MARKET BULLETIN

Tuesday 28 May 2013

ST. JAMES'S PLACE
WEALTH MANAGEMENT

Market eye

- Markets stumble as news from US and China gives investors a jolt

After a run which saw global equity markets move higher on a seemingly daily basis, last week saw a return of volatility as markets seesawed between gains and losses. Whilst all global markets ended the week lower, it was the Nikkei (index of leading Japanese shares) which dominated the headlines. After a run of sharp rises – triggered by the promise of massive liquidity injections by the central bank – drove the Nikkei up by over 70%, Thursday saw the index drop by 7%. Suggestions that the US Federal Reserve may begin to scale back on its $85 billion-a-month asset-purchase programme, together with the release of economic data indicating a slowing Chinese economy, were enough to send investors heading for safer assets and for the froth to come off the top of the exuberant rally.

Other markets followed suit with the S&P500 and FTSEurofirst 300 down 1.1% and 1.7% respectively on the week. In the case of the US, this retreat came after the market reached a record high on Wednesday; whilst in the UK, Thursday's market fall came after the FTSE 100 reached 6,840 – a level last seen in January 2000.

Of course, a sense of perspective is needed – the MSCI World index is still up 19.8% on the year to date and the FTSE100 up 12.8% excluding dividends, so very healthy returns which build on those investors enjoyed in 2012.

The return of nervousness in the equity markets led to a reprieve for traditional safe-haven assets. Gold, which has had a torrid 2013, was up $24 an ounce last week, yet is still down 17.2% to date in 2013.

Doubts already surface over 'Abenomics'

- Bank of Japan's reflationary plans come under pressure

Just weeks into Japan's latest attempt to reflate the moribund economy, dubbed 'Abenomics' after Prime Minister Shinzo Abe, officials are having difficulty bringing order to the country's bond markets. Japan's chief central banker, Haruhiko Kuroda, was forced to confirm the Bank of Japan's (BoJ) commitment to monetary easing, stressing that, "Through dialogue with the market and more flexible operations we will ensure the stability of financial and capital markets."

With the stock market falling dramatically on Thursday, the BoJ was forced to step in to buy bonds to reinforce its commitment to keep interest rates low. With Japanese banks owning huge volumes of government bonds, there is a fear that rising yields (and falling capital values) could create real solvency issues. In a measure that was hardly designed to calm markets, Kuroda suggested that interest rates could rise by between 1 and 3% if the economy continues to improve without causing instability. The result? More instability: with the Nikkei falling a further 3.2% on Monday.

As always, trying to second-guess the musings (and impact) of governments and central bankers is a futile task for investors, who are best advised to focus on their long-term objectives.

Closer to home, the surprising first-quarter GDP figures were reinforced with a second round of data confirming that the UK economy grew by 0.3% in the first quarter. The underlying data were mixed, with the large services sector showing signs of continued improvement but with retail sales falling sharply in April, perhaps reflecting the ongoing squeeze in real incomes. Paul Fisher, a Bank of England director, in a speech to business leaders, highlighted that the willingness (forced or otherwise) of the UK labour force to accept lower living standards is a key factor behind the continued relatively low levels of unemployment. But he also warned that economic growth would continue to be muted whilst households, banks and the government continued to work through the indebtedness built up over the previous decades.

With economic growth still sluggish, the IMF drew back from earlier criticism of the Chancellor's austerity measures but did propose a number of measures to help offset the drag on the economy from this year's £10 billion of fiscal tightening. Key amongst these is its recommendation to bring forward capital spending on the UK's infrastructure and help boost the UK's struggling construction industry.

However, fears of an increase in borrowing costs and a further threat to the UK's credit rating make such a move unlikely; and as we've stated many times, the road to sustained economic growth remains long and hard.

Where next for the housing market?

- Fears rise of another house price bubble

Fears have risen again about the future of the UK's perennial favourite topic – house prices. Criticism is growing that the Chancellor's strategy is in danger of stoking up another housing bubble. Admittedly, there have been steps to reduce the planning rules and thereby increase supply, to the ire of many 'NIMBYs'; but the argument is that the focus on maintaining ultra-low interest rates, together with the forthcoming state guarantees for home-owners with small deposits, creates a toxic combination driving demand and generating increases in house prices, even outside the UK.

Whilst rising house prices have a proven psychological impact on these fortunate home-owners, the feel-good factor potentially increasing their propensity to spend, the impact on first-time buyers and those renting is more problematic. The Nationwide Building Society calculates that the average house price is 5.1 times the average salary, more than a quarter higher than 25 years ago. In London that rate rises to 7.7 times earnings. Asset bubbles can continue to build well beyond rational expectations and in this case a lack of supply is undoubtedly supportive. Nevertheless, future interest rate rises may put pressure on prices and leveraged buy-to-let portfolios in particular.

Is Europe still a basket case?

- Despite its challenges, the eurozone remains home to some high-quality, undervalued global companies

Whilst the focus last week was on Japan, commentators have once again begun to talk about the prospects for Europe; the general consensus is that, whilst much of Europe remains in the economic doldrums, it is also home to many of the world's most powerful companies. Stuart Mitchell of S.W. Mitchell Capital has been a long-term proponent of leading European companies, pointing out that high-quality companies operating in global markets are trading at a substantial discount to their US counterparts who have led the rally in equities over the past 12 months. Without underplaying the challenges faced by the eurozone, Stuart also believes there are some myths, as he sees them, prejudicing those looking at Europe from a distance. Prime amongst these is the notion that the eurozone is massively indebted, both absolutely and relative to other economies. As the table below highlights, this is far from the truth:

Stuart Mitchell also manages funds for St. James's Place.

General government debt and deficits

	US	UK	Japan	Eurozone
Debt	98.3%	85.7%	205.5%	87.2%
Deficit	9.9%	8.3%	9.5%	4.1%
Rise in debt ratio	44.4%	51.6%	99.1%	17.6%
In % of GDP: Maastricht definition for Eurozone, US and UK, OECD definition for Japan; OECD definition for rise in debt ratio for all regions. The data for debt and deficit refer to 2011. The date for the rise in debt ratio refers to 1998-2012.				

Source: Eurostat, EU Commission, OECD

Conclusion

So after a week when investors were re-acquainted with the idea that markets can fall as well as rise, it is worth reflecting on the current markets and future prospects. As investors will understand, we believe that projecting returns over the next 3–6 months is both impossible and irresponsible, and this is particularly true when the pronouncements of governments and central banks can have such dramatic impacts on valuations of most asset classes. Undoubtedly equity markets have come a long way since the last bottom in March 2009, with the UK market almost doubling over the past 4 years. Yet as mentioned earlier, with the exception of the US they have still not recovered to their previous highs at the end of the last millennium. Though admittedly having advanced more quickly than the strength of the global economy may suggest, markets in general remain reasonably valued on a historic basis, and merger & acquisition activity remains muted – not symptoms of a market before a crash. It is worth reflecting that last week's wobble was, in part, the result of suggestions that the US may relax its QE as economic growth there strengthens. Such are the vagaries of markets and why we encourage all clients to take a long-term perspective.