MARKET BULLETIN

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Minsky moments?

World markets this week are back in business after the Easter lull, with global investors looking ahead to what the rest of the second quarter holds after a first quarter marked by volatile equity markets and a rally for bond markets. The US Federal Reserve's gradual taper of its quantitative easing programme is heading, at its current pace, towards an exit point later this year. Meanwhile, investor concerns linger over the lack of reaction from the European Central Bank to the risk of ultra-low inflation tipping into deflation. But the slowdown of emerging markets and the Chinese economy look to be the crucial developments for world markets over coming months; together with Russia's designs in Ukraine and on other former Soviet Union territories.

Strong US economic data has pointed to the first-quarter weakness as weather-related rather than signs of a deeper malaise. Retail sales in March rose by the most since September 2012, while industrial production last month exceeded expectations. US government bonds came under pressure, however, as uncertainty continued over Ukraine. Ten-year US Treasury yields rose 8 basis points (bps) last Thursday to 2.72%. Fed chair, Janet Yellen, has continued to try to corral market conjecture on an early US interest rate rise. Yellen last week suggested that the US economic recovery might not be able to push inflation to her 2% target, which would raise the need to keep interest rates at near zero for longer. The comments in New York have already helped delay market expectations of a rise in the second quarter 2015 until the second half of the year.

As US President Barack Obama tours the Asia-Pacific region, markets will be focused on Chinese manufacturing data as an early indicator of second-quarter growth. China's annualised growth slowed in the first quarter to 7.4% from 7.7% in the last quarter of 2013, and fund manager Schroders expects a further slowdown. "Hopes of stimulus are overblown, as we don't expect to see more than minor measures," comments Schroders' economist Craig Botham. Investors need to be confident that Beijing can de-leverage the Chinese economy without a 'hard landing' and a collapse of asset values or 'Minsky moment' (as in the 1998 financial crisis). "Such fears will have aided the performance of bonds and contributed to the continued underperformance of emerging market equities," adds Schroders.

Easter bulls

Global stocks ended the Easter week amid positive US earnings releases and the further good news that the world's largest economy continues to strengthen. The S&P 500 index closed up 2.7% over the period, which was its best weekly performance in nine months, and on Monday made a further 0.4% gain to 1,872 points. After losses in recent weeks for US technology companies, investors piled back into momentum stocks. Although quarterly growth from the technology sector was not as strong as anticipated, US banks' earnings were well received. The bullishness was reflected in the CBOE VIX index, or 'fear gauge', which was down 20% over the week.

In Europe, the FTSEurofirst 300 ended the holiday week up 1.2%, making a 0.5% gain on Thursday, to close at 1,329 points, despite some disappointing quarterly results and the mounting concerns over Ukraine. Beverage groups faced with a drop of sales in Asia, particularly in China, weighed on the pan-European index, as well as the FTSE 100 index. However, positive US corporate news, together with a rally for insurers and asset managers, contributed to a 1% advance for the FTSE 100 over the four-day week, with a 0.6% gain on Thursday to 6,625 points. The UK's supermarkets, which are embroiled in a corrosive price war, however, retreated further before the Easter holiday break, with Tesco, J Sainsbury and Wm Morrison losing ground.

In Asia, the Nikkei 225 Stock Average ended the week up 4%, after the index had hit a six-month low in the previous week amid concerns over the Japanese recovery. The Nikkei on Tuesday lost 1% and closed at 14,389 points. Worryingly for Japan's foreign market-focused conglomerates, the trade deficit is wider than ever as exports remain flat and imports mount. As production moves offshore, Japan's economy is rapidly becoming more investment-led. China's slowdown has pushed investors towards the yen, and Schroders warns that a deterioration for Japan's largest trading partner would push the yen higher and hit equity markets.

Asset reflation

Equity markets over the first three months of the year may have struggled to follow on from the performance in previous quarters in 2013, but they remain near highs across the developed nations. The S&P 500 has almost tripled in value since the trough after the financial crisis in March 2009. The Bank of America Merrill Lynch reports that the proportion of investors who think stocks are overvalued is now the highest since July 2000. Global growth is still slower than hoped for, with the International Monetary Fund forecast for 2014 trimmed slightly to 3.6%. And troubles in emerging markets have continued to prompt money to flow back to perceived safe havens. Corporate and government bonds, in these conditions, are back in favour in 2014.

However, the early signs are that this is not a reversal of the 'great rotation' into stocks that was one of the main investment themes in 2013, but a broader rebalancing between assets, or an 'asset reflation'. Investors in 2014 are buying both equities and bonds, rather than selling bonds to buy equities. Consequently, the retail flows into bonds would suggest there is no support for a bearish view of bond markets; and although there is less flow into equities, investors are still broadly supportive of equities. Equity markets are unlikely to replicate the returns generated in 2013, but long-term investors can still hope for healthy returns this year that are supported by the steady, if slower-than-expected, economic recovery across the developed economies.

Moreover, the volatility experienced by momentum-driven Wall Street stocks, as well as in emerging markets in recent weeks, underlines the futility of market timing and the advantages of a long-term investment strategy and a balanced portfolio of assets. Reflecting on the herd-like instincts that prevail in the short-term investment strategies that were on display in the first quarter, fund manager John Wood of J O Hambro observes that trend-following drives asset prices further from real values and risks asset bubbles. "Tech was the investment story of the hour but has been horribly undermined in recent weeks," adds Wood. "Quality compounders, the 'dull' stocks we seek out, remain out of favour. That's fine. We don't want to run with the herd."

Small beginnings…

Mary Poppins enthusiasts may remember the scene where the Fidelity Fiduciary Bank directors entice the young Michael to invest for the long term in their institution. "If you invest your tuppence wisely in the bank, safe and sound, soon that tuppence, safely invested in the bank, will compound." Headstrong Michael's insistence on the use of the coin to buy seed to feed the birds causes depositor panic and a run on the bank. But a more assiduous young Michael might have reaped the magic of compound growth.

Researchers CLSA calculate that a 21-year-old who saves into a pension pot until 30, and then leaves the sum to grow, will end up with a bigger fund than a saver who starts at 30 until retiring at 70. At a 7% growth rate with £2,500 set aside each year, our prudent twenty-something would have £553,000 from his £25,000, while the latter would have £534,000 from £100,000. Save for a newborn for just two years, and compound interest will create a £551,000 pot for their threescore-and-ten offspring (which would, of course, be far greater if contributions continued). Financial security requires us to save as much as we can, for as long as we can, and the sooner we start the greater the chance of success. Reinvest and reap the rewards. It's compound magic!

J O Hambro and Schroders are fund managers for St. James's Place Wealth Management.