrates the changing attitude to risk of investors striving for better returns, but does it also suggest complacency?

The 'magic potion' of global QE is still working for now, and rising prices may yet spark the economy back into life.

Remember the basics

- Making your money work hard and countering the threat of inflation remain at the core of an investment strategy

Although the outlook for savers continues to look bleak, cash remains a crucial element of any investment strategy as the right home for money that might be needed in the short term. Whilst interest rates have been squeezed all round, savers should still take the time to ensure they are getting the 'best of a bad lot'. Yet a recent study by Consumer Intelligence found that 11 out of 12 people with easy-access accounts have not switched in the last year, while more than half have had the same account for more than five years. A reduction in accounts offering introductory bonuses may be partly responsible as the incentives to switch become increasingly elusive – the number of easy-access accounts with bonuses has fallen 68% from 101 to 32 over the past two years.

Given the noises coming from the incoming BoE governor, Mr Carney, savers, investors and borrowers should be alive to the prospect of inflation levels remaining considerably above the 2% target for some time yet. That might be good news for those with interest-only mortgages, about whom the weekend press expressed much concern, because in real terms their debt will reduce faster. However, even at 3.1% – the average rate of CPI inflation over the past six years – the value of money would halve in 23 years, presenting an obvious challenge for those needing to build capital or maintain a standard of living in retirement. The solution is to invest in assets capable of keeping pace with inflation.

Equities have a proven track record of beating inflation over the longer term. Despite the recent stock market rally, the FTSE 100 Index is yielding just over 3.5% net of basic rate tax. Using similar arithmetic, by reinvesting dividends alone – without any growth in share prices – investors could in theory, double their money in 20 years, although this of course cannot be guaranteed and will depend entirely on how well the underlying investments perform. Equities are just one element of a diversified portfolio strategy that has historically proved the best way to shelter investors from the fluctuating fortunes of different asset classes.

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